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Critical Vendors: Line Breakers Par Excellence

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I first heard the term "critical vendor" when I was asked to comment on Travis Turner's Note. Consequently, my perspective on the issues raised by critical vendor orders is definitely that of a non-specialist. While my comments therefore may be of limited usefulness to the bankruptcy expert, my hope is that non-specialist readers will benefit—as I describe my own path in trying to understand this subject, perhaps they will be helped in understanding it too.

For reasons that will become clear, I begin by revealing my perspective on the judicial function. I believe in judicial restraint. My allegiance to this principle is premised in my political philosophy. I believe that the people should govern themselves through their elected representatives. As a general rule, judges should implement a statute as it is written by the lawmakers, even if the judge thinks that the statute is a bad idea. A judge should not, in derogation of statutory language, impose a result that the particular judge thinks is wiser. But why is this so bad? Might not the judge's outcome in fact be wiser? Perhaps, but any improved result would come at too high a cost—erosion of the principle of self-government. Individual judges, or small groups of judges, many of whom are unelected and some of whom serve for life, should not usurp the authority of the people to govern themselves.

Having supplied this necessary background, I will now begin to trace my progress in coming to grips with Turner's topic. First, congratulations to Turner on his Note. It is comprehensive, clearly written, and insightful. I could not have asked for a better guide into this interesting controversy. But why call it interesting? Is this not a technical, dull topic, with no possible appeal except to the bankruptcy expert? I disagree. Perhaps the subject's chief interest to the non-specialist is captured by the imagery used by another writer on the subject:

> The hot, harsh sun beats down on the hundreds, perhaps thousands, waiting in the line snaked around a solitary well. Those who are fortunate

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will receive a cupful or two of relief; others will get nothing. Suddenly, a small group of figures push their way to the front.

"We'll each take a gallon," their leader says.

"But that's not fair. There's only so much to go around," the well keeper replies.

"We don't care. We're critical vendors."[1]

This story grips our imagination. It summons up many past experiences. Every reader has encountered that particular subclass of humanity known as the line breakers. From our childhoods, we have all viewed those who break in line as disreputable characters. Critical vendors therefore automatically carry the stigma of immoral behavior. And their method of breaking in line adds to their shame. Critical vendors are bullies. As Turner puts it, they "threaten to disrupt the debtor's reorganization by withholding critical goods and services until paid their pre-petition debts."[2] Other commentators have used the terms "'economic blackmail'"[3] and "holdup power"[4] to describe the strong-armed tactics of critical vendors.

This is powerful language. Its use makes the ordinary person instinctively want to see critical vendors stopped, in the same way that as kids we were happy when some stern teacher or principal yanked a line breaker back to his or her proper place in the line. But now another fascinating element of the topic surfaces: Many of the judges whom we would expect to curtail critical vendors have instead authorized payments to them. While these judges no doubt believe that they are doing the right thing—ensuring "the continued survival and successful reorganization of the firm"[5]—they have been subjected to harsh criticism. They have been accused of acting illegally. The charge is that without any authority in the Bankruptcy Code, they have violated one of the Code's fundamental canons: "thou shall treat all similarly situate creditors equally."[6] These judges have also been accused

1. Joseph Gilday, *"Critical" Error: Why Essential Vendor Payments Violate the Bankruptcy Code*, 11 AM. BANKR. INST. L. REV. 411, 413 (2003).

2. Travis N. Turner, Note, Kmart *and Beyond: A "Critical" Look at Critical Vendor Orders and the Doctrine of Necessity*, 63 WASH. & LEE L. REV. 431, 434 (2006).

3. Gilday, *supra* note 1, at 414.

4. DOUGLAS G. BAIRD, ELEMENTS OF BANKRUPTCY 191 (3d ed. 2001).

5. Joshua A. Ehrenfeld, Comment, *Quieting the Rebellion: Eliminating Payment of Prepetition Debts Prior to Chapter 11 Reorganizations*, 70 U. CHI. L. REV. 621, 626 (2003).

6. Gilday, *supra* note 1, at 414. Critical vendor payments allow preferred creditors to be paid ahead of other claimants with the same—or higher—priority. *See* Turner, *supra* note 2, at

of "rebellion."[7] Despite federal circuit court decisions determining that critical vendor payments are contrary to the Code, some lower courts have continued to approve them anyway.[8]

It can thus readily be seen that Turner's subject is a veritable cornucopia of fascinating themes, mixing basic moral indignation toward bullies with alleged judicial lawlessness and insurrection. It would be difficult to find a legal topic more interesting than this!

However, interesting as the subject may be, a reader's chief concern is whether I can offer any useful insights. My initial thought as I began to read Turner's Note was to wonder how critical vendors could be brazen enough even to try recovering their pre-petition debts in the way he describes: "threaten[ing] to disrupt the reorganization by withholding critical goods and services [unless paid]."[9] I do remember a little from teaching individual bankruptcy a few years ago. One key bankruptcy concept is the automatic stay. Under Bankruptcy Code § 362, the filing of a bankruptcy petition brings to a screeching halt all efforts to collect pre-petition claims. Subsection (a)(6) has the broadest wording: it prohibits "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case."[10] The phrase "any act" is obviously very expansive. Would it not clearly bar a threat by critical vendors to disrupt the reorganization unless paid? Outright threats would be barred,[11] but critical vendors are too savvy to be so plain-spoken. According to David Schilli, a bankruptcy practitioner, a conversation between a critical vendor and the bankrupt might go something like this: Critical Vendor: "I can't supply you any further trade credit. I'm overextended." Bankrupt: "Is there something I can do to help you?"[12]

436–37 (laying out this very problem). Such payments simultaneously violate another

> central tenet[] of bankruptcy—the absolute priority rule . . . [which] requires that before junior claimants can receive anything in a bankruptcy reorganization, claimants having priority must be paid in full or agree to other treatment. . . . Critical vendor orders violate the absolute priority rule by paying certain unsecured creditors ahead of claimants having higher priority claims.

Id. (footnotes omitted).

7. Ehrenfeld, *supra* note 5, at 622.

8. *See id.* (noting that the acquiescence of lower courts allows the "rebellion" to quietly continue).

9. Turner, *supra* note 2, at 434.

10. 11 U.S.C. § 362(a)(6) (2001).

11. *See In re* Structurlite Plastics Corp., 86 B.R. 922, 932 (Bankr. S.D. Ohio 1988) (noting that threats or coercion by upset creditors should not be tolerated).

12. Telephone Interview with Dave Schilli, Partner, Robinson, Bradshaw & Hinson, P.A., Charlotte, N.C. (Aug. 26, 2005).

This, of course, is a coded conversation by which the vendor says no additional trade credit will be extended unless the pre-petition debt is paid. Does this violate the stay? One commentator points out that "[a]lthough the Bankruptcy Code prohibits [creditors] from acting to collect on previous debts, nothing requires them to continue shipping supplies to a [debtor] that owes them money."[13] This is accurate, but the critical vendor does more than simply cease to deal with the debtor. The vendor implicitly threatens to cease dealing with the debtor unless paid the pre-petition claim. To me, this is a clear violation of the stay.

How, then, were critical vendor payments ever allowed by the courts? If Congress had intended to permit such payments, one would have expected to find critical vendor payments listed in § 362(b), which enumerates numerous exceptions to the automatic stay.[14] But critical vendor payments are not there. Consequently, as Turner points out, the courts have looked to the common law and to numerous other provisions of the Code for purported authority to allow critical vendor payments.[15] Turner rejects all but one of these options as illusory sources of authority for critical vendor payments.[16] The basic flaw in these various authorization arguments is that § 507 of the Bankruptcy Code explicitly sets out those claims that Congress has determined are to be given priority.[17] Critical vendors are not on the list. Thus, pushing them to the front of the line via some alternative route subverts the express intent of Congress as to the order in which claims are to be paid. Plus, it gives critical vendors their money months before § 507 priority claimants are typically paid, assuming that they are paid at all.[18]

The one provision that Turner believes may provide statutory authority for critical vendor payments is § 363(b), which allows the debtor-in-possession, after notice and hearing, to use property of the estate outside of the ordinary

13. Ehrenfeld, *supra* note 5, at 621.

14. 11 U.S.C. § 362(b)(1)–(b)(18) (2001).

15. Turner, *supra* note 2, at 443–58.

16. *Id.* at 458.

17. 11 U.S.C. § 507(a) (2001).

18. Priority claims typically are paid pursuant to the confirmed Chapter 11 plan, and confirmation can take months. *See* Gilday, *supra* note 1, at 414 ("[C]ritical vendors blessed by the court receive some, and sometimes all, money due them at the beginning of the case, despite their unsecured status."); *see also* Anthony Michael Sabino, *The Death of Critical Vendor Motions and the Potential Demise of the Doctrine of Necessity: Farewell to Two Misbegotten Doctrines*, 6 TRANSACTIONS 47, 47 (2004) (describing how critical vendor motions disregard statutory practices). Moreover, having priority does not guarantee that any payment will be forthcoming. There simply may not be enough money for payments to be made.

course of business.[19] Turner cites, for example, Professor Douglas Baird's argument that a judge who permits a critical vendor payment under § 363(b) is not actually allowing the debtor to honor a pre-petition debt.[20] Instead, the debtor is being allowed to strike "an unusual bargain by which it is getting post-petition goods and services."[21]

The language of § 363(b), standing alone, may indeed be reasonably susceptible to Professor Baird's interpretation, but ultimately his argument is not convincing. Everyone knows that the debtor permitted to pay a critical vendor under § 363(b) is in fact being allowed to pay a pre-petition debt. This would be unobjectionable if § 363(b) actually signifies congressional openness to such payments.[22] When, however, the Bankruptcy Code is considered more broadly, the inescapable conclusion is that this use of § 363(b) frustrates the priority system established by Congress. First, as previously noted, critical vendors are not mentioned in either the exceptions to the automatic stay[23] or in the list of priority claimants.[24] Second, Congress declined the opportunity to extend the necessity of payment rule, one of the common law doctrines relied upon to justify critical vendor payments,[25] beyond "the narrow category of cases involving railroad reorganizations."[26] Third, § 362(d) of the present Code allows a court to grant relief from the automatic stay provisions directed to acts against property if the creditor shows that the debtor has no equity in the property and the "property is not necessary to an effective reorganization."[27] This provision shows that Congress, when it wants to, can craft language requiring that estate property be dealt with in a manner deemed necessary to a successful reorganization. Critical vendor payments are defended as necessary

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19. 11 U.S.C. § 363(b)(1) (2001); *see* Turner, *supra* note 2, at 450–57 (discussing the possibility that § 363(b) authorizes critical vendor orders).

20. Turner, *supra* note 2, at 454 (citing Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 97 (2004)).

21. *Id.* at 455.

22. Judge Easterbrook, in speculating (without finally deciding the question) that § 363(b)(1) might be read to authorize critical vendor payments, stated that this result would not impair congressional authority to establish priorities if the section in fact supports such judicial leeway: "If the [statutory] language is too open-ended, that is a problem for the legislature." *In re* Kmart Corp., 359 F.3d 866, 872 (7th Cir. 2004), *cert. denied*, 125 S. Ct. 495 (2004).

23. *See supra* notes 14–15 and accompanying text (stating that the Bankruptcy Code does not mention critical vendor payments in the enumerated exceptions).

24. *See supra* notes 17–18 and accompanying text (mentioning that the Bankruptcy Code nowhere gives critical vendors priority over other claimants).

25. Turner, *supra* note 2, at 443–47.

26. Ehrenfeld, *supra* note 5, at 627.

27. 11 U.S.C. § 362(d)(2)(B) (2001).

for effective reorganizations,[28] but Congress has not seen fit to recognize them in the Code.

Perhaps the strongest argument showing that critical vendor payments frustrate congressional intent is premised in changes made by the new Bankruptcy Code, which became effective on October 17, 2005. The new Code contains two provisions showing that Congress knows how to give special treatment to pre-petition trade creditors when it desires to do so. New § 546(c) strengthens the reclamation rights of those who have sold goods to the debtor shortly before bankruptcy.[29] To further protect these trade creditors, § 503(b)(9) creates a new priority administrative expense for the value of any goods received by the debtor within twenty days before the commencement of the case.[30]

These provisions indicate that Congress has given these pre-petition creditors all the protection it wants to provide. If a court grants further special treatment under the critical vendor rubric, the result is a direct conflict with congressional intent. Consider, for example, a trade creditor who supplied goods within twenty days of the petition, but for some reason has been unable to reclaim the goods. In the new Code, Congress grants this creditor an administrative priority for the value of those goods, but the claim will be paid pursuant to the confirmed plan, which means that payment could be delayed for months after filing.[31] Moreover, there is no guarantee that the claim will actually be paid.[32] Some debtors will be administratively insolvent, that is, unable to pay all administrative expenses.[33] Now consider the vast difference in outcome if this same trade creditor is designated a critical vendor. This exalted status is the gold standard of preferential treatment, as the result is often immediate payment in full. Moreover, the amount presumably would not be restricted to the value of goods supplied within the twenty-day period.

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28. *See supra* text accompanying note 5 (expressing a defense put forth in favor of critical vendor payments).

29. 11 U.S.C.A. § 546(c)(1) (Special Ed. 2005). One improvement is that the new power to reclaim goods is expressly granted by federal law, unlike the existing reclamation right, 11 U.S.C. § 546(c)(1) (2001), which depends upon incorporating state statutory or common law reclamation rights. *Id.*

30. 11 U.S.C.A. § 503(b)(9) (Special Ed. 2005).

31. *See supra* note 18 (explaining how long it currently takes for priority claimants to receive payments).

32. *Id.*

33. It is not uncommon for professional fees to exhaust available funds, leaving nothing for other administrative priority claimants. Telephone Interview with David Schilli, *supra* note 12.

To me, it is plain that critical vendor payments violate congressional intent. Thus, even if critical vendor payments are in some circumstances thought to be desirable as a matter of public policy, a judge should not approve them via jury-rigged claims of authority premised in a hodgepodge of inapplicable provisions. To do so is to substitute one judge's opinion for the will of our elected representatives. This violates fundamental principles of democratic government.

If, however, Congress can be convinced that critical vendor payments are sometimes a good thing, presumably it will amend the Bankruptcy Code expressly to authorize them. Once clear statutory authority is provided, Turner's heightened evidentiary standard for identifying the situations in which critical vendor payments should be made is worthy of serious consideration. His goal is to "require the debtor to prove and quantify the [payments'] supposed benefit to the debtor's estate in an effort to protect the other unsecured creditors."[34] This is a desirable objective, but my former colleague, Joe Ulrich, has suggested an alternative way to achieve it.[35] Why leave it up to the court to make such a complicated evidentiary finding? Why not say instead that no critical vendor payments will be approved unless creditors holding two-thirds of the remaining unsecured claims vote to approve the payments? After all, if the reorganization eventually fails, it is their money that would have been spent to pay the critical vendors. Since they bear the risk, are they not in the best position to decide if paying off critical vendors will ultimately create a larger pie?[36]

34. Turner, *supra* note 2, at 459.

35. Telephone Interview with Joe Ulrich, Professor of Law, Emeritus, Washington and Lee University School of Law (Aug. 2005).

36. To use imagery from our grammar school experiences with line breakers, Professor Ulrich's proposal would allow miscreants to keep their ill-gotten place in line only if those shoved aside vote to allow it. Displaced unsecured creditors presumably would give their approval only when critical vendor payments were believed to be beneficial not just to the preferred recipients, but to all those affected by the payments.

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