

2020

Critical Vendors in the Retail Apocalypse: How the Economic Crunch Exacerbates the Need for Critical Vendor Codification

Kennedy Bodnarek

Follow this and additional works at: <https://scholarlycommons.law.emory.edu/ebdj>

Recommended Citation

Kennedy Bodnarek, *Critical Vendors in the Retail Apocalypse: How the Economic Crunch Exacerbates the Need for Critical Vendor Codification*, 37 Emory Bankr. Dev. J. 139 (2020).
Available at: <https://scholarlycommons.law.emory.edu/ebdj/vol37/iss1/7>

This Comment is brought to you for free and open access by the Journals at Emory Law Scholarly Commons. It has been accepted for inclusion in Emory Bankruptcy Developments Journal by an authorized editor of Emory Law Scholarly Commons. For more information, please contact law-scholarly-commons@emory.edu.

CRITICAL VENDORS IN THE RETAIL APOCALYPSE: HOW THE ECONOMIC CRUNCH EXACERBATES THE NEED FOR CRITICAL VENDOR CODIFICATION

ABSTRACT

There is little hope for a retailer's successful chapter 11 reorganization without a supply of inventory from vendors. Without a codified legal test for critical vendor payments, vendors may be fearful to continue supplying inventory to a retailer's bankruptcy estate. This Comment demonstrates that not only are vendors fearful to engage with the retailer's bankruptcy estate, but their fear also undermines reorganization efforts. These effects are amplified in the current retail climate, which has been plagued by an onslaught of chapter 11 bankruptcies.

Vendor fear in the current retail climate is a catalyst for a critical vendor codification solution. Critical vendor payments are a widely adopted practice in the bankruptcy system but completely lack codification within the Bankruptcy Code. Though existing common law tests provide some guidance, the lack of uniformity across judges and jurisdictions has cultivated the current chaotic critical vendor standard. This Comment surveys the application of and discrepancies between existing critical vendor tests by judges in prominent jurisdictions including Illinois, Texas, Virginia, Delaware, and New York. This Comment proposes a test for codified clarity of critical vendor payments hoping to alleviate vendor fear and bolster the chances of a retailer's successful reorganization.

INTRODUCTION

“Critical vendor” payments are a widely adopted practice in the bankruptcy system but completely lack codification within the Bankruptcy Code.¹ Instead, these payments are grounded in judicial discretion and, as such, critical vendor tests vary across judges and jurisdictions. Depending on the jurisdiction, critical vendor payments may be analyzed in an elemental test, be considered controversial, or even be revoked after the fact. Understandably, legal discrepancy has generated skepticism among vendors. Vendors fear throwing good money after bad when they continue to deal with the ongoing business of the bankruptcy estate. Vendors also fear a detrimental reliance on payments received from the debtor that could later be revoked by the court. Without certainty of a legal standard, some debtors have reported a critical vendor “fear factor,” which discourages them from engaging with the bankruptcy estate.²

Vendor fear is especially relevant in light of the current economic climate where the “retail apocalypse” looms large over the present national and global economies. The term “retail apocalypse” emerged as a result of recent stress on the retail industry, forcing thousands of store closures.³ The culmination of these store closures resulted in an onslaught of retailers filing for chapter 11 bankruptcy.⁴ 2020 is expected to have the highest number of retail bankruptcies in a decade.⁵ Given this national trend of retailer bankruptcy amidst the “retail apocalypse,” it is imperative that distressed retailers be afforded clarity in critical vendor payments. Codified clarity of critical vendor payments may encourage vendors to continue engaging with the ongoing business of the debtor. The benefit of continued engagement is an increased likelihood of a successful chapter 11 reorganization. A successful chapter 11 reorganization, as opposed to a chapter 7 liquidation, generates value above and beyond liquidation value both for the creditors and the bankruptcy estate. Due to the lack of a uniform standard, however, the critical vendor fear factor in the current retail apocalypse

¹ The “critical vendor” classification in chapter 11 bankruptcies permits preferential payment to unsecured creditors. Allowing preference to critical vendors preserves trade credits imperative to conserve liquidity during reorganization.

² Vince Sullivan, *J&M Vendors’ Skittishness Threatens Ch. 11 Plan Hopes*, LAW 360 (Sept. 20, 2018), <https://www.law360.com/articles/1084663/j-m-vendors-skittishness-threatens-ch-11-plan-hopes>.

³ Bradford J. Sandler & Jonathan J. Kim, *Navigating the Retail Apocalypse*, 262 N.Y. L.J. 59 (2019).

⁴ See Hayley Peterson, *Store Closings in 2019 List*, BUS. INSIDER (Dec. 23, 2019, 1:25 PM), <https://www.businessinsider.com/stores-closing-in-2019-list-2019-3> (“More than 9,300 stores are closing in 2019 as the retail apocalypse drags on”).

⁵ Melissa Repko & Lauren Thomas, *As Pandemic Stretches On, Retail Bankruptcies Approach Highest Number in a Decade*, CNBC (Aug. 3, 2020 4:29 PM), <https://www.cnbc.com/2020/08/03/with-pandemic-retail-bankruptcies-approach-highest-number-in-a-decade.html> (“according to S&P Global Market Intelligence.”).

could result in a catastrophic number of conversions to complete liquidations. In contrast, a codified critical vendor standard payment would help preserve liquidity in organization and provide equitable treatment to creditors.

This Comment addresses how codification of a proposed critical vendor test may alleviate vendor fears of relying on court orders to grant critical vendor payment. First, this Comment surveys the legal framework and underlying authority that justifies critical vendor payments in the bankruptcy system. Second, this Comment analyzes the application of and discrepancies between existing critical vendor tests by judges in prominent jurisdictions. These jurisdictions include Illinois, Texas, Virginia, Delaware, and New York. Third, this Comment analyzes why vendors are fearful of engaging with a debtor's ongoing business and how this fear harms the chances of a retailer's successful reorganization. The impact of this harm is then multiplied by the current "retail apocalypse". Fourth and finally, this Comment proposes a test for codification. This Comment demonstrates that a codified critical vendor test would ease vendor fears to engage in the debtors' business, thus increasing the likelihood of a successful reorganization.

I. BACKGROUND

Critical vendor payments have not yet been codified in the Code but are a regular practice in bankruptcy proceedings.⁶ Without codification, the general framework of a chapter 11 bankruptcy, its underlying authority, and its current procedure are even more essential to understanding critical vendor payments in the current retail climate. Accordingly, this Section briefly discusses the framework of a chapter 11 bankruptcy, the underlying authority for critical vendor payments given the lack of codification, and the current bankruptcy court procedure to grant or deny such payments.

A. *Fundamental Framework of a Chapter 11 Reorganization*

The general chapter 11 framework offers insight into both the historical origins and modern interpretation of critical vendors. The principal goal of a chapter 11 bankruptcy is to allow the debtor to reorganize as opposed to liquidate in order to generate a higher going concern value.⁷ A chapter 11 bankruptcy

⁶ See Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Opens the Creditor's Bargain*, 99 VA. L. REV. 1235, 1256 (2013) ("While no explicit statutory authority supports these payments, a bankruptcy court could authorize them if they enhanced the bankrupt's overall value, benefiting all creditors.").

⁷ *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973, 978 (2017) ("In Chapter 7, a trustee liquidates the

vests the ongoing business in the debtor by continuing operations and paying creditors back a higher value than would be possible in a liquidation but over time.⁸ When a debtor files for a chapter 11 bankruptcy, the debtor has three possible outcomes: (1) a bankruptcy-court-confirmed plan to reorganize; (2) a conversion to a chapter 7 liquidation; or (3) a dismissal of the chapter 11 case.⁹ When the bankruptcy court confirms a chapter 11 plan, business operations continue in order to pay creditors a greater value over time.¹⁰ In contrast, conversion to a chapter 7 liquidation is caused by the debtor's inability to confirm or comply with a reorganization plan.¹¹ Finally, the last possible outcome, dismissal of a chapter 11 case, merely returns the debtor to a prepetition status quo.¹² The chapter 11 codified framework is important to better understanding the judicial discretion behind granting motions for critical vendor payments.

B. Underlying Authority for Critical Vendor Payments

Without express codification, the underlying authority for critical vendor payment draws from both equitable doctrines of the common law and the Code. Specifically, these authorities include the "doctrine of necessity," section 363(b), and section 105(a).

1. Doctrine of Necessity

The common law origination for the critical vendor payments is known as the doctrine of necessity and was established by the Supreme Court in *Miltenberger*.¹³ The doctrine of necessity historically maintained that an equity receiver may have discretion, as granted by the court, to pay debts when

debtor's assets and distributes them to creditors. In Chapter 11, debtor and creditors try to negotiate a plan that will govern the distribution of valuable assets from the debtor's estate and often keep the business operating as a going concern.") (internal citations omitted).

⁸ *Id.* at 979 ("Such a plan may keep the business operating but, at the same time, help creditors by providing for payments, perhaps over time.").

⁹ *Id.*

¹⁰ *Id.* ("It is important to keep in mind that Chapter 11 foresees three possible outcomes. The first is a bankruptcy-court-confirmed plan. Such a plan may keep the business operating but, at the same time, help creditors by providing for payments, perhaps over time.").

¹¹ *Id.* ("The second possible outcome is conversion of the case to a Chapter 7 proceeding for liquidation of the business and a distribution of its remaining assets. That conversion in effect confesses an inability to find a plan." (internal citations omitted)).

¹² *Id.* ("The third possible outcome is dismissal of the Chapter 11 case. A dismissal typically 'revests the property of the estate in the entity in which such property was vested immediately before the commencement of the 'case'—in other words, it aims to return to the prepetition financial status quo." (internal citations omitted)).

¹³ *Miltenberger v. Logansport, C. & S.W. R. Co.*, 106 U.S. 286 (1882).

“necessary and indispensable” for the continued operation of the business.¹⁴ Paying necessary and indispensable debts allows the equity receiver to protect and preserve the value of property in his care. Some courts today still apply the doctrine of necessity under the belief that equality of treatment is necessary for an effective reorganization.¹⁵

2. *Bankruptcy Code Section 363(b)*

Code section 363(b) is commonly referenced in judicial decisions to grant or deny a motion for critical vendor payments. Broad authority under section 363(b) loosely justifies critical vendor payments where a sound business purpose exists for doing so.¹⁶ The business purpose justification is expressly stated in section 363(b)(1): “[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.”¹⁷ In *Tropical Sportswear*, the court stated, “[b]ankruptcy courts recognize that section 363 is a source of authority to make critical vendor payments and section 105 is used to fill in the blanks.”¹⁸

3. *Bankruptcy Code Section 105(a)*

Often, filling in the blanks of section 363(b) to justify critical vendor payments is analogous to Code section 105(a). Section 105(a) is a broad grant of equitable powers to the bankruptcy court as a matter of judicial discretion.¹⁹

The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.²⁰

¹⁴ *Miltenberger*, 106 U.S. at 311.

¹⁵ See *In re Pioneer Health Services*, 570 B.R. 228, 232–33 (Bankr. S.D. Miss. 2017).

¹⁶ See *In re Kmart*, 359 F.3d 866, 872 (7th Cir. 2004) (recognizing prepetition claims may be paid under 363 but holding that the debtor’s evidentiary record did not support such payment regarding prepetition claims of vendors); *In re UAL Corp.*, 2002 Bankr. LEXIS 1943, at *3 (Bankr. N.D. Ill. Dec. 9, 2002) (Order granting debtors authority pursuant to sections 105(a), 363(c), 1107(a) and 1108 of the Code to pay prepetition obligations).

¹⁷ 11 U.S.C. § 363(b)(1) (2019).

¹⁸ *In re Tropical Sportswear Int’l Corp.*, 320 B.R. 15, 20 (Bankr. M.D. Fla. 2005).

¹⁹ 11 U.S.C. § 105.

²⁰ *Id.*

Under this grant of equitable powers and in connection with section 363(b), section 105(a) is regularly used to justify critical vendor payments by bankruptcy courts.

C. Critical Vendor Court Procedure

The procedure for motions and orders for critical vendor payments follow the same general format. To protect the chances of a successful reorganization in chapter 11, debtors seek to pay critical vendors' prepetition debts in contravention of codified priority.²¹ In return for payment, critical vendors agree to continue providing the debtor in possession with the goods and services essential to the business.²² The continued business relationship between the critical vendors and the debtor allows the debtor to continue operations in the ordinary course of business.²³ With continued business operations at stake, debtors file a motion with the bankruptcy court seeking permission to pay critical vendors' prepetition debts before they stop dealing with the debtor entirely.²⁴ Critical vendor motions can be filed in the first day motions²⁵ or filed in an emergency motion later.²⁶ Motions may be granted by the court when such payment enhances the bankruptcy estate to the benefit of all creditors.²⁷

II. ANALYSIS

A. Tests for Critical Vendor Payment Vary Across Judges and Jurisdictions

In the absence of express codification, motions to pay critical vendors are

²¹ Bruce S. Nathan, "Critical Vendor" Status Is No Escape from Preference Risk, *BUS. CREDIT*, November/December 2005, at 2 ("vendors receive quicker payment of all or a portion of their pre-petition unsecured claims. On the other hand, the debtor's other unsecured creditors have to wait until the end of the case for the disposition of their claims. . . .")

²² *Id.* at 1 (Despite *Kmart*, courts have continued to approve payments to critical vendor's prepetition unsecured claims.).

²³ *See id.*

²⁴ Jason B. Binford, *Not All Creditors Are Created Equal: Critical Vendors and Bankruptcy*, *NAT'L L. REV.* (Sept. 5, 2019), <https://www.natlawreview.com/article/not-all-creditors-are-created-equal-critical-vendors-and-bankruptcy> ("In large to mid-size Chapter 11 bankruptcy cases, critical vendor motions are quite typical. Such motions are filed at the beginning of the case and allow for a certain amount of funds to be used by the debtor to pay the claims of critical vendors.").

²⁵ *In re CoServ, LLC*, 273 B.R. 487, 490 (Bankr. N.D. Tex. 2002) ("Debtors filed the Motion contemporaneously with their petition with other 'first-day pleadings.'").

²⁶ *See* Emergency Motion for Authority to Pay the Prepetition Claims of Certain Critical Vendors at 1, 5, *In re New Athens Home for the Aged*, No. 3:18-bk-30148 (Bankr. S.D. Ill. 2019) (granted) [hereinafter *New Athens Home Emergency Motion*].

²⁷ *Roe & Tung*, *supra* note 6, at 1256 ("While no explicit statutory authority supports these payments, a bankruptcy court could authorize them if they enhanced the bankrupt's overall value, benefiting all creditors.").

granted or denied as a matter of judicial discretion.²⁸ Because of this judicial discretion, it becomes important to evaluate judicial opinions and orders across jurisdictions over time to understand the various critical vendor tests. Analysis of critical vendor tests by jurisdiction and judge is beneficial to recognizing the variety of tests applied regularly in bankruptcy proceedings. The jurisdictions analyzed in this Comment contain prominent bankruptcy courts and bankruptcy judges. These jurisdictions include the Northern District of Illinois, the Northern District of Texas, the Southern District of Texas, the Eastern District of Virginia, the District of Delaware, and the Southern District of New York. When critical vendor tests are analyzed across these jurisdictions and judges, it becomes clear that the absence of a codified provision has cultivated a chaotic environment with disparate critical vendor standards.

1. Illinois

Bankruptcy judges in Illinois regularly adhere to the same judicial test for granting critical vendor motions. *In re Kmart*, decided by Judge Easterbrook in the Seventh Circuit, continues to govern critical vendor motions in Illinois. The opinion in *Kmart* establishes a three-prong test for critical vendor payment.²⁹ First, the payments of prepetition debt must be necessary for a successful reorganization.³⁰ Second, as a result of the payment of prepetition debt, other disfavored vendors would be better off or at least no worse off.³¹ Third, if the outstanding prepetition debt was not paid, the vendor in question would cease doing business with the debtor.³² The next Section analyzes critical vendor motions in the Northern District of Illinois. Collectively analyzed, these motions indicate the continued application of the *Kmart* test.

²⁸ See *Roe & Tung*, *supra* note 6, at 1256.

²⁹ *In re Kmart Corp.*, 359 F.3d 866, 873 (7th Cir. 2004).

³⁰ The Seventh Circuit wanted to ensure that payments superseding the priority scheme truly went to critical vendors, finding:

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. If paying the critical vendors would enable a successful reorganization and make even the disfavored creditors better off, then all creditors favor payment whether or not they are designated as “critical.”

Id. at 872–73.

³¹ *Id.* at 873.

³² *Id.* (“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.”)

a. *The Kmart Critical Vendor Test*

In *Kmart*, the debtor, Kmart, sought permission to pay critical vendors immediately and in full.³³ Specifically, Kmart sought to pay 2,330 suppliers roughly \$300 million from debtor in possession financing.³⁴ The critical vendor motion was initially granted by the bankruptcy court. Fourteen months later the motion was reversed by the district court.³⁵ Subsequently, debtors appealed, and the issue was brought before the Seventh Circuit to decide.³⁶

In his opinion, Judge Easterbrook gave a colorful critique of the misapplication of equitable powers mentioned in section 105(a) and rejected of the doctrine of necessity as it pertained to critical vendor payments. Judge Easterbrook explained that section 105(a) “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.”³⁷ Instead, Judge Easterbrook argued that section 105(a) is a power to implement rather than override the Code.³⁸ In contrast to his interpretation of section 105(a), Judge Easterbrook flatly rejected the doctrine of necessity, stating that the “‘doctrine of necessity’ is just a fancy name for a power to depart from the Code.”³⁹ Concerned about departure from the Code, Judge Easterbrook asked: “So does the Code contain any grant of authority for debtors to prefer some vendors over others?”⁴⁰ In answering this question, Judge Easterbrook established the *Kmart* test.

Even though Judge Easterbrook rejected the doctrine of necessity as a justification for critical vendor payments, his opinion acknowledged that the test could be justified through statutory reliance on the Code in sections 363(b)(1)⁴¹ and 105(a).⁴² Section 363(b)(1) confers authority to the trustee in the bankruptcy proceeding to use the property of the estate.⁴³ Specifically, the Code states that “[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the

³³ *Id.* at 868.

³⁴ *Id.* at 869.

³⁵ *Id.* at 868–69.

³⁶ *See id.* at 866.

³⁷ *Id.* at 871 (*citing In re Chicago, Milwaukee, St. Paul & Pacific R.R.*, 791 F.2d 524, 528 (7th Cir. 1986)).

³⁸ *Id.* at 871.

³⁹ *Id.*

⁴⁰ *Id.* at 872.

⁴¹ *Id.* at 872–73 (Suggesting that § 363(b)(1) is similar in theory to a cram down with the impaired class doing at least as well under a chapter 7 liquidation.).

⁴² *Id.* at 871 (the broad judicial authority of § 105(a) is a power to implement rather than override the Code).

⁴³ 11 U.S.C. § 363(b)(1) (2019).

ordinary course of business, property of the estate.”⁴⁴ Filling in the blanks of section 363(b) is section 105(a), which grants broad equitable powers to the bankruptcy court.⁴⁵ Section 105(a) permits the court to act when it is “necessary or appropriate to carry out the provisions of this title.”⁴⁶ Pursuant to this opinion, bankruptcy judges in the Northern District of Illinois apply the *Kmart* test.

Rooted in the authority granted by sections 363(b) and 105(a), the *Kmart* test establishes three elements that critical vendor payments must satisfy to be granted a prepetition claim in the Seventh Circuit.⁴⁷ First, payments of prepetition debt to critical vendors must be necessary for a successful reorganization.⁴⁸ Second, as a result of the critical vendor payment of prepetition debt, other disfavored vendors would be better off or at least no worse off.⁴⁹ Third, if the outstanding prepetition debt were not paid to critical vendors, the critical vendors in question would cease doing business with the debtor.⁵⁰ The debtor, Kmart, failed to satisfy the three elements for payment to critical vendors and the judgment of the bankruptcy court was affirmed.⁵¹

b. Application of the Kmart test

Since the *Kmart* opinion, bankruptcy courts in the Northern District of Illinois have authorized numerous critical vendor payments pursuant to the holding.⁵² For example, Judge Cox authorized for critical vendor payments not to exceed \$7 million on interim order and \$8.2 million on final order in *In re Edison Mission Energy*.⁵³ In *Edison Mission Energy*, the debtors determined

⁴⁴ *Id.*

⁴⁵ 11 U.S.C. § 105(a).

⁴⁶ *Id.*

⁴⁷ *In re CoServ, LLC*, 273 B.R. 487, 498 (Bankr. N.D. Tex. 2002) (summarizing the three elements established in *Kmart*).

⁴⁸ See *In re Kmart Corp.*, 359 F.3d 866, 872–74 (7th Cir. 2004).

⁴⁹ See *id.* at 868–73.

⁵⁰ See *id.* at 868–74.

⁵¹ *Id.* at 873–74.

⁵² See New Athens Home Emergency Motion, *supra* note 26, at 5; Debtors’ Motion to Approve Payment of Prepetition Claims of Certain Vendors and to Authorize Procedures Related Thereto at 16, *In re Edison Mission Energy*, No. 1:12-bk-49219 (Bankr. N.D. Ill. 2016) (granted) [hereinafter Edison Mission Motion to Approve Payment]; Debtors’ Motion for Entry Of An Order (A) Authorizing Payment Of Certain Critical Pre-Petition Obligations, And (B) Directing All Banks To Honor Pre-Petition Checks For Payment Of Said Obligations at 44, *In re R & M Aviation Inc.*, No. 1:12-bk-10343 (Bankr. N.D. Ill. 2013) (granted) [hereinafter R&M Aviation Debtors’ Motion For Entry]; Order (J) Authorizing (A) Payment Of Certain Critical Pre-Petition Obligations, And (B) Directing All Banks To Honor Pre-Petition Checks For Payment Of Said Obligations at 10, *In re Ryan International Airlines, Inc.*, No. 3:12-bk-80802 (Bankr. N.D. Ill. Mar. 7, 2012) [hereinafter Ryan Int’l Order Authorizing Payment] (authorizing payments to critical vendors).

⁵³ Interim Order (A) Approving Payment of Prepetition Claims of Certain Vendors and (B) Authorizing Procedures Related Thereto at 1, *In re Edison Mission Energy*, No. 1:12-bk-49219 (Bankr. N.D. Ill. Dec. 17,

their list of critical vendors by applying the three elements of the *Kmart* test in their motion.⁵⁴ Because the debtors met each element of the *Kmart* test, the debtors' request was granted, and they received payment that was "absolutely necessary to maximizing enterprise value."⁵⁵

In another case, Judge Hollis authorized "payment by the Debtors of the very limited number of truly 'critical' vendors . . . satisfy[ing] that requirement of the *Kmart* decision,"⁵⁶ when it was in "the best interests of the Debtor's estates."⁵⁷ Judge Hollis noted in the order that "absent the relief granted herein, the Debtors would suffer 'immediate and irreparable harm,' as such term used in Bankruptcy Rule 6003 and that the payments requested herein may benefit all creditors and not just those being paid. . . ."⁵⁸ Likewise, Judge Barbosa has also authorized payment on similar basis.⁵⁹ Among many other orders, Judge Grandy authorized critical vendor payments when the "[d]ebtor is located in a small rural facility and obtaining goods and services from replacement vendors and providers is difficult to impossible," and in accordance with the *Kmart* test.⁶⁰ As such, the Northern District of Illinois continues to adhere to the *Kmart* test precedent.

2. Texas

Judge Lynn of the Northern District of Texas, now retired, developed a new three-part test resolving the justification for critical vendor payments.⁶¹ The *CoServ* test comprises three elements that must be satisfied.⁶² First, it must be critical for the debtor to pay the vendor's prepetition claim.⁶³ Second, unless the debtor pays the vendor's prepetition claim, the debtor risks the going concern of the business disproportionate to the vendor's claim.⁶⁴ Third, paying the vendor's

2012).

⁵⁴ See Edison Mission Motion to Approve Payment, *supra* note 52, at 4 (Critical vendor service was essential when the vendors were sole or limited providers, required compliance under law, provided custom products not otherwise available in a reasonable time, and/or had a unique knowledge of the debtor's business).

⁵⁵ Edison Mission Motion to Approve Payment, *supra* note 52, at 3.

⁵⁶ R&M Aviation Debtors' Motion for Entry, *supra* note 52, at 5–6.

⁵⁷ Ryan Int'l Order Authorizing Payment, *supra* note 52, at 1.

⁵⁸ Order (I) Authorizing (A) Payment of Certain Critical Pre-petition Obligations, and (B) Directing All Banks to Honor Pre-petition Checks for Payment of Said Obligations at 1, *In re R & M Aviation, Inc., et al.*, No. 1:12-bk-10343 (Bankr. N.D. Ill. Mar. 15, 2012).

⁵⁹ *Id.* at 1.

⁶⁰ New Athens Home Emergency Motion, *supra* note 26, at 5.

⁶¹ *In re CoServ, LLC*, 273 B.R. 487, 490 (Bankr. N.D. Tex. 2002) ("Debtors filed the Motion contemporaneously with their petition with other first-day pleadings The Court held hearings on first day pleadings on December 4, 2001." (internal quotations removed)).

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

prepetition claim is the only option when there is no practical or legal alternative.⁶⁵ This three-prong test is regularly applied and satisfied for orders granting critical vendor payments in Texas bankruptcy courts. Critical vendor motions analyzed in this section arise out of the Northern District of Texas and Southern District of Texas bankruptcy courts. Collectively, orders granting or denying critical vendor payments indicate the regular application of the *CoServ* test in the Northern District of Texas but less consistent application in the Southern District of Texas. Analysis first begins with the *CoServ* case and its authority, followed by the application of *CoServ* test in Texas bankruptcy cases since the opinion in 2002.

a. The CoServ Critical Vendor Test

The *CoServ* test arose out of the debtors' Emergency Motion for Order Authorizing Payment of Prepetition Claims of Critical Vendors.⁶⁶ Of all vendors, the debtor pared down a list to only seven critical vendors to whom the debtor wished to pay \$563,183 of prepetition claims in the critical vendor motion.⁶⁷ The debtors' business consisted of providing telecommunication services, cable television, and website development in North Texas.⁶⁸ In some areas of North Texas, the debtors were the only providers of these services.⁶⁹ Though the critical vendor motion was unopposed, Judge Lynn evaluated the motion as a contested matter to fulfill the court's "independent obligation to ensure that the Bankruptcy Code is complied with."⁷⁰ In evaluation of the contested matter, Judge Lynn asked three questions.⁷¹

First, Judge Lynn asked whether a bankruptcy court may ever authorize a chapter 11 debtor to pay prepetition general unsecured claims before a plan is filed.⁷² In response, Judge Lynn found that the court's equitable powers of section 105(a) provided enough muscle.⁷³ "Only Section 105(a) offers the equitable muscle that would allow a bankruptcy court to violate one of the principal tenets of [c]hapter 11: that prepetition general unsecured claims should

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.* at 490.

⁶⁸ *Id.* at 489.

⁶⁹ *Id.*

⁷⁰ *Id.* at 490–91.

⁷¹ *Id.* at 491.

⁷² *Id.*

⁷³ *Id.* at 493 ("The Court finds no support in Section 549 or Section 363(b)(1) for payment of prepetition claims").

be satisfied on an equal basis pursuant to a plan.”⁷⁴ That muscle, however, is merited “only under the most extraordinary circumstances.”⁷⁵ But, to get from section 105(a) to the doctrine of necessity—which permits payment of prepetition claims above secured creditors—Judge Lynn needed to bridge the Code to the common law doctrine.⁷⁶ The bridge between section 105(a) and the doctrine of necessity arises from the unique role of the debtor in possession acting as the equivalent of a trustee.⁷⁷ As a debtor in possession, a chapter 11 debtor owes the bankruptcy estate a fiduciary duty to manage the ongoing business of the bankruptcy estate.⁷⁸ The fiduciary duty owed to the bankruptcy estate bridges the powers under 105(a) to the doctrine of necessity in order to allow payment to critical vendors when it is necessary to the success of the reorganization.⁷⁹ A debtor in possession assumes these implicit fiduciary duties to protect and preserve the estate.⁸⁰ Specifically, fiduciary duties include protecting the business’s going-concern value under sections 1106 and 704 of the Code.⁸¹ In protecting the business, Judge Lynn explained that “[t]here are occasions when this duty can only be fulfilled by the preplan satisfaction of a prepetition claim.”⁸² As such, the debtors were authorized by their fiduciary duties as debtor in possession, and Judge Lynn was justified “to apply the Doctrine of Necessity to authorize payment of prepetition claims in appropriate cases.”⁸³

Second, Judge Lynn asked what test the bankruptcy court should apply in deciding whether a claim should be paid.⁸⁴ Judge Lynn noted the lack of uniformity across jurisdictions.⁸⁵ “None of the cases reviewed by the Court, however, articulates a clear standard for when Section 105(a) may be so used.”⁸⁶ Given the lack of a clear standard to apply section 105(a), it became important

⁷⁴ *Id.*

⁷⁵ *Id.* at 493–94.

⁷⁶ *Id.* at 496–97.

⁷⁷ *Id.* at 497.

⁷⁸ *Id.*

⁷⁹ *Id.* (analogizing a debtor in possession’s role to a trustee with a fiduciary duty to operate the business to the benefit of the estate).

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.* at 491.

⁸⁵ *Id.* at 495 (“Though courts in the Second, Third and Seventh Circuits have authorized payment of prepetition debt, the Fifth Circuit, among others, has come perilously close to the view of the bankruptcy court for the District of Montana.”).

⁸⁶ *Id.* at 497.

that the guidelines were stated with specificity.⁸⁷ As such, Judge Lynn adopted the *CoServ* three-part test to resolve whether a general unsecured prepetition claim to a critical vendor could be paid in priority.⁸⁸

First, it must be critical that the debtor deal with the claimant. Second, unless it deals with the claimant, the debtor risks the probability of harm, or, alternatively, loss of economic advantage to the estate or the debtor's going concern value, which is disproportionate to the amount of the claimant's prepetition claim. Third, there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim.⁸⁹

These three elements of the *CoServ* test permit courts to authorize payment of the prepetition critical vendor claim.⁹⁰

Third, Judge Lynn asked which prepetition critical vendor claims the court should authorize in the *CoServ* case.⁹¹ In the test's first application, Judge Lynn authorized the debtors to pay only two of the seven critical vendors in the motions, referencing the debtors' failure to show a lack of necessity and the existence of alternatives to payment.⁹² Of the two approved vendors, Judge Lynn approved the payment to a contract employee when the "claim of \$ 3,500 is thus either wages or the cost of assumption of a contract. In either event, it is payable under a legal theory other than the Doctrine of Necessity."⁹³ Judge Lynn also approved payment to a traffic services engineer with a unique understanding of the debtors' system.⁹⁴ If the engineer was not provided critical vendor payments, the bankruptcy estate would be at substantial risk.⁹⁵ After *CoServ*, bankruptcy court judges across the Northern District of Texas regularly apply the three-prong test to determine when to authorize critical vendor payments.

b. Application of the CoServ Test

Since the *CoServ* opinion in 2002, bankruptcy courts in both the Northern District of Texas and the Southern District of Texas have authorized numerous critical vendor payments. Motions analyzed in this Section arise out of both

⁸⁷ *Id.* ("Because the bankruptcy court's equitable powers should be used sparingly in authoring payment of prepetition claims").

⁸⁸ *Id.* at 498.

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.* at 491.

⁹² *Id.* at 499-501.

⁹³ *Id.* at 501.

⁹⁴ *Id.* at 500.

⁹⁵ *Id.*

districts, indicating jurisdictional and judicial discrepancies in the application of the *CoServ* test. Bankruptcy judges in the Northern District of Texas often adhere to the test, while application of the test in the Southern District of Texas varies.

i. Northern District of Texas

The Northern District of Texas is comprised of a well-known bench of bankruptcy judges. Select judges are analyzed separately to observe differences in application of the *CoServ* test to grant critical vendor payment including Judge Lynn, Judge Houser, and Judge Hale.

Judge Lynn reaffirmed his commitment to the *CoServ* test in *In Re Mirant Corp.*⁹⁶ In *Mirant*, the debtors in possession were “among the most important providers of power in the United States.”⁹⁷ A disruption of the debtors’ services would have an “adverse effect on segments of the national economy.”⁹⁸ To prevent this adverse effect, the debtors sought to pay the prepetition claims of critical vendors.⁹⁹ As justification, the debtors argued that they deserve preferential treatment when payment would meet each *CoServ* element by a preponderance of the evidence.¹⁰⁰ In response to the debtors’ argument, Judge Lynn concluded that the consequences of the particular vendor’s failure to provide goods or services could have been disastrous.¹⁰¹ To avoid such disaster, Judge Lynn authorized payment of prepetition critical vendor debts using the *CoServ* test.¹⁰² The debtors were further authorized to pay the prepetition claims of any entity that refused to deal with the debtor absent payment to continue their respective businesses,¹⁰³ provided that such business was not in violation of the section 362(a)(6) automatic stay.¹⁰⁴

Only a year after *Mirant*, Judge Lynn further articulated the specifics of applying the *CoServ* test. In a hearing regarding an otherwise unopposed critical vendor motion, Judge Lynn held that a vendor would be in violation of the automatic stay when it conditioned future performance on payment of

⁹⁶ See *In re Mirant Corp.*, 296 B.R. 427, 430 (Bankr. N.D. Tex. 2003).

⁹⁷ *Id.* at 428.

⁹⁸ *Id.*

⁹⁹ *Id.* at 429.

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Id.* at 430. (When debtors reasonably believe in the exercise of their business judgment that critical vendor payments must be made to continue the business.).

¹⁰⁴ *Id.*

prepetition debt.¹⁰⁵ Judge Lynn explained to the vendor that the *CoServ* test must be argued and met by the debtor, not a creditor.¹⁰⁶ “But you mistake the *CoServ* test. The *CoServ* test is the test the Debtor must meet to pay. It’s not necessarily the test that must be met to keep the creditor from violating the stay by demanding payment.”¹⁰⁷ If vendors were given the opportunity to move for critical vendor payment, such authorization would give license to violate the automatic stay and be used as leverage for payment.¹⁰⁸ Judge Lynn ultimately answered the debtor’s request: “I’ll let you pay them, but then you’re going to come in for the order to show cause why you shouldn’t be held in contempt for violating the stay for forcing them to pay you, if that’s the case.”¹⁰⁹

Subsequently, Judge Lynn has granted numerous critical vendor motions. Judge Lynn granted the debtors’ motion to pay prepetition debt to critical vendors with cash collateral.¹¹⁰ Judge Lynn also carved out a narrow exception and allowed the *CoServ* test to be applied to prepetition vendors of a prepackaged chapter 11 plan.¹¹¹ Following *CoServ*, Judge Lynn granted multiple motions to pay critical vendors where “the Debtor [was] only seeking to pay those Critical Vendors who are absolutely vital to the continuation of the Debtor’s business and who will be providing substantial postpetition administrative services for the benefit of the estate.”¹¹²

Other judges from the Northern District of Texas apply the *CoServ* test when granting critical vendor payments. Both Chief Judge Houser and Judge Hale grant critical vendor motions that comply with the three *CoServ* elements. An

¹⁰⁵ Transcript of Proceedings Before the Honorable D. Michael Lynn, United States Bankruptcy Judge at 11–12, *In re* Thompson Restaurant Management, Inc., et. al., No. 4:04-bk-91103 (Bankr. N.D. Tex. Nov. 15, 2004) [hereinafter Thompson Transcript].

¹⁰⁶ Thompson Transcript, *supra* note 105, at 14–15.

¹⁰⁷ Thompson Transcript, *supra* note 105, at 14–15.

¹⁰⁸ Thompson Transcript, *supra* note 105, at 11.

¹⁰⁹ Thompson Transcript, *supra* note 105, at 15.

¹¹⁰ Order at 1, *In re* Images Cosmetic & Laser Center, LLC, No. 4:11-bk-44718 (Bankr. N.D. Tex. Aug. 19, 2011) (“Came on to be considered Debtor’s Motion to Pay Pre-petition Debt to Critical Vendors. The court finds that such motion should be granted. It is Hereby Ordered that Debtor’s motion to pay pre-petition Debt to Critical Vendor “PSS” in the amount of \$4600, be and is hereby approved.”) (emphasis removed).

¹¹¹ Interim Order Pursuant to Sections 105(a) and 363(b) of the Bankruptcy Code for Authorization to Pay Prepetition Claims of Certain Creditors in the Ordinary Course of Business at 2–3, *In re* Texas Rangers Baseball Partners, No. 4:10-bk-43400 (Bankr. N.D. Tex. May 24, 2010) (granting the motion and noting that the motion provided sufficient legal and factual cause to grant relief in that it was in the best interest of “the Debtor, its estate, creditors, and all parties in interest”); Final Order Pursuant to Sections 105(a) and 363(b) of the Bankruptcy Code for Authorization to Pay Prepetition Claims of Certain Creditors in the Ordinary Course of Business at 3, *In re* Texas Rangers Baseball Partners, No. 4:10-bk-43400 (Bankr. N.D. Tex. June 10, 2010).

¹¹² Debtor’s Second Motion for Order Authorizing Debtor to Pay Critical Vendors at 7, *In re* West 380 Family Care Facility, No. 4:12-bk-46274 (Bankr. N.D. Tex. Dec. 13, 2012) (granted from the bench).

example of Chief Judge Houser's adherence to *CoServ* can be seen where the Chief Judge granted the debtors' motion for critical vendor payments when "[t]he overseas creditors specified as 'critical' clearly [fell] within the categories discussed in *CoServ* and *Mirant*."¹¹³ In the order, Chief Judge Houser stated that the critical vendor payment was "essential, appropriate, and in the best interests of the Debtors, their estates, and all parties-in-interest; and it appearing that such relief must be granted forthwith to avoid immediate and irreparable harm."¹¹⁴ Judge Hale also applies *CoServ*. Judge Hale issued an order stating that it was "economically inefficient to transition to a different vendor such that any change will be catastrophic for the Debtor."¹¹⁵ Demonstrated by Judge Lynn, Chief Judge Houser, and Judge Hale, the Bankruptcy Court in the Northern District of Texas adheres to the *CoServ* test.

ii. *Southern District of Texas*

The Southern District of Texas is also comprised of a well-known bench of bankruptcy judges. Analysis indicates that bankruptcy judges of the Southern District of Texas are less likely to follow the *CoServ* test than their neighboring northern jurisdiction. In fact, bankruptcy judges in the Southern District of Texas may be just as likely to apply other case law as they are to apply *CoServ*. The judges analyzed in this Section are Chief Judge Jones and Judge Isgur.

Chief Judge Jones has applied a variety of legal standards when granting critical vendor payments, including, but not limited to, the *CoServ* test.¹¹⁶ One of those other tests comes from *Transcom USA Mgmt. Co.*, a case from the Southern District of Texas predating the *CoServ* opinion. This test is satisfied when good cause is shown.¹¹⁷ Further, Chief Judge Jones granted a debtor's

¹¹³ Debtors' Emergency Motion for Authority to Pay Pre-Petition Obligations to Certain Critical Overseas Vendors at 8, *In re Home Interiors & Gifts, Inc.*, No. 3:08-bk-31961 (Bankr. N.D. Tex. Apr 29, 2008) (granted).

¹¹⁴ Order Granting Debtors' Emergency Motion for Authority to Pay Pre-Petition Obligations to Certain Critical Overseas Vendors at 1-2, *In re Home Interiors & Gifts, Inc.*, No. 3:08-bk-31961 (Bankr. N.D. Tex. Apr 29, 2008).

¹¹⁵ Order Authorizing Debtor to Pay Critical Vendors at 1-2, *In re Auger Drilling, Inc.*, No. 3:19-bk-31410 (Bankr. N.D. Tex. May 2, 2019).

¹¹⁶ For example, Chief Judge Jones granted debtors' motion for critical vendor payments when such payment met each element of the *CoServ* test and was in the best interest of the debtors' estate. See Final Order (I) Authorizing, But Not Directing, Debtors to Pay Pre-petition Claims of Critical Vendors and (II) Authorizing and Directing Financial Institutions to Honor and Process Related Checks and Transfers at 2, *In re Geokinetics Inc.*, et al., No. 4:18-bk-33410 (Bankr. S.D. Tex. July 16, 2018).

¹¹⁷ Debtor's Emergency Motion for Order Authorizing Payment of Prepetition Claims of Critical Vendors at 7, *In re Suppies, Inc.*, No. 4:13-bk-36616 (Bankr. S.D. Tex. Oct. 28, 2013) (citing *In re Transcom USA Mgmt. Co.*, et. al, No. 01-35158- H5-11 (Bankr. S.D. Tex. May 16, 2001)); see Order Granting Emergency Motion for Order Authorizing Payment of Prepetition Claims of Critical Vendor at 1-2, *In re Suppies, Inc.*, No. 4:13-bk-36616 (Bankr. S.D. Tex. Oct. 30, 2013).

motion for critical vendor payment which cited to *Kmart*, *CoServ*, and *CEI Roofing*.¹¹⁸

Judge Isgur, much like Chief Judge Jones, applies *CoServ* in some cases, but not all, when deciding a motion for critical vendor payments. For example, Judge Isgur granted a motion for critical vendor payments that expressly held “payment of the Critical Vendor Claims meets each element of the *CoServ* court’s standard and is a valid exercise of the Debtors’ fiduciary duties to their estates.”¹¹⁹ However, Judge Isgur has also granted a motion for critical vendor payments that briefly referenced but did not apply the *CoServ* test as authority for payment.¹²⁰

Judge Isgur also granted a debtor’s motion for critical vendor payments that cited to *In re Equalnet Communications Corp.*,¹²¹ rather than *CoServ* entirely, finding payment necessary to the debtors’ reorganization.¹²² *Equalnet* recognizes the necessity of payment doctrine alone as sufficient authority to allow a bankruptcy court to grant critical vendor payments on prepetition claims.¹²³ “A bankruptcy court may authorize the payment of prepetition obligations when necessary to facilitate a debtor’s reorganization. This authority stems from the common-law ‘necessity of payment’ doctrine, which courts have applied when the failure to pay prepetition obligations poses a real and significant threat to a debtor’s reorganization.”¹²⁴ Evidenced by their court

¹¹⁸ *In re CEI Roofing, Inc.*, 315 B.R. 50, 52 (Bankr. N.D. Tex. 2004) (Debtors were authorized to pay prepetition wages and benefit plan contributions prior to confirmation of the plan. When granting the relief, the court reasoned that it could only apply 105(a) in conjunction with another section of the Bankruptcy Code in order to authorize payment.)

¹¹⁹ Debtors’ Emergency Motion for Entry of Interim and Final Order (I) Authorizing, But Not Directing, Payment of Certain Claims of Critical Vendors; (II) Approving Related Payment Procedures; and (III) Granting Certain Related Relief at 10. *In re Francis’ Drilling Fluids, Ltd.*, No. 4:18-bk-35441 (Bankr. S.D. Tex. Sept. 29, 2018) (granted).

¹²⁰ Debtor’s Emergency Motion for Order Authorizing Payment of Prepetition Obligations of Critical Vendor ACG Materials at 8, *In re Kaye & Sons Site Development, LLC*, No. 2:17-bk-20283 (Bankr. S.D. Tex. July 13, 2017); Order Authorizing Critical Vendor Payment at 1, *In re Kaye & Sons Site Development, LLC*, No. 2:17-bk-20283 (Bankr. S.D. Tex. July 17, 2017) (granted).

¹²¹ *In re Equalnet Comm. Corp.*, 258 B.R. 368, 369 (Bankr. S.D. Tex. 2001) (The court granted debtor’s emergency motion for critical vendor payments under the doctrine of necessity when the debtors’ sought to pay customers for prepetition billing errors in the ordinary course debtors’ business. The court further noted that the doctrine of necessity authorizes bankruptcy courts to pay critical vendors’ prepetition claims when such payment is vital to the continued business operations of the debtor.)

¹²² Emergency Motion to Compel Payment of Prepetition Invoices to Critical Vendors ESP Petrochemical, Inc. at 7-8, *In re Southcross Holdings LP, et. al.*, No. 2:16-bk-20111 (Bankr. S.D. Tex. Apr. 4, 2016) [hereinafter *Southcross Emergency Motion*] (granted); Order Authorizing Payment to ESP Petrochemical, Inc. at 2, *In re Southcross Holdings LP, et. al.*, No. 2:16-bk-20111 (Bankr. S.D. Tex. Apr. 4, 2016).

¹²³ See *In re Equalnet Comm.*, 258 B.R. at 369.

¹²⁴ *Southcross Emergency Motion*, *supra* note 122, at 7–8.

orders, Chief Judge Jones and Judge Isgur of the Bankruptcy Courts of the Southern District of Texas do not deny the application the *CoServ* test. The judges, however, are far less rigid than the Bankruptcy Courts of the Northern District of Texas in their adherence to the *CoServ* test.

3. *Virginia*

Like the Seventh Circuit and the Northern District of Texas, the Eastern District of Virginia also established a separate test for critical vendor payments in the early 2000s. *In re United American* established a three-element test which interpreted and applied the doctrine of necessity.¹²⁵ First, payment to critical vendors must be necessary to the debtor's successful reorganization.¹²⁶ Second, payment must be made in the debtor's sound business judgment.¹²⁷ Third, the payment does not result in unfair prejudice to other creditors.¹²⁸ *United American* is accepted and applied regularly as the test for critical vendor payments in the Bankruptcy Courts for the Eastern District of Virginia. With limited exception, these three prongs must be expressly satisfied in orders granting critical vendor payment in the Eastern District of Virginia. The critical vendor motions analyzed in this Section are those raised in the Eastern District of Virginia bankruptcy proceedings. Collectively analyzed, these motions indicate regular adherence to the *United American* three-prong test. Analysis begins with the *United American* case and its authority, followed by application of the *United American* test in the Eastern District of Virginia since the opinion in 2005.

a. *The United American Critical Vendor Test*

Judge Mayer's 2015 opinion in *In re United American*, established the Eastern District of Virginia test for critical vendor payments.¹²⁹ In the case, the debtor was a construction contractor who sought permission to pay critical vendors, including an electrical subcontractor and cabinet supplier.¹³⁰ With these payments and the vendor's continued services and supplies, the debtor hoped to complete a nearly finished construction project and provide the profits to the bankruptcy estate.¹³¹ In analyzing the critical vendor payments, Judge Mayer

¹²⁵ *In re United American, Inc.*, 327 B.R. 776, 782 (Bankr. E.D. Va. 2005).

¹²⁶ *Id.*

¹²⁷ *Id.* at 783–84.

¹²⁸ *Id.* at 784.

¹²⁹ *See id.* at 779.

¹³⁰ *Id.*

¹³¹ *Id.* at 779–81.

looked to both *Kmart* and *CoServ* as guideposts.¹³² Similar to those cases, *United American*'s analysis also relied heavily on the doctrine of necessity.¹³³ Specifically, the *United American* test aimed to narrowly construe judicial application of the doctrine of necessity.¹³⁴ This narrow construction was accomplished through drafting a three part test for critical vendor payment;¹³⁵ the three parts are: "(1) the vendor must be necessary for the successful reorganization of the debtor; (2) the transaction must be in the sound business judgment of the debtor; and (3) the favorable treatment of the critical vendor must not prejudice other unsecured creditors."¹³⁶ Under *United American*, all three elements must be satisfied to justify critical vendor payments.

The first element of the *United American* test requires that "the vendor must be necessary for the successful reorganization of the debtor."¹³⁷ This first element was supported by two cases, *In re NVR LP*, from the Eastern District of Virginia and *In re CoServ*, from the Northern District of Texas.¹³⁸ In *NVR*, the court held that prepetition payments to critical vendors must "show substantial necessity."¹³⁹ Both *United American* and *NVR* "underline the strictness of the necessity prong of the Doctrine of Necessity."¹⁴⁰ In *United American*, Judge Mayer explained "there are two aspects to necessity."¹⁴¹ First, there "must be no substitute vendor available even at a greater expense."¹⁴² Second, there must be no "practical or legal alternative" to deal with the claim.¹⁴³

The second element of the *United American* critical vendor test requires that payment be made in the sound business judgment of the debtor.¹⁴⁴ A payment made in sound business judgment "should provide an adequate and complete remedy, but not a windfall."¹⁴⁵ A complete remedy would also include an

¹³² *Id.* at 781–82.

¹³³ *Id.* at 781–83.

¹³⁴ *Id.* at 782 ("If there is to be a Doctrine of Necessity, it must be narrowly construed and sparingly applied. Three tests for the application of the Doctrine of Necessity have developed which, if applied, retain the narrowness and the exceptional quality of the Doctrine.")

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *See id.*

¹³⁹ *Id.* (citing *In re NVR L.P.*, 147 B.R. 126 (Bankr. E.D. Va. 1992); *In re CoServ, LLC*, 273 B.R. 487, 497 (Bankr. N.D. Tex. 2000)).

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² *Id.* ("There must be no substitute vendor available even at a greater expense. Alternative means of obtaining the vendor's cooperation in supplying his goods or services must be exhausted.")

¹⁴³ *Id.*

¹⁴⁴ *Id.* at 783–84.

¹⁴⁵ *Id.* at 784.

obligation on the critical vendors' part to provide future supplies to the debtor; even if a vendor is critical, requiring continued business with a debtor prevents abuse of the vendor's privileged position.¹⁴⁶

The third element of the *United American* critical vendor test is the absence of prejudice to other creditors.¹⁴⁷ Judge Mayer noted that “the application of the Doctrine of Necessity offends the principal of equal treatment of creditors less when the other creditors of the estate are not prejudiced—and may be benefitted—by its application.”¹⁴⁸ Essentially, Judge Mayer explained that payments to critical vendors should at the very least do no harm to other creditors of the bankruptcy estate.¹⁴⁹

Ultimately, Judge Mayer granted the debtors' motion to an electrical subcontractor and denied it for a cabinet supplier in the *United American* case.¹⁵⁰ The court held that payment to the cabinet supplier was not justified when viable alternatives were available.¹⁵¹ Judge Mayer did, however, grant critical vendor payment to an electrical subcontractor when payment would result in a positive net cash flow to the debtor to either bolster operations or pay creditors in liquidation.¹⁵² The *United American* test is now applied regularly in the Eastern District of Virginia to evaluate motions to pay critical vendors.

b. Application of the United American Test

Since the *United American* opinion, bankruptcy courts in the Eastern District of Virginia now authorize numerous critical vendor payments, with limited exception. The test is followed by Chief Judge Santoro, Judge Huennekens, and the U.S. Trustee of the Eastern District of Virginia.

Judge Huennekens regularly adheres to the *United American* test for critical vendor payments. Judge Huennekens granted a debtor's motion for critical vendor payment when the debtor satisfied each element of *United American* to the case at issue.¹⁵³ In a different case, Judge Huennekens granted debtors'

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* at 786.

¹⁵¹ *Id.* at 783.

¹⁵² *Id.* at 786.

¹⁵³ Debtor's Motion for Order Authorizing, But Not Requiring, Debtor to Pay Pre-Petition Claims of Certain "Critical Vendors" and Memorandum in Support Thereof at 3–5, *In re Kroppan Group, Inc.*, No. 3:07-bk-34143 (Bankr. E.D. Va. Nov. 7, 2007) (granted) (Debtors cite to *United American* and note that the *United American* factors have been followed in the Eastern District).

motion for critical vendor payments not to exceed \$44.5 million applying the *United American* test.¹⁵⁴ Judge Huennekens also granted a motion for critical vendor payments when the motion relied on the *United American* test and specifically noted that “[t]he Debtors submit that the requested relief represents a sound exercise of the Debtors’ business judgment and is justified under sections 105(a) and 363(b) of the Bankruptcy Code.”¹⁵⁵

In contrast, Judge Huennekens granted a motion for critical vendor payments in *In re Circuit City Stores* that neither cited, nor applied, the *United American* test.¹⁵⁶ Though the motion addressed the doctrine of necessity, Judge Huennekens ultimately granted authority for payment based on the debtors’ argument for justification under Rule 6003(b).¹⁵⁷

Chief Judge Santoro of the Bankruptcy Court for the Eastern District of Virginia, has denied a debtor’s motion for critical vendor payments pursuant to the U.S. Trustee’s objection that the debtor failed to satisfy the *United American* test.¹⁵⁸ Evidenced by motions for critical vendor payments both granted and

¹⁵⁴ Final Order, Pursuant to Sections 105(a), 363(b) and 503(b)(9) of the Bankruptcy Code, Authorizing the Debtors to Pay Prepetition Claims of Certain Essential Suppliers and Service Providers at 2, 18, *In re Alpha Natural Resources, Inc.*, No. 3:15-bk-33896 (Bankr. E.D. Va. Aug. 3, 2015) (The motion applied the *United American* test and argued that “the payment . . . [wa]s necessary and appropriate to (i) prevent serious disruptions to the Debtors’ business operations and (ii) preserve the going concern value of the Debtors’ businesses and the Debtors’ estates for the benefit of all stakeholders.”).

¹⁵⁵ Debtors’ Motion for Entry of Interim and Final Orders Authorizing (i) Payment of Certain Prepetition Claims of Critical Vendors, (ii) Payment of 503(b)(9) Claims to Certain Critical Vendors and (iii) Financial Institutions to Honor and Process Related Checks and Transfers at 20, *In re James River Coal Company*, No. 3:14-bk-31848 (Bankr. E.D. Va. Apr. 7, 2014) (motion granted on a final basis) (Where debtors were a coal company that purchased goods and services from vendors that were effectively the sole source suppliers without which the debtor could not operate.).

¹⁵⁶ See Motion of Debtors for Order Under Bankruptcy Code Sections 105(a), 363, and 366, and Bankruptcy Rule 6003 (I) Approving Debtors’ Adequate Assurance of Payment, (II) Establishing Procedures for Resolving Requests by Utility Companies for Additional Assurance of Payment, (III) Scheduling a Hearing with Respect to Contested Adequate Assurance of Payment Requests, and (IV) Authorizing Debtors to Pay Claims of a Third Party Vendor at 29-31, *In re Circuit City Stores, Inc.*, No. 3:08-bk-35653 (Bankr. E.D. Va. Nov. 10, 2008) [hereinafter *Circuit City Motion*] (granted); Order Under Bankruptcy Code Sections 105(a), 363, and 366, and Bankruptcy Rule 6003 (I) Approving Debtors’ Adequate Assurance of Payment, (II) Establishing Procedures for Resolving Requests by Utility Companies for Additional Assurance of Payment, (III) Scheduling a Hearing with Respect to Contested Adequate Assurance of Payment Requests, and (IV) Authorizing Debtors to Pay Claims of a Third Party Vendor at 14–15, *In re Circuit City Stores, Inc.*, No. 3:08-bk-35653 (Bankr. E.D. Va. Nov. 10, 2008).

¹⁵⁷ *Circuit City Motion*, *supra* note 156, at 29–30.

¹⁵⁸ See Order Sustaining U.S. Trustee’s Amended Objection to the Motion for Entry of Order to Pay Prepetition Claim of Sullivan, Andrews & Taylor, PC as Critical Vendor at 1, 3, *In re Wood Vending, Inc.*, No. 2:12-bk-73156 (Bankr. E.D. Va. Sept. 27, 2012) (Pursuant to the *United American* test, the U.S. Trustee objected that the debtors failed to satisfy the second element, lack of alternative, when “[i]t is unlikely that no practical or legal alternative to retaining SAT exists.”).

denied by Judge Huennekens and Chief Judge Santoro, bankruptcy courts in the Eastern District of Virginia regularly but do not exclusively adhere to the *United American* test.

4. *Delaware*

Unlike other jurisdictions, the Bankruptcy Courts in the District of Delaware have yet to opine their own common law test with regard to critical vendor payments. Given the lack of district precedent, judges in Delaware are free to apply the test, Code section, or doctrine of their choice. As a result, motions for critical vendor payments in the District of Delaware take on a comprehensive approach and refer to multiple independent sources of authority.

a. *Various Tests Adopted by Delaware Judges*

Without a jurisdiction-specific test, each bankruptcy judge in the District of Delaware is left to their own interpretation regarding a motion to pay critical vendors. Specifically, Judge Gross, Judge Sontchi, and Judge Walrath each rely on a variety of legal authorities in granting motions for critical vendor payment.

Judge Gross, who retired early in 2020,¹⁵⁹ relied on a variety of legal authorities in granting motions to pay prepetition claims of critical vendors. This is evidenced by the motions for critical vendor payments he granted. For example, Judge Gross granted debtors' motion for critical vendor payments of \$5.7 million when the motion for payment referenced the Code and three common law tests.¹⁶⁰ Code sections referenced in the motion included 363(b), 1107(a), and 1108.¹⁶¹ In addition to three provisions in the Code, the debtor also cited the *CoServ* test, the *Kmart* test, and the *Tropical Sportswear* test (this test conducts a similar section 363(b) analysis to *Kmart*).¹⁶² After analysis, the debtor settled on two tests that would both independently justify payment: the *Kmart* and *Tropical Sportswear* tests.¹⁶³ "The Relief Requested in this Motion easily satisfies the standards set forth in *Kmart* and *Tropical Sportswear*."¹⁶⁴ In a different bankruptcy case, Judge Gross granted debtors' motion for critical

¹⁵⁹ *Bankruptcy Judge Kevin Gross Joins Richards, Layton & Finger*, BLOOMBERG LAW (March 13, 2020), <https://news.bloomberglaw.com/bankruptcy-law/bankruptcy-judge-kevin-gross-joins-richards-layton-finger>.

¹⁶⁰ See Debtors' Motion for Authority to Pay Prepetition Claims of Critical Vendors at 15, *In re EG Liquidating Company, Ltd.*, et. al, No. 1:06-bk-10396 (Bankr. D. Del. Apr. 20, 2006) [hereinafter EG Liquidating Co. Motion] (granted).

¹⁶¹ EG Liquidating Co. Motion, *supra* note 160, at 15.

¹⁶² EG Liquidating Co. Motion, *supra* note 160, at 19–21.

¹⁶³ EG Liquidating Co. Motion, *supra* note 160, at 21.

¹⁶⁴ EG Liquidating Co. Motion, *supra* note 160, at 21.

vendor payments when “the relief requested [was] supported by sections 1107(a), 1108, and 363(c) of the Code.”¹⁶⁵ In other cases, Judge Gross has granted a debtor’s motions to pay critical vendors justified by sections 363(b) and 105(a) (paired with the doctrine of necessity).¹⁶⁶

Like Judge Gross, Judge Sontchi relies on a variety of legal authorities in evaluating critical vendor payments. Judge Sontchi granted a motion to pay critical vendors that relied on the distinct and independent authority of sections 1107(a) and 1108, 363(b), and 105(a) of the Code.¹⁶⁷ Judge Sontchi granted the order explaining that “[t]he Debtor is authorized, but not directed, pursuant to section 105(a), 363(b), and 503(b)(9) of the Bankruptcy Code, in the reasonable exercise of their business judgment, to pay some or all of the Critical Vendor Claims.”¹⁶⁸ Judge Sontchi also granted debtors’ motion to pay critical vendors that relied on Section 105(a) and section 363(b).¹⁶⁹

Similar to other judges, Judge Walrath also relies on a variety of legal authorities in evaluating critical vendor payments. For instance, Judge Walrath granted a debtor’s motion for critical vendor payments where debtors based their claims independently on sections 363(b) and 105(a).¹⁷⁰ Further, Judge Walrath granted a debtor’s motion for critical vendor payments where relief relied on

¹⁶⁵ Order Granting Debtor’s Motion Pursuant to Sections 105(a), 363(b), 1107(a) and 1108 of the Bankruptcy Code, (I) Authorizing the Debtor to Pay the Certain Prepetition Claims of a Critical Vendor, (II) Authorizing Banks to Honor and Process Check and Electronic Transfer Requests Related Thereto, and (III) Granting Certain Related Relief at 1, *In re Zumobi, Inc.*, No. 1:19-bk-12284 (Bankr. D. Del. Nov. 15, 2019).

¹⁶⁶ See Final Order, Pursuant to Sections 105(a), 363, and 1108 of the Bankruptcy Code: (I) Authorizing the Debtors to Pay Certain Prepetition Critical Vendor Claims; (II) Authorizing Banks to Honor and Process Check and Electronic Transfer Requests Related Thereto; and (III) Granting Certain Related Relief at 2-3, *In re F+W Media, Inc.*, No. 1:19-bk-10479 (Bankr. D. Del. Apr. 1, 2019); Order Granting Liquidating Trustee’s Motion for Entry of Order Authorizing Payment of Pre-Petition Claim of Certain Critical Vendor and Service Provider at 1, *In re Filip Technologies, Inc.*, No. 1:16-bk-12192 (Bankr. D. Del. May 12, 2017).

¹⁶⁷ Final Order Authorizing Payment of Prepetition Obligations Owed to Critical Vendors at 2, *In re Cedar Haven Acquisition, LLC*, No. 1:19-bk-11736 (Bankr. D. Del. Sept. 4, 2019) [hereinafter Cedar Haven Final Order].

¹⁶⁸ *Id.*

¹⁶⁹ Motion of the Debtors for Entry of Interim and Final Order (I) Authorizing the Debtors to Pay Prepetition Critical Vendor Claims and 503(b)(9) Claims in the Ordinary Course of Business, (II) Authorizing the Debtors to Return Goods, and (III) Granting Related Relief at 14, *In re Borden Dairy Company*, No. 1:20-bk-10010 (Bankr. D. Del. Jan. 5, 2020); Cedar Haven Final Order, *supra* note 167, at 2.

¹⁷⁰ Debtors’ Motion for Entry of Interim and Final Orders, Pursuant to Sections 105(a), 363, 1107(a), and 1108 of the Bankruptcy Code (I) Authorizing the Debtors to Pay Certain Pre-Petition Claims of Critical Vendors and (II) Authorizing and Directing Financial Institutions to Honor and Process checks and Transfers Related to Such Claims at 7–8, *In re HDR Holding, Inc.*, No. 1:19-bk-11396 (Bankr. D. Del. June 24, 2019); Final Order, Pursuant to Sections 105(a), 363, 1107(a) and 1108 of the Bankruptcy Code: (I) Authorizing the Debtors to Pay Certain Pre-Petition Claims of Critical Vendors and (II) Authorizing and Directing Financial Institutions to Honor and Process Checks and Transfers Related to Such Claims at 1, *In re HDR Holding, Inc.*, No. 1:19-bk-11396 (Bankr. D. Del. June 24, 2019).

several provisions in the Code including sections 363(b), 1107(a), 1108, and 105(a) with the doctrine of necessity.¹⁷¹

In light of the varying legal authorities in motions granted to pay critical vendors, the Bankruptcy Courts for District of Delaware have yet to establish a concrete common law test for critical vendors. As such, Judge Gross, now retired, Judge Sontchi, and Judge Walrath have looked to numerous sections of the Code for authority. Accordingly, motions for critical vendor payments take on a holistic approach and refer to each independent section for authority as a result.

5. *New York*

Rather than an elemental test like other districts, the United States Bankruptcy Court for the Southern District of New York relies on the Code for critical vendor payment authority. Critical vendor payments in the Southern District of New York are authorized under sections 105(a), 363(b) and 503(b)(9) of the Code. The seminal case laying out the Southern District of New York bankruptcy court's critical vendors payment test is *In re Ionosphere Clubs, Inc.*¹⁷²

In *In re Ionosphere Clubs* the court discussed whether it may grant an order authorizing the debtor to pay specific pre-petition wage, salary, and medical benefits to union employees on strike.¹⁷³ Though payments were not ultimately authorized by the court, the case provided an approach for critical vendor payments under the Code.¹⁷⁴ The Code sections discussed in *In re Ionosphere Clubs* were sections 363 and 105(a), but the case additionally discussed the doctrine of necessity.¹⁷⁵ Regarding section 363, the court explained that “[a] bankruptcy court is empowered pursuant to § 363 of the Bankruptcy Code to

¹⁷¹ Motion of Debtor for Order (I) Under 11 U.S.C. §§ 105(a), 363(b), 364, 1107(a), and 1108 and Fed. R. Bankr. P. 6003 Authorizing Payment of Prepetition Claims of Certain Critical Vendors and Service Providers, and (II) Under 11 U.S.C. §§ 105(a), 363(c), and 503(b)(1)(A) and Fed. R. Bankr. P. 6003 Confirming Administrative Expense Priority Status of Debtor's Undisputed Obligations for Postpetition Delivery of Goods and Services at 10, 12, 13 *In re Lensar, Inc.*, No. 1:16-bk-12808 (Bankr. D. Del. Jan. 5, 2017) (granted); Final Order (I) Under 11 U.S.C. §§ 105(a), 363(b), 364, 1107(a), and 1108 and Fed. R. Bankr. P. 6003 Authorizing Payment of Prepetition Claims of Certain Critical Vendors and Service Providers, and (II) Under 11 U.S.C. §§ 105(a), 363(c), and 503(b)(1)(A) and Fed. R. Bankr. P. 6003 Confirming Administrative Expense Priority Status of Debtor's Undisputed Obligations for Postpetition Delivery of Goods and Services at 1, *In re Lensar, Inc.*, No. 1:16-bk-12808 (Bankr. D. Del. Jan. 27, 2017).

¹⁷² *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989).

¹⁷³ *Id.* at 179.

¹⁷⁴ *See id.*

¹⁷⁵ *Id.* at 175–76.

authorize a debtor to expend funds in the bankruptcy court’s discretion outside the ordinary course of business.”¹⁷⁶ The court found that section 363 works with section 105 to provide authority for critical vendor payments.¹⁷⁷ Finally, the court explained that the ability to authorize critical vendor payments is a longstanding concept under the doctrine of necessity.¹⁷⁸ The court found that “[c]learly, the ‘necessity of payment’ doctrine is applicable to the instant dispute” because the debtor needed to find a way to pay essential pre-petition claims that could have an effect on its ability to reorganize.¹⁷⁹ In a nutshell, *In re Ionosphere* found that the doctrine of necessity, section 363, and section 105(a) together provide the authority to the court, in its equitable power, to approve critical vendor payments.¹⁸⁰

a. Bankruptcy Code Authority Adopted by Judge Bernstein

The bankruptcy court for the Southern District of New York bench boasts many well-regarded judges, one of the most well-regarded of their judges was Judge Bernstein, who retired in 2020. Similar to the court’s *In re Ionosphere Clubs* decision, Judge Bernstein authorized critical vendor payments pursuant to sections 105(a), 363(b) and 503(b)(9).¹⁸¹ In another case, Judge Bernstein ordered the authorization to pay critical vendors under sections 105(a), 363(b), 503(b), and 507(a).¹⁸² In other cases, Judge Bernstein authorized critical vendor payments when the debtors’ motion cited to *In re Ionosphere Clubs* and analyzed sections 363, 105(a), and the doctrine of necessity.¹⁸³ However, and distinct

¹⁷⁶ *Id.* at 175.

¹⁷⁷ *Id.* (“In order to effectuate the policies and provisions of the Bankruptcy Code, the Bankruptcy Court is also empowered pursuant to 11 U.S.C. § 105(a)”).

¹⁷⁸ *Id.* at 175–76.

¹⁷⁹ *Id.* at 176.

¹⁸⁰ *See id.* at 177 (referencing H.R. Rep. No. 595 95th Cong. 1st Sess. 16 (1977)).

¹⁸¹ *See, e.g.*, Final Order (I) Authorizing Debtors to Pay Certain Prepetition Obligations to Critical Vendors, Lien Claimants, and Foreign Creditors, (II) Approving Related Procedures, (III) Confirming Administrative Expense Priority Status of Certain Goods Delivered and Services Provided Postpetition, and (IV) Granting Related Relief at 1–3, *In re Fusion Connect, Inc.*, No. 1:19-bk-11811 (Bankr. S.D.N.Y. July 1, 2019) (granting debtors to pay \$20.5 million to critical vendors and other pre-petition creditors “pursuant to sections 105(a), 363(b), and 503(b)(9) of [the Bankruptcy Code]”).

¹⁸² *See* Final Order Pursuant to 11 U.S.C. §§ 105(a), 363(b), 503(b), and 507(a) (I) Authorizing Debtors to Pay Prepetition Obligations Owed to Lien Claimants and Other Critical Vendors; and (II) Confirming Administrative Status for Goods and Services Delivered to the Debtors Post Petition at 1, *In re Waypoint Leasing Holdings Ltd.*, No. 1:18-bk-13648 (Bankr. S.D.N.Y. Dec. 19, 2018) (permitting Debtors to “pay prepetition obligations owed to certain vendors, suppliers, service providers, and other similar parties and entities” pursuant to sections 105(a), 363(b), 503(b), and 507(a)).

¹⁸³ *See* Debtors’ Motion for Entry of Interim and Final Orders Authorizing, But Not Directing, FlatIronHotel Operations LLC to Pay Certain Prepetition Claims of Critical Vendors at 3–8, *In re 1141 Realty Owner*, No. 1:18-bk-12341 (Bankr. S.D.N.Y. July 31, 2018); Final Order Authorizing, But Not Directing,

from *In re Ionosphere Clubs*, Judge Bernstein also granted a critical vendor motion based on section 363 and found “[a]uthority for such payments also may be found in Bankruptcy Code sections 1107(a) and 1108, which vest debtors in possession with authority to continue operating their businesses.”¹⁸⁴ These examples showcase that Judge Bernstein and other judges on the bankruptcy court for the Southern District of New York more generally authorize payment to critical vendors pursuant to the Code sections 363 and 105(a), but with some variation.

6. *Relative Supreme Court Silence*

Despite the variety of interpretations and lack of a uniform standard, the Supreme Court has yet to explicitly weigh in on a test for critical vendors. The Supreme Court recently referenced the Seventh Circuit *Kmart* case in a string citation in *Czyzewski v. Jevic Holding Corp.* In the *Jevic* parenthetical, the Supreme Court generally reinforced the benefit of critical vendor payments.¹⁸⁵ Only touching on the topic, the court explained “these courts have usually found that the distributions at issue would ‘enable a successful reorganization and make even the disfavored creditors better off.’”¹⁸⁶ By this parenthetical, critical vendor payments may be justified to ensure to the benefit of all creditors when they better enable a successful reorganization.¹⁸⁷ The Supreme Court further noted that it is not uncommon for bankruptcy courts to approve distributions that violate ordinary priority rules and that such violations are often justified by the Code objectives.¹⁸⁸

FlatIronHotel Operations LLC to Pay Certain Prepetition Claims of Critical Vendors at 1–3, *In re* 1141 Realty Owner, No. 1:18-bk-12341 (Bankr. S.D.N.Y. Sept. 20, 2018).

¹⁸⁴ Debtors’ Motion for Entry of Interim and Final Orders (I) Authorizing Payment of Certain Critical Trade Claims in the Ordinary Course of Business; and (II) Authorizing Financial Institutions to Honor All Related Checks and Electronic Payment Requests at 12, *In re* International Shipholding Corp., No. 1:16-bk-12220 (Bankr. S.D.N.Y. Aug. 1, 2016); Final Order (I) Authorizing Payment of Certain Critical Trade Claims in the Ordinary Course of Business; and (II) Authorizing Financial Institutions to Honor All Related Checks and Electronic Payment Requests, *In re* International Shipholding Corp., No. 1:16-bk-12220 (Bankr. S.D.N.Y. Sept. 15, 2016).

¹⁸⁵ See *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973, 985 (2017).

¹⁸⁶ *Id.*

¹⁸⁷ See *id.*

¹⁸⁸ The Supreme Court noted:

We recognize that *Iridium* is not the only case in which a court has approved interim distributions that violate ordinary priority rules. But in such instances one can generally find significant Code-related objectives that the priority-violating distributions serve. Courts, for example, have approved “first-day” wage orders that allow payment of employees’ prepetition wages, “critical vendor” orders that allow payment of essential suppliers’ prepetition invoices, and ‘roll-ups’ that allow lenders who continue financing the debtor to be paid first on their prepetition claims.

The Supreme Court opinion in *Jevic* left the door open for further judicial discrepancy in interpreting a critical vendor standard. This lack of a uniform test, however, causes uncertainty in legal rights. As a result, many vendors may be hesitant to continue engaging with the debtor absent payment on prepetition claims.

B. The Variety of Critical Vendor Tests is Detrimental to a Retail Reorganization

The absence of a uniform critical vendor test may have grave consequences to the prospect of a successful retailer reorganization because vendors will be fearful to continue providing inventory to the debtor. Without inventory to sell from vendors, there is little hope for the retailer's business to continue in a chapter 11 reorganization. These implications are analyzed in three separate parts. First, vendors are fearful to continue to engage with the retail debtors' bankruptcy estate. Second, this vendor fear undermines reorganization efforts. Third and finally, undermined reorganization efforts are amplified across the current dismal retail climate.

1. Vendors are Fearful to Engage with the Debtor in Possessions' Bankruptcy Estate

Without certainty of repayment on prepetition debt, many vendors are hesitant to continue extending trade credit to retail debtors.¹⁸⁹ Understandably, vendors are fearful of throwing good money after bad by continuing to deal with the bankruptcy estate.¹⁹⁰ Vendors are also fearful of detrimentally relying on critical vendor payments if such payments bear the risk of revocation.¹⁹¹

This fear among vendors is manifested in Sears' recent chapter 11 reorganization.¹⁹² "In the two weeks leading up to its Chapter 11 bankruptcy filing, about 200 vendors have stopped or refused to ship merchandise."¹⁹³ Judge Easterbrook recognized this fear in *Kmart* noting that "[d]oubtless 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

Id. (internal citations omitted).

¹⁸⁹ See *True Religion: Key Vendors to Recover 100% of Claims*, 21 TROUBLED CO. REP. (Aug. 2017).

¹⁹⁰ *In re Kmart Corp.*, 359 F.3d 866, 873 (7th Cir. 2004).

¹⁹¹ See *id.* at 869–70; *Capital Factors v. Kmart Corp.*, 291 B.R. 818, 823 (N.D. Ill. 2003).

¹⁹² See *Sears Holdings: Says 200 Vendors Stopped Shipping Merchandise*, TROUBLED CO. REP. (Nov. 22, 2018).

¹⁹³ *Id.*

basis.”¹⁹⁴ Thus, fear of throwing good money after bad is an economically understandable concern held by many vendors.

More concerning, however, is if vendors are fearful to rely on critical vendor payments granted by the court. For example, in a chapter 11 bankruptcy where the court approved critical vendor payments, “there was a ‘general fear factor’ among suppliers over the debtor’s ability to pay” accordingly “[n]o one was willing to go first. Everyone was nervous about it.”¹⁹⁵ One of the most notable examples of why vendors may be fearful to trust court orders granting critical vendor payments comes from *Kmart*. In *Kmart*, the debtor was authorized by the bankruptcy court to pay the prepetition critical vendor claims of 2,330 suppliers.¹⁹⁶ These 2,330 suppliers received about \$300 million and as a result continued to do business with the debtor.¹⁹⁷ A little more than fourteen months later, as the debtors plan of reorganization was on the verge of approval, the bankruptcy judge reversed the order authorizing payment to critical vendors.¹⁹⁸ The reversal was later affirmed in the Seventh Circuit by Judge Easterbrook.¹⁹⁹

Another example is from a more recent chapter 11 case, *In re Personal Communications Devices, LLC*. In *Personal Communications Devices*, even though the court granted a motion for priority payments to the known vendor in a “customer promotions program” the court denied the application of critical vendor status after the fact when contested.²⁰⁰ After the fact, the court held that the customer promotion program could not qualify as a critical vendor motion because the program failed to specify the vendor, timing, and amounts of payments even though they were approved by the court.²⁰¹ When the court originally granted the motion, the vendor continued to provide refurbishment services to debtor under the belief that it would be treated like a critical vendor.²⁰² The vendor would not have otherwise provided these services and thus detrimentally relied on a differing interpretation of critical vendor.²⁰³

¹⁹⁴ *In re Kmart*, 359 F.3d at 873; *but see* *Roe & Tung*, *supra* note 6, at 1256–57 (“Rational creditors understand sunk costs. If future sales to the bankrupt are profitable, the economically rational supplier will sell and ship, even if it lost money on pre-bankruptcy shipments.”).

¹⁹⁵ Sullivan, *supra* note 2.

¹⁹⁶ *In re Kmart*, 359 F.3d at 869.

¹⁹⁷ *Id.*

¹⁹⁸ *Id.*; *Capital Factors v. Kmart Corp.*, 291 B.R. 818, 820 (N.D. Ill. 2003).

¹⁹⁹ *In re Kmart*, 359 F.3d at 869.

²⁰⁰ *In re Pers. Communs. Devices, LLC*, 588 B.R. 661, 670 (Bankr. E.D.N.Y. 2018).

²⁰¹ *Id.* at 666 (The court alleged “what is crucial to a doctrine of necessity request is to spell out who will be paid on a pre-petition claim, how much they will be paid, and why that payment is essential to the debtor’s ongoing operations and its efforts to reorganize.”).

²⁰² *Id.* at 667.

²⁰³ *Id.*

Though the critical vendor motion did not identify the specific vendor “there was no real disagreement about the fact that KMT Wireless: had been paid in full for its prepetition services to the debtors; had provided all the post-petition services it had been requested of the debtors to perform; and was paid for its post-petition services to the debtors.”²⁰⁴ The court evaluated whether the debtor could apply hindsight analysis to interpret a critical vendor agreement from a “customer promotions program” but declined to offer the priority payments.²⁰⁵ The complete lack of critical vendor motion filing requirements resulted in a vendor’s detrimental reliance on a customer promotion program only to have payments revoked after the fact. Thus, vendor fear to trust court orders granting critical vendor payments directly undermines the chances of a successful retailer reorganization.

2. *Vendor Fear Undermines Reorganization Efforts*

When vendors are too fearful to rely on orders granting critical vendor payments, there can be catastrophic consequences on the debtor’s ordinary course of business.²⁰⁶ Specific consequences include diminished liquidity in reorganization due to lack of inventory from vendors.²⁰⁷ For example, a retailer in chapter 11 reported that “[w]ithout inventory from the vendors, the debtor was unable to meet cash flow requirements under its debtor in possession financing package and was in default.”²⁰⁸ Ultimately, when a debtor is unable to operate the retail business, it is unable to maintain liquidity. Without cash flow, debtors will struggle to achieve a confirmable chapter 11 reorganization plan. Vendor fear prevents debtors from meeting cash flow requirements under the reorganization plan. As a result, the bankruptcy court may have to convert their case to a chapter 7 liquidation.

²⁰⁴ Rudolph J. Di Massa Jr. & Keri L. Wintle, *Bankruptcy Court Rejects Hypothetical Preference Waiver in Critical Vendor Defense*, THE LEGAL INTELLIGENCER (Dec. 27, 2018).

²⁰⁵ *In re Pers. Communs. Devices*, 588 B.R. at 662; *see also* Di Massa Jr. & Wintle, *supra* note 204 (discussing *In re Pers. Communs. Devices*, noting that the case served as a “lesson for critical vendors seeking to insulate themselves from preference liability. These vendors should first ensure that any order: specifically identify them as critical vendors; contain language directing, rather than authorizing, payment of any prepetition claims; and include an express waiver of all preference claims against them.”).

²⁰⁶ *True Religion: Key Vendors to Recover 100% of Claims*, 21 TROUBLED CO. REP. (Aug. 2017) (“Failure to continue sourcing and managing inventory and sales through their existing network of vendors and service providers on commercially reasonable terms could have catastrophic consequences for the Debtors.”).

²⁰⁷ *Id.* (The Chief Financial Officer explained it is essential to a restructuring that the debtor maintain supply of merchandise for retail stores.).

²⁰⁸ Sullivan, *supra* note 2.

3. *Vendor Fear May be Amplified by the Recent Retail Climate*

The impact of vendor fear may be multiplied across the record number of retailer reorganizations. Even before COVID-19, the 2019 retail apocalypse resulted in an onslaught of retailers filing for chapter 11 bankruptcy.²⁰⁹ Substantial stress on the retail industry has forced thousands of store closures and bankruptcies.²¹⁰ In 2019 nearly twenty large retailers had filed for bankruptcy including Barney's, Payless Shoes, Gymboree,²¹¹ and Forever 21.²¹² In 2018, there were twenty-five similar sized retailer bankruptcies, thirty-seven in 2017, and eighteen in 2016.²¹³ Now, in a COVID-19 climate, the retail apocalypse has reached an unprecedented level of devastation. According to S&P Global Market Intelligence, "2020 is on track to have the highest number of retail bankruptcies in a decade."²¹⁴ Only part-way through 2020, forty-three major retailers filed for bankruptcy.²¹⁵ These bankruptcies include Brooks Brothers, J.Crew, Lord & Taylor, Neiman Marcus, Pier 1, and Sur La Table.²¹⁶

Unfortunately for retailers, the odds are already against a successful retailer reorganization. A recent AlixPartners Retail Bankruptcy Study reported that nearly 50% of retail bankruptcies with more than \$50 million in liabilities ended in liquidation as opposed to less than 10% of other similarly sized non-retail bankruptcies.²¹⁷ In light of the sheer volume of bankruptcies filed pursuant to the retail apocalypse combined with an already slim chance at a successful reorganization, the concern of vendor fear to engage in the retailer debtors estate is only amplified.

²⁰⁹ Hayley Peterson, *Store Closings in 2019 List*, BUS. INSIDER (Sep. 9, 2019, 12:00 PM), <https://www.businessinsider.com/stores-closing-in-2019-list-2019-3> ("More than 8,200 stores are closing in 2019 as the retail apocalypse drags on.").

²¹⁰ Sandler & Kim, *supra* note 3.

²¹¹ Sandler & Kim, *supra* note 3.

²¹² Eliza Ronalds-Hannon & Lauren Coleman-Lochner, *Forever 21 Goes Bust Adding 178 Stores to Retail Apocalypse*, MIAMI DAILY BUS. REV., Oct. 7, 2019, at A14.

²¹³ Sandler & Kim, *supra* note 3.

²¹⁴ Repko & Thomas, *supra* note 5.

²¹⁵ Repko & Thomas, *supra* note 5.

²¹⁶ Áine Cain & Madeline Stone, *These 33 Retailers and Restaurant Companies Have Filed for Bankruptcy or Liquidation in 2020*, BUS. INSIDER (Sept. 23, 2020, 4:02 PM) <https://www.businessinsider.com/retailers-filed-bankruptcy-liquidation-closing-stores-2020-2>.

²¹⁷ Sandler & Kim, *supra* note 3 ("[B]etween 2006 and most of 2017, nearly half of retail bankruptcies with more than \$50 million in liabilities ultimately ended in liquidation, as opposed to a reorganization or going concern sale.").

C. Codification of a Critical Vendor Test Would Prevent Harm to Retail Reorganizations

Vendors fear throwing good money after bad and are fearful of relying on court orders granting critical vendor payments, pressing the need for a solution. If the Code instead codified a concrete test, critical vendors could confidently engage in the business of the bankruptcy estate and prevent a catastrophic number of liquidations. Critical vendor payments are an important tool employed by the bankruptcy courts to guide a company into a successful reorganization. This Section proposes a uniform test for codification that relies on each of the elements from the three well-known and regularly followed tests for critical vendors and argues how it could benefit debtors.

1. Comparison of Existing Critical Vendor Tests

The three critical vendor tests from *Kmart*, *CoServ* and *United American*, provide guidance to each of their respective jurisdictions. Given three similar three-prong tests from prominent bankruptcy courts, this proposed test applies the best of each. The result is also a three-prong test. Paraphrased and organized, the three tests comprise many similar elements.

<i>Kmart</i>	<i>CoServ</i>	<i>United American</i>
First, payment must be necessary to a successful reorganization. ²¹⁸	First, payment must be critical to a successful reorganization. ²¹⁹	First, payment must be necessary to a successful reorganization. ²²⁰
Second, other disfavored vendors would better off or at least no worse off. ²²¹	Second, without payment, there would be a greater harm to the business compared vendor's claim. ²²²	Second, payment must be made in the debtor's sound business judgment. ²²³
Third, if the outstanding prepetition debt were not paid, the vendor in question would cease doing business with the debtor. ²²⁴	Third, paying the vendor's prepetition claim is the only option since there is no practical or legal alternative. ²²⁵	Third, the payment does not result in unfair prejudice to other creditors. ²²⁶

²¹⁸ See *In re Kmart Corp.*, 359 F.3d 866, 872–74 (7th Cir. 2004).

²¹⁹ See *In re CoServ, LLC*, 273 B.R. 487, 498 (Bankr. N.D. Tex. 2002).

²²⁰ *In re United Am., Inc.*, 327 B.R. 776, 782 (Bankr. E.D. Va. 2005).

²²¹ See *In re Kmart*, 359 F.3d at 873.

²²² *In re CoServ*, 273 B.R. at 498–99.

²²³ *In re United Am.*, 327 B.R. at 782.

²²⁴ *In re Kmart*, 359 F.3d at 873.

²²⁵ *In re CoServ*, 273 B.R. at 498–99.

²²⁶ *In re United Am.*, 327 B.R. at 782.

2. Proposed New Test for Critical Vendor Payments

This proposed test encompasses each element of the three tests used by prominent judges and courts. As a result, this proposed test synthesizes the best tests from across the country into one uniform test for critical vendor payment. First, payment to a critical vendor must be necessary to a successful reorganization. Second, the critical vendor payment does not unfairly disfavor other creditors. Third, there is no feasible alternative to critical vendor payment.

Based on the first element of *Kmart*, *CoServ*, and *United American*, the first element of this proposed test is necessity. Payment to a critical vendor is necessary to a successful reorganization. Though *CoServ* used the word “critical”²²⁷ as opposed to necessary, using necessary expressly indicates reliance on the doctrine of necessity. To better define “necessity” the second element of the *CoServ* test provides guidance. Necessity means that there would be a greater financial harm to the debtor’s ongoing business compared to the cost of the critical vendor prepetition claim.²²⁸ Necessity can further be defined by the second element of *United American*. Necessity of critical vendor payment is determined by the sound business judgment of the debtor.²²⁹

The second element of this proposed test relies on the second element of *Kmart* and the third element of *United American*. This second element requires that the critical vendor payment does not unfairly disfavor other creditors. Explained in *Kmart*, disfavored creditors would at the very least be no worse off than if payment had not been made.²³⁰ From *United American*, in contrast, the payment to critical vendors cannot result in unfair prejudice to other creditors.²³¹

The third element of this proposed test requires that there be no alternative to such payment. This lack of alternative is addressed in the third element of *Kmart* which explains that without payment, the vendor would cease doing business with the debtor.²³² Further, as explained in *CoServ*, there can be no other legal or practical alternative but payment to keep the vendor engaging with the bankruptcy estate.²³³

²²⁷ *In re CoServ*, 273 B.R. at 498.

²²⁸ *Id.* at 498–99.

²²⁹ *In re United Am.*, 327 B.R. at 782.

²³⁰ *In re Kmart Corp.*, 359 F.3d 866, 873 (7th Cir. 2004).

²³¹ *In re United Am.*, 327 B.R. at 782.

²³² *In re Kmart*, 359 F.3d at 873.

²³³ *In re CoServ*, 273 B.R. at 498.

Codification of this proposed three-element test would encourage continued critical vendor participation with the bankruptcy estate. Uniformity across jurisdictions would alleviate vendor fears to trust court orders granting critical vendor payment. Reliance on the three well-regarded common law tests ensures the test is narrowly tailored to prevent abuse and adhere to the purpose of the bankruptcy system.

CONCLUSION

Vendor fear in the retail apocalypse is a catalyst for critical vendor codification. Though existing common law tests provide guidance, the lack of uniformity across judges and jurisdictions demonstrates a chaotic critical vendor standard. Codification of this proposed test would incorporate the best elements of each jurisdiction in a consistent manner. Consistent application of a codified test would alleviate vendors' fears both to throw good money after bad and to rely on court orders granting critical vendor payments. Alleviating vendor fear is especially imperative in the current retail climate. As such, codification of this test could prevent the onslaught of retail apocalypse chapter 11 bankruptcies from being converted into complete liquidations.

KENNEDY BODNAREK*

* Executive Administrative Editor, *Emory Bankruptcy Developments Journal*; J.D. Candidate, Emory University School of Law (2021); B.B.A., magna cum laude, University of Iowa (2015). First, I would like to thank Professor Rafael I. Pardo, Robert T. Thompson Professor of Law, for believing in me and encouraging me to pursue the bankruptcy practice. Second, I would like to thank Professor Jennifer Romig, Professor of Practice, for teaching me that "surprise is the enemy of good legal writing." Third, I would like to thank Grant Stein for his counsel and guidance that shaped this Comment. Fourth, I would like to thank the *Emory Bankruptcy Developments Journal* for all their efforts in editing this Comment. Finally, I would like to thank my family and friends for their endless support throughout this process.