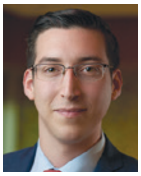
business CREDIT
OCTOBER 2021
THE PUBLICATION FOR CREDIT & FINANCE PROFESSIONALS $9.00

Critical Vendor Status Is Not a Preference Defense Without 'Something More'

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Some trade creditors are so important to a customer's business that, after filing for bankruptcy protection, the customer will seek authority from the bankruptcy court to pay these creditors' prepetition claims. Debtors frequently obtain this relief immediately after their bankruptcy filing on the premise that they could not maximize value for stakeholders if these critical vendors refuse to provide goods and services post-petition. The bankruptcy court's order authorizing the payment of prepetition claims—often referred to as a "critical vendor order"—induces these creditors to continue providing goods and/or services on credit terms where the debtor pays the creditors' outstanding prepetition claims.

Being sued on a preference claim is frustrating for any creditor, but particularly so for critical vendors that continue to do business with, and extend credit to, a debtor post-petition under the comfort of the court's critical vendor order. Critical vendors have attempted to defeat preference claims by arguing that the plaintiff cannot prove one of the required elements—that the prepetition payment resulted in the creditor receiving more than it would have received in a hypothetical Chapter 7 liquidation—because the court authorized the debtor to pay the creditor's outstanding prepetition invoices during the bankruptcy case. However, it is becoming increasingly clear from recent decisions from one of the most active districts in the country for large Chapter 11 filings—the District of Delaware—that being granted critical vendor status, by itself, may not be enough to defeat a preference claim. As the Delaware Bankruptcy Court noted in its recent opinion in *Insys Therapeutics, Inc.*, "something more is required" to eliminate preference risk.

The 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 United States 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 approved a debtor's payment of critical vendors' prepetition claims 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 denied a debtor's request to pay critical vendors' prepetition claims. These courts relied on the absence of a Bankruptcy Code provision that carves out an exception to claims priority rules that require the payment of claims based on where they are situated on the ladder governing claims priority. Secured creditors are on 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 that 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, as a general rule, are not entitled to receive any distribution from the debtor until the higher priority creditors are paid in full. Critical vendor payments are an exception to this rule.

A third group of courts has granted critical vendor status if the debtor satisfies stringent requirements. For instance, the United States Court of Appeals for the Seventh Circuit (which covers bankruptcy courts in the federal districts of Illinois, Indiana and Wisconsin), in its watershed 2004 *Kmart* ruling, rejected the debtor's request to pay prepetition unsecured claims in the aggregate amount of approximately $300 million asserted by 2,330 of Kmart's trade creditors. The Seventh Circuit held that 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) the non-participating creditors would be better off if the debtor paid the critical vendor's prepetition claim.

Preference Claims and Defenses

Pursuant to Section 547(b) of the Bankruptcy Code, a trustee or debtor-in-possession may avoid payments made to creditors within 90 days of the debtor's bankruptcy filing (or within one year of the bankruptcy filing, if the recipient is an insider of the debtor) as preferences. A trustee or debtor-in-possession must prove each of the following elements to prevail on its preference claim:

- The debtor transferred its property to or for the benefit of a creditor. The transfer of any type of property can be avoided, but the most frequent type of transfer is the debtor's payment from its bank account to a creditor [Section 547(b)(1)];
- The transfer was made on account of antecedent or existing indebtedness, such as outstanding invoices for goods sold and delivered and/or services rendered, that the debtor owed to the creditor [Section 547(b)(2)];
- The transfer was made when the debtor was insolvent [Section 547(b)(3)], which is based on a balance sheet test of the debtor's liabilities exceeding its assets and is presumed during the 90-day preference period;
- The transfer was made within 90 days of the debtor's bankruptcy filing in the case of a transfer to a non-insider creditor, such as a trade creditor [Section 547(b)(4)]; and
- The transfer enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation of the debtor [Section 547(b)(5)].

  This "greater than liquidation" requirement was at issue in the in the *Insys Therapeutics* case.

Additionally, the Small Business Reorganization Act of 2019, which took effect on February 19, 2020, amends Section 547(b) to require a trustee or debtor-in-possession to allege its preference claim is based on reasonable due diligence under the circumstances of the case and takes into account the creditor's known or reasonably knowable affirmative defenses.

Bankruptcy Code Section 547(c) contains multiple affirmative defenses that a creditor can assert to reduce its preference exposure. For example, a creditor may assert the "new value" defense under Section 547(c)(4), which reduces a creditor's preference liability dollar for dollar based on the creditor's sale and delivery of goods and/or provision of services to the debtor on credit terms after the debtor's receipt of an alleged preference payment. Alternatively, a creditor may assert the "ordinary course of business" defense to reduce its preference liability. This defense generally requires the creditor to prove that the alleged preference payment satisfied a debt incurred by the debtor in the ordinary course of business and the alleged preference payment was made either in the ordinary course of business between the creditor and debtor or according to ordinary business terms in the applicable industry.

Creditors granted "critical vendor" or similar status have argued that the plaintiff cannot prove Section 547(b)(5)'s requirement that the alleged preferential transfer had enabled the creditor to receive more than the creditor would have received in a hypothetical Chapter 7 liquidation. The basic premise is that the creditor did not receive more than it would have received in a Chapter 7 liquidation because the bankruptcy court had entered an order authorizing the debtor to pay the creditor's unpaid prepetition invoices, which could include the invoices paid by any alleged preference that is ultimately disgorged.

Background Regarding the *Insys Therapeutics* Decision

On June 10, 2019, Insys Therapeutics, Inc. and its affiliated debtors (Debtors)—a specialty pharmaceutical company that developed and commercialized certain drugs and novel drug delivery systems for targeted therapies—filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. As part of their requested "first day" relief, the Debtors moved for authority to pay all prepetition amounts owed under certain "customer programs" to "critical customers." Among these critical customers were McKesson Corporation and certain of its affiliates (Defendants), which were parties to multiple prepetition agreements with the Debtors under which the Defendants had assisted with the development, implementation, and maintenance of certain programs related to drugs that the Debtors sold. The Bankruptcy Court entered an order granting the Debtors' motion (Customer Order), which stated that "[t]he Debtors are authorized, but not directed … to maintain and administer the [critical] Customer Programs." The relief that the Customer Order granted was very similar to the relief that critical vendor orders usually grant, authorizing the Debtors to pay the otherwise general unsecured prepetition claims of certain customers that were critical to the Debtors' post-petition operations.

On January 16, 2020, the Bankruptcy Court entered an order confirming the Debtors' Chapter 11 plan of liquidation. Pursuant to the confirmed plan, a liquidating trustee (Liquidating Trustee) was appointed to administer the plan and pursue causes of action (such as preference claims) held by the Debtors' estates. On February 23, 2021, the Liquidating Trustee filed a complaint against the Defendants to avoid and recover approximately $155,000 in payments the Debtors had made to the Defendants in the 90 days prior to the Debtors' bankruptcy filing as a preference under Section 547 of the Bankruptcy Code, and also objected to the Defendants' claims against the Debtors.

The Defendants moved to dismiss the preference action based on the "critical vendor defense." They argued that the Liquidating Trustee could not satisfy Bankruptcy Code Section 547(b)(5)'s "greater than liquidation" requirement because the Defendants had not recovered more from their receipt of the alleged preference payments than they would have recovered in a hypothetical Chapter 7 liquidation. The Customer Order authorized the Debtors to pay the Defendants' prepetition claims. Therefore, the Defendants argued that had the alleged preference payments not been made prepetition, the Defendants would have nevertheless been paid in full pursuant to the Customer Order.

The Liquidating Trustee responded that the Customer Order did not preclude preference claims against the "critical customers." The Customer Order's authorization to pay the prepetition claims of critical customers was discretionary—not mandatory—and, therefore, a genuine issue of material fact existed as to whether the Defendants' prepetition general unsecured claims would have been paid in full in a hypothetical Chapter 7 liquidation. The Liquidating Trustee also noted that the Customer Order had expressly preserved the Debtors' preference actions, by stating that "Nothing contained . . . in this [Customer] Order is intended to be or shall be construed as … a waiver of any claims or causes of action that may exist against any creditor."

The Bankruptcy Court's Decision

The Bankruptcy Court ruled that the Defendants could not rebut the applicability of Bankruptcy Code Section 547(b)(5)'s greater-than-liquidation requirement. The court found an issue of material fact as to whether the recipients of the alleged preference payments totaling approximately $155,000 got more than they would have recovered in a hypothetical Chapter 7 liquidation.

In reaching its decision, the Bankruptcy Court analyzed the decisions of various other courts within the Third Circuit that considered the applicability of the critical vendor preference defense. The Bankruptcy Court relied on prior decisions of the Delaware Bankruptcy Court in cases such as *Maxus Energy Corp.* (2020) and *Hayes Lemmerz Int'l, Inc.* (2004) that rejected the critical vendor preference defense where the debtor's authority to pay the critical vendor claims was permissive, not mandatory.

The Bankruptcy Court noted that the critical vendor defense (or similar defenses aimed at rebutting Section 547(b)(5)'s greater-than-liquidation requirement) have only been upheld by courts within the Third Circuit where either: (1) the debtor was *required* to pay the prepetition claims, or (2) the creditor against whom the preference claim was asserted held a priority claim that would have unquestionably been paid in full in a Chapter 7 liquidation.

For example, in its 2015 holding in *AFA Inv. Inc.*, the Delaware Bankruptcy Court denied the plaintiff's motion for summary judgment on a preference claim where the debtor had entered into a post-petition agreement that required the debtor to pay the prepetition claims of the defendant. In another case, *Primary Health*, the Delaware Bankruptcy Court granted a defendant's motion to dismiss a preference claim holding that the plaintiff could not satisfy Section 547(b)(5)'s greater-than-liquidation requirement where the court's prior order had authorized the debtor's payment of the defendant's prepetition wages and the prepetition wages were otherwise entitled to priority status and full payment under the Bankruptcy Code in a Chapter 7 liquidation. Finally, in *Kiwi Int'l Airlines, Inc.*, the U.S. Court of Appeals for the Third Circuit granted summary judgment in favor of a preference defendant where the debtor had assumed its prepetition contracts with the defendant under Bankruptcy Code Section 365—and Section 365 *requires* the debtor to cure all prepetition defaults as a prerequisite to assumption.

The Bankruptcy Court concluded that the mere fact that a creditor was named in a "critical vendor" order is not, in and of itself, a bar to a preference claim. As the Bankruptcy Court stated, "something more is required" for a creditor to prevail on a critical vendor preference defense. Here, the Customer Order authorized but did not mandate payment of the Defendants' prepetition claims. The Defendants had general unsecured claims, not priority claims entitled to full payment. There was also no post-petition agreement between the Debtors and the Defendants and no obligation on the Debtors' part to pay the Defendants' prepetition claims. And finally, the Customer Order did not provide that previously made payments could not be recovered, nor did it waive preference claims; to the contrary, as the Bankruptcy

Court noted, the Customer Order expressly preserved the Debtors' causes of action. Therefore, the Bankruptcy Court concluded that "something more" did not exist here, and rejected the Defendants' critical vendor defense in partially denying the Defendants' motion to dismiss the preference claim.

Conclusion

Being deemed "critical" in a Chapter 11 case gives a creditor the benefit of potentially having its outstanding prepetition claim paid. However, the *Insys Therapeutics* decision reinforces the clear trend in the case law and makes it abundantly clear that being granted critical vendor status does not eliminate preference risk. Creditors offered critical vendor status can protect themselves from preference liability by insisting that the critical vendor order either *require* a debtor to fully pay critical vendors' prepetition claims (making the critical vendor payments mandatory rather than permissive) or include a waiver of preference claims against the critical vendors. Alternatively, a creditor granted critical vendor status can insist that the debtor enter into a trade agreement that requires the debtor to fully pay the creditor's prepetition claim, again making the critical vendor payments mandatory. Bottom line, critical vendors seeking to solidify their preference defenses should make sure that they have that "something more" that will insulate them from preference liability down the road.