THE DEATH OF CRITICAL VENDOR MOTIONS AND THE POTENTIAL DEMISE OF THE DOCTRINE OF NECESSITY: FAREWELL TO TWO MISBEGOTTEN DOCTRINES

Anthony Michael Sabino*

INTRODUCTION

Since the promulgation of the modern Bankruptcy Code ("the Code") in 1978, the nation's insolvency laws have been a virtual paragon of the orderly administration of debtors' estates and a model of equality of distribution to needy creditors. The latter can largely be credited to a cogent and concise statutory scheme that precisely ordinates creditors and provides for the payment of their claims in that same strict order. Or at least, that is what it is supposed to do.

The simple truth is that sometimes it does not. In recent years, certain bankruptcy courts have unilaterally discarded the clear statutory directives found in the Code. Instead, by dredging up arcane notions from a bygone era in the name of equity and expediency, they have circumvented the statutory priorities, paying certain favored creditors prematurely, often to the detriment of the general creditor body.

The justification for this disregard of statutory priorities was once known as the "Doctrine of Necessity"; in recent days, however, it has evolved into the more sinister guise of so-called "critical vendor" motions. Critical vendor motions arise when a debtor seeks court authority to pay a select group of pre-petition creditors, in full or in part, based on their pre-bankruptcy claims, long before the great mass of general creditors sees a penny. Debtors and the "vendor elite" justify such extraordinary measures by claiming that these creditors are vital to the post-bankruptcy operations of the debtor, and that such vendors will refuse to supply goods or services until they are made whole by the payment of old debts. Thus, the debtors plead that it is imperative to pay these pre-petition claims to assure post-petition business, regardless of the unfairness to all other not-so-elite creditors, to say nothing of the blatant disregard for statutory authority. Is this a form of economic

---

* Associate Professor of Law, The Peter J. Tobin College of Business, St. John's University, New York, and partner, Sabino & Sabino, P.C., New York. The author dedicates this Article to the Honorable E. Donald Shapiro, Dean Emeritus and The Joseph Solomon Distinguished Professor of Law, New York Law School, with profound thanks for his years of encouragement, support, and, most of all, true friendship, which made this Article and a great many other things possible.

blackmail? Quite possibly so, but bankruptcy courts now succumb to it almost routinely, threatening to make it the norm, not the exception.

However, a notable core of courts has stepped forward to champion adherence to the statutory priorities of the Bankruptcy Code. Under the law's banner, they have refused to give in to the demands of critical vendors. Recently, a landmark ruling has emerged from one of the circuit courts of appeals, calling for a strict limitation of these so called "critical vendor" motions; in essence, advocating their prohibition except for the most dire circumstances.

The controversy surrounding critical vendor motions first implicates an issue vital to the recognition and preservation of sound and well-reasoned bankruptcy practice in today's complex cases. Second, it represents an opportunity to debunk tired old concepts that have been rendered irrelevant by the modern Code. But most of all, this controversy highlights the dangers inherent in ignoring clear statutory authority, or stretching the plain meaning of statutes beyond recognition. Conversely, the correct outcome of the instant controversy stands as a model for principled statutory construction and a sensible adherence to the plain meaning of statutes.

THE "DOCTRINE OF NECESSITY" AND "CRITICAL VENDOR" MOTIONS

Every controversy has a starting point. We find that the beginnings of the instant dispute stretch back nearly a century and a half. It all started with dogma, supposedly based upon dire necessity, but the intervening decades—particularly at the end of the Twentieth Century—turned it into an overworked and abused doctrine.

It is an axiom of bankruptcy law that pre-petition claims be paid at the end of a case, either as a liquidated distribution or pursuant to the terms of a plan of reorganization.[1] However, even limited rues have their exceptions. The "Doctrine of Necessity" is such an exception in Chapter 11 cases.

The "Doctrine of Necessity" permits early payouts to otherwise ordinary creditors if the circumstances are compelling. A typical example is for a pre-petition creditor, whose services are vital to the post-petition efforts to reorganize, to demand to be paid now rather than later. Because the Chapter 11 proceeding would

[1] *See* 11 U.S.C. § 726 (2004) for Chapter 7 cases. *See also* 11 U.S.C. §§ 1123, 1129, 1142 (2004) for Chapter 11 cases.

be jeopardized if the creditor refused to do business post-petition, the pre-petition creditor may be paid much earlier than usual upon such a showing of "necessity."[2]

The modern "Doctrine of Necessity" had a humble beginning. It began as the "Necessity of Payment" rule, developed especially for use in railroad reorganizations. It was justified by the perceived need for the advance payment of pre-petition debts "paid under duress to secure continued supplies or services essential to the continued operation of the railroad."[3] In its second iteration, the "Necessity of Payment" rule came to be known as the "Doctrine of Necessity" and was applied broadly for the first time to all types of reorganizations, not just railroads. In modern times, its use has been justified for the pre-reorganization payment of the pre-petition claims of creditors who threaten to withhold goods or services believed critical to the Chapter 11 reorganization efforts.[4] Hence, in its third iteration, the concept became known as the "critical vendor" motion.

"Critical vendor" motions are generally grouped under the heading of "first day orders" or "first day motions." The Bankruptcy Code prohibits debtors from taking certain actions, especially paying pre-bankruptcy claims, once a bankruptcy case is commenced. The attendant disruptions to business, particularly for a reorganizing debtor, can be detrimental to the going concern value of the Chapter 11 estate. Therefore, "it is common to ask for certain 'first day' relief from the Bankruptcy Court to allow for a smooth transition into bankruptcy," including the maintenance of preexisting vendor relationships.[5]

The "critical vendor" motion comes into play where trade creditors "hold some type of advantage over the [debtor] or could otherwise create difficulties with the [debtor's] reorganizational efforts."[6] For example, a critical vendor may supply an essential or customized product or may be the sole source of a product, or it may be impractical for the debtor to find a reasonably priced replacement vendor. The loss of such an irreplaceable vendor would be disadvantageous, if not crippling, to

---

2 *In re* Ionsphere Clubs, Inc., 98 B.R. 174, 176 (Bankr. S.D.N.Y. 1989) (authorizing the early payment of pre-petition employee claims, which were already entitled to priority as wage claims).

3 *In re* B & W Enterprises, Inc., 713 F.2d 534, 537 (9th Cir. 1983).

4 *See generally* WILLIAM L. NORTON JR., 2 NORTON BANKR. L. AND PRAC. 2d § 42:11 (1997 & Supp. 2002).

5 Jay M. Goffman & Greenville R. Day, *First Day Motions and Orders in Large Chapter 11 Cases: (Critical Vendor, Dip Financing and Cash Management Issues)*, 12 J. BANKR. L. & PRAC. 59, 63 (2003).

6 *Id.*

the reorganization effort.[7] Yet the "critical vendor" motions of today are merely the flowers of seeds planted long ago. Thus, to fully comprehend the practices of the present, we must examine their antecedents.

The Railroad Cases – A Voice from the Past

The Supreme Court discussed the most direct ancestor of the modern critical vendor rule in 1878, a full century before the Bankruptcy Code became the law of the land, and two complete decades prior to the promulgation of the former Bankruptcy Act.

That case, *Fosdick v. Schall*,[8] centered on a railroad reorganization. History tells that this case established a "six month" rule giving priority to pre-petition unsecured creditors over and before secured claims. But it is the language of this venerable opinion that is so prescient. Writing for the Court, Chief Justice Waite stated, "we have no doubt" that a court of equity may direct "payments from the income" during the insolvency case to "outstanding debts for labor, supplies, equipment . . . as may, under the circumstances of the particular case, appear to be reasonable."[9] The comparative newness of railroad mortgage financing and its highly individualistic nature gave the Court pause. "Peculiar" in character and "affect[ing] peculiar interests," such mortgages involve large amounts, "and the rights of the parties oftentimes [are] complicated and conflicting."[10] This was an interesting observation from the Supreme Court one hundred years before the advent of the modern Bankruptcy Code. But more was to come.

Significantly, the Chief Justice declared that it is rare for railroad reorganizations to proceed "without some concession by some parties from their strict legal rights, in order to secure advantages that could not otherwise be attained, and which it is supposed will operate for the general good of all who are interested. This results almost as a matter of *necessity* . . . ."[11] Viewed in the light of today's bankruptcy jurisprudence, this is a magnificent rendering of the penultimate rationale of bending the nominal rights of superior creditors in order to obtain a greater good.

---

[7] *Id.* at 69. *See also* Daniel A. Lowenthal, III & Peter V. Marchetti, *Critical Vendor Motions*, 20 THE BANKR. STRATEGIST 1 (June 10, 2003) ("[U]nless such motions are granted, vendors will cease supplying them and thus jeopardize their ability to reorganize.").

[8] 99 U.S. 235 (1878).

[9] *Id.* at 251-52.

[10] *Id.* at 252.

[11] *Id.* (emphasis added).

But the Supreme Court could not have anticipated the consequences of its use of the word "necessity."

The Court continued with the common sense observation that railroads are creatures of credit. Moreover, the temporal span of such borrowing, whether long or short term, is dictated by necessity. This creates a situation where normally short term obligations for current usage of labor, supplies, and equipment are left to accumulate in order to forestall the exercise of the secured creditors' lawful powers to foreclose or otherwise shut down the insolvent railroad by seizing pledged assets. In short, "daily and monthly earnings, which ordinarily should go to pay the daily and monthly expenses" are diverted from "those to whom in equity they belong, and used to pay the mortgage debt."[12]

In those times, secured creditors of railroads accepted collateral and "impliedly agreed" that current debt from continuing operations would "be paid from the current receipts before [the creditor] has any claim upon the income. If for the convenience of the moment something is taken" from what stands as the current debt and paid to secured creditors, "it certainly is not equitable for the court" to impose a requirement that funds be restored by paying current expenses before secured creditors may realize upon their collateral.[13] Thus, "a court will only do what . . . the company ought itself to do."[14] To be sure, this was an equitable approach, and the Court was mindful to take steps solely "to restore the parties to their original equitable rights."[15] Indeed, because this was a notion grounded in equity, the Court refused to impose any "fixed and inflexible rule."[16]

Yet what is truly amazing about *Frosdick* is that while it is often cited as establishing the "six month" rule, in truth it does no such thing. The actual text of the opinion delivered by Chief Judge Waite makes but a single, isolated mention of the fact that the state court receiver had been authorized by a state judge to make payment to creditors out of funds derived from secured collateral "for six months before" the receiver was appointed.[17] At the conclusion of the Justices' decision, the

---

12 *Id.*

13 *Id.* at 252-53.

14 *Id.* at 253.

15 *Id.* at 254.

16 *Id.*

17 *Id.* at 250.

circuit court's decision was reversed only insofar as to the payment of certain sums, but was affirmed in all other respects.[18]

The inescapable fact is that the Supreme Court never emotes a "six month" rule under that name or any other. Notwithstanding their detailed discussion of collateral, secured creditors, and what we today call post-petition administrative claims, the Justices never, directly or indirectly, declares a so-called "six month" rule. Were it not for the barest of mentions in the factual description of the lower court proceedings, there would be absolutely no basis to associate *Fosdick* with a purported "six month" rule.[19]

Another Nineteenth Century railroad case often cited in support of the "Doctrine of Necessity" is *Miltenberger v. Logansport Railway Co.*,[20] decided a few years after *Fosdick*. Compared to its predecessor, *Miltenberger* comes a few steps closer to actually articulating the Doctrine, but does not quite succeed. On the facts, Justice Blatchford first notes that the lower federal court appointed a receiver for the failed railroad, and "empower[ed] him to operate and manage said road, receive its revenues, pay its operating expenses . . . and to pay the arrears due for operating expenses for a period in the past not exceeding ninety days."[21]

This fact made its presence keenly felt in the legal discussion when the Justices addressed the allowance of expenses incurred more than ninety days before the receiver was appointed.[22] Notably, the receiver's petition alleged "that payment of that class of claims was indispensable to the business of the road, and that, unless the receiver was authorized to provide for them at once, the business of the road

---

[18] *Id.* at 255-56.

[19] As was the style of the reporting of Supreme Court opinions in the nineteenth century, a detailed discussion of the underlying facts was followed by the presentation of each side's arguments—only then did the Court's opinion follow. Within the statement of facts, there is only one mention of "six months" or its like. The Federal Circuit Court below held that the clerk of the court, as the stakeholder of funds generated during the stat court receivership, could pay rent for the subject coal cars "at the rate of seven dollars per moth for the *six months preceding*" the date of the appointment of the state court receiver. *Id.* at 240 (emphasis added). Significantly, neither side's argument ever utters the words "six months" or anything remotely similar to them. *Id.* at 241-49. While the syllabus is irrelevant and holds not an ounce of weight of authority, *United States v. Detroit Timber and Lumber Co.*, 200 U.S. 321, 337 (1906), is utterly silent as to the alleged "six month" rule or anything akin to such a proposition.

[20] 106 U.S. 286 (1882).

[21] *Id.* at 292.

[22] *Id.* at 311.

would suffer great detriment."[23] To be sure, the court below deemed that explanation satisfactory.[24]

Intriguingly, Justice Blatchford further relates that the special master who was appointed later to review the receiver's accounting "disallowed several items in the receiver's accounts, . . . where the claims were made on the ground that the creditors threatened not to furnish any more supplies on credit unless they were paid the arrears."[25] The master's action, as approved by the judge below and implicitly approved here, "appears to have been careful, discriminating, and judicious."[26] But the legal justification validating the master's move was far more significant.

The Supreme Court opined:

> Many circumstances may exist which may make it necessary and indispensable to the business of the road and the preservation of the property, for the receiver to pay preexisting debts of certain classes, out of the earnings of the receivership, or even the corpus of the property, under the order of the court, with a priority of lien. Yet the discretion to do so should be exercised with very great care. The payment of such debts stands, prima facie, on a different basis from the payment of claims arising under the receivership, while it may be brought within the principle of the latter by special circumstances.[27]

It is apparent that operating expenses arising out of "indispensable business relations, where a stoppage of the continuance of such business relations would be a probable result, in case of non-payment" may be paid in limited amounts.[28] Such payments have the efficacy of preserving the mortgaged property and maintaining the good will and value of the enterprise as an integrated, operating whole.[29] Yet let there be no mistake, the Supreme Court encapsulated this holding with one vital caveat: the foregoing perspective was firmly grounded upon the public interest in a railroad as public convenience whose smooth functioning made for special

---

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] *Id.* at 312.

[29] *Id.*

considerations.[30] Given the above, the failure of the objecting parties to specify what sums paid they believed to be improper, along with all the other circumstances implicitly unique to railroads and the public interest therein, led the Supreme Court to uphold the lower court's allowance of the payments.[31]

There we have the two Supreme Court landmarks that purportedly justify the "Doctrine of Necessity" and its progeny of today, the critical vendor motion. It is indeed astounding that certain key words such as "necessity" crop up in the supposed context of a six-month time frame. But is this enough? Are these few, vague references, made in unique circumstances that became irrelevant long ago, still a foundation for the critical vendor relief granted today?

The Doctrine of Necessity – A Troubled Dogma

Despite the undeniably controversial aspects of the "Doctrine of Necessity," some courts found reliance upon it to be unavoidable. From time to time, the doctrine came into play with regard to employee claims. In *In re Eqalnet Communications Corp.*,[32] the debtor pleaded necessity to pay the pre-petition claim of an essential contract employee well before plan confirmation. The bankruptcy court declared its unwillingness to substitute its judgment for the business judgment of the debtor. It was inclined to accept on good fait the movant's cry of necessity.[33] Moreover, some of the proposed payment in this case was entitled to priority as a statutory wage claim. Given the preexisting priority, the bankruptcy judge declared that common sense dictated that the payment be permitted since it would assist in the debtor's reorganization.[34] Therefore, the early payment of the pre-petition wage claim was allowed, though it was limited to the sum entitled to under Section 507(a)(3) wage priority.[35]

---

[30] *Id.* (citing Barton v. Barbour, 104 U.S. 126, 135 (1881)).

[31] *Id.* *See also id.* at 293 (The receiver had pleaded to the lower court that part of a ten thousand dollar debt due to connecting railroad lines was incurred more than 90 days before his appointment, "but the payment of that class of claims was indispensable to the business of the road, and it would suffer great detriment unless he was authorized to proved for them at once.").

[32] 258 B.R. 368 (Bankr. S.D. Tex. 2001).

[33] *Id.* at 370.

[34] *Id.*

[35] *Id.*

Not every court has embraced the troublesome doctrine. The "Doctrine of Necessity" came under scathing criticism in *In re Chandlier*.[36] In that unusual case, an attorney who had been found not authorized to practice law in the jurisdiction attempted to collect pre-petition legal fees relating to his alleged representation of a Chapter 7 debtor.[37] The U.S. Trustee sought disgorgement at the fees and sanctions.[38] The putative attorney claimed entitlement to his fee on the basis of the "Doctrine of Necessity."

On that argument, Bankruptcy Judge Jo Ann C. Stevenson held nothing back, declaring, "[t]he Doctrine itself is a violation of 11 U.S.C. § 507 and in fact, is not authorized by any Bankruptcy Code section."[39] When it has been employed, it is in Chapter 11 cases "under very extraordinary circumstances of a few critical vendors who furnish the debtor with unique and vital supplies so that the debtor can operate and reorganize."[40] Thus, the court refused to apply the "Doctrine of Necessity." This was a liquidation case, not reorganization; the purported attorney was neither a vendor nor a supplier; and the debtor had no further need of the attorney's services, given that other counsel could fill any future need.[41] The putative attorney did not collect a fee on the basis of the doctrine or any other basis.[42]

In many respects, the "Doctrine of Necessity" was an unwanted and undesired intruder into the absolute priority of creditor claims. It is rarely a good thing for mere doctrine to overcome statutory text; yet some courts have seen the "Doctrine of Necessity" as a sometimes-necessary evil. It was therefore left to bankruptcy courts to employ it sparingly, if at all, so as to not upset the delicate balance struck by Congress in the Code. Otherwise, use of this questionable doctrine would be inequitable and would usurp the carefully balanced priorities already established.

---

36 292 B.R. 583 (Bankr. W.D. Mich. 2003).

37 *Id.* at 583.

38 *Id.* at 585-86.

39 *Id.* at 586.

40 *Id.* at 588.

41 *Id.*

42 *Id.*

"Critical Vendor" Motions Today

Notwithstanding the cautionary note above, the "Doctrine of Necessity" took on a new life and is now seen all too frequently in so-called "critical vendor" motions. The reorganizing debtor seeks permission to pay the pre-petition, non-priority, unsecured claims of certain vendors. The debtor alleges it must satisfy those claims in order to keep doing vital post-petition business with those vendors. These extraordinary motions encountered increased skepticism from the courts, as did the "Doctrine of Necessity" itself. Many courts sought to limit application of the Doctrine to truly extreme circumstances.[43] Not surprisingly, many jurisdictions frowned upon the practice.[44]

A linchpin of the instant controversy is the appropriate use of Section 105 of the modern Bankruptcy Code. In relevant part, the statute provides that the court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."[45] As one might imagine, a liberal interpretation of Section 105 would empower a bankruptcy court to do many things under the banner of "necessary and appropriate," including granting "critical vendor" motions. Conversely, a more conservative point of view would limit the use of the statute to achieve the ends of the Bankruptcy Code.

The quintessential case for judicial restraint in employing Section 105 to pay creditors out of turn is the Fifth Circuit landmark of *Chiasson v. Matherne* (*In re Oxford Management, Inc.*).[46] There, the nub of the dispute was the payment of a real estate broker's commissions out of the property of a debtor, which was itself a defunct real estate broker.[47] The bankruptcy court exercised its equitable power under Section 105 to compel the debtor to pay the claimant before any general distribution. An appeal followed.[48]

Pertinent to this article is the Fifth Circuit's finding of the limitations inherent in Section 105. The court recognized that the statute expressly "authorizes a bankruptcy court to fashion such orders as are necessary to further the substantive

---

43 *In re* Coserve L.L.C., 273 B.R. 487, 496-98 (Bankr. N.D. Tex. 2002).

44 *See, e.g., In re* Oxford Mgmt., Inc., 4 F.3d 1329 (5th Cir. 1993).

45 11 U.S.C. § 105(a) (2004).

46 4 F.3d 1326 (5th Cir. 1993).

47 *Id.* at 1332-33.

48 *Id.* at 1333.

provisions" of Title 11.[49] "But, the powers granted by [Section 105] must be exercised in a manner that is consistent with the Bankruptcy Code."[50] The statute does not authorize the creation of substantive rights not firmly rooted in law. Bankruptcy judges cannot create rights or remedies by judicial fiat or hold a "roving commission" to do equity.[51]

Applying that principle of limitation to the case before it, the tribunal further noted that pre-Code law did not grant bankruptcy courts authority to allow payment out of estate property except as strictly provided for by statute.[52] As for the modern Code, it lacks any statute that "would allow the payment of post-petition funds to satisfy pre-petition claims."[53] The court held that it was wrong for the lower court to elevate the status of these particular creditors above other general unsecured claimants.[54] Such a deviation from the scheme of equality of distribution called for by the Code "effectuated an impermissible substantive alteration of the Code's provisions."[55] It was thus clear error for the bankruptcy court to exceed its equitable powers as found in Section 105; thus, the order was reversed.[56]

It comes as no surprise that *Oxford* has long been a landmark for curtailing the use of Section 105 and limiting its application to situations such a critical vendor relief. Thus, we often find *Oxford* cited by jurists opposed to such motions. But the Fifth Circuit's decision has not been universally accepted. Certain courts have voiced disagreement by relying upon Section 105, among other statutes, in approving "critical vendor" motions.

Given the disagreement, we shall begin this part of our discussion by examining those courts that have taken a broader view of their powers under Section 105-those courts that have concluded that they can usurp statutory priorities and grant critical vendor relief.

---

49 *Id.*

50 *Id.* at 1334.

51 *Id.* (quoting United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986)).

52 *Id.*

53 *Id.*

54 *Id.*

55 *Id.*

56 *Id.*

"All Those in Favor of "Critical Vendor" Motions . . ."

One of the most oft cited cases used to justify the granting of "critical vendor" motions is *In re Just for Feet, Inc.*,[57] which arose from the travails of the popular sneaker and athletic apparel chain in the late 1990s. The debtor started its corporate life in 1973 as a chain of superstores specializing in name brand footwear and related apparel.[58] Outsized floor space, in-store entertainment, and even basketball courts for "test runs" of the merchandise characterized Just for Feet retail outlets. Most pertinent to this analysis, Just for Feet made its mark by carrying anywhere from 2,500 to 4,500 different styles of sneakers and foot gear, an astronomical leap beyond the typical mall-based rivals that typically carried a few hundred styles at best.[59]

Despite its unique approach to athletic footwear retailing, Just for Feet encountered liquidity difficulties in mid-1999. Unable to stanch its decline, the chain filed for Chapter 11 in November of that same year.[60] Days after filing its petition, the debtor made a critical vendor motion.[61] In testimony, the retailer's CEO argued that the surviving stores required a continuous flow of new footwear and apparel from a few key suppliers.[62] The debtor's chief executive emphasized that the debtor's business was not just selling sneakers; rather, it was in the business of selling athletic gear as fashion. Given the dynamic and fickle nature of the industry, the debtor "'need[s] new styles, new colors, hot products on the floor to get the customer in the door.'"[63]

Just for Feet's suppliers were the dominant vendors of cutting edge merchandise and the list was a virtual "who's who" of the athletic footwear elite: Nike, New Balance, Fila, Reebok, Adidas, Asics, K-Swiss, and Converse.[64] Those sellers knew well the essential role they played in the debtor's business, for just after the retailer filed for Chapter 11, most, if not all, of them demanded immediate

[57] 242 B.R. 821 (D. Del. 1999).

[58] *Id.* at 822.

[59] *Id.* at 822-23

[60] *Id.* at 822.

[61] *Id.*

[62] *Id.* at 823.

[63] *Id.*

[64] *Id.*

payment of their pre-petition claims in exchange for post-petition shipments.[65] In effect, the major sneaker makers held new merchandise hostage until Just for Feet paid old debts. The top vendor's pre-petition claims were not insignificant. They totaled approximately $33 million in gross and comprised almost half of the debtor's trade vendor arrearages.[66]

According to Just for Feet's chief executive, this put the debtor in a horrid situation. The debtor supposedly needed $50 million in fresh inventory before Thanksgiving (less than three weeks away), but this far had only obtained half that amount in post-petition financing.[67] The debtor portrayed the situation as a fight for survival for the debtor, for without court approval of critical vendor payments, the retailer's reorganization might be doomed to failure.[68]

While there is no doubt that Just for Feet was in dire straits, various creditors and the U.S. Trustee objected to the proposal to pay the pre-petition claims of the footwear vendors.[69] The objectors first argued that the court had no power under the Bankruptcy Code to authorize such out of turn payments.[70] Second, the opposition criticized the debtor's proposal as lacking in sufficient detail to merit court approval.[71]

Thus, the dispute came before Delaware District Judge McKelvie.[72] The court first examined Section 105, the broad statutory grant of the Bankruptcy Code that empowers courts presiding over bankruptcy cases to issue any order necessary or appropriate to carry out the provisions of Title 11.[73] The court noted that this

---

65 *Id.*

66 *Id.*

67 *Id.*

68 *Id.* at 823-24.

69 *Id.* at 824.

70 *Id.*

71 *Id.*

72 To be sure, federal district judges normally hear only appeals of bankruptcy judge orders. However, as the District of Delaware became the favored court for filing complicated Chapter 11 "megabankruptcies," it was decided that the small and already overburdened Delaware Bankruptcy Court would share bankruptcy case allocation with its superiors on the district bench. Since bankruptcy jurisdiction vests with the Article III district court and is "referred down" to the Article I bankruptcy court, 28 U.S.C. § 157(a), *et seq.*, this was both simple and constitutionally correct.

73 *In re* Just for Feet, Inc., 242 B.R. at 824. *See* 11 U.S.C. § 105(a) (2004).

statute has been employed in modern times as a justification for the exercise of an equitable power to authorize the early payment of pre-petition claims, and deemed to be a natural extension of the uncodified "Doctrine of Necessity" found in pre-Code days.[74] The Delaware court cited decisions of its home appellate court, the Third Circuit, to exemplify this history.[75] Notably, it cited its home tribunal's precedents in railroad reorganizations.

The *Just for Feet* court also acknowledged decisions cited by the opposition which forbade the immediate payment of pre-petition claims.[76] Judge McKelvie was also cognizant of recent Supreme Court cases that forbid derogation of the Bankruptcy Code's statutory scheme of priority of payment.[77] Nonetheless, the district court found those cases inapposite. As for the Supreme Court precedents, Judge McKelvie contended that they merely prevented the subordination of IRS tax claims under a different Bankruptcy Code section.[78] "The Supreme Court cases . . . do not hold that a bankruptcy court may never use its equitable powers to authorize payment to vendors when such payment is critical to the reorganization."[79] Continuing, the court relied upon the "Doctrine of Necessity" for authority to pay critical vendors pre-bankruptcy claims.[80] Thus, in dual reliance upon the pre-Code "Doctrine of Necessity" and the modern law's Section 105, District Judge McKelvie found himself empowered to authorize the payment of critical vendors.[81]

Nonetheless, the court still had to address the objectors' claims that the debtor's proposal was too poorly defined. Here, *Just for Feet* recognized that it is the movant's burden to demonstrate the unavoidable need for early payment.[82] Again, Judge McKelvie held that the debtor had a better argument. "Clearly, Just for Feet

---

[74] *In re* Just for Feet, Inc., 242 B.R. at 824-25.

[75] *Id.* (citing *In re* Lehigh & New England Railway Co., 657 F.2d 570, 581 (3rd Cir. 1981); *In re* Penn Central Transp. Co., 467 F.2d 100, 102 n.1 (3rd Cir. 1972)).

[76] *In re* Just for Feet, Inc., 242 B.R. at 825. *See In re* Oxford Mgmt., Inc. 4 F.3d at 1333-34; *In re* FCX, Inc., 60 B.R. 405, 410 (E.D.N.C. 1986).

[77] *In re* Just for Feet, Inc., 242 B.R. at 825.

[78] *Id.* (discussing United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213 (1996); United States v. Noland, 517 U.S. 535 (1996)).

[79] *Id.*

[80] *Id.* at 825-26.

[81] *Id.* at 826.

[82] *Id.*

cannot survive unless it has name brand sneakers and athletic apparel to sell in its stores."[83] A steady supply of new goods from the aforementioned top-drawer suppliers was absolutely necessary if the debtor had any hope of surviving.[84] Thus, given the essential status of those highly recognizable vendors, the court concluded that paying them was appropriate.[85]

Various bankruptcy courts have approached "critical vendor" motions differently. Chief Bankruptcy Judge Arthur Federman of Missouri's Western District confronted a somewhat unique situation in *In re Payless Cashways, Inc.*,[86] and rendered an intelligent but specialized decision that has not found broad application.

The debtor Payless operated over one hundred stores, selling lumber and building materials to contractors and homeowners.[87] The instant case was its second Chapter 11 case, so it proceeded from shaky ground.[88] Lumber was one of its key sales items; for without it, customers would go elsewhere to buy wood and all other related items that comprised the bulk of Payless' sales.[89] Simply put, no lumber meant no business.

Thus, the debtor filed an emergency "first day" motion, seeking by various means to ensure a steady post-bankruptcy supply of this essential lumber.[90] Part of the enticement for critical lumber vendors was the post-petition payment of all or some of their pre-petition claims.[91] The debtor's CEO testified as to the absolute necessity to have lumber in stock, the ability of the lumber vendors to ignore Payless and sell to solvent competitors, the debtor's near lack of lumber products in its depleted inventory during the peak season, and Payless' significant difficulties in

---

[83] *Id.*

[84] *Id.*

[85] *Id.*

[86] 268 B.R. 543 (Bankr. W.D. Mo. 2001).

[87] *Id.* at 544.

[88] *Id.*

[89] *Id.* at 545.

[90] *Id.* at 544-45.

[91] *Id.* at 545.

obtaining credit on customary terms because this proceeding was its second Chapter 11 case.[92]

The CEO's testimony that the debtor did not have post-petition financing, but was instead seeking court authority to use cash collateral was important. Accordingly, the court treated the prayer for relief before it as a borrowing request under Section 364.[93] Notably, this treatment implied that there was no actual motion to borrow money pursuant to Section 364.[94]

The debtor's request was only opposed by the U.S. Trustee, who argued that the Bankruptcy Code did not empower a court to authorize a debtor to pay pre-petition debts prior to the confirmation of a plan of reorganization.[95] Indeed, the committee of unsecured creditors approved the proposal to pay the pre-petition debts that Payless owed to the lumber vendors.[96]

Chief Judge Federman first acknowledged the nominal correctness of the U.S. Trustee's reliance upon the absolute priority rule for the payment of claims in bankruptcy cases.[97] Nonetheless, "courts [have] recognized that in certain circumstances it was in the best interest of all concerned to pay certain pre-petition creditors out of turn, as an inducement to them to continue working for, or doing business with, the debtor."[98] Alluding to the pre-Code evolution of the "Doctrine of Necessity," the chief judge recognized the U.S. Trustee's point that nothing in the modern codification "authorizes, or even contemplates" the early payment of pre-petition claims.[99] More to the point, the bankruptcy courts "are obligated to strictly adhere to the priorities established by the Code . . . ."[100]

---

92 *Id.*

93 *Id.*

94 *See* 11 U.S.C. § 364 (2004).

95 *In re* Payless, 268 B.R. at 545.

96 *Id.* at 546.

97 *Id.* *See* 11 U.S.C. § 507 (2004).

98 *In re* Payless, 268 B.R. at 545.

99 *Id.*

100 *Id.* Parenthetically, the court further noted that it was forbidden from confirming a Chapter 11 plan if said plan unfairly discriminated among creditors. *Id.*

However, the *Payless* court declared that the current Bankruptcy Code "does not absolutely prohibit payment of pre-petition claims prior to confirmation.[101] Judge Federmen noted that Section 549 authorizes Chapter 7 trustees to put aside only post-petition payments of pre-petition claims without court approval.[102] Therefore, the court declared that it possessed "some limited power" to authorize such obviously preferential treatment of specific pre-petition creditors.[103]

The court then turned to the question of appropriate timing in exercising the admittedly circumscribed power. Returning to Section 364, the *Payless* court noted its wide ability to authorize a debtor to borrow money on terms other than in the ordinary course of business and give such lenders an administrative expense priority.[104]

In this particular Chapter 11 proceeding, the court found that the lack of post-petition financing was a significant factor. This financing would make the mere promise of a priority administrative expense claim far less attractive to potential post-bankruptcy suppliers[105] More was needed, and the *Payless* court contemplated the preferred treatment of paying the pre-petition claims of critical vendors.[106]

In order to grant preferred treatment to critical vendors, Chief Judge Federman articulated a six-point test, where the court must ask: (1) if procedural requirements have been met; (2) if the transaction is arms-length; (3) if any borrowing is vital to the continuance of the business; (4) if the transaction would benefit the estate and its creditors, not just the vendors; (5) if interested parties have been represented in the proceedings and, if not, the sophistication of unrepresented parties; and (6) the extent to which there is support or opposition from the general body of creditors.[107]

---

101 *Id.*

102 *Id.* *See* 11 U.S.C. § 549 (2004). To be sure, the Payless description of Section 549 is not entirely accurate. The statute is broader in permitting a trustee (or debtor in possession) to invalidate such post-petition transfers.

103 *In re* Payless, 268 B.R. at 545.

104 *Id.* at 546-47.

105 *Id.* at 547.

106 *Id.*

107 *Id.*

Applying a new set of principles, the *Payless* court added that the court "must be guided by practicality and common sense."[108] A court sitting in bankruptcy must first be satisfied that such goods are "critical to survival of the business."[109] Then the bench must decide if the court's preferential treatment of some creditors "is a better result than closing the business, or allowing it to dies slowly for lack of necessary supplies."[110] On these points, Chief Justice Federman declared that the views of the creditor body were important, particularly the opinions of the unsecured creditors who would be most impacted.[111]

In *Payless*, the court duly noted that the creditors' committee had approved the critical vendor motion.[112] Moreover, the chief judge found that ensuring an uninterrupted supply of lumber from the critical vendors was vital to the debtor's survival.[113] In addition, the amount proposed to be paid to the elite vendors constituted less than two percent of the debtor's pre-petition debt.[114] Chief Judge Federman found that in return for paying the critical vendors' pre-petition claims, Payless could restock its supplies of lumber, tools, and other goods for sale.[115] Similarly, in applying its own standards, the *Payless* court found that the lumber transactions were arms-length, that the vendors would not do business with the debtor absent of the relief requested, and that the debtor had no place else to obtain the essential inventory it needed.[116] For all these reasons, the *Payless* court granted the "critical vendor" motion.[117]

Just for Feet and *Payless* not only granted "critical vendor" motions under the rubric of the "Doctrine of Necessity," but both courts also embraced the doctrine and its modern day offspring. Not every lower court has been so welcoming. Even when granting the requested relief, these courts have done so begrudgingly and with

---

108 *Id.*

109 *Id.*

110 *Id.*

111 *Id.*

112 *Id.*

113 *Id.*

114 *Id.*

115 *Id.*

116 *Id.*

117 *Id.*

a healthy dose of skepticism. Given this more thoughtful approach, let us examine that more critical view of "critical vendor" motions.

CoServ – A Critical Methodology for Critical Vendor Motions

In re CoServ, L.L.C.[118] is a thorough and recent analysis of the critical vendor controversy. The debtor's principal business was providing telecommunications services and website development and hosting in northern Texas[119] As part of its "first day" motions, CoServ sought court permission to pay over $2 million in pre-petition claims, held by over two dozen critical vendors, as part of a plan to maintain allegedly essential business relationships post-petition.[120] After some earlier debate and modification to the proposal, the committee of unsecured creditors and other principal creditors acquiesced to the relief requested.[121]

Bankruptcy Judge Dennis Michael Lynn listed three reasons why the lack of opposition to the motion was not enough.[122] First, the court declared its "independent obligation" to ensure that the strictures of the Bankruptcy Code are obeyed.[123] Second, the United States Trustee had historically taken a position against the early payment of pre-petition claims.[124] Third, additional vendors were in the wings, awaiting the bankruptcy court's decision.[125] If that decision was favorable, apparently those vendors would step forward on a "me, too" basis, seeking critical vendor classification.[126] For these reasons, Bankruptcy Judge Lynn decided a strict analysis was necessary.

The court posited three questions: (1) was there authority to pay certain pre-petition creditors before a reorganization plan was approved; (2) what is the proper

---

118 273 B.R. 487 (Bankr. N.D. Tex. 2002).

119 *Id.* at 489.

120 *Id.* at 490.

121 *Id.*

122 *Id.* at 490-91.

123 *Id.*

124 *Id.*

125 *Id.*

126 *Id.*

test for deciding which claims are thus paid; and (3) which creditors should be paid?[127]

As to the first issue, the matter of what authority in law existed for such relief, the debtor argued the "Doctrine of Necessity."[128] Significantly, the *CoServ* court did not disagree that it possessed the power to pay pre-petition creditors outside of a Chapter 11 plan, "but . . . may do so only under extraordinary circumstances."[129] Judge Lynn observed that thousands of debtors have successfully emerged from Chapter 11 without paying so-called "critical vendors."[130] In a seeming rebuke, the *CoServ* court faulted the increasing willingness of other courts to allow critical vendor payments.[131] Notwithstanding the liberality of other bankruptcy jurists, "this Court does not believe there has been a sea change in the law that would warrant such a drastic expansion of the 'Doctrine of Necessity,' a device to be used only in rare cases."[132]

Parenthetically, *CoServ* noted that the theorem called the "Doctrine of Necessity" today is actually the outgrowth of two separate postulations arising before the advent of the modern Bankruptcy Code.[133] The "Six Months Rule" was rooted in railroad receiverships and, in subsequent codifications, only applied to railroad reorganizations.[134] The "Necessity of Payment Rule," a common law device, paralleled the "Six Months Rule," for it only dealt with the peculiarities of railroad bankruptcies.[135] However, "[t]he Rule has occasionally been extended to on-railroad debtors."[136] In the first decade of the Code, the "Necessity of Payment" rule was used in cases analogous to railroad reorganizations. The application has a concurrently strong emphasis that the Rule was applied to further the "paramount

---

127 *Id.*

128 *Id.*

129 *Id.*

130 *Id.*

131 *Id.*

132 *Id.*

133 *Id.* at 493 n.7.

134 *Id. See also* 11 U.S.C. § 1171(b) (2004) (found in Subchapter IV of Chapter 11, and restricted to railroad reorganizations only).

135 *In re* Coserv, L.L.C., 273 B.R. at 493 n.7.

136 *Id.*

consideration" of Chapter 11, the continued operation and rehabilitation of the debtor.[137] When the courts extended the "Necessity of Payment" rule to cases involving non-railroad debtors, the rule morphed into the current "Doctrine of Necessity."[138]

Continuing its search for statutory authority to pay the pre-bankruptcy claims of critical vendors, Judge Lynn rejected allegations that such payments were permissible under Section 363 as the utilization of estate property outside the ordinary course of business as a power of a debtor in possession under Section 1107, or allowed by Section 549 to condone post-petition transfers.[139]

"Only Section 105(a) offers the equitable muscle that would allow a bankruptcy court to violate one of the principal tenets of Chapter 11: that pre-petition general unsecured claims should be satisfied on an equal basis pursuant to a plan."[140] More importantly, Judge Lynn opined that the court's Section 105 equity power is severely circumscribed" and may be employed "*only* to carry out the provisions of Title 11."[141] To be certain, the *CoServ* court declared that relying upon Section 105 to pay critical vendors prior to plan confirmation "is generally *inconsistent with* rather than in *furtherance of* the Bankruptcy Code.[142] That is why such relief can only be granted "under the most extraordinary circumstances."[143]

Judge Lynn found support for this in the overall structure of the Bankruptcy Code. "Congress clearly knew how to place some unsecured claims ahead of others," he observed in looking to the priority scheme of payment so fundamental to the insolvency law.[144] Similarly, the lawmakers made another deliberate choice by allocating "special protections which might lead to post-petition, pre-plan

---

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

138 *Id.*

139 *Id.* at 493.

140 *Id.*

141 *Id.* at 493, 494 n.9 (emphasis added).

142 *Id.* at 494 n.9 (emphasis added).

143 *Id.* at 494.

144 *Id.* (citing 11 U.S.C. § 507(a) (2004) (priority of payment statute); 11 U.S.C. § 1171(b) (2004) (railroad reorganization priorities)).

satisfaction" of unsecured claims elsewhere in the statutes.[145] The *Corserv* bench continued, "[T]he entire scheme of the Bankruptcy Code favors equal (and simultaneous) treatment" of pre-petition claims.[146] This apparent goal of equal status, be it in a Chapter 7 liquidation or a Chapter 11 reorganization, "suggests that Congress would not approve of a prepetition creditor asserting so-called "critical" status to put itself ahead of its peers in the timing of payment; indeed, such conniving might well be characterized as '"economic blackmail."'[147]

The situation is different when the vendor's own solvency is put at risk by the debtor's bankruptcy filing. Vendors need not risk going into bankruptcy themselves, which is precisely why Congress crafted mechanisms such as deposits and cash on delivery payments, among other devices to ensure against further losses by the creditors post-petition. If such devices are inadequate to assure the vendor for purposes of continuing to deal with the debtor post-petition, this may open the door to extraordinary relief.[148]

Following its cogent analysis of the Bankruptcy Code, the *CoServ* court turned to the applicable case precedents. There it found, at best, "mixed support" for the debtor's application.[149] Judge Lynn's own circuit had come "perilously close" to the bright line rule adopted by the bankruptcy courts of Montana in refusing to elevate pre-petition claims to a higher level of priority.[150] Specifically, the Court of Appeals for the Fifth Circuit "took almost as hard a line" in *In re Oxford Management, Inc.*[151] While *Oxford* was distinguishable upon its precise facts, the *CoServ* court still

---

[145] *Id.* (citing 11 U.S.C. § 546(c), (d) (2004) (rights reclamation); 11 U.S.C. § 547(c)(3) (2004) (allowing post-petition perfection of a security interest securing a pre-bankruptcy indebtedness); 11 U.S.C. § 366 (2004) (special treatment for utilities)).

[146] *Id.* at 494 (citing 11 U.S.C. §§ 362(a), 726, 1122, 1129(b)(1) (2004).

[147] *Id.* (quoting *In re* Structurlite Plastics Corp., 86 B.R. 922, 932 (Bankr. S.D. Ohio 1998) (early payment of selective pre-petition debt should not be authorized "as a result of threats or coercion by disgruntled creditors." *Id.* Such behavior violates the automatic stay and jeopardizes the basic tenets of equality of treatment for similarly situated creditors.).

[148] *Id.* at 494-95.

[149] *Id.* at 495.

[150] *Id.* at 495 (citing *In re* Timberhouse Post & Beam, Ltd., 196 B.R. 547, 550-51 (Bankr. D. Mont. 1996)).

[151] 4 F.3d 1329 (5th Cir. 1993)).

regarded its outlook as determinative in barring early payment of pre-petition claims, a precept reflected in other Fifth Circuit holdings.[152]

Judge Lynn then looked to Supreme Court jurisprudence. The *CoServ* court expressed doubt that the Supreme Court would assume it had broad discretion to approve critical vendor payments; although that assumption would not be sensible in light of the Court's recent decisions barring subordination of claims.[153] Paying critical vendors may not equate to subordinating tax claims, but nonetheless, "it has the smell of a similar inappropriate adjustment of congressionally established priorities" and flies in the face of Supreme Court edicts.[154] In conclusion, *Coserv* ruled, "even a cursory review of the law makes clear that this Court does not possess the broad powers" to approve critical vendor claims as requested by the debtor.[155] Clearly, such wide authority was absent. But then the bench turned to the next question: can a bankruptcy court *ever* authorize critical vendor payments?[156]

To answer this question, the *CoServ* court perceived the issue as largely a matter of the debtor's obligations, the first of which was to act as a fiduciary to creditors and protect and preserve the estate, including the going concern value of an operational business.[157] Judge Lynn opined that "[t]here are occasions when this duty can only be fulfilled by the preplan satisfaction of a prepetition claim."[158] The court cited as examples the payment of foreign creditors beyond the reach of a U.S. bankruptcy court, refunds to customers to preserve their business, and the payment of license fees, albeit pre-petition in nature, whose loss would have been detrimental.[159] "It may be that payment of a prepetition unsecured claim is the only means to effect a substantial enhancement of the estate," observed Judge Lynn.[160]

---

152 *In re* Coserv L.L.C., 273 B.R. at 495. *See In re* AWECO, 725 F.2d 293 (5th Cir. 1984), *cert. denied*, 469 U.S. 880 (1984) (pre-plan compromise and payment of an unsecured claim prohibited as violative of the absolute priority rule).

153 *In re* Coserv L.L.C., 273 B.R. at 495 (citing United States v. Noland, 517 U.S. 535 (1996); United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213 (1996)).

154 *Id.* at 496.

155 *Id.*

156 *Id.*

157 *Id.* at 497.

158 *Id.*

159 *Id.*

160 *Id.*

Thus, "it is only logical" to call upon the broad powers of Section 105 to authorize the early satisfaction of pre-petition claims to preserve or enhance a debtor's estate.[161]

At the end of the day, the *CoServ* court was satisfied that, in the right circumstances, it could order the kind of relief requested by the debtor.[162] But this court was left wholly unsatisfied with the present state of the case law on this subject, finding that none of the cases established a clear set of rules for principled decision-making in such matters.[163]

To answer his final question, Judge Lynn set out to articulate his own standard for critical vendor motions.[164] First, the court in *CoServ* was careful to declare that the equitable power to be used here "should be used sparingly," and then only within specific parameters.[165] In promulgating its own test, the court explicitly rejected reliance upon amorphous standards such as "essential to the continued operation of the debtor," for reason that such vague rationales simply did not provide real guidance.[166] Without meaningful precedents, Judge Lynn criticized, ill-advised "critical vendor" motions sprout like weeds.[167]

Judge Lynn's test was formulated upon three points: First, it was imperative that the debtor and the vendor continue to do business. Second, there must be a likelihood of harm unless the debtor maintains a good business relationship with the vendor and the impact of that harm would be "disproportionate to the amount of the claimant's pre-petition claim."[168] Third, the debtor must be out of options—it lacks either a practical or legal way to deal with the claimant, except for acceding to the vendor's demand that its pre-petition claim be paid as a condition to transacting

161 *Id.*

162 *Id.*

163 *Id.* at 498.

164 *Id.* at 497.

165 *Id.*

166 *Id.* at 498 (criticizing *In re* Just for Feet, 242 B.R. at 825).

167 *Id.*

168 *Id.*

post-petition business.[169] A "critical vendor" motion can be granted if these three conditions can be shown by a preponderance of the evidence.[170]

With the more arduous part of the opinion completed, the *CoServ* bench turned to apply its new test to the facts at bar. Here, the debtor achieved mixed results for, to coin a phrase, some vendors turned out to be more critical than others.[171] In truth, which creditors had their pre-petition claims paid early as critical vendors and which did not obtain such favorable status is irrelevant. The point is that the bankruptcy court in *CoServ* added an erudite analysis to the controversy of critical vendor motions. The power of this opinion cannot be underestimated, as it concludes by yet again emphasizing that well-established law demands granting critical vendor relief only in "the most extraordinary circumstances."[172]

Mirant Energizes the Controversy

The bankruptcy court in *In re Mirant Corp.*[173] supplied another intriguing perspective. Mirant and its affiliates were among the most essential providers of power throughout the United States. Thus, the reorganization case posed some rather troublesome issues in need of swift and just resolution.[174] Because of the potentially harmful effects on the nation's economy if Mirant's operations were disrupted, the debtor requested expedited relief, including the right to pay so-called "critical vendors."[175]

This troubled Bankruptcy Judge Lynn, for he had grave misgivings about granting such requests, as he had previously expressed in the *CoServ* case.[176] In writing the *Mirant* opinion, Judge Lynn reiterated his "reservations about granting such relief when to do so could result in certain favored unsecured creditors receiving treatment preferential to that received by other unsecured creditors under a

---

[169] *Id.*

[170] *Id.*

[171] *Id.* at 499-501 (with apologies to Orwell and "Animal Farm").

[172] *Id.* at 501-02.

[173] 296 B.R. 427 (Bankr. N.D. Tex. 2003).

[174] *Id.* at 428.

[175] *Id.* at 428-29.

[176] *Id.* at 429 (citing *In re* Coserv L.L.C., 237 B.R. at 437).

[Chapter 11] plan."[177] In the case at bar, the bench voiced concern that the compressed time frame had virtually excluded the U.S. Trustee and other interested parties from meaningful participation in the hearings.[178]

The *Mirant* court announced that its desired course in such matters was to treat vendors on a case-by-case basis and to grant preferential treatment based on evaluation of several factors. The court must evaluate: whether the weight of the evidence demonstrates necessity of the debtor/vendor relationship, the risk of harm that will result if the debtor cannot deal with the vendor, and finally, the lack of any practical or legal alternative to compel the vendor to continue to do business with the debtor except immediate payment of the pre-bankruptcy claim.[179] A bankruptcy court could require positive proof of all three of these elements.[180] Businesses in Chapter 11 are usually in dire straits, particularly in those early, problematic days of reorganization. In the instant case, any loss of a vital vendor relationship could have been "disastrous."[181] Furthermore, because critical vendor payments have "become commonplace in some jurisdictions," the *Mirant* court acknowledged that some vendors have come to expect and demand such extraordinary treatment, regardless of the holdings in *CoServ* or similarly minded cases.[182]

Given all these weighty concerns, the bankruptcy judge admitted that he could not risk the consequences of damage to this debtor's operations, by delaying to handle the critical vendor request the way he wished.[183]

Accordingly, the *Mirant* court conditioned relief for "critical" vendors in the following way: the debtor was first authorized to pay the pre-petition debt of any creditor claiming secured status, providing that Mirant, in its business judgment as to the best interests of its estate, believed the lien asserted was valid and would make the amount of the debt only to the extent the debtor believed necessary.[184]

---

177 *Id.* at 429.

178 *Id.* at 429 n.3.

179 *Id.* at 429.

180 *Id.*

181 *Id.*

182 *Id.*

183 *Id.*

184 *Id.*

Second, calling upon the multiple requirements enumerated in *Corserv*, the debtor was authorized to pay pre-petition claims that passed the *Corserv* test.[185] As a further protection, the debtor was ordered to file a schedule of payments made under either of these two methods with the U.S. Trustee and the creditors committee, thus insuring some oversight to the process.[186]

Third, the court gave Mirant permission to pay the pre-petition claim of any vendor that refused to do business with them unless such pre-bankruptcy debt was paid, and where Mirant, in its best business judgment, reasonably believed continuing to trade with the vendor was essential to Mirant's business[187] Notably, Judge Lynn appended some strenuous provisions to this last grant of authority. If the debtor believed this vendor's claim failed the *CoServ* test, it could move for a determination of "ordinariness" of the claim and recover the sums already paid.[188] Furthermore, any vendor that demands recognition as a critical vendor, but still refuses to deal with the debtor, would be subject to sanctions.[189]

Judge Lynn took one final step to ensure compliance with his mandate: any vendor put on notice of the instant order would be sanctioned if it still refused, absent good cause, to conduct post-petition business with the debtor even though the vendor was assured via deposit or prepayment that its post-petition goods would be properly purchased.[190]

Mirant was light on legal substance, but that was not surprising or untoward. After all, Judge Lynn firmly grounded *Mirant* upon *CoServ*. Why be unduly repetitive?

The legal rational thus incorporated by reference, the opinion was free to be eminently practical. As we will elaborate upon later, *Mirant*, rendered in the heat of battle, does not suffer for the haste of its issuance. Rather, its firm grasp of the dilemma of "critical vendor" motions makes it a template for the future.

---

[185] *Id.* at 429-30.

[186] *Id.*

[187] *Id.* at 430.

[188] *Id.*

[189] *Id.*

[190] *Id.*

By any measure, the twin prongs of *CoServ* and *Mirant* were a better reasoned, more thoughtful attack on "critical vendor" motions. But they were but a prelude to the true onslaught, destined to bring down such motions. Next, critical vendor relief is besieged by a higher court, one of the nation's pre-eminent appellate courts, in the next case for our consideration.

Kmart **– Rejecting "Critical Vendor" Motions**

We now come to *Capital Factors, Inc. v. Kmart Corp.*,[191] the pivotal case that may prove to be either the catalyst for cataclysmic change or merely the perpetuation of the status quo. This pivotal case of course arises from the travails of the troubled retailer. While the last words have not yet been spoken, we can thoroughly examine the first and second opinings of judicial wisdom.

In *Kmart*, the bankruptcy court previously issued four final orders authorizing Kmart to pay certain pre-petition obligations before it proposed a plan of reorganization providing for the treatment of all claims under a unitary plan.[192] These orders were issued pursuant to "critical vendor" motions.[193]

Kmart alleged the earlier payments were vital to maintain relationships essential to its efforts to stay in business and reorganize. Accordingly, Kmart justified its request under the "Doctrine of Necessity."[194] The bankruptcy judge agreed with Kmart, authorizing certain "critical vendor" payments; Capital Factors, a creditor who was receiving nothing for its pre-petition claim, objected and appealed.[195]

District Judge Grady chose to first examine the bankruptcy court's power under Section 105 to authorize the critical vendor payments.[196] This inevitably compelled the reviewing court to analyze the "Doctrine of Necessity." While the bankruptcy court did not invoke the doctrine by name, Kmart's reliance upon it was explicit.[197] Considering the bankruptcy court's invocation of terms such as

---

191 291 B.R. 818 (Bankr. N.D. Ill. 2003).

192 *Id.* at 820.

193 *Id.*

194 *Id.*

195 *Id.* at 820-21.

196 *Id.* at 821.

197 *Id.* at 822.

"necessary," "integral" and the like,[198] there could be no mistake that the "Doctrine of Necessity" was the cornerstone of the relief requested and granted below.

Because the doctrine is equitable and not codified within the text of the Bankruptcy Code, Judge Grady concluded that the doctrine could only be applied by way of Section 105-the Code's grant of general equitable powers to the bankruptcy courts. The exercise of that equitable power pursuant to Section 105 is limited to what is "necessary to enforce the [statutory] provisions of the Code," but a judge may not unilaterally engraft new powers onto the Code as he or she sees fit.[199] This is consistent with the Supreme Court's edict that any "authority give to the bankruptcy courts under § 105 must be exercised within the [written] confines of the . . . Code" itself.[200]

As Sections 503 and 507 provide, specific requirements must be met to classify claims for priority of payment at the end of any case. As the district court noted, "[t]he Code does not carve out priority or administrative expense status for prepetition general unsecured claims based on the 'critical' or 'integral' status of a creditor."[201] Nevertheless, that is what the bankruptcy court did when it altered the statutory priority scheme by "elevat[ing] the claims of the 'critical' vendors" and subordinating the claims of all other general, unsecured creditors.[202]

Can courts rightly usurp the statutory priorities merely by invoking Section 105? District Judge Grady observed that there is a split of authority on the subject. Several bankruptcy judges "and a handful of district courts" have held that bankruptcy courts can authorize such critical vendor motions.[203] Conversely, "a number of courts of appeals and a few lower courts have held just the opposite."[204] The *Kmart* court allied itself with this camp. "[W]e cannot ignore the Bankruptcy Code's statutory scheme of priority in favor of 'equity,'" opined Judge Grady.[205] The

---

198 *Id.* at 822 n.4.

199 *Id.* at 822 (citing *In re* Fesco Plastics Corp., 996 F.2d 152, 156 (7th Cir. 1993)).

200 *Id.* *See* Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988).

201 *Kmart Corp.*, 291 B.R. at 822.

202 *Id.*

203 *Id.*

204 *Id.*

205 *Id.* at 823.

equitable nature of bankruptcy proceedings does not give bankruptcy courts the unlimited discretion to reconfigure statutory rights.[206]

The district court acknowledged the well-intended and even possibly beneficial results to be obtained from applying the "Doctrine of Necessity" through Section 105 to the case at bar.[207] It is likely that allowing pre-plan payments to select creditors would minimize business disruptions and promote a successful reorganization; however, this utility and practicality does not make up for the lack of statutory authorization.[208] Judge Grady concluded that by not codifying the "Doctrine of Necessity" into the Bankruptcy Code, Congress freely elected to leave the priority scheme of payment intact.[209] Thus, finding that the court below lacked the statutory or equitable power to authorize the critical vendor payments, the district court reversed the bankruptcy judge's orders.[210]

Additionally, the debtor raised another issue on appeal to preserve the relief granted by the bankruptcy court. Kmart argued the principle of equitable mootness, asserting that substantial payments to selected vendors under the lower court's order rendered futile any alteration to that result.[211] The district court was not persuaded by this argument. First, noting that it was highly unlikely for the bankruptcy judge to stay his own orders pending appeal, the district court relieved that appellant of the ordinary requirement of obtaining a stay to preserve its rights on appeal.[212]

More to the point, the entire theory of equitable mootness was largely anathematized from this venue by the Seventh Circuit's decision in *In re UNR Indus., Inc.*,[213] where the prominent Circuit Judge Easterbrook recognized the significant distinction between the inability and the unwillingness to alter outcomes on appeal.[214] Rather, the fundamental questions left behind are the basic fairness to affected

---

206 *Id.* (quoting *In re* Chicago, Milwaukee, St. Paul & Pac. R.R. Co., 791 F.2d 524, 528 (7th Cir. 1986)).

207 *Id.*

208 *Id.*

209 *Id.*

210 *Id.* at 825.

211 *Id.* at 823.

212 *Id.*

213 20 F.3d 766, 768 (7th Cir. 1994).

214 *Kmart*, 291 B.R. at 823 (quoting UNR, 20 F.3d at 769).

parties and the overall propriety to undo on appeal what the bankruptcy court did below.[215] Parenthetically, Judge Grady found it noteworthy that the once-named equitable mootness doctrine had its greatest application to appeals of confirmed plans of reorganization.[216] Considering the evolved, yet nameless, doctrine, Judge Grady held that "it is not too late" to reverse the decision below and that the critical vendors could be ordered to repay the previously received funds.[217]

Moreover, the district court flatly rejected the debtor's "doomsday speculations" of reorganization paralysis and the supposedly Herculean task of suing allegedly thousands of vendors to recover hundreds of millions of dollars.[218] Giving no credibility to Kmart's assertions, the court declared there was no evidence the debtor would have to litigate, given the bankruptcy judge's power to simply order the return of the very funds paid out pursuant to his earlier ruling.[219] Finally, the district judge succinctly rejected the debtor' lenders' alternative argument that the critical vendor payments could be justified as payments of adequate protection under Section 361.[220] Because the bankruptcy court did not base its ruling upon adequate protection grounds, there was no basis to allow the decision below to stand.

For the forgoing reasons, the bankruptcy court's critical vendor order was reversed. However, far more important, the district court in *Kmart* most likely struck a fatal blow, not only to "critical vendor" motions, but to the "Doctrine of Necessity" itself. Nonetheless, more was to be said.

The Seventh Circuit's Declaration

The much-awaited appeal of *Kmart* to the Seventh Circuit followed.[221] As the highest court to recently confront the issue, the Seventh Circuit's decision might well be the last word. Yet, because of the complexity of the issue and the potential impact on bankruptcy practice, the United States Supreme Court may still hear it.

---

215 *Id.* at 823-24 (citing *UNR*, 20 F.3d at 769).

216 *Id.* at 824 n.9. *See also* Mac Panel Co. v. Virginia Panel Corp., 283 F.3d 622 (4th Cir. 2002).

217 *Id.* at 824.

218 *Id.*

219 *Id.*

220 *Id.* at 824-25. *See* 11 U.S.C. § 361 (2004) (providing that a bankruptcy court may authorize cash payments to a creditor to adequately protect from "a decrease in the value of such entity's interest in such property").

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

But before we cross a bridge yet to be built, let us examine the Seventh Circuit's decision.

At the outset, it is worth noting that fans of the Seventh Circuit's hard-driving school of law and economic pragmatism will not be disappointed with the opinion. True to form, the Seventh Circuit quickly recapped the facts, but even that brief preamble was most insightful into the panel's way of thinking. Analyzing the "theory behind the request," Judge Easterbrook posited that "[f]ull payment to critical-vendors thus could in principle make even the disfavored creditors better off" because, theoretically, even they will garner a larger recovery because the debtor's current operations will be sustained.[222] But there is always a catch. The court found this theorem "implies . . . the debtor must prove, and not just allege," that vendors would halt all business with the debtor unless their pre-petition claims were paid immediately; and the debtor will realize a net gain from the continued transactions with the elite vendors sufficient "to provide some residual benefit to the remaining, disfavored creditors, or at least leave them no worse off."[223]

The Seventh Circuit then proceeded to relentlessly criticize the original actions taken by the bankruptcy court. In sharp words, Judge Easterbrook noted the bankruptcy court's unfaltering acceptance of the critical vendors order as proposed by Kmart, the lack of notice to disfavored—i.e. non-critical—creditors, a lack of pertinent evidence (Judge Easterbrook made a scathing comment about "unhelpful" testimony by debtor's CEO, "who could not speak for vendors"), and an utter lack of factual finding as to the impact of the relief upon the disenfranchised, general creditor body.[224] The court characterized the original relief as "open-ended" and as allowing an "exercise of unilateral discretion" by Kmart.[225] Clearly, the panel found the lower court's actions grossly improper.

Continuing, the Seventh Circuit noted that Kmart used its unchecked power to pay well over two thousand vendors a total of some $300 million, the money coming from a $2 billion post-petition credit facility.[226] This left some two thousand non-critical vendors, not to mention more than forty-three thousand general unsecured creditors, out in the cold until Kmart finally distributed about ten cents on the dollar, "mostly in [new] stock of the reorganized Kmart," after eventual approval

---

222 *Id.* at 868.

223 *Id.*

224 *Id.* at 868-69.

225 *Id.*

226 *Id.*

of debtor's Chapter 11 plan.[227] This fact was pivotal because the district court reversed the bankruptcy judge's order just at about the same time Kmart emerged from bankruptcy. This led to the first legal argument of note.

As stated, Bankruptcy Judge Susan Pierson Sonderby's alacrity in moving Kmart to a fairly swift emergence from bankruptcy, combined with the usual progression of the critical vendors order, resulted in both events occurring nearly simultaneously. Thus, Kmart's initial argument was that the instant appeal had been rendered a moot point. As characterized by Judge Easterbrook, the debtor's salient point was "it was too late. Money had changed hands" and could not be refunded.[228] With utter pragmatism, the tribunal responded that reversing preferential transfers[229] "is an ordinary feature of bankruptcy practice," often undertaken post-bankruptcy pursuant to a confirmed Chapter 11 plan.[230] Unmistakably signaling where it was heading, the appellate court opined that if the critical vendor order was flawed, then such fortunate vendors received nothing more than a preferential payment, easily recoverable under bankruptcy norms.[231] To be sure, plan confirmation normally does not end the administration of the debtor's estate.[232]

Additionally, in counterpoise are several specific Bankruptcy Code sections that shelter particular orders for relief from reversal.[233] But critical vendor orders are afforded no such protection. The panel sharply stated, "[N]othing comparable anywhere in the Code" exists for such decisions; "[j]udges do not invent missing language."[234]

Admittedly, the Seventh Circuit has recognized the longstanding doctrine of equitable mootness when a Chapter 11 plan has already been confirmed.[235] But the

---

[227] *Id.* at 869.

[228] *Id.*

[229] *See* 11 U.S.C. § 547 (2004).

[230] *Kmart Corp.*, 359 F.3d at 869.

[231] *Id.*

[232] *Id.*

[233] *Id.* (citing 11 U.S.C. § 364(e) (2004) (providing that post-petition financing orders cannot be reversed)).

[234] *Id.*

[235] *Id. See In re* UNR Industries, Inc., 20 F.3d 766 (7th Cir. 1994), *In re* Envirodyne Indus., Inc., 29 F.3d 301, 304 (7th Cir. 1994).

instant situation is different because the Kmart plan provided for the initiation of adversary proceedings to recover preferential transfers, which the tribunal again characterized as critical vendor payments.[236] Kmart's equitable mootness argument was an attempt to usurp its own plan by way of a collateral attack—an attempt the court would not allow.[237]

Furthermore, the circuit court declined to find detrimental reliance on the part of the critical vendors. The court said to continue to do business with a debtor post-petition "may or may not be a form of reliance," but is certainly not detrimental reliance.[238] Arguably, if Kmart had never emerged from bankruptcy, it might then make sense to permit the vendors to keep the critical vendor payments to offset post-petition deficiencies. But that was not the case here, as the debtor had emerged from Chapter 11.[239] In sum, the critical vendors had no reliance and, moreover, no language in the Bankruptcy Code posed an obstacle to recover the payments made to them.[240]

"Thus we arrive at the merits," Judge Easterbrook announced.[241] Wasting no words, the Seventh Circuit addressed the scope of power bestowed by Section 105, the provision that the bankruptcy court relied upon to approve the critical vendor motion. Here, the tribunal explicitly rejected the bankruptcy court's view and ratified the district court's perspective.[242] The court firmly declared that Section 105 "does not create discretion to set aside the Code's rules . . . [and] the power conferred by § 105(a) is one to implement rather than override."[243] Indeed, every circuit to previously address the question has ruled affirmatively that the statute does not

---

236 *Kmart Corp.*, 359 F.3d at 870.

237 *Id.*

238 *Id.*

239 *Id.*

240 *Id.* One critical vendor made a highly technical argument. The vendor claimed lack of due process because it was not named on the notice of appeal to the district court. Judge Easterbrook handily disposed of that argument by pointing to the approximately forty-seven thousand other unsecured creditors "left high and dry" and denied notice, and thus due process, when the critical vendor motion was first heard in the bankruptcy court. *Id.*

241 *Id.* at 871.

242 *Id.*

243 *Id.*

support full payment to certain unsecured creditors unless the entire class of unsecured creditors is made whole.[244]

The Seventh Circuit agreed with its brethren. Bankruptcy jurists do not have unbridled discretion to rearrange rights and priorities despite the fact that bankruptcy proceedings are inherently equitable in nature.[245] The court noted that the "Doctrine of Necessity" "is just a fancy name for a power to depart from the Code" rooted in judicial practices of wielding far ranging powers to reprioritize creditors at will in a bygone era "before bankruptcy law was codified."[246] The tribunal declared, "[T]oday it is the Code rather than the norms of a Nineteenth Century railroad reorganization that must prevail."[247] *Miltenberger* and *Fosdick* predated even the Bankruptcy Act of 1898.[248] The tribunal found germane the fact that the first attempt at organizing the nations' insolvency laws near the turn of the Twentieth Century was fully supplanted by the modern codification over twenty-five years ago.[249] Writing for the panel, Judge Easterbrook held that the modern Code "supplies the rules" today.[250] It is useless to ask if Congress intended to discard old common law doctrines "because [Congress] did not need to; the Act curtailed, and then the Code replaced, the entire apparatus."[251]

Simply put, the solutions to today's problems lie in the text of the Bankruptcy Code. The Seventh Circuit unequivocally ruled that if archaic pre-Code practices survive, it is "as glosses on ambiguous language" within the Code, "but not on freestanding entitlements to trump the text."[252] The tribunal made clear that the answers to the controversy before it are to be found within the Code itself.

---

244 *Id.* (citing *In re* Oxford Mgmt., Inc., 4 F.3d 1329 (5th Cir. 1993); Official Comm. Of Equity Sec. Holders v. Mabey, 832 F.2d 299 (4th Cir. 1987); *In re* B & W Enter., Inc., 713 F.2d 534 (9th Cir. 1983)).

245 *Id.*

246 *Id.*

247 *Id.*

248 *Id.*

249 *Id.*

250 *Id.*

251 *Id.*

252 *Id.*

Judge Easterbrook looked to the Code and first asked if it had some proviso permitting debtors to favor some vendors over others.[253] The Court found that most of the modern Code specifies equal treatment or sets forth a particularized scheme of priority when claims exceed assets.[254]

Kmart offered several sections of the Code that authorized disparate treatment and the panel dissected them, one by one.[255] First, the debtor offered Section 364(b), which allows the estate to incur post-petition debt and give it priority, as Kmart did in this situation.[256] The court held that the statute does not, however, say anything about disturbing the money or rearranging creditor priorities.[257] By rejecting Section 364(b) as a valid basis for critical vendor payments, the Seventh Circuit rejected *Payless* and similar cases for their contrary reasoning.[258]

The court next looked at what of Section 503 regulates administrative expenses. The panel ruled it "irrelevant" because pre-petition debt owed to vendors, critical or otherwise, is not a post-bankruptcy cost of administration.[259] They are antithetical. To say otherwise would merge old debt with new, post-petition expenses that would condemn a reorganizing debtor to failure.[260]

The last statute that Kmart relied upon to justify its critical vendor relief was Section 363(b)(1). The appellate court initially found this section promising, since it authorized use of estate property outside the ordinary course.[261] Paying the pre-petition debt of critical vendors in order to keep needed supplies flowing could be construed as an extraordinary use.[262] The appellee argued that the statute contemplated, and Section 363(b)(1) should be limited to, extraordinary expenditures for long-term, capital projects, not antecedent debts; paying old vendors is clearly an

---

[253] *Id.*

[254] *Id.*

[255] *Id.* at 872.

[256] *Id.*

[257] *Id.*

[258] *Id.*

[259] *Id.*

[260] *Id.*

[261] *Id. See* 11 U.S.C. § 363(b)(1) (2004).

[262] *Kmart Corp.*, 359 F.3d at 872.

ordinary course of business exercise[263] To hold to the contrary would invite disaster because it would give bankruptcy judges *carte blanche* to resist creditor priorities without reference to the Code.[264]

Judge Easterbrook opined that priority of payment can change in bankruptcy if supported by a statute.[265] Section 363(b)(1) might be such a law. The tribunal, acting as a model of judicial restraint, made two rulings. The court first held that if Section 363(b)(1) was too liberal, then that was an issue for Congress, rather than the courts, to remedy.[266] The Seventh Circuit next decreed it wise to interpret Section 363(b)(1) "to do the least damage possible to priorities established by contract and by other parts of the Bankruptcy Code."[267] The tribunal thus decided that it need not resolve that precise issue in the present case because the critical vendor relief ordered by the bankruptcy court was fatally flawed, no matter the interpretation ascribed to Section 363(b)(1).[268]

The tribunal then turned to the evolution of the critical vendor order itself. Judge Easterbrook described the relief in *Kmart* as premised on the belief that critical vendors had to be retained via payment so that all creditors could benefit from a successful Chapter 11 reorganization.[269] This suggested a use of Section 363(b)(1) similar to a "cramdown" reorganization plan upon dissenting creditors where such creditors would be at least as well off under a Chapter 11 plan of which they did not approve than if the debtor was liquidated.[270] This notion presupposed a demonstration that the dissenting creditors would do the same or better with the plan as in a Chapter 7 proceeding, a showing *Kmart* never attempted.[271] Additionally, there must be evidence that critical vendors would stop doing business with the

263 *Id.*

264 *Id.*

265 *Id.*

266 *Id.*

267 *Id.*

268 *Id.*

269 *Id.*

270 *Id.* at 872-73. *See* 11 U.S.C. § 1129 (2004).

271 *Kmart Corp.*, 359 F.3d at 872-73.

debtor. Without such proof of abandonment by unsatisfied creditors, preferential treatment for select vendors would not be necessary.[272]

The tribunal observed that some critical vendors would still trade with the debtor "because they must."[273] In *Kmart*, Fleming Companies, the largest beneficiary of the bankruptcy court's order, was in such a position. It supplied nearly $100 million in groceries to Kmart each week.[274] Fleming could not cut off the debtor even if it wanted to do so. It was contractually and legally bound to Kmart.[275] It was superfluous to treat Fleming as a critical vendor for doing something it could not avoid doing. The panel found it unlikely that Fleming would have stopped dealing with Kmart, because every post-petition delivery meant fresh profit. No sane vendor would turn away new money because of old debt—that "would be a self-inflicted wound."[276] The final proof was that Fleming collapsed and went bankrupt when its contract expired and Kmart took its business elsewhere.[277] The court observed that the typical justification for critical vendor relief is highly suspect because no vendor commits financial suicide.[278]

The panel acknowledged the general hesitancy of vendors to "throw good money after bad" by continuing to do business with a debtor that already owes the supplier significant amounts of money.[279] Such concerns are not properly allayed, however, by bestowing critical vendor status. Rather, in the post-petition arena, cash payments or the presence a of D.I.P. credit facility are used to encourage existing vendors to keep supplies flowing.[280] Kmart's failure to do so was its undoing. Judge Easterbrook chastised Kmart for rejecting C.O.D. payments "as if a litigant's druthers could override the rights of third parties."[281] As previously noted, Kmart

---

272 *Id.*

273 *Id.* As one example, the court noted vendors with long-term contracts must honor them, lest they be penalized for violating the automatic stay. *Id.* *See* 11 U.S.C. § 362 (2004).

274 *Kmart Corp.*, 359 F.3d at 873-74.

275 *Id.*

276 *Id.* "They might as well burn money or drop it into the ocean." *Id.*

277 *Id.*

278 *Id.*

279 *Id.*

280 *Id.*

281 *Id.*

had a war chest of $2 million in its post-petition credit facility. "Some of that credit could have been used to assure vendors" of payment for post-bankruptcy goods.[282] In short, Kmart had alternatives that it chose not to pursue.

The tribunal faulted the bankruptcy judge for not considering any form of relief other than the "critical vendor" motion Kmart brought forth. The bankruptcy judge never investigated whether any vendor would have ceased doing business with Kmart.[283] The meager record below would not have supported such a conclusion. The Seventh Circuit faulted the court below for finding that preferring critical vendors was the only solution to foster reorganization and that the disenfranchised creditors benefited from the grant of critical vendor relief.[284]

The tribunal declared that even if Section 363(b)(1) could be properly read to authorize critical vendor payments, "preferential payments to a class of creditors are proper only if the record shows the prospect of benefit to the other creditors."[285] Because this scant record did not, the critical vendor order could not stand. The circuit court affirmed the district court's reversal of the bankruptcy judge.[286]

That is where the case law presently stands. "Critical vendor" motions have suffered a seemingly fatal blow. The "Doctrine of Necessity" has fallen or is very near collapse. But some analysis is in order before we celebrate the demise of these two misbegotten doctrines.

ANALYSIS & COMMENTARY

The Supreme Court's Edicts of a Century Past

The first part of our analysis requires an examination of the Nineteenth Century opinions of the Supreme Court. These opinions deserve respect, for it is not their advanced age that detracts from their precedential value today. Rather, it is the inescapable fact that they were decided in the narrow context of railroad reorganizations that occurred over a century ago. It is not the opinions themselves that are so troubling, but the modern misapprehensions about their true meaning.

---

282 *Id.*

283 *Id.*

284 *Id.* at 873-74.

285 *Id.* at 874.

286 *Id*

Having dealt with these Supreme Court opinions at length, wasteful repetition is unnecessary. Nonetheless, their salient points can and should be repeated.

First, the "Six Month Rule" is an illusion, for nowhere in *Fosdick* do the Justices even hint at, let alone clearly articulate, such a principle of common law. *Mitleberger* is no less an apparition. The vague specters found in those decisions do not make law. While the factual circumstances from which these cases arose are important, these phantoms never coalesce into tangible axioms.

Second, these holdings were rendered in the discrete venue of railroad reorganizations. For reason of legal distinctions, practical business considerations, and common sense, it is not possible to compare these rules from a century ago to modern bankruptcy cases involving today's diversified industry sectors. The realities of running a railroad in the Eighteen-Eighties have no relevance to propping up a retail debtor in the Twenty-first Century. Just as steam locomotives are no longer depended upon for transportation across the continent, pragmatism demands we leave such dogma in the historical archives where it belongs.

Third, the acute fact that the old notions of the "Six Month Rule" and the "Doctrine of Necessity" never made it into the Bankruptcy Code emboldened the Seventh Circuit in *Kmart* to decry the rationale of "critical vendor" motions. Congress had over ninety years of history to ponder when the modern codification was promulgated in 1978, yet Congress chose to ignore it. It would be pure folly to suggest that the archaic practices of that era were surreptitiously subsumed into the Code. To do so presumes a level of either deceit or stupidity on the part of our lawmakers that cannot be countenanced. Congress not only failed to codify these hoary old tales into law in 1978, but the legislators also declined to adopt them as law when enacting the Bankruptcy Act of 1898—a time much closer, chronologically and circumstantially, to the heyday of *Fosdick* and *Miltenberger*.

The Supreme Court's foretelling of the day of the "critical vendor" motion is truly amazing. The similarity and sometimes identical choice of words is uncanny. This is unmistakably the wellspring of inspiration for today's proponents of critical vendor relief. Admittedly, their arguments are not wholly lacking in merit, however thin these merits may be.

But it is all for naught. The Supreme Court's pronouncements of the late Nineteenth Century, a day of steam engines and horse-drawn carriages, cannot be extended beyond their narrow world to be broadly applied in today's world of multi-state retailers and e-commerce. These antiquated opinions have little modern value; were never woven into the fabric of today's bankruptcy law. We should respect them, but we cannot rely upon them.

Courts of a Feather Fail Together

In our analysis, we can likewise make short work of the opinions favoring critical vendor relief. Since they proceed along common paths, we can group them together and, thus, refute them.

Each of the decisions in favor of "critical vendor" motions began with the same highly erroneous premise. This threshold flaw is so debilitating as to be nearly fatal. This mortal blow is the unwarranted and clearly erroneous expansion of Section 105 beyond comprehensible and sensible boundaries.

The court cases we have cited state the case well enough. We merely reflect upon their well-founded holding that Section 105 can solely be read and applied within the confines of the Bankruptcy Code. We cannot venture beyond the written text of what Congress has declared to be our nation's insolvency law; to do so would be dangerous and wholly unnecessary. No one denies the inherently equitable nature of bankruptcy proceedings. No one challenges the broad, equitable powers of bankruptcy judges to fashion appropriate relief in such cases. No one refutes the intention of Congress to grant wide powers to the courts under Section 105 to accomplish their mandate. Yet none of this is *carte blanche* to the courts of bankruptcy to range far and wide over the landscape and dispense justice as they see fit under the rubric of Section 105. As with everything, this statute has rational limits. However, the courts granting vendor relief have routinely exceeded those limits. This is a large part of their undoing and reason why these motions are doomed to failure as excessive and wrongful exercises of nonexistent powers.

The "Plain Language" Admonition

The central role of Section 105 in cases drives much of the preceding and subsequent analysis. The point is simple: the plain language of the Bankruptcy Code controls. Otherwise, what follows does not make sense. Certainly, the plain language doctrine has endured for countless ages and has displayed no signs of diminishing vigor. The Supreme Court has employed it time and again to a variety of situations calling for statutory interpretation.

Indeed, the Bankruptcy Code is one statutory body to which the Supreme Court has applied the maxim with forcefulness. Among the many landmarks, *Connecticut National Bank v. Germain*[287] stands out as the tip of the spear in declaring that plain language controls. Supreme Court precedents make abundantly clear "that

---

[287] 503 U.S. 249 (1992).

the starting point for . . . analysis is the statutory text."[288] Where "the words are ambiguous, the 'judicial inquiry is complete.'"[289]

The commandments of statutory interpretation require no embellishment here. In the context of critical vendor relief, we have seen courts err in going beyond the scope of Section 105's plain language. When citing additional statutory portions of the Bankruptcy Code to support their actions, the same error is committed. The cases that follow comport with the rule of plain language concerning Section 105. These opinions read and follow the statute plainly.

***CoServ* and *Mirant* – A More Reasonable Approach**

In this analysis, one cannot underestimate the value of the decisions of Bankruptcy Judge Dennis Michael Lynn in *CoServ* and *Mirant*. In many ways, these cases presaged what is now the penultimate opinion on the issue by the Seventh Circuit in *Kmart*. Yet the affirmation of the bankruptcy court's viewpoints by an appellate court, albeit by a different court, is but one element that underscores the former's wisdom.

Initially, Bankruptcy Judge Lynn proceeded from a sound foundation—a firm adherence to the plain statutory text of the controlling law. The court rightly noted that there is a distinct and unmistakable lack of clear statutory authority for "critical vendor" motions. Additionally, only the broad grant of authority bestowed by Section 105 might conceivably be interpreted to permit the out-of-order payment of certain pre-petition debt. But *Coserv* and *Mirant* rightly warned that such an interpretation should not be taken lightly from the general statute. Most of all, Section 105 should not be tortured so as to supposedly yield a remedial power that Congress never intended to grant to the courts.

Second, justification for paying so-called critical vendors should not be forcibly extracted from other statutory provisions. By enacting the modern Bankruptcy Code in 1978, Congress set in place various operative provisions to do

---

[288] Desert Palace, Inc. v. Costa, 539 U.S. 90, 98 (2003) (employment discrimination case brought under Civil Rights Act of 1964) (citing Connecticut Nat'l Bank v. Germain, 503 U.S. 249, 253-54 (1992)).

[289] *Id.* (quoting Germain, 503 U.S. at 254). *See also* Hartford Underwriters Ins. Co. v. Union Planters Bank N.A., 530 U.S. 1 (2000). * Associate Professor of Law, The Peter J. Tobin College of Business, St. John's University, New York, and partner, Sabino & Sabino, P.C., New York. The author dedicates this Article to the Honorable E. Donald Shapiro, Dean Emeritus and The Joseph Solomon Distinguished Professor of Law, New York Law School, with profound thanks for his years of encouragement, support, and, most of all, true friendship, which made this Article and a great many other things possible.

specific, discrete tasks, such as allowing for the sales or use of property. These Code sections should neither be indiscriminately applied to purportedly solve problems beyond their scope nor grant relief in situations where the lawmakers never intended relief to be given. If Congress wanted to empower those statutes to do the additional tasks that proponents of "critical vendor" motions claimed they could do, Congress could have done so by writing the law in that way. "Each in its own place" is the motto here.

Third, the crowning achievement of both *Coserv* and *Mirant* is the establishment of a rigorous test for permitting critical vendor relief, if at all. Judge Lynn recognized that many judges simply took the debtor's outcry for granted or did not delve deeply enough into the merits of a "critical vendor" motion before granting it. Such a relaxed approach is banished by these two decisions. In its place, *Coserv* and *Mirant* rightly install a disciplined process of fact-finding and adjudication—which leads to principled decision-making.

To be sure, *Coserv* and *Mirant* still err in granting critical vendor relief. Still, if such relief is ever to be granted, then Judge Lynn's proactive measures lend discipline and credibility to the result that was surely lacking before. Because of the principled decision-making in *CoServ* and *Mirant*, their predecessors pale in comparison, due to a multitude of sins.

The first and most common mistake is the extrapolation from Section 105 of a power to pay pre-petition debts out of sequence. Undeniably, Section 105 espouses a broad, general grant of power to the bankruptcy courts to do what is right and necessary. Yet that is not *carte blanche* from the lawmakers who wrote the insolvency laws. The Supreme Court has warned time and again that the capabilities of Section 105 must be confirmed within the explicit text of the Bankruptcy Code. The Supreme Court has proclaimed that the statute is to be used in just and rational proportion to accomplish the goals of the Code; Section 105 is not a usurper of plain statutory text or a talisman that conjures substantive remedies out of thin air.

Just for Feet and its ilk find justification when none exists. As set forth above, statutes like Sections 363 and 364 have their own jobs to do. It does violence to their plain statutory text to twist them into vehicles to justify critical vendor relief, a task for which they were never intended.

Finally, too many of the decisions favoring critical vendor relief collapse under their own weight; they are built upon a foundation of sand. Here, we speak to the distinct lack of factual investigation and principled decision-making therein. Lacking discipline, too many of these courts succumb to accepting the debtor's mere say-so as a viable basis for granting critical vendor relief. Lacking the necessary rigor of compelling a debtor and/or its so-called critical vendors to make a reasonable and substantial demonstration of a need for such extraordinary relief, principled decision-making and firm factual underpinnings fall to the wayside. Probably the words offender in this category was the bankruptcy court in *Kmart*.

Kmart **and the Death of Two Doctrines**

It is not surprising that both the district court and the Seventh Circuit excoriated the lower court for its lack of solid factual findings. It is no wonder that the higher benches were unabashedly critical of the debtor's abject failure to bring more reliable facts to the forefront in seeking relief. Here, the circuit court in particular strikes a resounding chord of warning. Debtors must bring forth a compelling case for extraordinary relief based upon a great many provable facts that would justify overriding or extending the statutory text of the Code. Bankruptcy judges should be sure to be skeptical of pleas for critical vendor relief, act only after vigorous fact-finding and should not use the chaos of the first day of a Chapter 11 proceeding as a ground for hasty decisions. One should not torture plain statutory provisions to justify results. The end does not justify the means in "critical vendor" motions.

In addition, the tribunal in *Kmart* was eminently correct in its point-by-point dismantling of the reliance upon other sections found within Chapter 3 of the Code. The operating provisions of Title 11 have well-defined purposes. Let them stick to what Congress intends and do not bend them to suit the purposes of a "critical vendor" motion, a task for which they were never intended.

In many ways, it is most fitting that the Seventh Circuit has spoken on this divisive issue. That appellate court has historically been one of the staunchest adherents to the plain meaning doctrine of statutory interpretation. Moreover, the tribunal has sagely applied the plain meaning doctrine to the Bankruptcy Code with particularly just results. Even a novice to bankruptcy jurisprudence would not be surprised that the Seventh Circuit clamped down hard on this misuse of Section 105 in critical vendor situations. Indeed, this is the last tribunal in America that could be expected to take a broad, unrestrained view of such a statutory grant of power. The Seventh Circuit made clear that Section 105 is not a panacea for a debtor's ills in a Chapter 11 case.

At the end of the day, what has the Seventh Circuit wrought in *Kmart*? Admittedly, it did not slam the door entirely on critical vendor relief. Even for this writer, who is staunchly opposed to such ill-conceived tinkering with the Bankruptcy Code, it would be unwarranted to say that *Kmart* absolutely forbids such relief. The point remains that the Seventh Circuit did not go so far because there was no need to do so. The imprimateaur of the panel is manifold with profound effect. First, it severely curtails an expansive, activist use of Section 105 as an answer for any and all relief asked for but not contemplated by the written text of the Bankruptcy Code. "Anything goes" is not a synonym for Section 105 action.

Second, *Kmart* disabuses the misguided notion that other substantive provisions of the Bankruptcy Code can come to the rescue. Critical vendor relief cannot be justified based upon statutory authority to borrow money, sell assets in the ordinary course or even utilize assets outside the ordinary course of a debtor's business. The lesson imprinted by the panel is to not look for statutory relief in wholly unrelated provisions.

Third, if the reorganizing debtor was nonetheless still able to surmount these hurdles, then it and its favored vendors would still have to make a substantial showing of fact, law and circumstance to justify a grant of critical vendor relief. By advocating such formidable prerequisites, the Seventh Circuit has imposed much needed and long absent rules to the process. No longer can critical vendor relief be granted "on the fly" as part of the mad rush of "first day" orders. This is now undeniably and irrevocably replaced with sound principles that make for better law. No doubt, *Kmart* has not outlawed critical vendor relief, but it brings order to the chaos. In so doing, Kmart achieves a greater goal of limiting success in such adventures to only those debtors and vendors truly worthy of such relief.

Where do we go from here? Absent from the reports is the filing of an appeal to the United States Supreme Court. Admittedly, the Seventh Circuit's brethren in other circuits may dispute its ruling, but the Midwestern tribunal does not stand alone. It has an ally to the south in the prescient decision of the Fifth Circuit in *Oxford*. While other circuits might differ from their learned colleagues, the odds do not favor the emergence of a contrary viewpoint, at least not with the sagacity to overwhelm the Seventh Circuit's wise opinion.

Rather, one can forecast *Kmart* as the new landmark that sweeps away the debris and hubris of decades of misconceived "Doctrines of Necessity" and its misbegotten offspring of critical vendor relief. Certainly, "critical vendor" motions are a branch on the tree of the "Doctrine of Necessity." Generally, cutting off the branch does not kill the roots; but to cut back the branch so deeply often denies life to the trunk, destroying the roots. It is firmly believed that lopping off this critical vendor branch will kill the roots of the "Doctrine of Necessity" once and for all. If nothing else, with "critical vendor" motions reduced to an occasionally troublesome nettle, the once obstreperous tree of the "Doctrine of Necessity" will die down to a shrub.

CONCLUSION

Critical vendor relief is one of the newest and most important controversies roiling the bankruptcy courts today. It has grave implications for the appropriate administration of Chapter 11 cases and even more important ramifications for the proper statutory construction of the Bankruptcy Code. Yet it is a controversy that should not be.

Today's "critical vendor" motions are based in part upon the very old Supreme Court elaborations of situational rules for railroad cases prevalent in the late Nineteenth Century. They have no relevance under the modern Code or in present commercial circumstances. Reliance upon those railroad cases is simply wrong, and thus, the notion is fatally flawed.

Moreover, critical vendor relief is the undesirable spawn of the misbegotten "Doctrine of Necessity," which is another worn out rubric having no place in modern bankruptcy jurisprudence. The time is long past to discard the "Doctrine of Necessity" as a wrongful, inappropriate usurpation of clear statutory authority. As the "Doctrine of Necessity" dies, "critical vendor" motions must perish with it.

Now the Seventh Circuit has forcefully declared that critical vendor relief violates statutory priorities. Admittedly, that appellate court left open a window for critical vendor relief, but it is a tiny aperture at best. Far more important, the court meticulously hammered nail after nail into the coffins of both "critical vendor" motions and the "Doctrine of Necessity." These misguided notions are now so eviscerated by the Seventh Circuit's wisdom that they are effectively defunct.

We can now proceed to the tasks at hand: reorganizing debtors, distributing monies in equal measure to needy creditors and, finally free of these overreaching dogmas, following the clear statutory priorities as set out in unequivocal statutory language. In sum, the death of these doctrines brings new and better life to the Bankruptcy Code.