

Second Circuit Dismisses Appeal of Critical Vendor Order in *Windstream Holdings*



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Debtors in large Chapter 11 cases frequently seek bankruptcy court approval of an order that authorizes the debtor to pay the prepetition claims of certain vendors that the debtor deems to be critical to the success of its bankruptcy case. Debtors seek this authority on the premise that the business would be irreparably disrupted and that efforts to maximize value for their estates and creditors would be severely impaired if these "critical vendors" refuse to provide goods and services post-petition. Courts routinely approve these critical vendor orders in the districts in which some of this country's most prominent Chapter 11 cases are filed, such as the District of Delaware and the Southern District of New York, and more recently in the Southern District of Texas.

The U.S. Court of Appeals for the Second Circuit (Second Circuit) recently had an opportunity to weigh in on a critical vendor order that was approved by the U.S. Bankruptcy Court for the Southern District of New York (Bankruptcy Court) in the *Windstream Holdings Inc., et al* Chapter 11 cases and affirmed by the U.S. District Court for the Southern District of New York (District Court). In *Windstream*, the Bankruptcy Court had authorized the debtors' payment of the prepetition claims of critical vendors over objections raised by one of the debtors' unsecured creditors, GLM DFW, Inc. (GLM). Following the District Court's decision affirming the Bankruptcy Court's order, GLM appealed to the Second Circuit.

However, those hoping that the Second Circuit would provide a robust analysis of the merits of the critical vendor order that the Bankruptcy Court had approved will



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be disappointed. Instead of deciding the appeal on the merits, the Second Circuit dismissed the appeal as equitably moot because, despite GLM's pending appeal, GLM had never sought to prevent the debtors from making payments under the critical vendor order or obtaining confirmation of a Chapter 11 plan after the District Court had affirmed the critical vendor order.

History Behind Critical Vendor Treatment

Prior to the enactment of the Bankruptcy Code, courts had approved a debtor's payment of a creditor's prepetition claim during the bankruptcy case based on the "necessity of payment" doctrine that the U.S. Supreme Court adopted in its 1882 decision in *Miltenberger v. Logansport Railway*. The Supreme Court had approved a debtor's post-petition payment of the prepetition claims of those creditors that were found to be necessary for the reorganization and rehabilitation of the debtor's business.

Since the enactment of the Bankruptcy Code, courts have reached conflicting decisions over whether to grant critical vendor status. Many courts have granted

critical vendor relief based on the necessity of payment doctrine and/or section 105(a) of the Bankruptcy Code. Section 105(a) recognizes the bankruptcy court's equitable power to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title." These courts, particularly in Delaware and the Southern District of New York, have approved a debtor's payment of critical vendors' prepetition claims without imposing onerous evidentiary requirements that the debtor has to satisfy.

Other courts have refused to grant preferred critical vendor status. These courts relied on the absence of any Bankruptcy Code provision that carves out an exception to the Code's claims priority rules. Claims priority rules require payment of claims based on where they are situated on the ladder governing claims priority. Secured creditors sit at the top of the claims priority ladder and are entitled to payment from the proceeds of their collateral. Creditors providing goods and services to a debtor in bankruptcy have administrative priority claims, which sit on the next lower rung of the priority ladder. Creditors at the next lower priority level include wage, salary, benefit and tax claimants. Prepetition general unsecured claims occupy the lowest creditor rung of the priority ladder and are not entitled to receive any distribution from the debtor until the higher priority creditors are paid in full.

A third group of courts has granted critical vendor status if the debtor satisfies stringent requirements. For instance, the U.S. Court of Appeals for the Seventh Circuit (Seventh Circuit), in its watershed 2004 *Kmart* ruling, affirmed the district court's reversal of a bankruptcy court order granting the debtor authority to pay prepetition unsecured claims of 2,330 critical vendors, which held about \$300 million in trade claims against Kmart.

The Seventh Circuit held the necessity of payment doctrine does not apply to cases filed under the Bankruptcy Code and a bankruptcy court could not rely on its equitable power under Bankruptcy Code section 105(a) to approve a debtor's payment of critical vendors' prepetition claims. Under the *Kmart* test, a debtor

seeking court approval of the post-petition payment of a critical vendor's prepetition claim has to prove that (a) the creditor would not do business with the debtor on any terms (even on cash terms) without the debtor's payment of the creditor's prepetition claim, and (b) nonparticipating creditors would be better off if the debtor paid the critical vendor's prepetition claim.

Background on the Doctrine of Equitable Mootness

Equitable mootness is a doctrine under which a court may dismiss a bankruptcy appeal when the implementation of the relief requested would be inequitable. The doctrine is typically applied in the context of orders confirming Chapter 11 plans to protect the finality of the confirmation order and the parties that have relied on the confirmation order, and to avoid the inherent inequity and practical difficulties that would arise in attempting to undo the transactions taken pursuant to a confirmed plan.

The equitable mootness doctrine is alive and well within the Second Circuit (where the bankruptcy court overseeing the *Windstream* cases is located), notwithstanding that the doctrine has faced criticism in recent years for being invoked too broadly even in circumstances where limited relief is available. In fact, courts within the Second Circuit are required to presume that an appeal is equitably moot once a Chapter 11 plan has been substantially consummated. A party seeking to overcome the presumption of equitable mootness must prove each of the following factors set forth in the Second Circuit's opinion in *In re Chateaugay Corp.*:

- (1) The court can still order some effective relief;
- (2) Such relief will not affect the re-emergence of the debtor as a revitalized corporate entity;
- (3) Such relief will not unravel intricate transactions so as to knock the props out from under the authorization for every transaction that has taken place and create an unmanageable, uncontrollable situation for the bankruptcy court
- (4) The parties who would be adversely affected by the modification have

- notice of the appeal and an opportunity to participate in the proceedings; and
- (5) The appellant pursued with diligence all available remedies to obtain a stay of execution of the objectionable order if the failure to do so creates a situation rendering it inequitable to reverse the orders appealed from.

Background Regarding Decision in *Windstream*

(i) The Bankruptcy Court Enters Critical Vendor Order; GLM Appeals to District Court

On February 25, 2019 (Petition Date), *Windstream Holdings, Inc.* and its affiliated debtors (debtors) filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. That same day, the debtors filed a number of "first day" motions that are frequently filed in large Chapter 11 cases.

Among these first day motions was a motion (Critical Vendor Motion) seeking interim and final orders authorizing the debtors to pay, among other claims, the prepetition claims of approximately 263 critical vendors owed about \$80 million collectively. The Bankruptcy Court entered an order granting the Critical Vendor Motion on an interim basis on February 28, 2019.

GLM objected to the interim critical vendor order on three grounds: (i) the Bankruptcy Court should have determined critical vendor status, not the debtors; (ii) the debtors were required to disclose the identities of the critical vendors; and (iii) the Bankruptcy Court failed to impose or identify a permissible standard for determining which creditors were critical vendors. No other party objected to the Critical Vendor Motion.

After hearing testimony from the debtors' consultant that set forth the bases for the debtors' identification of and payments to the critical vendors, the Bankruptcy Court entered, over GLM's objection, a final order authorizing the debtors to pay unpaid prepetition critical vendor claims (critical vendor order). The court concluded that the relief granted would "provide a material net benefit to the debtors' estates and creditors after taking into account the Bankruptcy Code's priority scheme."

GLM appealed the critical vendor order to the District Court, but did not seek a stay of the order pending the appeal. GLM argued that the Bankruptcy Court had failed to apply the correct legal standard in determining which vendors would be entitled to “critical vendor” payments. GLM also argued that (i) the debtors had impermissibly usurped the Bankruptcy Court’s authority to decide which vendors were critical; (ii) it was improper for the debtors to keep confidential the list of critical vendors and other creditors who would receive payment of their pre-petition claims under the critical vendor order; and (iii) GLM was denied due process.

(ii) The District Court Affirms the Critical Vendor Order; GLM Appeals to Second Circuit

On April 3, 2020, the District Court upheld the Bankruptcy Court’s approval of the Critical Vendor Motion. The District Court held that the Bankruptcy Court’s approval of the critical vendor order was authorized under Bankruptcy Code sections 363(b) and 105(a). Section 363(b) allows the debtors to use estate assets outside the ordinary course of business if the debtors provide some business justification. Further, section 105(a) empowers the Bankruptcy Court to enter any order that is necessary or appropriate to carry out the provisions of the Bankruptcy Code. The District Court was swayed by the debtors’ consideration of whether a vendor would refuse to provide goods or services to the debtors post-petition unless it receives payment for its prepetition claim, whether the goods or services were critical to the business, and whether the debtors had meaningful alternatives to the vendor. Accordingly, the District Court held the Bankruptcy Court had appropriately applied the doctrine of necessity and utilized its broad equitable power to ensure the rehabilitation of the debtors and viability of the estate for *all* creditors by enabling the debtors to pay the critical vendors.

The District Court also rejected GLM’s argument that the Bankruptcy Court had impermissibly delegated authority to the debtors to determine which creditors would have critical vendor status, because courts require payments to critical vendors to be “in the sound business judgment of

the debtor.” The District Court also held that the Bankruptcy Court was correct in not ordering the debtors to publicly file their critical vendor list, primarily because releasing the names of critical vendors would harm the debtors’ estates by reducing the debtors’ negotiating leverage with the critical vendors and raising the risk of a potential “run on the bank” where all critical vendors would demand immediate payment of their claims. Finally, the District Court also rejected GLM’s due process argument, explaining that there was no indication that the Bankruptcy Court did not consider the various arguments raised by GLM, and the fact that GLM did not win on the merits “[was] not a matter of process at all.”

GLM then appealed to the Second Circuit, but again failed to either seek a stay of the District Court’s order or seek to expedite the appeal to the Second Circuit. In June 2020, the Bankruptcy Court approved an order confirming the debtors’ Chapter 11 plan of reorganization with the debtor having previously made payments to vendors pursuant to the critical vendor order.

As a result, the debtors argued (in addition to merits-based arguments in favor of the critical vendor order) that the appeal should be dismissed as moot because GLM would receive no recovery under the confirmed plan (which GLM had not challenged) even if Second Circuit reversed the District Court’s order upholding the critical vendor order and the critical vendor payments were clawed back. The debtors also argued that the appeal should be dismissed as equitably moot because GLM had never attempted to stay the critical vendor order. Therefore, it would be inequitable to allow GLM to overturn the critical vendor order, prejudice those creditors treated as critical vendors who had relied on their receipt of critical vendor payments under the critical vendor order in continuing to do business with the debtors’ post-petition, and “throw the debtors’ reorganization into disarray.”

In response, GLM argued, among other things, against the applicability of the equitable mootness doctrine because the doctrine is intended to preclude parties from undoing a confirmed Chapter 11 plan. Here, GLM had appealed the critical vendor order, not the order confirming the

plan, and, according to GLM, the doctrine of equitable mootness cannot be applied to the critical vendor order. GLM also argued that, in any event, the debtors had failed to present any evidence that forcing some or all of the critical vendors to disgorge their payments would impose any prejudice or hardship on anyone.

The Second Circuit Affirms the District Court’s Reversal

The Second Circuit dismissed GLM’s appeal based on the doctrine of equitable mootness. The Second Circuit held that equitable mootness “can be applied in a range of contexts, including appeals involving all [types] of bankruptcy court orders.” The Second Circuit also noted that an appeal does not need to directly challenge a Chapter 11 plan to impact the plan. The Second Circuit asserted that GLM’s appeal of the critical vendor order impacted the plan insofar as the appeal disrupted the finality that attaches to a bankruptcy case once a Chapter 11 plan is confirmed, and that reversal of the critical vendor order may “potentially require the bankruptcy court to reopen the plan.”

The Second Circuit held that GLM had clearly failed to satisfy all of the *Chateaugay* factors that would have to be proven to rebut the presumption that GLM’s appeal of the critical vendor order was equitably moot. First and foremost, the Second Circuit held that the diligence requirement is the chief consideration, and GLM had never sought to either stay the critical vendor order or to expedite the appeal from the order. In addition, unraveling the payments made under the critical vendor order would prejudice the Debtors’ critical vendors because it would likely be highly disruptive for the vendors that received critical vendor payments to have to return those funds more than a year later. The Second Circuit reasoned that “while a parade of horrors is not guaranteed to occur ... GLM bear[s] the burden of this uncertainty” because GLM never sought any form of stay pending appeal. As the Second Circuit stated, “In the absence of any request for a stay, the question is not solely whether we *can* provide relief without unraveling the plan, but also whether we *should* provide such relief in light of fairness concerns.” Accordingly, the Second Circuit concluded it would be inequitable to grant GLM its requested relief

"at this belated stage" and dismissed the appeal as equitably moot.

Kmart Seventh Circuit Decision Distinguished

The Second Circuit's dismissal of GLM's appeal in the *Windstream* case contrasts with the Seventh Circuit's holding in *Kmart* in 2004. In the *Kmart* case, the Seventh Circuit affirmed the district court's reversal of the bankruptcy court's entry of an order authorizing the debtors to pay the prepetition claims of critical vendors. In connection with their appeal to the Seventh Circuit, certain of the appellants sought dismissal of the appeal on equitable mootness grounds. These appellants argued that it was "too late" to undo the critical vendor payments by Kmart pursuant to the critical vendor order that vendors had relied upon in continuing to do business with the debtor. While the Seventh Circuit acknowledged that "detrimental reliance comparable to the extension of new credit against a promise of security, or the purchase of assets in a foreclosure sale, may make it appropriate for judges to exercise such equitable discretion as they possess in order to protect those reliance interests," the court nonetheless rejected the appellants' argument.

The Seventh Circuit never explicitly addressed the doctrine of "equitable mootness" or the *Chateaugay* factors that courts

in the Second Circuit must consider in applying the equitable mootness doctrine. The Seventh Circuit reasoned, among other things, that: (i) nothing in the Bankruptcy Code explicitly precludes the reversal of critical vendor payments, and reversing preferential transfers is "an ordinary feature of bankruptcy practice," (ii) reversing the critical vendor payments would not require any extraordinary measures to "turn back the clock" on the debtor's Chapter 11 plan, since the estate could recover the payments through avoidance actions, and (iii) though the vendors may have relied on the critical vendor payments they received, that reliance was not detrimental because the vendors received payment for their post-petition transactions with the debtor.

Conclusion

Unfortunately, the Second Circuit did not jump on the opportunity presented by *Windstream* to weigh in on the substantive merits of the common practice of courts approving critical vendor orders in large Chapter 11 cases. That said, the Second Circuit did bolster the applicability of the equitable mootness doctrine by expressly permitting the doctrine to apply to orders other than plan confirmation orders. Courts following the Second Circuit's *Windstream* decision will also be inclined to dismiss appeals as equitably moot where the appellant had not sought a stay of the relevant

orders or otherwise prevent the bankruptcy case from unfolding. But one must wonder if other courts may hold differently. While the Second Circuit placed a considerable amount of weight on the inaction of the appellant, other courts may be more inclined to find that specific relief from the critical vendor order can be tailored (e.g., as the Seventh Circuit, in the *Kmart* case, had previously suggested that reversing a critical vendor order and clawing back critical vendor payments would not disrupt a Chapter 11 plan).

In any event, the Second Circuit's silence regarding the merits of critical vendor orders means that critical vendor relief will likely continue to be routinely granted in large Chapter 11 cases—particularly in the Southern District of New York. ■■■■■

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