

BY SCOTT A. WOLFSON

## Critically Thinking About Your Critical-Vendor Status

Critical-vendor orders are back in retail, automotive and other cases (if they ever even left).<sup>1</sup> Entry of these orders inspires immediate bravado by vendor clients who reflexively insist that they must be critical and cease providing the debtor with goods or services until they are rightfully so named and their pre-petition indebtedness is paid in full. And then they call you.

Being designated a critical vendor requires more than the debtor's dire need for a vendor's product. Since *Kmart*<sup>2</sup> and *Jevic*,<sup>3</sup> the critical-vendor landscape has been littered with landmines for even the well-intentioned. This article maps the hazards and opportunities for vendors when financing is available to pay critical vendors.

### Authority for Critical-Vendor Orders

Perhaps the comeback of critical-vendor orders should not be heralded, as they have been here in some form for years.<sup>4</sup> The "doctrine of necessity" or the "necessity-of-payment rule" has roots in railway cases going as far back as 1882 in *Miltenberger v. Logansport Ry. Co.*,<sup>5</sup> allowing a receiver to pay pre-receivership unsecured creditors.<sup>6</sup> Since the Bankruptcy Code's enactment,<sup>7</sup> courts have relied on § 105(a)<sup>8</sup> and its grant of broad equitable powers to the bankruptcy courts, along with § 363(b)(1), which allows a trustee to "use, sell, or lease, other than in the ordinary course of business, property of the estate."<sup>9</sup>

However, there is no statutory Code provision that expressly authorizes payment of vendor pre-petition debts before the confirmation of a chapter 11 plan, nor is the term "critical vendor" defined in the Code. The practice of authorizing the payment of pre-petition amounts owed to vendors des-

ignated by the debtor as critical had become routine until the Seventh Circuit closely examined the practice in *In re Kmart*.<sup>10</sup>

Kmart obtained a critical-vendor order and paid in full the pre-petition debts of 2,330 suppliers, which collectively received about \$300 million.<sup>11</sup> Calling the doctrine of necessity "just a fancy name for a power to depart from the Code," the Seventh Circuit held that § 105(a) did not create discretion to set aside the Code's priority rules. Thus, "the power conferred by § 105(a) is one to implement rather than override."<sup>12</sup> The court suggested in *dicta* that § 363(b)(1) could provide support if paying the critical vendors — that is, vendors who would have ceased deliveries if old debts were unpaid — would enable a successful reorganization and make even the disfavored creditors better off.<sup>13</sup>

Critical-vendor-order proponents received a golden nugget of *dicta* from the U.S. Supreme Court in *Czyzewski v. Jevic Holding Corp.*<sup>14</sup> The court's decision that distributions in a structured dismissal of a chapter 11 case could not — without the consent of the affected parties — deviate from basic Bankruptcy Code priority rules did not seem like a setup for critical-vendor-order support. However, the court contrasted the invalid *Jevic* distributions that violated the Code's priority scheme with priority-skipping distributions in the critical-vendor context:

[O]ne can generally find significant Code-related objectives that the priority-violating distributions serve. Courts, for example, have approved "first-day" wage orders that allow payment of employees' prepetition wages, "critical vendor" orders that allow payment of essential suppliers' pre-petition invoices, and "roll-ups" that allow lenders who continue financing the debtor to be paid first on their pre-petition claims.

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In doing so, *these courts have usually found that the distributions at issue would "enable a successful reorganization and make even the disfavored creditors better off."* *In re Kmart Corp.*, 359 F.3d 866, 872



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1 See, e.g., *In re Party City Holdco Inc., et al.*, Case No. 23-90005 (Bankr. S.D. Tex. 2023) (Docket No. 440); *In re Stanadyne LLC, et al.*, Case No. 23-10207 (Bankr. D. Del. 2023) (Docket No. 50); *In re Bolta US Ltd.*, Case No. 23-70042 (N.D. Ala. 2023) (Docket No. 177); *In re Invacare Corp., et al.*, Case No. 23-90068 (Bankr. S.D. Tex. 2023) (Docket No. 299).

2 *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004), cert. denied sub nom., *Handleman Co. v. Capital Factors Inc.*, 543 U.S. 986 (2004).

3 580 U.S. 451 (2017).

4 See LL Cool J, "Mama Said Knock You Out" (1991).

5 106 U.S. 286 (1882).

6 *Id.* at 311 ("Many circumstances may exist [that] may make it necessary and indispensable ... 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.")

7 11 U.S.C. § 101, *et seq.*

8 11 U.S.C. § 105(a) permits a bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of" the Bankruptcy Code.

9 11 U.S.C. § 363(b)(1).

10 359 F.3d 866 (7th Cir. 2004).

11 *Id.* at 869.

12 *Id.* at 871.

13 *Id.* at 872-73.

14 580 U.S. 451 (2017).

(CA7 2004) (discussing the justifications for critical-vendor orders).<sup>15</sup>

While not deciding the issue, the Supreme Court went out of its way to suggest that critical-vendor orders may provide the “significant offsetting bankruptcy-related justification”<sup>16</sup> that the *Jevic* structured dismissal lacked. It behooves not only debtors, but also the vendors who would receive payments under a critical-vendor order, to ensure that an adequate evidentiary record supports entry of the critical-vendor order.

## Don't Violate Automatic Stay by Demanding Payment of Pre-Petition Indebtedness

If the debtor has successfully persuaded the bankruptcy court to enter a critical-vendor order, vendors must be careful about how they seek to obtain payment under the order. The automatic stay is fundamental, and courts go to great lengths to ensure that a debtor has a breathing spell from its creditors. Section 362(a)(6)<sup>17</sup> of the Bankruptcy Code specifically prohibits any act to collect a claim against the debtor that arose before the commencement of the case. This applies even when the vendor is not obligated under a contract to provide goods or services to the debtor.

An example of the reach of this provision, and the care with which vendors must approach post-petition supply requests from a debtor, is *In re Sportfame of Ohio*.<sup>18</sup> Sportfame was a sporting goods retailer, and Wilson Sporting Goods Co. supplied the debtor for almost 10 years. It ceased supplying goods before Sportfame's bankruptcy filing due to its failure to timely pay.<sup>19</sup>

Sportfame sought to restart shipments from Wilson after filing for bankruptcy, but Wilson refused to do so unless Sportfame brought its account current or made arrangements to pay 100 percent of the arrearage.<sup>20</sup> Sportfame asserted that Wilson's refusal to resume shipments absent full payment of its pre-petition debt violated § 362(a)(6) and sought an injunction requiring Wilson to resume supply on a cash basis.<sup>21</sup>

The bankruptcy court found that Wilson's “sole animus in refusing to ship goods to [the] debtor for cash was its desire to coerce debtor's repayment of its pre-petition indebtedness and that this act, albeit a passive one,”<sup>22</sup> violated § 362(a)(6).<sup>23</sup> Sportfame could have hung up the phone when Wilson called and not violated the stay, and Wilson could have refused to ship for any reason other than the one it communicated:

Wilson could have simply refused, for any reason, to sell goods to debtor or offered no explanation for its

refusal to do business. Instead, its sole reason for refusing to sell goods to debtor was its desire to collect its pre-petition debt. The act in this context had the effect of interfering with the reorganization effort, a result at odds with the purpose of the bankruptcy laws.<sup>24</sup>

As a result, the bankruptcy court entered an injunction requiring Wilson to ship goods to Sportfame on a cash-in-advance or on-delivery basis, and “on a normal basis consistent with their dealings for the past 10 years.”<sup>25</sup> The practical lesson is clear: Be careful what is said in response to a debtor's request for supply post-petition, even if you did not have a contract with the debtor. Generically inquiring about the debtor's proposed trade terms and whether the debtor intends to treat you as a critical vendor — assuming that such an order has been entered — is the safest course.

**Vendors should assess their ongoing performance obligations under any existing contracts and be circumspect in communications with a debtor about refusals to ship — even in the absence of an executory contract.**

## Don't Violate the Stay by Ceasing Performance Under an Executory Contract Without Leave of Court

Stay violations are common where the vendor and debtor are parties to a contract as of the petition date. As the *Kmart* court noted, a vendor is not always entitled to cease deliveries, as it depends on the vendor's contractual relationship with the debtor. For example, there might be “long-term contracts, and the automatic stay prevents these vendors from walking away as long as the debtor pays for new deliveries.”<sup>26</sup>

Section 365(a) of the Bankruptcy Code provides debtors with the ability to, subject to court approval, assume or reject an executory contract.<sup>27</sup> The Code does not define “executory contract,” but many courts have adopted the Countryman definition: “[A] contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.”<sup>28</sup>

Executory contracts are enforceable against the non-debtor party before assumption or rejection.<sup>29</sup> Section 365 provides “a means whereby a debtor can force others to continue to do business with it when the bankruptcy filing might otherwise make them reluctant to do so.”<sup>30</sup> A debtor may

15 *Id.* at 467-68 (emphasis added).

16 *Id.* at 468.

17 11 U.S.C. § 362(a)(6) (petition “operates as a stay, applicable to all entities, of — any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title”).

18 *In re Sportfame of Ohio Inc.*, 40 B.R. 47 (Bankr. N.D. Ohio 1984).

19 *Id.* at 48-49.

20 *Id.* at 49.

21 *Id.*

22 Creditors may have additional arguments under *City of Chicago, Illinois v. Fulton* that the “passive” refusal to ship is not a prohibited “affirmative act” to collect a pre-petition claim under § 362(a)(6), which, similar to § 362(a)(3), prohibits “any act to...” 141 S. Ct. 585 (2021) (section 362(a)(3) prohibits only “affirmative acts” that would change “status quo” of estate property as of time a bankruptcy petition is filed and that, therefore, entity's “mere retention” of estate property after filing of bankruptcy petition does not violate § 362(a)(3)).

23 *Id.* at 50.

24 *Id.*

25 *Id.* at 56.

26 359 F.3d 866, 873.

27 11 U.S.C. § 365(a).

28 Vern Countryman, “Executory Contracts in Bankruptcy: Part I,” 57 *Minn. L. Rev.* 439, 460 (1973).

29 See *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984); 11 U.S.C. § 365(e)(1) (prohibiting executory contract counterparty from suspending performance solely due to bankruptcy filing).

30 *Chateaugay Corp. v. LTV Steel Co. (In re Chateaugay Corp.)*, 10 F.3d 944, 954-55 (2d Cir. 1993).

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assume or reject an executory contract at any time before plan confirmation, although a creditor may ask the bankruptcy court to make such a determination within a particular time frame.<sup>31</sup>

A cautionary tale for vendors having an executory contract with a debtor can be found in *In re Feyline Presents Inc.*,<sup>32</sup> where Coke and the debtor entered into an agreement pre-petition under which Coke was to pay the debtor a fee for the debtor's promotional identification of Coke and its exclusive right to sell soft drinks at the debtor's concerts.<sup>33</sup> Coke was obligated under the executory contract to pay the debtor \$150,000 post-petition as a pre-payment for the next year's concert series, but it did not make the payment. Instead, it sent the debtor a notice that Coke had suspended its performance due to the debtor's "precarious financial situation" and "inability to perform" its obligations under the contract.<sup>34</sup>

In denying Coke's motion for summary judgment, the *Feyline* court held that Coke's refusal to make the payment was improper: "If a nondebtor party could unilaterally cease performance on an executory contract, the powers provided to a debtor under § 365(d) would have no mean-

ing."<sup>35</sup> The court also provided guidance on what Coke *should have done*:

Without question, the breathing spell afforded by 11 U.S.C. § 365(d) can impose a penalty on the other party to the contract. However, that party has a remedy and that remedy is to move, pursuant to Section 365(d)(2), for an order requiring the debtor to make an early election.<sup>36</sup>

Vendors who believe that they will be harmed by continuing to perform under an executory contract with a debtor should move to compel the debtor to make an early election to assume or reject their contract, or for relief from stay to terminate it. Failure to do so may violate both §§ 365 and 362.

### Conclusion

The entry of a critical-vendor order, and the prospect of payment of a vendor's pre-petition indebtedness, can lead vendors to take actions that might jeopardize the very payments they desperately seek. Vendors should assess their ongoing performance obligations under any existing contracts and be circumspect in communications with a debtor about refusals to ship — even in the absence of an executory contract. **abi**

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31 11 U.S.C. § 365(d)(2).

32 81 B.R. 623 (Bankr. D. Colo. 1988).

33 *Id.* at 624.

34 *Id.* at 625-26.

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35 *Id.* at 627.

36 *Id.* at 626.

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