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# THE FUTURE OF THE DOCTRINE OF NECESSITY AND CRITICAL-VENDOR PAYMENTS IN CHAPTER 11 CASES

ALAN N. RESNICK\*

**Abstract:** This Article explores the history and justification for the doctrine of necessity in Chapter 11 cases. It discusses the doctrine's gradual narrowing, due to appellate courts' reluctance to permit payment of prepetition debts or recognize courts' authority to authorize such payments. The Article analyzes the effect of recent amendments to the Bankruptcy Code on the doctrine and confirms that there is uncertainty regarding the propriety of payment of certain prebankruptcy debts. The Article proposes that the Code be amended to clarify the extent to which the doctrine of necessity applies in Chapter 11 cases and asserts that courts should recognize different standards depending on the type of debt being repaid. Finally, this Article argues that courts should have discretion to authorize payments in extraordinary circumstances when they follow procedural safeguards.

## INTRODUCTION

The recognition and application of the doctrine of necessity, especially with respect to the treatment of so-called "critical vendors," have been the subject of controversy in Chapter 11 reorganization cases in recent years. The doctrine of necessity is a judge-made rule that courts rely upon to justify permitting a debtor in possession in a Chapter 11 case, prior to the confirmation of a plan of reorganization, to pay certain creditors the full amount of their prebankruptcy unsecured claims. This special treatment is, in theory, reserved for

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those vendors and other creditors who are critical to the survival of the debtor because of the goods or services they provide.

Frequently permitted by bankruptcy courts in response to motions made on the first day of the case—sometimes with only a few hours' notice to the United States trustee and a handful of parties in interest—the appellate courts tend to narrow the availability and scope of the doctrine of necessity in bankruptcy cases. Most recently, Congress enacted the most comprehensive and sweeping bankruptcy legislation in more than twenty-five years, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act" or "2005 amendments").<sup>1</sup> Though the recent legislation does not directly address the viability of, or limitations on, the doctrine of necessity, several provisions of the 2005 Act are likely to have an impact on the use of the doctrine in future cases. In addition to these judicial and legislative developments, proposed amendments to the Federal Rules of Bankruptcy Procedure have been published which, in reaction to criticism regarding the lack of notice and process safeguards, will have an impact on the procedural aspects of the doctrine of necessity.

Although predicting the future significance or resolution of any controversial issue in bankruptcy jurisprudence is a foolish endeavor, this Article will nonetheless address the likely future of the doctrine of necessity in Chapter 11 reorganization cases, taking into account recent judicial and legislative developments and the pending amendments to the Federal Rules of Bankruptcy Procedure.

## I. WHAT IS THE DOCTRINE OF NECESSITY?

One of the most fundamental principles of American bankruptcy law is the equal treatment of similarly situated creditors. The Bankruptcy Code contains numerous provisions designed to achieve such equality.<sup>2</sup> For example, only similarly situated creditors may be placed in the same class under a plan of reorganization,<sup>3</sup> and the same treatment must be afforded to each and every member of that class unless a

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<sup>1</sup> Pub. L. No. 109-8, 119 Stat. 23 (2005) [hereinafter BAPCPA] (to be codified in scattered sections of 11 U.S.C., 12 U.S.C., 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

<sup>2</sup> The current law of bankruptcy is found in Title 11 of the United States Code. *See* 11 U.S.C. §§ 101 *et seq.* (2000). Its foundation is the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (effective Oct. 1, 1979) (codified as amended at 11 U.S.C. §§ 101 *et seq.* (2000)). The Bankruptcy Reform Act of 1978 is typically referred to as the "Bankruptcy Code" or the "Code." References in this work to the "Bankruptcy Code" or the "Code" are to Title 11 of the United States Code as amended through April 20, 2005.

<sup>3</sup> 11 U.S.C. § 1122(a).

creditor receiving less favorable treatment consents.<sup>4</sup> Furthermore, if a non-accepting class becomes the subject of a “cram down” request—by which the court may confirm a plan notwithstanding the rejection of a class of creditors—the Bankruptcy Code prohibits the confirmation unless the plan does not “discriminate unfairly” against the non-accepting class.<sup>5</sup> That standard means that the plan may not treat an accepting class more favorably than the non-accepting class of equal rank unless the court finds that the discrimination is fair under the circumstances. Also, if an insolvent debtor pays an unsecured claim within ninety days before bankruptcy, and the payment enables the creditor to receive more than the creditor would have received from the debtor’s bankruptcy estate if the debtor had not made the payment and had filed a chapter 7 petition, the payment may be recovered by the trustee or debtor in possession as a voidable preference.<sup>6</sup> The theoretical predicate for providing for the recovery of the preference is, again, the equality of treatment of similarly situated creditors. In addition, the automatic stay under section 362 of the Bankruptcy Code prohibits creditors from obtaining an unfair advantage over others by enforcing collection rights after filing a bankruptcy petition.<sup>7</sup> All of these provisions of the Bankruptcy Code are designed to give similarly situated creditors the same or substantially similar treatment in bankruptcy.

This principal of treating creditors equally when a debtor is in bankruptcy is violated when an insolvent debtor in possession in Chapter 11 is allowed to pay a creditor, in full, with respect to a pre-bankruptcy general unsecured claim before a plan of reorganization is confirmed. So why permit it? Why should a bankruptcy court order that the debtor may pay prebankruptcy unsecured claims in full for certain creditors, but not for other creditors, leaving the latter group with recoveries of only a few cents on the dollar under a confirmed plan of reorganization? The easy answer is that, in certain situations, it is necessary for the survival of the debtor’s business and for the successful reorganization of the debtor. This, in turn, inures to the benefit of all parties in interest, including employees who keep their jobs, vendors and others who may be dependent on the continuing existence of the debtor for future business, equity holders who may reap economic benefits when the business is rehabilitated, and gen-

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<sup>4</sup> *Id.* § 1123(a)(4).

<sup>5</sup> *Id.* § 1129(b)(1).

<sup>6</sup> BAPCPA, Pub. L. No. 109-8, § 1213(a)(1), 119 Stat. 23, 194 (to be codified at, and amending, 11 U.S.C. § 547(b)).

<sup>7</sup> 11 U.S.C. § 362, amended by Pub. L. No. 109-8, 119 Stat. 23.

eral unsecured creditors whose recovery will be based on the going concern value of the reorganized business, rather than on the scrap value of assets resulting from forced liquidation at auction sales.

Aside from the fact that, at least until the amendments enacted in 2005,<sup>8</sup> there has been no provision of the Bankruptcy Code that expressly authorizes the payment of prebankruptcy debts before confirmation of a Chapter 11 plan, critics of the doctrine of necessity have argued that there is no effective way to determine who, in fact, is a "critical vendor."<sup>9</sup> Skeptics are particularly concerned about the lack of adequate procedural protection for other unsecured creditors who wish to challenge the application of the doctrine of necessity. As any experienced Chapter 11 practitioner knows, there is usually inadequate opportunity to challenge emergency motions made on the first day of the case that result in court orders on the same day or within a few days thereafter.

The doctrine of necessity—that is, court-approved payment of unsecured prebankruptcy claims before a Chapter 11 plan is confirmed—has its origin in nineteenth-century railroad receivership cases.<sup>10</sup> Two similar doctrines developed at that time. First, railroad receiverships in the late 1800s recognized an equitable rule of priority, known as the "six months rule," which authorized receivers to pay the unpaid claims of "operating creditors" arising within the six-month period immediately preceding the receivership case.<sup>11</sup> To be entitled to such payments, a creditor had to show that the obligation to pay was incurred within six months before the receivership pro-

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<sup>8</sup> Amendments to the Bankruptcy Code made by BAPCPA, which, in general, are effective in bankruptcy cases commenced on or after October 17, 2005, are discussed later in this article.

<sup>9</sup> Christopher D. Hunt, Note, *Not-So-Critical Vendors: Redefining Critical Vendor Orders*, 93 KY. L.J. 915, 924 (2004); Robert A. Morris, *The Case Against "Critical Vendor" Motions*, AM. BANKR. INST. J., Sept. 2003, [http://www.abiworld.org/Content/NavigationMenu/Publications/Online\\_ABI\\_Journal/Archive1/ABI\\_Journal\\_Archives.htm](http://www.abiworld.org/Content/NavigationMenu/Publications/Online_ABI_Journal/Archive1/ABI_Journal_Archives.htm) (click on "2003," then "September," then follow "FINANCIAL STATEMENTS: The Case Against 'Critical Vendor' Motions" hyperlink).

<sup>10</sup> See *B&W Enter. Inc. v. Goodman Oil Co.* (*In re B&W Enter. Inc.*), 713 F.2d 534, 536 (9th Cir. 1983) (discussing the origins of the doctrine of necessity and the parallel doctrine called the six months rule); *In re Boston & Me. Corp.*, 634 F.2d 1359, 1366 (1st Cir. 1980) (discussing same).

<sup>11</sup> Russell A. Eisenberg & Frances F. Gecker, *The Doctrine of Necessity and Its Parameters*, 73 MARQ. L. REV. 1, 4 (1989); Andrew J. Currie & Sean McCann, *Hold on to Those Payments, Critical Vendors: Capital Factors v. Kmart*, AM. BANKR. INST. J., June 2003, [http://www.abiworld.org/Content/NavigationMenu/Publications/Online\\_ABI\\_Journal/Archive1/ABI\\_Journal\\_Archives.htm](http://www.abiworld.org/Content/NavigationMenu/Publications/Online_ABI_Journal/Archive1/ABI_Journal_Archives.htm) (click on "2003," then "June," then follow "FEATURE ARTICLE: Hold on to Those Payments, Critical Vendors: Capital Factors v. Kmart" hyperlink).

ceeding commenced, in which case it was given an equitable priority over other creditors and was entitled to payment.<sup>12</sup> Such payments were made even before mortgagees were paid.<sup>13</sup> The justification for the doctrine was that it would be inequitable to operating creditors, supplying the necessary services and products for the railroad's continued existence and revenue generation, if the resulting operating revenue benefited secured creditors, who were not entitled to the operating revenue of the railroad until a receiver was appointed.<sup>14</sup> In essence, the rule gave prebankruptcy unsecured claims of vendors and other operating creditors that arose within six months before the receivership priority in payment over secured creditors.

When the Bankruptcy Act of 1898 was enacted, the six months rule became part of railroad reorganization cases under section 77(b) of the Act.<sup>15</sup> When the Bankruptcy Act of 1898 was repealed and replaced by the Bankruptcy Code as part of the Bankruptcy Reform Act of 1978, the six months rule, though not expressly mentioned, continued under section 1171(b), in the Subchapter of Chapter 11 which deals exclusively with railroad reorganizations.<sup>16</sup> Section 1171(b) provides that

[a]ny unsecured claim against the debtor that would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the date of the order for relief under this title shall be entitled to the same priority in the case under this Chapter.<sup>17</sup>

Similar in concept to, but separate and distinct from, the six months rule, the "necessity of payment doctrine" also developed in nineteenth-century railroad receivership proceedings. Since first enunciated in the 1882 decision of the U.S. Supreme Court in *Miltenberger v. Logansport Railway Co.*, the doctrine became an important part of railroad reorganizations and receiverships.<sup>18</sup> Like the six months rule, the necessity of payment doctrine permitted courts to allow receivers to pay certain pre-receivership unsecured creditors. Courts

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<sup>12</sup> Currie & McCann, *supra* note 11, at 34.

<sup>13</sup> *Id.*

<sup>14</sup> See *id.*

<sup>15</sup> Act of July 1, 1898, ch. 541, § 77B, 30 Stat. 544 (1899); Jeffrey N. Pomerantz, *The Bare Necessities of Critical Vendor Motions—It's a Jungle Out There*, 13 J. BANKR. L. & PRAC. 73, 76 (2004).

<sup>16</sup> See 11 U.S.C. § 1171(b) (2000); Pomerantz, *supra* note 15, at 76.

<sup>17</sup> See 11 U.S.C. § 1171(b).

<sup>18</sup> See 106 U.S. 286, 310–12 (1882).

limited the doctrine's use, however, to secure only the continued delivery of supplies and services essential to the debtor's continuation in business.<sup>19</sup> Also, unlike the six months rule, the "doctrine of necessity," as it became known later, is not a rule establishing priority of claims; rather, it is a doctrine giving courts discretion to deviate from the otherwise applicable rules of priority by making early payments to certain creditors to achieve the greater goal of a successful reorganization. Whereas the six months rule directly changes the priority of claims by paying ordinary course claims incurred within the six months prior to a railroad reorganization before secured claims, the doctrine of necessity permits payment of prebankruptcy unsecured claims only when such payment is needed so that trade vendors or other creditors will not refuse to supply critical goods and services after the debtor files for bankruptcy protection.

When first developed, courts applied the doctrine of necessity, like the six months rule, only in railroad reorganization cases for which success was considered vital to the public interest.<sup>20</sup> Consequently, giving preference to some creditors at the expense of others was acceptable because the public depended on continued rail operations. In *Dudley v. Mealey*, a 1945 decision written by Learned Hand and joined by Jerome Frank and Augustus Hand, involving the application of the six months rule, the Court of Appeals for the Second Circuit for the first time extended the six months rule to a non-railroad reorganization case with the goal of encouraging successful reorganization.<sup>21</sup> In particular, the court held that a hotel in a Chapter X case under the former Bankruptcy Act could provide for the grant of priority of claims of prepetition vendors in its reorganization plan.<sup>22</sup> Gradually, other courts expanded the use of the doctrine of necessity to cases that do not involve railroad reorganization, and courts eventually utilized the doctrine to protect the interests of creditors and reorganization efforts more generally.<sup>23</sup>

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<sup>19</sup> *Goodman Oil*, 713 F.2d at 537; *In re Boston & Me.*, 634 F.2d at 1382.

<sup>20</sup> *Currie & McCann*, *supra* note 11, at 34.

<sup>21</sup> See 147 F.2d 268, 271 (2d Cir. 1945).

<sup>22</sup> See *id.*

<sup>23</sup> See *In re CoServ, L.L.C.*, 273 B.R. 487, 493 n.7, 497 (Bankr. N.D. Tex. 2002).

## II. THE DOCTRINE OF NECESSITY IN CASES UNDER THE BANKRUPTCY CODE

Unlike the six months rule, the doctrine of necessity was not codified when the Bankruptcy Code was enacted as part of the Bankruptcy Reform Act of 1978.<sup>24</sup> As such, it could be argued that the absence of any mention of the doctrine demonstrates Congressional intent for its demise upon the Code's enactment. Thus, bankruptcy courts should not have the authority to permit payment of prepetition unsecured indebtedness, even if the continuing provision of goods and services from certain creditors is critical to the debtor's reorganization.<sup>25</sup>

It also could be argued, however, that the Bankruptcy Code contains no indication that Congress intended to eliminate the doctrine of necessity and to prohibit critical-vendor payments.<sup>26</sup> Under prevailing statutory construction policies, the absence of any mention of the doctrine does not necessarily mean that it did not survive the enactment of the Bankruptcy Code. The Supreme Court has written that, in the field of bankruptcy, when the Bankruptcy Code is silent regarding the survival of a judge-made rule that existed in cases under the former Bankruptcy Act, the law as it existed before the Code's enactment should be assumed to continue to be applicable absent a strong reason to the contrary: "[w]e will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure."<sup>27</sup>

Most courts that have expanded the doctrine of necessity beyond railroad reorganization cases have done so relying on the equitable power provided in section 105(a) of the Bankruptcy Code.<sup>28</sup> Section 105(a), which sets forth the general equitable powers of bankruptcy

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<sup>24</sup> See Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (effective Oct. 1, 1979) (codified as amended at 11 U.S.C. §§ 101 *et seq.* (2000)).

<sup>25</sup> See Joshua A. Ehrenfeld, *Quieting the Rebellion: Eliminating Payment of Prepetition Debts Prior to Chapter 11 Reorganizations*, 70 U. CHI. L. REV. 621, 627 (2003); Eisenberg & Gecker, *supra* note 11, at 3-4.

<sup>26</sup> See Victor A. Vilaplana, *Stretching the Code for Critical Vendors: Necessity Is the Mother of Invention*, in 2, 26TH ANNUAL CURRENT DEVELOPMENTS IN BANKRUPTCY & REORGANIZATION, 491, 528 (2004).

<sup>27</sup> Pa. Dept. of Pub. Welfare v. Davenport, 495 U.S. 552, 563 (1990) (citing Kelly v. Robinson, 479 U.S. 36, 47 (1986)).

<sup>28</sup> 11 U.S.C. § 105(a); see *In re Just for Feet, Inc.*, 242 B.R. 821, 824 (D. Del. 1999) (explaining that even if the doctrine of necessity is not codified in the Code, courts have authorized pre-petition claims when necessary using their equitable powers under § 105(a)).



courts, provides in relevant part: "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]."<sup>29</sup>

Section 1107(a) of the Bankruptcy Code grants a debtor in possession the rights, powers, and duties of a trustee serving in a case under Chapter 11, including the right to operate the debtor's business, authorized by section 1108.<sup>30</sup> The argument that follows, therefore, is that section 105(a) gives courts the authority to enable a debtor in possession to fulfill its duty to do what is reasonably necessary to keep its existing business operating. Included in this duty is paying prepetition claims when necessary to assure that creditors whose continuing delivery of goods and services are critical to the reorganization effort do not stop dealing with the debtor due to non-payment of prepetition indebtedness.

The brevity of section 105(a) and its legislative history, however, do not provide much insight to the limits of the courts' equitable powers authorized by this section.<sup>31</sup> Section 105(a) and its legislative history are silent about critical-vendor payments and the ability of the courts to circumvent the priority scheme under section 507 of the Bankruptcy Code.<sup>32</sup> Courts condemning the use of section 105(a) to allow critical-vendor payments point out that the Supreme Court has noted that "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."<sup>33</sup> The Bankruptcy Code specifically sets out certain types of claims that are entitled to an administrative expense priority.<sup>34</sup> As one bankruptcy court has noted, "a prepetition unsecured claim cannot be elevated to an administrative expense since the scheme of the 1978 Bankruptcy Code does not allow [a] Court to change the classification of claims set by Congress in the Code."<sup>35</sup>

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<sup>29</sup> 11 U.S.C. § 105(a).

<sup>30</sup> *Id.* §§ 1107(a), 1108.

<sup>31</sup> See *id.* § 105(a); S. REP. NO. 95-989, at 29 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5815; H.R. REP. NO. 95-595, at 316 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6273-74; 140 CONG. REC. H10,764 (daily ed. Oct. 4, 1994).

<sup>32</sup> Joseph Gilday, "Critical" Error: Why Essential Vendor Payments Violate the Bankruptcy Code, 11 AM. BANKR. INST. L. REV. 411, 431-32 (2003); see 11 U.S.C. § 105(a) (2000); S. REP. NO. 95-989, at 29 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5815; H.R. REP. NO. 95-595, at 316 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6273-74; 140 CONG. REC. H10,764 (daily ed. Oct. 4, 1994).

<sup>33</sup> *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988).

<sup>34</sup> See 11 U.S.C. §§ 503(b), 507(a), *amended by* Pub. L. No. 109-8, 119 Stat. 23.

<sup>35</sup> *In re Timberhouse Post & Beam, Ltd.*, 196 B.R. 547, 550-51 (Bankr. D. Mont. 1996); see also *United States v. Noland*, 517 U.S. 535, 541 (1996).

Notwithstanding the uncertainty about the doctrine of necessity's existence under the Code, bankruptcy courts have often relied on the doctrine and section 105(a) to authorize the payment of prepetition claims.<sup>36</sup> In many cases, the doctrine has been used, without objection, to justify the payment of prepetition unsecured claims that are entitled to priority under section 507(a) of the Bankruptcy Code.<sup>37</sup> In fact, probably the most common use of the doctrine of necessity is for the payment of prepetition wages.<sup>38</sup> For example, if a debtor ordinarily pays its employees their weekly wages on Friday afternoons and files a Chapter 11 petition on Wednesday after the close of business, the debtor would not have the right to pay its employees their earned wages for the week, except for the wages earned postpetition (Thursday and Friday), until a Chapter 11 plan is confirmed.<sup>39</sup> The debtor could pay wages earned postpetition because those wages constitute administrative expenses,<sup>40</sup> which may be paid in the ordinary course of business.<sup>41</sup> The delay in the payment of wages earned prepetition, however, could cause substantial hardship to employees and could damage employee morale. It is important to note that the unpaid wage claims for the prepetition part of that week ordinarily would be entitled to priority under section 507(a) so that such employees would most likely be paid in full after a plan is confirmed, subject to the statutory cap on the wage-claim priority.<sup>42</sup> To avoid undue hard-

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<sup>36</sup> *In re Bob's Stores, Inc.*, No. 03-13254 (Bankr. D. Del. filed Oct. 22, 2003); *In re Discovery Zone, Inc.*, No. 99-00941 (Bankr. D. Del. filed Apr. 20, 1999); *In re Acme Steel Co. et al.*, No. 98-02180 (Bankr. D. Del. filed Sept. 28, 1998).

<sup>37</sup> *In re Bob's Stores, Inc.*, No. 03-13254 (Bankr. D. Del. filed Oct. 22, 2003); see Donald S. Bernstein & Nancy L. Sanborn, *The Going Concern in Chapter 11*, in CHAPTER 11 BUSINESS REORGANIZATIONS 1993, at 157, 212-15.

<sup>38</sup> *In re Bradlees Stores, Inc.*, No. 00-16035 (Bankr. S.D.N.Y. filed Dec. 26, 2000).

<sup>39</sup> *Id.*

<sup>40</sup> See BAPCPA, Pub. L. No. 109-8, § 329, 119 Stat. 23, 101 (to be codified at, and amending, 11 U.S.C. § 503(b)(1)(A)).

<sup>41</sup> See 11 U.S.C. § 363(c)(1) (2000); *In re New Almanacs, Inc.*, 196 B.R. 244 (Bankr. N.D.N.Y. 1996) (citing *In re Telesphere Commc'ns, Inc.*, 148 B.R. 525, 530-31 (Bankr. N.D. Ill. 1992)).

<sup>42</sup> See 11 U.S.C. § 507(a)(4), amended by BAPCPA §§ 212(2), (5), 1401, 119 Stat. at 51-52, 214. Before the 2005 amendments, the wage priority was in section 507(a)(3). 11 U.S.C. § 507(a)(3) (2000). The statutory limit on employee wage claims was \$4925 per employee in cases commenced on or before April 20, 2005. *Id.* (according to § 104(b) of the Bankruptcy Code, on April 1, 2004, the dollar amount increased from \$4650 to \$4925 based on the Consumer Price Index). The dollar limit was increased to \$10,000 per employee for cases commenced on or after April 20, 2005. 11 U.S.C. § 507(a)(4), amended by BAPCPA §§ 212(2), (5), 1401, 119 Stat. at 51-52, 214. This dollar amount will be adjusted every three years under 11 U.S.C. 104(b). 11 U.S.C. § 104(b), amended by Pub. L. No. 109-8, 119 Stat. 23.

ship on employees that could result in poor employee morale, many courts have granted motions filed by debtors in possession, usually on the first day of the case, permitting the payment of prepetition wages in the ordinary course of business to the extent that such wage claims would have priority under section 507(a).<sup>43</sup>

Similarly, the doctrine of necessity has been used, almost routinely in large Chapter 11 cases, to authorize a debtor in possession to honor customer claims, such as warranty claims,<sup>44</sup> and other customer obligations, such as discount programs,<sup>45</sup> the right to return goods,<sup>46</sup> lay-away plans,<sup>47</sup> and frequent flier programs.<sup>48</sup> The honoring of these obligations is necessary to continue the debtor's good will with its customers and to instill customer confidence in the debtor's business.

### III. THE LIMITS (OR SLOW DEATH) OF SECTION 105(A)

Bankruptcy courts and district courts have often relied on section 105(a) to authorize critical-vendor payments in Chapter 11 cases. When challenged, they often found that the doctrine of necessity gave them the discretion to permit payments to critical vendors. For example, in *In re Just for Feet, Inc.*, the District Court for the District of Delaware, relying on the doctrine of necessity and section 105(a) as authority, held that the debtor, an athletic footwear and apparel retailer, could pay prepetition claims of certain critical vendors.<sup>49</sup> The debtor persuaded the court that the debtor's reorganization efforts would be seriously harmed if the debtor could not get the necessary

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<sup>43</sup> See, e.g., *In re CEI Roofing, Inc.*, 315 B.R. 50, 53, 61 (Bankr. N.D. Tex. 2004). See generally, *In re EqualNet Commc'ns Corp.*, 258 B.R. 368, 370 (Bankr. S.D. Tex. 2000) (discussing the doctrine of necessity, and noting that employee wage claims are priority claims in whole or in part, the court wrote that "[t]he need to pay these claims in an ordinary course of business time frame is simple common sense. Employees are more likely to stay in place and to refrain from actions which could be detrimental to the case and/or the estate if their pay and benefits remain intact and uninterrupted").

<sup>44</sup> *In re Allis-Chalmers Corp.*, No. 87-11226 (Bankr. S.D.N.Y. filed June 29, 1987).

<sup>45</sup> *In re ANC Rental Corp.*, No. 01-11200 (Bankr. D. Del. Dec. 5, 2001); Debtor's Motion Pursuant to § 105(a) of the Bankruptcy Code and the Doctrine of Necessity for an Order Authorizing but not Directing Debtors in Possession to Honor Prepetition Obligations Relating to Certain (i) Vendors that Support Marketing and Sales Programs (ii) Customer Incentive Programs (iii) Critical Contract Labor and (iv) Employee Related Corporate Credit Card Programs, *In re ANC Rental Corp.*, No. 01-11200 (Bankr. D. Del. filed Nov. 13, 2001).

<sup>46</sup> *In re Bob's Stores, Inc.*, No. 03-13254 (Bankr. D. Del. filed Oct. 22, 2003).

<sup>47</sup> *In re ZB Co. Inc.*, No. 03-13672 (JBR) (Bankr. D. Del. filed Dec. 4, 2003).

<sup>48</sup> *In re Delta Air Lines, Inc.*, No. 05-17923 (Bankr. S.D.N.Y. filed Sept. 14, 2005).

<sup>49</sup> 242 B.R. 821, 824-26 (D. Del. 1999).

goods from its trade vendors in time for the holiday season.<sup>50</sup> The court commented that the doctrine of necessity remained viable in the Third Circuit, although most of the cases cited by the court in support of the doctrine involved railroad reorganizations.<sup>51</sup> The court asserted that, despite the automatic stay under section 362 of the Code, "[c]ertain pre-petition claims by employees and trade creditors, however, may need to be paid to facilitate a successful reorganization." The court further noted that section 105(a) "provides a statutory basis for the payment of pre-petition claims."<sup>52</sup>

Although bankruptcy courts and district courts were using the doctrine of necessity and section 105(a) to permit critical-vendor payments, appellate courts in several circuits have been less willing to permit payment of prepetition debt to vendors or to recognize section 105(a) as authority for such payments.<sup>53</sup> Probably the most dramatic and sympathetic set of facts in any case involving payment of prepetition claims under the authority of section 105(a) was *Official Committee of Equity Security Holders v. Mabey*.<sup>54</sup> That decision involved thousands of personal-injury claims held by women who were injured by the Dalkon Shield contraceptive device sold by A.H. Robins Co., the Chapter 11 debtor.<sup>55</sup> The examiner in that case sought court authorization to place \$15 million in an emergency treatment fund to provide surgery or in-vitro fertilization to certain victims who were likely to benefit from such medical treatment in connection with their claimed infertility.<sup>56</sup> The funds would be paid directly to the doctor and hospital providing medical assistance to the injured victims.<sup>57</sup> The cost of the surgery would be between \$10,000 and \$15,000 per claimant.<sup>58</sup> Under a proposed plan of reorganization, Dalkon Shield claimants would be compensated out of a \$1.75 billion fund and all other creditors would be paid in full.<sup>59</sup> Also, the distribution to each Dalkon Shield claimant would be reduced by the amount spent on the surgery, so that the

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<sup>50</sup> *Id.* at 826.

<sup>51</sup> *Id.* at 824–25 (citing *In re Lehigh & New Eng. Ry. Co.*, 657 F.2d 570, 581 (3d Cir. 1981), *In re Penn Cent. Transp. Co.*, 467 F.2d 100, 102 n.1 (3d Cir. 1972), *In re Columbia Gas Sys., Inc.*, 171 B.R. 189, 191–92 (Bankr. D. Del. 1994)).

<sup>52</sup> *Id.* at 824.

<sup>53</sup> See, e.g., *In re Kmart Corp.*, 359 F.3d 866, 871, 874 (7th Cir. 2004); *Chiasson v. J. Louis Matherne & Assocs. (In re Oxford Mgmt., Inc.)*, 4 F.3d 1329, 1334 (5th Cir. 1993).

<sup>54</sup> 832 F.2d 299, 299–301 (4th Cir. 1987).

<sup>55</sup> See *id.* at 300.

<sup>56</sup> See *id.*

<sup>57</sup> *Id.*

<sup>58</sup> *Id.* at 301.

<sup>59</sup> *Mabey*, 832 F.2d at 301.

amount paid from the \$15 million emergency treatment fund would actually be a loan against subsequent distributions.<sup>60</sup>

The district court approved the establishment of the emergency treatment fund, subsequently indicating that its authority for the unusual order was section 105(a) of the Code.<sup>61</sup> The Court of Appeals for the Fourth Circuit, however, reversed, stating:

[w]hile the equitable powers emanating from § 105(a) are quite important in the general bankruptcy scheme, and while such powers may encourage courts to be innovative, and even original, these equitable powers are not a license for a court to disregard the clear language and meaning of the bankruptcy statutes and rules.<sup>62</sup>

The court continued:

While one may understand and sympathize with the district court's concern for the Dalkon Shield claimants, who may desire reconstructive surgery or in-vitro fertilization, the creation of the Emergency Treatment Fund at this stage in the Chapter 11 bankruptcy proceedings violates the clear language and intent of the Bankruptcy Code, and such action may not be justified as an exercise of the court's equitable powers under § 105(a). The Bankruptcy Code does not permit a distribution to unsecured creditors in a Chapter 11 proceeding except under and pursuant to a plan of reorganization that has been properly presented and approved.<sup>63</sup>

Appellate courts in other circuits have also limited the application of the court's equitable powers in connection with the payment of prepetition claims. For example, the Ninth Circuit Court of Appeals rejected the notion that a bankruptcy court's equitable powers support the payment of critical vendors' prebankruptcy claims. In *B&W Enterprises, Inc. v. Goodman Oil Co. (In re B&W Enterprises, Inc.)*, the court wrote that it is "unwise to tamper with the statutory priority scheme devised by Congress."<sup>64</sup> After the debtor, a trucking company,

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<sup>60</sup> See *id.* at 300.

<sup>61</sup> See *id.* at 301 (referring to the lower court's order approving the establishment of the emergency fund).

<sup>62</sup> *Id.* at 302.

<sup>63</sup> *Id.*

<sup>64</sup> 713 F.2d 534, 537 (9th Cir. 1983).

paid prepetition claims of certain trade creditors without obtaining court approval, the Chapter 7 trustee sought to avoid such payments under sections 549 and 550 of the Bankruptcy Code.<sup>65</sup> The bankruptcy court held that the transfer can be avoided and the district court and Ninth Circuit affirmed.<sup>66</sup> The Ninth Circuit reasoned that “[t]here is no indication that Congress intended the courts to fashion their own rules of super-priorities within any given priority class” and that the court’s equitable powers cannot be used to justify such prepetition claims payments.<sup>67</sup>

The Court of Appeals for the Fifth Circuit, in *Chiasson v. J. Louis Matherne & Associates (In re Oxford Management, Inc.)*, held that claims for real estate brokerage commissions, incurred before the commencement of the bankruptcy case, could not be paid to the agents to which they were owed because such payments would violate the priority scheme of the Bankruptcy Code.<sup>68</sup> The court said that “[s]ection 105(a) authorizes a bankruptcy court to fashion such orders as are necessary to further the substantive provisions of the Bankruptcy Code” but could not be used to allow postpetition payments on prepetition claims of general unsecured creditors because making such payments “deviated from the pro rata scheme of distribution envisioned by the Code.”<sup>69</sup>

After the Fifth Circuit’s decision in *Chiasson*, the Bankruptcy Court for the Northern District of Texas, in *In re CoServ, L.L.C.*, announced that it would approve a debtor’s request for payment of prepetition claims only in very limited circumstances.<sup>70</sup> The court noted that the Fifth Circuit held that section 105(a)’s equitable powers do not extend to a payment of prepetition claims in all situations.<sup>71</sup> The court reasoned that payments of the prepetition claims disrupt the priority scheme of the Bankruptcy Code and, therefore, courts should carefully evaluate allowance of such requests.<sup>72</sup> The court commented that a creditor’s demand for payment of prepetition claims, particularly where the creditor has a contract with the debtor, constitutes “economic blackmail” and may violate the automatic stay imposed by

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<sup>65</sup> *Id.* at 535–36; see 11 U.S.C. §§ 549, 550.

<sup>66</sup> *Goodman Oil*, 713 F.2d at 535–36, 538.

<sup>67</sup> *Id.* at 537.

<sup>68</sup> 4 F.3d at 1334.

<sup>69</sup> *Id.* at 1333–34.

<sup>70</sup> See 273 B.R. 487, 498 (Bankr. N.D. Tex. 2002).

<sup>71</sup> See *id.* at 495.

<sup>72</sup> See *id.* at 494.

section 362(a).<sup>73</sup> The court then adopted a three-part test for deciding whether prepetition claims should be paid.<sup>74</sup> First, the court must determine whether the payment is indispensable to the debtor's business, such as when the creditor is a sole supplier of a given product or a creditor with control over valuable property.<sup>75</sup> Second, the court must determine whether nonpayment of the claim risks probable harm or eliminates an economic advantage disproportionate to the amount of the actual claim.<sup>76</sup> Third, the court must decide whether there is any practical or legal alternative to payment of the claim, such as providing a deposit or assuming an executory contract between the debtor and the creditor.<sup>77</sup>

A subsequent bankruptcy case in Texas, *In re Mirant Corp.*, followed *In re CoServ* and applied the same three-part test.<sup>78</sup> The debtor in that case generated and sold electric power and a trade creditor's refusal to supply necessary goods and services would have seriously impaired not only the debtor's reorganization, but also the nation's economy.<sup>79</sup> Recognizing these circumstances, the bankruptcy court gave the debtor the authority to evaluate the propriety of potential critical-vendor payments on an on-going basis under the *In re CoServ* three-part test.<sup>80</sup>

#### IV. THE K MART DECISION

The most recent, as well as notorious, decisions dealing with critical-vendor payments were rendered in *In re Kmart Corp.* and *Capital Factors, Inc. v. Kmart Corp.*<sup>81</sup> On January 22, 2002, Kmart Corporation and certain of its domestic subsidiaries and affiliates filed a voluntary Chapter 11 petition for reorganization.<sup>82</sup> In one of the motions filed on the first day of the case, Kmart sought authority to pay certain prepetition obligations to critical vendors and certain for-

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<sup>73</sup> *Id.* (citing *In re Structurlite Plastics Corp.*, 86 B.R. 922, 932 (Bankr. S.D. Ohio 1988)).

<sup>74</sup> *Id.* at 498.

<sup>75</sup> *In re CoServ*, 273 B.R. at 498.

<sup>76</sup> *Id.*

<sup>77</sup> *Id.* at 498-99.

<sup>78</sup> 296 B.R. 427, 429 (Bankr. N.D. Tex. 2003).

<sup>79</sup> *See id.* at 428.

<sup>80</sup> *Id.* at 429-30.

<sup>81</sup> *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004); *Capital Factors, Inc. v. Kmart Corp.*, 291 B.R. 818 (N.D. Ill. 2003).

<sup>82</sup> *Kmart*, 291 B.R. at 820.

eign vendors.<sup>83</sup> On the same day, the Bankruptcy Court for the Northern District of Illinois issued an order granting Kmart “opened permission to pay any debt to any vendor [Kmart] deemed ‘critical’ in the exercise of unilateral discretion, provided that the vendor agreed to furnish goods on ‘customary trade terms’ for the next two years.”<sup>84</sup> The bankruptcy court relied on section 105 and, implicitly, on the doctrine of necessity in authorizing the critical-vendor payments.<sup>85</sup> In total, Kmart was authorized to pay, at its discretion, in excess of \$320 million in prepetition claims to numerous critical vendors, both foreign and domestic, including liquor distributors and advertising companies.<sup>86</sup> Kmart did not include Capital Factors, a factoring company with an unsecured claim of approximately \$20 million, as a critical vendor. As a result, Capital Factors objected to Kmart’s first-day motion.<sup>87</sup> The objection was unsuccessful in the bankruptcy court.<sup>88</sup> Capital Factors appealed the critical-vendor payment order to the district court, but failed to obtain a stay of the bankruptcy court’s first-day orders pending appeal.<sup>89</sup> Kmart proceeded to pay out more than \$300 million to 2330 “critical” suppliers in payment of their prepetition claims.<sup>90</sup> Approximately 2000 vendors were not deemed “critical” and therefore were not paid, and, eventually, they received a distribution under a plan of reorganization that was worth approximately ten percent of their claims.<sup>91</sup>

On appeal, the district court reversed and remanded the matter back to the bankruptcy court to order the return of all payments made to vendors with respect to prepetition claims.<sup>92</sup> As to the doctrine of necessity, the court asserted that the doctrine derived from railroad reorganization cases and was not codified in the Bankruptcy

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<sup>83</sup> *Id.*

<sup>84</sup> *In re Kmart*, 359 F.3d at 868–69. Over the next two weeks Kmart filed two more motions seeking authority to pay issuers of prepetition letters of credit and prepetition claims of certain liquor vendors. *Kmart*, 291 B.R. at 820. Both of these motions were approved by the court and became subject to Capital Factors’ later appeal. *Id.* at 820–21.

<sup>85</sup> See *Kmart*, 291 B.R. at 821–23.

<sup>86</sup> Thomas J. Salerno, “*The Mouse That Roared*” or, “*Hell Hath No Fury Like a Critical Vendor Scorned*,” AM. BANKR. INST. J., June 2003, [http://www.abiworld.org/Content/NavigationMenu/Publications/Online\\_ABI\\_Journal/Archive1/ABI\\_Journal\\_Archives.htm](http://www.abiworld.org/Content/NavigationMenu/Publications/Online_ABI_Journal/Archive1/ABI_Journal_Archives.htm) (click on “2003,” then “June,” then follow “LAST IN LINE: ‘The Mouse That Roared’: Or, ‘Hell Hath No Fury Like a Critical Vendor Scorned’” hyperlink).

<sup>87</sup> *Kmart*, 291 B.R. at 820.

<sup>88</sup> *Id.*

<sup>89</sup> *Id.* at 821, 823.

<sup>90</sup> *In re Kmart*, 359 F.3d at 869.

<sup>91</sup> *Id.*

<sup>92</sup> *Kmart*, 291 B.R. at 825.



Code.<sup>93</sup> The only way to apply the doctrine of necessity, wrote the court, was through section 105.<sup>94</sup> The district court noted, however, that courts were split on allowing critical-vendor payments based on the doctrine of necessity and on the section 105(a) equitable powers of the bankruptcy courts.<sup>95</sup> The district court noted that the Seventh Circuit stated that “the grant of equitable power in § 105 is limited in that it ‘allows [bankruptcy] courts to use their equitable powers only as necessary to enforce the provisions of the Code, not to add on to the Code as they see fit.’”<sup>96</sup>

The district court cited the Seventh Circuit’s admonition that “[t]he fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be.”<sup>97</sup> It also determined that the bankruptcy court’s order elevated the claims of the critical vendors over those of other unsecured creditors and subordinated the claims of non-critical unsecured creditors.<sup>98</sup> The district court concluded that the bankruptcy court had impermissibly altered the priority scheme set forth in the Bankruptcy Code without articulating any applicable authority to support doing so and, therefore, its critical-vendor order could not be allowed to stand.<sup>99</sup>

In 2004, the Court of Appeals for the Seventh Circuit affirmed the district court’s decision.<sup>100</sup> Judge Easterbrook, writing for the court, wrote that section 105(a) does not give bankruptcy courts discretion to permit the debtor to pay prebankruptcy unsecured claims in violation of the Bankruptcy Code’s rules on priority.<sup>101</sup>

The Seventh Circuit also noted that section 105(a) allows bankruptcy courts to issue orders or judgments that are necessary to carry out the provisions of the Bankruptcy Code, but “does not create discretion to set aside the Code’s rules about priority and distribu-

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<sup>93</sup> *Id.* at 822.

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*

<sup>96</sup> *Id.* (alteration in original) (quoting *In re Fesco Plastics Corp. Inc.*, 996 F.2d 152, 156 (7th Cir. 1993)).

<sup>97</sup> *Kmart*, 291 B.R. at 823 (alterations in original) (quoting *In re Chicago, Milwaukee, St. Paul & Pac. R.R. Co.*, 791 F.2d 524, 528 (7th Cir. 1986)).

<sup>98</sup> *Id.* at 822.

<sup>99</sup> *See id.* at 822–23.

<sup>100</sup> *In re Kmart*, 359 F.3d at 874.

<sup>101</sup> *See id.* at 871.

tion.”<sup>102</sup> The court further pointed out that “the power conferred by § 105(a) is one to implement rather than override.”<sup>103</sup> The equitable nature of the bankruptcy proceedings does not permit the judges to redistribute rights in accordance with their personal views of fairness.<sup>104</sup> “Every circuit that has considered the question has held that this statute does not allow a bankruptcy judge to authorize full payment of any unsecured debt, unless all unsecured creditors in the class are paid in full.”<sup>105</sup> Judge Easterbrook then announced the Seventh Circuit’s agreement with that view.<sup>106</sup>

Judge Easterbrook’s opinion went on to say that “doctrine of necessity is just a fancy name for a power to depart from the Code.”<sup>107</sup> The court stated that the Bankruptcy Code replaced the common-law bankruptcy principles worked out in the railroad reorganization cases.<sup>108</sup> Older doctrines, such as the doctrine of necessity, may still survive only as aids to interpretation of ambiguous language of the Bankruptcy Code, but not as “freestanding entitlements to trump the text.”<sup>109</sup>

The court then considered whether any other provisions of the Bankruptcy Code could be used to authorize the grant of critical-vendor payments.<sup>110</sup> The court rejected the notion that section 364(b) could provide a basis for permitting payment of prepetition debt to critical vendors.<sup>111</sup> Judge Easterbrook noted that section 364 authorizes the debtor to obtain credit but does not say anything about how the money will be distributed or about priorities among creditors.<sup>112</sup> The court specifically rejected the holding in *In re Payless Cashways, Inc.*, where critical-vendor payments were allowed pursuant to section 364.<sup>113</sup> The Seventh Circuit in *In re Kmart* likewise held that section 503 could not be used to justify critical-vendor payments.<sup>114</sup> The court reasoned that “[p]re-filing debts are not administrative expenses; they

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<sup>102</sup> *Id.*

<sup>103</sup> *Id.*

<sup>104</sup> *Id.* (citing *In re Chicago, Milwaukee*, 791 F.2d at 528).

<sup>105</sup> *In re Kmart*, 359 F.3d at 871.

<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

<sup>110</sup> *In re Kmart*, 359 F.3d at 872.

<sup>111</sup> *Id.*; see 11 U.S.C. § 364(b) (2000).

<sup>112</sup> *In re Kmart*, 359 F.3d at 872; see 11 U.S.C. § 364.

<sup>113</sup> *In re Kmart*, 359 F.3d at 872; *In re Payless Cashways, Inc.*, 268 B.R. 543, 544 (Bankr. W.D. Mo. 2001); see 11 U.S.C. § 364.

<sup>114</sup> 359 F.3d at 872; see 11 U.S.C. § 503.

are the antithesis of administrative expenses. . . . Treating pre-filing debts as 'administrative' claims against the post-filing entity would impair the ability of bankruptcy law to prevent old debts from sinking a viable firm."<sup>115</sup>

In dicta, Judge Easterbrook left the door open to possible use of section 363(b) to authorize critical-vendor payments in future cases.<sup>116</sup> That section provides that "[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate."<sup>117</sup> It could be argued that section 363(b) may be used to authorize the debtor, in exercising its business judgment, to use estate funds to make payments of prepetition claims to certain creditors.<sup>118</sup> Judge Easterbrook wrote that section 363(b) "is more promising, for satisfaction of a prepetition debt in order to keep 'critical' supplies flowing is a use of property other than in the ordinary course of administering an estate in bankruptcy."<sup>119</sup> The Seventh Circuit also cautioned against using section 363(b) authority to disrupt the priority scheme of the Bankruptcy Code, stressing that although section 363(b) may allow certain changes in the priority of creditors, such changes should be kept to a minimum: "it is prudent to read, and use, § 363(b)(1) to do the least damage possible to priorities established by contract and by other parts of the Bankruptcy Code."<sup>120</sup> The court then refused to rule on whether section 363(b)(1) may be used to justify payment of prepetition unsecured debt to maintain the flow of goods from "critical vendors," because "this order was unsound no matter how one reads § 363(b)(1)."<sup>121</sup>

The Seventh Circuit then placed strict procedural and evidentiary limits on the use of § 363(b)(1) to pay prepetition unsecured debts, without deciding whether that section of the Code may ever justify such payments:

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<sup>115</sup> *In re Kmart*, 359 F.3d at 872.

<sup>116</sup> *See id.*

<sup>117</sup> 11 U.S.C. § 363(b)(1) (2000). Section 363(b)(1) was amended in 2005, but the amendments did not change the quoted language. BAPCPA, Pub. L. No. 109-8, § 231(a), 119 Stat. 23, 72-73 (to be codified at, and amending, 11 U.S.C. § 363(b)(1)).

<sup>118</sup> *See* 11 U.S.C. § 363(b)(1); *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989) ("Section 363(b) gives the court broad flexibility in tailoring its orders to meet a wide variety of circumstances."); *cf. In re CoServ, L.L.C.*, 273 B.R. 487, 493 (Bankr. N.D. Tex. 2002) (rejecting the notion that section 363 can be used to authorize critical-vendor payments).

<sup>119</sup> *In re Kmart*, 359 F.3d at 872.

<sup>120</sup> *Id.*

<sup>121</sup> *Id.*

The foundation of a critical-vendors order is the belief that vendors not paid for prior deliveries will refuse to make new ones. Without merchandise to sell, a retailer such as Kmart will fold. . . . [I]t is necessary to show not only that the disfavored creditors *will* be as well off with reorganization as with liquidation—a demonstration never attempted in this proceeding—but also that the supposedly critical vendors would have ceased deliveries if old debts were left unpaid while the litigation continued. If vendors will deliver against a promise of current payment, then a reorganization can be achieved, and all unsecured creditors will obtain its benefit, without preferring any of the unsecured creditors.<sup>122</sup>

The court also noted that some critical vendors would continue to do business with the debtor postpetition because they are legally obligated to perform long-term contracts and the automatic stay under section 362(a) prevents these vendors from refusing to make postpetition deliveries so long as the debtor pays for new goods.<sup>123</sup> One vendor, Fleming Companies, which received the largest payment for prepetition debt among Kmart's alleged critical vendors because it sold Kmart between \$70 million and \$100 million of groceries and related goods weekly, was one of those obligated to continue to make deliveries under a long-term contract: "[n]o matter how much Fleming would have liked to dump Kmart, it had no right to do so. It was unnecessary to compensate Fleming for continuing to make deliveries that it was legally required to make."<sup>124</sup>

The court also explained why it would be very difficult for a debtor in possession, when attempting to justify the use of section 363(b)(1) to authorize payment of prepetition debt, to prove that a particular vendor would, in fact, refuse to make future deliveries, even if not obligated to do so under a prepetition contract.<sup>125</sup>

Each new delivery produced a profit; as long as Kmart continued to pay for new product, why would any vendor drop the account? That would be a self-inflicted wound. To abjure new profits because of old debts would be to commit the sunk-cost fallacy; well-managed businesses are unlikely to do this. Firms that disdain current profits because of old losses

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<sup>122</sup> *Id.* at 872–73.

<sup>123</sup> *Id.* at 873; see 11 U.S.C. § 362(a) (2000).

<sup>124</sup> *In re Kmart*, 359 F.3d at 873.

<sup>125</sup> See *id.*

are unlikely to stay in business. They might as well burn money or drop it into the ocean.<sup>126</sup>

The Seventh Circuit also addressed the concern that vendors might refuse to deliver goods postpetition out of fear that they would not get paid for those deliveries.<sup>127</sup> By suggesting ways to address those concerns, the court apparently heightened the debtor's burden of proof in obtaining an order authorizing the payment of prepetition debt owed to critical vendors.<sup>128</sup>

Doubtless many suppliers fear the prospect of throwing good money after bad. It therefore may be vital to assure them that a debtor will pay for new deliveries on a current basis. Providing that assurance need not, however, entail payment for prepetition transactions. Kmart could have paid cash or its equivalent. (Kmart's CEO told the bankruptcy judge that COD arrangements were not part of Kmart's business plan, as if a litigant's druthers could override the rights of third parties.) Cash on the barrelhead was not the most convenient way, however. Kmart secured a \$2 billion line of credit when it entered bankruptcy. Some of that credit could have been used to assure vendors that payment would be forthcoming for all post-petition transactions. The easiest way to do that would have been to put some of the \$2 billion behind a standby letter of credit on which the bankruptcy judge could authorize unpaid vendors to draw. That would not have changed the terms on which Kmart and any of its vendors did business; it just would have demonstrated the certainty of payment. If lenders are unwilling to issue such a letter of credit (or if they insist on a letter's short duration), that would be a compelling market signal that reorganization is a poor prospect and that the debtor should be liquidated post haste.

Yet the bankruptcy court did not explore the possibility of using a letter of credit to assure vendors of payment. The court did not find that any firm would have ceased doing business with Kmart if not paid for pre-petition deliveries, and the scant record would not have supported such a

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<sup>126</sup> *Id.*

<sup>127</sup> *See id.*

<sup>128</sup> *See id.*

finding had one been made. The court did not find that discrimination among unsecured creditors was the only way to facilitate a reorganization. It did not find that the disfavored creditors were at least as well off as they would have been had the critical-vendors order not been entered. . . . Even if § 362(b)(1) [sic] allows critical-vendors orders in principle, preferential payments to a class of creditors are proper only if the record shows the prospect of benefit to the other creditors. This record does not, so the critical-vendors order cannot stand.<sup>129</sup>

The Seventh Circuit in *In re Kmart*, by rejecting section 105(a) and the doctrine of necessity as a basis for authorizing payment of prebankruptcy claims of unsecured vendors, and by re-focusing the critical-vendor debate on section 363(b), which it interpreted as having a high burden of proof, has clearly and substantially raised the bar for debtors seeking to pay critical-vendor claims early in a Chapter 11 case.<sup>130</sup> The decision also exemplifies the trend in the appellate courts of limiting bankruptcy courts' previously broad discretion to authorize a debtor to pay prepetition claims outside of a plan of reorganization.<sup>131</sup>

## V. THE IMPACT OF THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005 ON THE DOCTRINE OF NECESSITY AND CRITICAL-VENDOR PAYMENTS

### A. *Administrative Priority for Goods Delivered Within Twenty Days Before Bankruptcy*

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 has amended the Bankruptcy Code in two significant ways that are likely to impact critical-vendor payments. First, the 2005 Act

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<sup>129</sup> *In re Kmart*, 359 F.3d at 873–74.

<sup>130</sup> See *id.* at 871–73. That does not mean, however, that courts following *In re Kmart* have not authorized payment to critical vendors. In *In re Tropical Sportswear Int'l Corp.*, 320 B.R. 15, 18, 20–21 (M.D. Fla. 2005), the bankruptcy court allowed the debtors, a designer and marketer of clothing, to use estate funds to pay 77.5% of prepetition amounts owed to certain critical vendors. The court relied on sections 105 and 363(b)(1), and the court's opinion heavily referenced *In re Kmart* and the evidentiary test proposed by *In re Kmart* in determining whether the critical payments should be allowed. *Id.* at 19–20; see 11 U.S.C. §§ 105, 363(b)(1) (2000).

<sup>131</sup> Notwithstanding, courts have distinguished *In re Kmart* in cases involving the payment of prepetition priority wage claims, because there are fewer concerns about affecting the priority scheme of the Bankruptcy Code or unfairly favoring some unsecured creditors over others. See *In re CEI Roofing, Inc.*, 315 B.R. 50, 53–54 (Bankr. N.D. Tex. 2004).

added section 503(b)(9) to the Code to give administrative expense treatment for "the value of any goods received by the debtor within 20 days before the date of commencement of a case under [the Bankruptcy Code] in which the goods have been sold to the debtor in the ordinary course of such debtor's business."<sup>132</sup> The result is that such claims have administrative priority under section 507(a)(2) of the Code.<sup>133</sup> Apparently, the rationale for granting priority to such vendors is that within twenty days before bankruptcy, a debtor is likely to know that bankruptcy is imminent and that it will not be able to pay for goods delivered within that time period. Moreover, goods delivered so close to the bankruptcy filing are likely to benefit the bankruptcy estate. This new provision is a radical departure from the general rule that only postpetition expenses are afforded administrative priority. Curiously, section 503(b)(9) gives providers of goods priority over similarly situated providers of services or lenders who gave the debtor value within the twenty-day period.

This new provision is similar in concept to the six months rule used in railroad reorganization cases in at least two ways. First, it is a rule of priority, rather than payment. That is, by giving such claims administrative expense status, the amendment clearly gives such vendors priority over general unsecured creditors and above most other priority claims. Indeed, such vendor claims will have priority over wage and tax claims.<sup>134</sup> In involuntary bankruptcy cases, section 503(b)(9) vendor claims will have priority over claims of unsecured creditors who extend credit in the ordinary course of business during the gap period between the filing of the petition and the earlier of the appointment of a trustee or order for relief.<sup>135</sup> The Code does not,

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<sup>132</sup> BAPCPA, Pub. L. No. 109-8, § 1227, 119 Stat. 23, 199-200 (to be codified at 11 U.S.C. § 503(b)(9)). This section is effective in cases that are commenced on or after October 17, 2005. *See id.* § 1501, 119 Stat. at 216 (to be codified at 11 U.S.C. § 101 note) (providing effective date of amendments).

<sup>133</sup> 11 U.S.C. § 507(a)(2) (2000), *amended by* BAPCPA §§ 212(2),(3), 1401, 119 Stat. at 51-52, 214. In cases commenced before October 17, 2005, administrative expenses were afforded a first priority under section 507(a)(1). 11 U.S.C. § 507(a)(1). In cases commenced on or after that date, domestic support obligations are afforded the first priority under section 507(a)(1), 11 U.S.C. § 507(a)(1), *amended by* BAPCPA §§ 212(2),(9), 1404, 119 Stat. at 51-52, 214, and administrative expenses are afforded a second priority under section 507(a)(2). *Id.* § 507(a)(2), *amended by* BAPCPA §§ 212(2),(3), 1404, 119 Stat. at 51-52, 214.

<sup>134</sup> *See* 11 U.S.C. § 507(a), *amended by* BAPCPA § 212, 119 Stat. at 51, for the ranking among priority claims.

<sup>135</sup> BAPCPA § 1227(b), 119 Stat. at 199-200 (to be codified at, and amending, 11 U.S.C. § 503(b)). With respect to priority of claims allowed under section 502(f) of the

however, specify *when* payment will be made. It remains to be seen whether courts in Chapter 11 cases will allow payment of these vendor claims before confirmation of a plan of reorganization. Under section 503(a) of the Code, any entity with an administrative claim may file a request for payment, and it is within the court's discretion whether to authorize payment during the case.<sup>136</sup> In a Chapter 11 case, administrative expenses must be paid in full on the effective date of the plan unless paid earlier, either in the ordinary course of business or with court authorization.<sup>137</sup> Arguably, prepetition vendor claims are never payable in the ordinary course of business because of the intervening bankruptcy and the automatic stay, even if afforded administrative expense priority. If courts adopt that view, actual payment of section 503(b)(9) vendor claims will require either a court order authorizing payment or a confirmed Chapter 11 plan.

Section 503(b)(9) is also similar to the six months rule in that priority status is granted automatically.<sup>138</sup> The debtor does not have to demonstrate that the creditor is "critical" or that payment of the claim is necessary for a successful reorganization. In fact, the new section applies in all types of bankruptcy cases—including Chapter 7 liquidation cases—indicating that Congress did not intend to link payment of these prepetition vendor claims to the necessity for effective reorganization.

It is worth noting that section 503(b)(9) refers to the "value" of the goods received by the debtor within the twenty-day period before bankruptcy.<sup>139</sup> It does not refer to "purchase price" or "claim" arising from the sale.<sup>140</sup> It can be expected that value will be the same as the purchase price in most cases, especially if any arguable difference in the two amounts is not so material as to warrant litigation over that issue. Nevertheless, the language of the section leaves open the argument that value, in a particular case, may be an amount that is either higher or lower than the purchase price.<sup>141</sup>

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Bankruptcy Code, see 11 U.S.C. § 502(f); BAPCPA § 212(2), (4), 119 Stat. at 51–52; *Id.* § 1401, 119 Stat. at 214 (to be codified at, and amending, 11 U.S.C. § 507(a)(3)).

<sup>136</sup> See 11 U.S.C. § 503(a); ALAN N. RESNICK, *BANKRUPTCY LAW MANUAL* § 6:27 at 519–20 n.1 (5th ed. 2002).

<sup>137</sup> See 11 U.S.C. § 363(c)(1); BAPCPA § 1502(a)(8), 119 Stat. at 216–17 (to be codified at, and amending, 11 U.S.C. § 1129(a)(9)).

<sup>138</sup> See BAPCPA § 1227, 119 Stat. at 199–200 (to be codified at 11 U.S.C. § 503(b)(9)).

<sup>139</sup> See *id.*

<sup>140</sup> See *id.*

<sup>141</sup> See *id.*



The need to rely on the doctrine of necessity to pay critical vendors will be reduced in future cases because of section 503(b)(9).<sup>142</sup> Critical vendors, as well as non-critical vendors, with claims for goods delivered within twenty days before bankruptcy should be willing to continue to do business with the debtor in possession in a Chapter 11 case, unless there is a concern that the debtor may not have sufficient assets from which to pay administrative expense claims in full. That concern could be alleviated by appropriate provisions in postpetition financing arrangements that will assure sufficient funds to pay administrative expenses.

Alternatively, a request may be made under section 503(a) for immediate payment for goods delivered within the twenty-day pre-bankruptcy period.<sup>143</sup> Determining when an administrative expense is to be paid is within the discretion of the bankruptcy court.<sup>144</sup> As discussed above, courts have been more willing to permit immediate payment of prepetition claims, such as wage claims, when such claims are entitled to priority in treatment and, therefore, are likely to be paid in full later in the case. It could be anticipated that a critical vendor that insists on immediate payment of its section 503(b)(9) claim as a condition to doing business with the debtor in possession will have its claim treated in a manner similar to the treatment of priority wage claims; courts will likely grant the debtor's request under section 503(a) to make such payment. Clearly, the burden of proof to pay an administrative priority claim will be easier to satisfy than the burden required to pay a nonpriority unsecured claim under section 105(a), section 363(b), or the doctrine of necessity.

### B. *Expansion of Reclamation Rights of Vendors*

The 2005 Act also amended section 546(c) of the Code, which deals with a seller's right to reclaim goods sold to the debtor in the ordinary course of the seller's business.<sup>145</sup> The Act could also reduce the demand for court authorization to pay critical vendors.

In cases commenced before the effective date of the 2005 amendments, section 546(c) provides that the avoiding powers of a trustee or debtor in possession are subject to any statutory or com-

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<sup>142</sup> See *id.*

<sup>143</sup> See 11 U.S.C. § 503(a) (2000).

<sup>144</sup> *In re Verco Indus.*, 20 B.R. 664, 665 (B.A.P. 9th Cir. 1982).

<sup>145</sup> BAPCPA § 1227(a), 119 Stat. at 199–200 (to be codified at, and amending, 11 U.S.C. § 546(c)).

mon-law right of a seller that has sold goods to the debtor, in the ordinary course of the seller's business, to reclaim those goods if the debtor has received the goods while insolvent.<sup>146</sup> Nevertheless, strict time limits apply in such cases.<sup>147</sup> To exercise this right in cases commenced before the effective date of the 2005 amendments, the seller must demand reclamation in writing before ten days after the debtor received the goods or, if the ten-day period expired after commencement of the bankruptcy case, before twenty days after receipt of the goods.<sup>148</sup> If a timely demand is made, the seller must comply with state law regarding reclamation, which is section 2-702 of the Uniform Commercial Code.<sup>149</sup> Under state law, the right of reclamation is subject to the rights of a purchaser in the ordinary course or other good-faith purchaser of the goods.<sup>150</sup> In addition, for the right of reclamation to apply, the debtor must have possession of the goods when the demand was made,<sup>151</sup> and the goods must be identifiable.<sup>152</sup> If a timely reclamation demand is made, the court has discretion to compel the return of the goods to the seller, or it may deny reclamation and grant the seller's claim administrative priority, or secure the claim with a lien on property.<sup>153</sup>

The 2005 amendments have expanded a seller's right to reclaim goods. First, rather than requiring the seller to demand reclamation within ten days after receipt of the goods (or twenty days if the ten-day period expires after commencement of the bankruptcy case), section 546(c), as amended, gives the seller reclamation rights if the debtor

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<sup>146</sup> 11 U.S.C. § 546(c); *see also* BAPCPA § 406(1), (2), 119 Stat. at 105-06 (to be codified at, and amending, 11 U.S.C. § 546(h)) (designated as 11 U.S.C. § 546(g) before the 2005 amendments). Section 546(c), first added to the Code in 1994, authorizes the court, on motion made within 120 days after the order for relief in a Chapter 11 case, to permit a trustee or debtor in possession, with the seller's consent, to return goods shipped to the debtor before the commencement of the case, and the seller may offset the purchase price against any prepetition claim of the seller. 11 U.S.C. § 546(g) (2000). The court, however, must find that the return of the goods is in the best interest of the estate. *Id.*

<sup>147</sup> *See* 11 U.S.C. § 546(c).

<sup>148</sup> *Id.* § 546(c) (1).

<sup>149</sup> *See* U.C.C. § 2-702(3) (2003).

<sup>150</sup> *Id.*

<sup>151</sup> *See, e.g., In re Adventist Living Ctrs., Inc.*, 52 F.3d 159, 162 (7th Cir. 1995); *Flav-O-Rich, Inc., v. Rawson Food Serv., Inc. (In re Rawson Food Service, Inc.)*, 846 F.2d 1343, 1347 (11th Cir. 1988).

<sup>152</sup> *See, e.g., Archer Daniels Midland Co. v. Charter Int'l Oil Co.*, 60 B.R. 854, 856 (M.D. Fla. 1986); *Eagle Indus. Truck Mfg., Inc. v. Cont'l Airlines, Inc. (In re Cont'l Airlines, Inc.)*, 125 B.R. 415, 417 (Bankr. D. Del. 1991).

<sup>153</sup> *See* 11 U.S.C. § 546(c) (2) (2000).

has received the goods within forty-five days before the commencement of the bankruptcy case and the seller demands reclamation in writing within forty-five days after the date of receipt of the goods or, if the forty-five day period expires after the commencement of the case, within twenty days after the case is commenced.<sup>154</sup> Because debtors are usually insolvent during the forty-five day period, the amendment effectively gives sellers the right to reclaim goods sold on credit and received by the debtor within forty-five days before bankruptcy.<sup>155</sup>

Second, the amendments to section 546(c) delete the reference to statutory or common-law right of reclamation which, presumably, was intended to replace nonbankruptcy law regarding reclamation rights with the rights granted under section 546(c).<sup>156</sup> Third, the section 546(c) amendments clarify that a seller's right of reclamation is subject to prior rights of secured creditors that have security interests in the goods or the proceeds thereof.<sup>157</sup> This change is not significant because, under the version of section 546(c) in effect before the 2005 amendments, the seller's rights were subordinated to the rights of a good-faith purchaser and courts have held that a secured creditor is such a purchaser.<sup>158</sup> Fourth, the 2005 amendments delete the judicial option of giving the seller, in lieu of reclamation, either administrative claim priority or a lien to secure its claim.<sup>159</sup> Finally, section 546(c), as amended, provides that if a seller fails to make a timely written demand for reclamation, "the seller still may assert the rights contained in section 503(b) (9)."<sup>160</sup>

To the extent that the debtor still has possession of goods delivered within forty-five days before bankruptcy, and a timely demand for reclamation is made, the seller would have the right to the return of the goods.<sup>161</sup> Upon return, of course, the debtor could repurchase the same or similar goods from the seller, paying for the goods in the ordinary course of business under section 363(c)(1).<sup>162</sup> Postpetition

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<sup>154</sup> BAPCPA § 1227(a), 119 Stat. at 199–200 (to be codified at, and amending, 11 U.S.C. § 546(c)).

<sup>155</sup> *See id.*

<sup>156</sup> *See id.*

<sup>157</sup> *Id.*

<sup>158</sup> *See, e.g., In re Reliable Drug Stores, Inc.*, 70 F.3d 948, 949 (7th Cir. 1995); *Pester Ref. Co. v. Ethyl Corp. (In re Pester Ref. Co.)*, 964 F.2d 842, 844–45 (8th Cir. 1992); *see also* 11 U.S.C. § 546(c).

<sup>159</sup> *See* BAPCPA § 1227(a), 119 Stat. at 199–200 (to be codified at, and amending, 11 U.S.C. § 546(c)).

<sup>160</sup> *Id.*

<sup>161</sup> *See id.*

<sup>162</sup> *See* 11 U.S.C. § 363(c)(1) (2000).

purchases are administrative expenses under section 503(b).<sup>163</sup> It is likely, therefore, that there will be a reduction in the need for courts to order critical-vendor payments where the vendor has reclamation rights. Alternatively, courts are likely to be more willing to grant the debtor authority to pay in full the prepetition claims of critical vendors who have the right to compel the return of goods, whether relying on section 105(a), section 363(b), or the doctrine of necessity as authority. It is unlikely that courts will require the debtor to return reclaimed goods only to repurchase them. The practical solution in such cases is to allow the debtor to pay the prepetition claim for the purchase price immediately.

*C. A Broader Implication of the 2005 Amendments on Payment of  
Critical-Vendor Claims*

The enactment of section 503(b)(9) may also affect the doctrine of necessity and critical-vendor payments in another way. As discussed above, supporters of the doctrine of necessity and judicial authority to pay critical vendors have argued that the Bankruptcy Code's silence regarding a doctrine that existed under pre-Code law does not stand in the way of its recognition after the Code's enactment in 1978.<sup>164</sup> The absence of any mention of the doctrine in the Code could be consistent with its continuing viability. Nevertheless, now that Congress has spoken on the treatment of prepetition unsecured vendor claims in section 503(b)(9), a broader question that may arise when debtors request court authorization to pay prepetition critical-vendor claims is whether the 2005 legislation includes a negative inference.<sup>165</sup> Indeed, the Bankruptcy Code now expressly grants administrative expense priority to vendors under section 503(b)(9).<sup>166</sup> The 2005 amendments also give vendors broader reclamation rights that exceed those afforded to vendors under state law.<sup>167</sup> Clearly, the Code is no longer silent on the authority to pay prepetition unsecured claims be-

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<sup>163</sup> 11 U.S.C. § 503(b), amended by BAPCPA § 329, 119 Stat. at 101.

<sup>164</sup> See Vilaplana, *supra* note 26, at 528.

<sup>165</sup> See BAPCPA § 1227(b), 119 Stat. at 199–200 (to be codified at 11 U.S.C. § 503(b)(9)).

<sup>166</sup> *Id.*

<sup>167</sup> Compare *id.* § 1227(a), 119 Stat. at 199–200 (to be codified at, and amending, 11 U.S.C. § 546(c)) (allowing a seller to demand in writing reclamation of goods received by an insolvent debtor within 45 days of the date of receipt of such goods by the debtor, provided certain conditions are met), with U.C.C. § 2–702(2) (2003) (allowing a seller to reclaim goods received by an insolvent buyer within ten days of receipt).

fore confirmation of a plan. The more protection that Congress expressly provides for prepetition vendors, the less likely it will be that courts will use equitable powers to authorize extraordinary treatment to vendors who do not qualify for the codified protection. For example, a seller delivers goods twenty-five days before the commencement of the case and, therefore, is not eligible for administrative priority. If the goods have been resold to consumers before a reclamation demand is made so that reclamation is not possible, will appellate courts tolerate a bankruptcy court's exercise of discretion to allow payment to the seller in full at the commencement of the case? Will courts be willing to give a provider of services (who is not within the scope of section 503(b)(9)) essentially the same section 503(b)(9) rights as the provider of goods by using section 105(a), section 363(b), or the doctrine of necessity? Or will appellate courts view such orders as an inappropriate rewriting of the Code?

#### VI. PROCEDURAL SAFEGUARDS UNDER PROPOSED AMENDMENTS TO THE FEDERAL RULES OF BANKRUPTCY PROCEDURE

Critics of critical-vendor orders at the early stages of a case have complained that there are few, if any, procedural safeguards on such orders.<sup>168</sup> First-day motions for authority to pay certain prebankruptcy claims have been routine in many bankruptcy courts. These motions have been granted without sufficient notice and opportunity to be heard. In some cases, such motions are granted before the formation of a committee of unsecured creditors and with little input from creditor interests. In reaction to such criticism regarding motions for relief filed and heard on the first day of a case, the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States proposed a draft of a new Rule 6003 of the Federal Rules of Bankruptcy Procedure.<sup>169</sup> The preliminary draft of the proposed

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<sup>168</sup> See Patricia L. Barsalou & Zack Mosner, *Preferential First-Day Orders: Same Question, Different Look*, AM. BANKR. INST. J., Feb. 2003, [http://www.abiworld.org/Content/NavigationMenu/Publications/Online\\_ABI\\_Journal/Archive1/ABI\\_Journal\\_Archives.htm](http://www.abiworld.org/Content/NavigationMenu/Publications/Online_ABI_Journal/Archive1/ABI_Journal_Archives.htm) (click on "2003," then "February," then follow "AFFAIRS OF STATE: Preferential First-day Orders: Same Question, Different Look" hyperlink).

<sup>169</sup> Preliminary Draft of Proposed Amendments to the Federal Rules of Appellate, Bankruptcy, Civil, and Criminal Procedure, (Aug. 2005), <http://www.uscourts.gov/rules/newrules1.html> (click on "Bankruptcy Rule 6003") [hereinafter Draft of Proposed Amendments].

amendments was published for public comment in August 2005.<sup>170</sup> The rule, as amended, would read as follows:

**Rule 6003. Interim and Final Relief Immediately Following the Commencement of the Case—Applications for Employment; Motions for Use, Sale, or Lease of Property; and Motions for Assumptions, Assignments, and Rejections of Executory Contracts**

Except to the extent that relief is necessary to avoid immediate and irreparable harm, the court shall not, within 20 days after the filing of the petition, grant relief regarding the following:

....

(b) a motion to use, sell, lease, or otherwise incur an obligation regarding property of the estate, including a motion to pay all or part of a claim that arose before the filing of the petition, but not a motion under Rule 4001. . . .<sup>171</sup>

The Committee Note explaining the purpose of the proposed rule states:

[t]here can be a flurry of activity during the first days of a bankruptcy case. This activity frequently takes place prior to the formation of a creditors' committee, and it also can include substantial amounts of materials for the court and parties in interest to review and evaluate. This rule is intended to alleviate some of the time pressures present at the start of a case so that full and close consideration can be given to matters that may have a fundamental impact on the case.<sup>172</sup>

The eventual promulgation of the new Rule 6003 by the Supreme Court is highly likely, though it probably will not become effective until at least December 1, 2007, because of the lengthy rulemaking process under the Rules Enabling Act.<sup>173</sup> The result will be greater creditor and committee response to any request by a debtor to pay prepetition unsecured claims.

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<sup>170</sup> *Id.*

<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

<sup>173</sup> 28 U.S.C. § 2075 (2000).

## CONCLUSION

The 2005 amendments to the Bankruptcy Code, which grant vendors administrative priority for goods delivered within twenty days before bankruptcy and greater reclamation rights, should reduce the demand for payments to critical vendors during the early days of a Chapter 11 case. In those situations where a debtor seeks permission to pay a vendor's prebankruptcy administrative claim, the court would have the discretion to grant the request under section 503(b). Nevertheless the 2005 amendments leave uncertain the bankruptcy court's discretion to provide similar protection for, or to authorize early payment to, creditors with unsecured claims that fall outside the scope of these new statutory protections.

The recent judicial trend has been to narrow the bankruptcy court's equitable power to authorize payment of prebankruptcy unsecured claims before confirmation of a Chapter 11 plan. Several appellate court decisions have rejected entirely the doctrine of necessity and the use of section 105(a) to authorize payment of prebankruptcy non-priority claims, while the Seventh Circuit in *In re Kmart Corp.* has kept the door open to the possible use of section 363(b) with strict evidentiary burdens to safeguard against unwarranted payments.<sup>174</sup> Several bankruptcy courts have provided stringent tests for making critical-vendor payments, such as the three-part test used in *In re CoServ, L.L.C.* and *In re Mirant Corp.*<sup>175</sup> Clearly, orders granting debtors wide discretion to pay prebankruptcy claims of creditors that they perceive as critical to the reorganization effort will no longer be routine in future cases.

Yet bankruptcy courts should, and likely will, continue the practice of authorizing the payment of prebankruptcy debt in certain situations, such as when the claim has priority under section 507(a) and a delay in payment would cause disruption to the debtor's business. Courts probably will rely on the doctrine of necessity, section 105(a), or section 363(b) when granting such orders. For example, the timely payment of priority wage claims, which now can be as high as \$10,000 per employee, has been, and will continue to be, unchallenged and routine in the majority of Chapter 11 cases. If and when the proposed new Bankruptcy Rule 6003 becomes effective, it should be relatively easy for a reorganizing debtor to prove that payment of priority wage claims during the first days of the case is "necessary to

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<sup>174</sup> 359 F.3d 866, 872-73 (7th Cir. 2004).

<sup>175</sup> *In re Mirant Corp.*, 296 B.R. 427, 429 (Bankr. N.D. Tex. 2003); *In re CoServ L.L.C.*, 273 B.R. 487, 498 (Bankr. N.D. Tex. 2002).

avoid immediate and irreparable harm" so that the court would not have to wait until twenty days after the commencement of the case to grant the requested relief.<sup>176</sup>

Courts also should have discretion to authorize payment of non-priority claims, but only in extraordinary circumstances and with procedural safeguards that afford parties in interest an opportunity to be heard before relief is granted. Anyone who doubts that such authority should exist should read *Official Committee of Equity Security Holders v. Mabey*, where the Fourth Circuit, only because of its view that section 105(a) was insufficient authority on which to rely, shut the door on the creation of a \$15 million emergency treatment fund to be used to pay the \$10,000–\$15,000 cost of timely surgery or fertilization for each victim of a defective contraceptive device.<sup>177</sup> The medical treatment was likely to cure infertility, the expenditure would have benefited the estate by mitigating tort claims, and the amount spent on each woman would have been deducted from future plan distributions almost certain to exceed the cost of the medical treatment, so creation of the treatment fund would not adversely affect distributions to creditors.<sup>178</sup>

Now that Congress has added section 503(b)(9) to the Code to grant administrative priority to claims of certain vendors, and has amended section 546(c) to expand reclamation rights, it should complete its statutory treatment with respect to the payment of prebankruptcy claims before a Chapter 11 plan is confirmed. The Code should be amended to clarify the extent to which the doctrine of necessity applies in Chapter 11 cases. The legislation would avoid further uncertainty, as well as expensive and time-consuming litigation, over the propriety of allowing payment of prebankruptcy debts. It also would result in more national uniformity (and less forum shopping) regarding payment of prebankruptcy claims outside of a plan. The legislation should recognize different standards to be applied depending on the type of debt sought to be paid.

The National Bankruptcy Conference<sup>179</sup> has proposed the addition of a new section 1117 to the Code dealing with payment of pre-

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<sup>176</sup> See Draft of Proposed Amendments, *supra* note 169.

<sup>177</sup> See 832 F.2d 299, 301–02 (4th Cir. 1987).

<sup>178</sup> See *id.* at 301.

<sup>179</sup> The National Bankruptcy Conference is a voluntary, non-profit, non-partisan, self-supporting organization of approximately sixty-five lawyers, law professors, and bankruptcy judges. Its primary purpose is to study the operation of bankruptcy and related laws and to make proposals for their reform. The Author is a member of the Conference.



bankruptcy claims before confirmation of a plan.<sup>180</sup> That proposal would establish a “best interest of the estate” test for the payment of priority wage claims and contributions to an employee benefit plan owed to employees, and for payment of customer claims, such as warranty claims and claims based on price discount or frequent flier-type programs. Apparently, the standard for these claims would be the same as the standard used whenever the court, under section 363(b), approves an expenditure outside the ordinary course of business. For other types of unsecured claims, however, the court would not have

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<sup>180</sup> The following is the proposal:

**Section 1117. Payment of Prepetition Claims**

(a) After the order for relief, except as provided in section 365, 503, 546, 1110, 1113, 1114, or 1168, subsection (b) or (c) of this section, a plan confirmed in the case, or the order confirming the plan, the trustee may not pay an unsecured claim that arose before the commencement of the case under this title.

(b) The court, on request of the trustee and after notice and a hearing, may authorize the trustee to pay, or otherwise perform an obligation in connection with, an unsecured claim that arose before the commencement of the case, whether or not proof of the claim has been filed or deemed filed or the claim has been allowed, if such payment is in the best interest of the estate and—

(1) the claim is owed to an employee of the debtor and is of the kind and for the amount and time periods specified in section 507(a) (4) or 507(a) (5); or

(2) the claim arose from the purchase, before the commencement of the case, of goods or services, or the right to use technology or information, from the debtor in the ordinary course of business of the debtor, including a claim based on a warranty, right to a price discount, or right to receive delivery of goods or services.

(c) The court, on request of the trustee and after notice and a hearing, may authorize the trustee to pay, or otherwise perform an obligation in connection with, an unsecured claim that arose before the commencement of the case, other than a claim of the kind specified in subsection (b), whether or not proof of the claim has been filed or deemed filed or the claim has been allowed, if—

(1) there is a compelling public interest in the continuation of the debtor's business and a material risk that the debtor's business will not continue without such payment or performance;

(2) such payment or performance is necessary to permit the reorganization of the debtor and the benefit to the estate of such payment or performance substantially outweighs the cost to the estate; or

(3) there is a compelling public interest in such payment or performance and the benefit to the estate of such payment or performance outweighs the cost to the estate.

discretion to authorize payment unless there is an evidentiary showing that at least one of the following three more stringent standards is satisfied: (1) there is a compelling public interest in the continuation of the debtor's business and a material risk that the debtor's business will not continue without such payment; (2) the payment is necessary to permit the reorganization of the debtor and the benefit to the estate of the payment substantially outweighs the cost to the estate; or (3) there is a compelling public interest in the payment and the benefit to the estate of such payment or performance outweighs the cost to the estate.<sup>181</sup>

Congress should consider enactment of the National Bankruptcy Conference proposal or a similar provision on payment of prebankruptcy claims in a Chapter 11 case before confirmation of a plan. If such a proposal is enacted, and proposed new Rule 6003 of the Federal Rules of Bankruptcy Procedure is promulgated, courts will have the flexibility they need to authorize payment of a prebankruptcy claim only when the particular circumstances justify such payment, and parties in interest will have procedural safeguards to assure a meaningful opportunity to be heard at the evidentiary hearings.

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<sup>181</sup> The National Bankruptcy Conference also supports the adoption of procedural requirements to assure an opportunity for the creditors' committee, United States trustee, and other parties in interest to be heard before the court grants an order authorizing payment of prebankruptcy debt, unless delay in payment would cause immediate and irreparable harm to the estate. It has, however, temporarily deferred proposing a statutory provision on procedural matters in view of the proposed new Rule 6003 of the Federal Rules of Bankruptcy Procedure.

