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**When a Critical Vendor may be Insulated from Preference Liability**

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**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.<sup>1</sup> The Bankruptcy Code contains certain defenses to preference claims.<sup>2</sup> 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.”<sup>3</sup> 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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<sup>1</sup> See 11 U.S.C. § 547(b) (2018).

<sup>2</sup> See 11 U.S.C. § 547(c).

<sup>3</sup> See Mark A. McDermott, *Critical Vendor and Related Orders: Kmart and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 14 AM. BANKR. INST. L. REV. 409, 411–14 (2006).

## 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.<sup>4</sup> 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.<sup>5</sup>

Statutory defenses to this power include the contemporaneous exchange for new value defense and the ordinary course of business defense.<sup>6</sup>

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] . . . .”<sup>7</sup> 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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<sup>4</sup> See 11 U.S.C. § 547(b).

<sup>5</sup> *Id.*

<sup>6</sup> See 11 U.S.C. § 547(c).

<sup>7</sup> See *Miltenberger v. Logansport, C. & S.W.R. Co.*, 106 U.S. 286, 311 (1882).

lease . . . property of the estate . . . ,” provide the statutory support for such orders.<sup>8</sup> Apart from the First, Tenth, and D.C. Circuits, all federal circuits have allowed payments to be made to critical vendors.<sup>9</sup> 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.<sup>10</sup>

### 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.<sup>11</sup> 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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<sup>8</sup> See *Dudley v. Mealey*, 147 F.2d 268, 271 (2d Cir. 1945); *In re Eagle-Picher Indus. Inc.*, 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991); *In re Kmart Corp.*, 359 F.3d 866, 871–74 (7th Cir. 2004); 11 U.S.C. § 105(a); 11 U.S.C. § 363(b).

<sup>9</sup> See *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 176 (Bankr. S.D.N.Y. 1989); *In re Just for Feet, Inc.*, 242 B.R. 821, 824–25 (Bankr. D. Del 1999); *In re NVR L.P.*, 147 B.R. 126, 128 (Bankr. E.D. Va. 1992); *In re Mirant Corp.*, 296 B.R. 427, 429 (Bankr. N.D. Tex. 2003); *In re Quality Interiors, Inc.*, 127 B.R. 391, 396 (Bankr. N.D. Ohio 1991); *In re Wehrenberg, Inc.*, 260 B.R. 468, 469 (Bankr. E.D. Mo. 2001); *In re Kmart Corp.*, 359 F.3d at 871–74; *Burchinal v. Cent. Wash. Bank (In re Adams Apple, Inc.)*, 829 F.2d 1484 (9th Cir. 1987); *In re Tropical Sportswear Int’l Corp.*, 320 B.R. 15, 20 (Bankr. M.D. Fla. 2005).

<sup>10</sup> See *In re AFA Inv. Inc.*, 538 B.R. 237 (Bankr. D. Del. 2015); *In re Maxus Energy Corp.*, 615 B.R. 62 (Bankr. D. Del. 2020); *In re Hayes Lemmerz Intern., Inc.*, 313 B.R. 189 (Bankr. D. Del. 2004); *In re Phoenix Rest. Grp., Inc.*, Nos. 301-12036, 303-0568A, 2004 WL 3113719 (Bankr. M.D. Tenn. Dec. 16, 2004); *In re Kiwi Int’l Air Lines, Inc.*, 344 F.3d 311 (3d Cir. 2003); *In re Pers. Commc’ns Devices, LLC*, 588 B.R. 661 (Bankr. E.D.N.Y. 2018); *In re Primary Health Systems, Inc.*, 275 B.R. 709 (Bankr. D. Del. 2001).

<sup>11</sup> 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.<sup>12</sup> 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.<sup>13</sup>

*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.<sup>14</sup> 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.<sup>15</sup> 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.<sup>16</sup> There is no hard and fast rule to determine when the transfer amount is too high.<sup>17</sup> 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.”<sup>18</sup>

*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.<sup>19</sup> Critical vendor orders do not create a

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<sup>12</sup> 538 B.R. at 243–44 (citing *In re Kiwi Int’l Air Lines, Inc.*, 344 F.3d at 321).

<sup>13</sup> See 11 U.S.C. 547(b)(5).

<sup>14</sup> See *In re AFA Inv. Inc.*, 538 B.R. at 244; *In re Maxus Energy Corp.*, 615 B.R. at 67, 73–74.

<sup>15</sup> See *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).

<sup>16</sup> See *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).

<sup>17</sup> See *In re AFA Inv. Inc.*, 538 B.R. at 244.

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

<sup>19</sup> See *In re Hayes Lemmerz Intern., Inc.*, 313 B.R. 189, 194 (Bankr. D. Del. 2004); *In re Phoenix Rest. Grp., Inc.*, Nos. 301-12036, 303-0568A, 2004 WL 3113719, at \*18–19 (Bankr. M.D. Tenn. Dec. 16, 2004).

blanket waiver of preference liability.<sup>20</sup> The Tennessee bankruptcy court in *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 . . . .”<sup>21</sup> 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.

*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.<sup>22</sup> Under section 365 of the Bankruptcy Code, a trustee or DIP may assume or reject any executory contract with the court’s approval.<sup>23</sup> To assume an executory contract, “the debtor must cure all defaults, assure future performance, and make the other contracting party whole.”<sup>24</sup> Thus, once a contract is assumed, it becomes an administrative expense which would be entitled to priority status.<sup>25</sup> 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.<sup>26</sup> 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.<sup>27</sup> In such a scenario, the critical vendor would be a general unsecured creditor, and the pre-petition payment made pursuant to the contract

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<sup>20</sup> *In re Hayes Lemmerz Intern., Inc.*, 313 B.R. at 194.

<sup>21</sup> 2004 WL 3113719, at \*19.

<sup>22</sup> *See In re Kiwi Int’l Air Lines, Inc.*, 344 F.3d 311 (3d Cir. 2003); *In re Pers. Commc’ns Devices, LLC*, 588 B.R. 661 (Bankr. E.D.N.Y. 2018); *In re Primary Health Systems, Inc.*, 275 B.R. 709 (Bankr. D. Del. 2001).

<sup>23</sup> *See* 11 U.S.C. § 365.

<sup>24</sup> 11 U.S.C. § 365(b)(1).

<sup>25</sup> *See In re Kiwi Int’l Air Lines, Inc.*, 344 F.3d at 318; 11 U.S.C. § 507.

<sup>26</sup> *See* 11 U.S.C. § 547(b)(5).

<sup>27</sup> *See In re Pers. Commc’ns Devices, LLC*, 588 B.R. at 667–68 (citing *In re Kiwi Int’l Air Lines, Inc.*, 344 F.3d at 314).

would cause the creditor to receive more than it would have under a Chapter 7 liquidation or had the payment not been made.<sup>28</sup>

## 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.<sup>29</sup>

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<sup>28</sup> *See id.*; 11 U.S.C. § 547(b)(5).

<sup>29</sup> *See In re AFA Inv. Inc.*, 538 B.R. 237 (Bankr. D. Del. 2015); *In re Maxus Energy Corp.*, 615 B.R. 62 (Bankr. D. Del. 2020); *In re Hayes Lemmerz Intern., Inc.*, 313 B.R. 189 (Bankr. D. Del. 2004); *In re Phoenix Rest. Grp., Inc.*, Nos. 301-12036, 303-0568A, 2004 WL 3113719 (Bankr. M.D. Tenn. Dec. 16, 2004); *In re Kiwi Int'l Air Lines, Inc.*, 344 F.3d at 318; *In re Pers. Commc'ns Devices, LLC*, 588 B.R. at 667–68; *In re Primary Health Systems, Inc.*, 275 B.R. 709 (Bankr. D. Del. 2001).