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When a Critical Vendor may be Insulated from Preference Liability

Michael A. Solimani, J.D. Candidate 2023


INTRODUCTION

Under Title 11 of the United States Code (the “Bankruptcy Code”) a trustee or debtor in possession (“DIP”) may avoid certain payments made by the debtor to a creditor within ninety days prior to filing for bankruptcy, or one year if the creditor is an insider.1 The Bankruptcy Code contains certain defenses to preference claims.2 A court may also release a creditor from such claims. Such a release may be found in orders approving payment of pre-petition claims to a “critical vendor.”3 Absent such an express release, it is unclear whether a trustee or DIP is precluded from pursuing a preference claim against a critical vendor.

This memorandum analyzes whether a critical vendor is immune from a preference claim under the Bankruptcy Code. Part I provides an overview of preference law and the critical vendor doctrine. Part II examines rules established through case law covering when a critical vendor designation will bar a preference claim.

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DISCUSSION

I. A Trustee’s Power to Avoid Preference Payments and the Critical Vendor Doctrine

Section 547(b) of the Bankruptcy Code allows a trustee to avoid certain payments made by a debtor to a creditor prior to filing for bankruptcy. To do this, the trustee or DIP must show that the payment was made

(1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made— (A) on or within 90 days before the date of the filing of the petition; or (B) between 90 days and 1 year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and (5) that enables such creditor to receive more than such creditor would receive if— (A) the case were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Statutory defenses to this power include the contemporaneous exchange for new value defense and the ordinary course of business defense.

In general, a debtor may not pay claims that arose prior to the bankruptcy filing. However, a court may authorize a debtor to pay pre-petition claims to critical vendors, which are generally referred to as critical vendor payments. Critical vendor payments stem from the pre-Bankruptcy Code “doctrine of necessity,” which acknowledges that “circumstances may exist which may make it necessary and indispensable to the business . . . and to the preservation of the property, for the receiver to pay pre-existing debts . . . out of the earnings of the [debtor] . . . .” Section 105(a) of the Bankruptcy Code, which allows the court to “issue any order . . . that is necessary to carry out the provisions of this title,” and section 363(b) of the Bankruptcy Code, which allows a trustee to “use, sell, or

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4 See 11 U.S.C. § 547(b).
5 Id.
lease . . . property of the estate . . .,” provide the statutory support for such orders.  

Apart from the First, Tenth, and D.C. Circuits, all federal circuits have allowed payments to be made to critical vendors. Despite the wide acceptance of critical vendor orders, it is unclear whether critical vendor status will insulate a creditor from preference liability.

II. When Critical Vendor Status will Bar a Preference Claim

Courts have held that under certain circumstances, critical vendor status will bar a preference claim. Critical vendor status will bar a preference claim where (1) a critical vendor order is mandatory; (2) a critical vendor order is discretionary but the amount of the claim is small when compared to the allowed cap; (3) a critical vendor order contains a waiver of preference liability; and (4) a critical vendor order provides that a contract with the critical vendor be assumed and assigned.

A. Critical Vendor Status will Bar a Preference Claim When the Order is Mandatory

When a critical vendor order mandates payment of pre-petition debts, the creditor will be insulated from preference liability. In In re AFA Inv. Inc., the Delaware bankruptcy court found that a critical vendor order which mandated payment insulated the creditor from preference liability because the creditor would be paid in full for the debt regardless of whether the pre-

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11 See In re AFA Inv. Inc., 538 B.R. at 239; In re Maxus Energy Corp. 615 B.R. at 64.
petition payment had been made.\textsuperscript{12} Thus, the trustee would not be able to satisfy the fifth element of a preference claim, as the transfer did not allow the creditor to receive more than it would have under a Chapter 7 liquidation or had the transfer not been made.\textsuperscript{13}

\textbf{B. Critical Vendor Status will Bar a Preference Claim When the Order is Discretionary, But the Amount of the Claim is Small When Compared to the Allowed Cap}

Where a critical vendor order is discretionary, the bankruptcy court will compare the amount of the pre-petition transfer to the total amount of pre-petition debt allowed to be paid under the critical vendor order.\textsuperscript{14} When the amount of the transfer is small in comparison to the total amount allowed under the critical vendor order, the creditor will be insulated from preference liability.\textsuperscript{15} In contrast, when the amount of the transfer is large in comparison to the total amount allowed under the critical vendor order, the creditor will not be insulated from preference liability.\textsuperscript{16} There is no hard and fast rule to determine when the transfer amount is too high.\textsuperscript{17} The key inquiry is whether the transfer would have “been likely to draw an objection or result in the court’s refusal to enter the order.”\textsuperscript{18}

\textbf{C. Critical Vendor Status will Bar a Preference Claim When the Order Contains an Explicit Waiver of Preference Liability}

A critical vendor order will also insulate a creditor from preference liability when the order contains an explicit waiver of preference claims.\textsuperscript{19}

\textsuperscript{12} 538 B.R. at 243–44 (citing \textit{In re Kiwi Int’l Air Lines, Inc.}, 344 F.3d at 321).
\textsuperscript{13} See 11 U.S.C. 547(b)(5).
\textsuperscript{14} See \textit{In re AFA Inv. Inc.}, 538 B.R. at 244; \textit{In re Maxus Energy Corp.}, 615 B.R. at 67, 73–74.
\textsuperscript{15} See \textit{In re AFA Inv. Inc.}, 538 B.R. at 244 (finding that there were unlikely to be any objections when the pre-petition transfer was less than one percent of the total amount allowed under the critical vendor order).
\textsuperscript{16} See \textit{In re Maxus Energy Corp.}, 615 B.R. at 73–74 (denying a creditor’s motion for summary judgment where the pre-petition transfer was approximately eleven percent of the total amount allowed under the critical vendor order).
\textsuperscript{17} See \textit{In re AFA Inv. Inc.}, 538 B.R. at 244.
\textsuperscript{18} Id.
blanket waiver of preference liability.\textsuperscript{20} The Tennessee bankruptcy court in \textit{In re Phoenix Rest. Grp., Inc.} emphasized that, despite this, creditors identified as critical vendors may “us[e] [their] unique leverage with the Debtors . . . [to] bargain[] for a provision releasing it from preference liability . . . .”\textsuperscript{21} Such a provision would prevent the court from conducting a preference analysis in the first place, as the action would be barred at the outset of the case.

\textbf{D. Critical Vendor Status will Bar a Preference Claim When a Critical Vendor Order Provides that a Contract with the Critical Vendor be Assumed and Assigned}

Critical vendors are insulated from preference liability where the order calls for a contract to be assumed and assigned, and the pre-petition transfer was made pursuant to that contract.\textsuperscript{22} Under section 365 of the Bankruptcy Code, a trustee or DIP may assume or reject any executory contract with the court’s approval.\textsuperscript{23} To assume an executory contract, “the debtor must cure all defaults, assure future performance, and make the other contracting party whole.”\textsuperscript{24} Thus, once a contract is assumed, it becomes an administrative expense which would be entitled to priority status.\textsuperscript{25} Assumption ultimately means that a trustee will not be able to prove the fifth element of a preference claim, because the transfer did not allow the creditor to receive more than it would have under a Chapter 7 liquidation or had the transfer not been made.\textsuperscript{26} If the critical vendor order did not call for the contract to be assumed and assigned, then critical vendor status would not protect the creditor from preference liability.\textsuperscript{27} In such a scenario, the critical vendor would be a general unsecured creditor, and the pre-petition payment made pursuant to the contract

\textsuperscript{20} \textit{In re Hayes Lemmerz Intern., Inc.}, 313 B.R. at 194.
\textsuperscript{21} 2004 WL 3113719, at *19.
\textsuperscript{24} 11 U.S.C. § 365(b)(1).
\textsuperscript{25} See \textit{In re Kiwi Int’l Air Lines, Inc.}, 344 F.3d at 318; 11 U.S.C. § 507.
\textsuperscript{26} See 11 U.S.C. § 547(b)(5).
would cause the creditor to receive more than it would have under a Chapter 7 liquidation or had the payment not been made.\(^{28}\)

**CONCLUSION**

Critical vendor status may bar a preference claim under the following circumstances: (1) where a critical vendor order is mandatory; (2) where a critical vendor order is discretionary, but the amount of the claim is small when compared to the allowed cap; (3) where a critical vendor order contains a waiver of preference liability; and (4) where a critical vendor order provides that a contract with the critical vendor be assumed and assigned.\(^ {29}\)

\(^{28}\) See id.; 11 U.S.C. § 547(b)(5).