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Feature

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Keep Your Friends Close, but Keep Your Critical Vendors Closer

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The Seventh Circuit Court of Appeals's 2004 decision in *Kmart* is the most frequently cited case on critical-vendor motions. In *Kmart*, the Seventh Circuit, in an opinion authored by Hon. Frank Easterbrook, affirmed a district court order setting aside a bankruptcy court order approving critical-vendor payments.[1]

In that case, the Seventh Circuit noted that it did not need to reach the issue of whether critical-vendor payments could ever be authorized in bankruptcy cases because the record before the court did not show the "prospect of benefit to other creditors."[2] The *Kmart* court nevertheless noted that if the Bankruptcy Code permits critical-vendor payments, such payments should only be authorized if it is shown "that the disfavored creditors *will* be as well off with reorganization as with liquidation ... but also that the supposedly critical vendors would have ceased deliveries if old debts were left unpaid while the litigation continued."[3]

Notwithstanding the threshold described in *Kmart*, critical-vendor motions have become routine in New York, Delaware and some other jurisdictions, without the evidentiary showing articulated by the *Kmart* decision. In contrast, some other courts, following *Kmart*, require creditor-by-creditor evidence as a precondition to approval of a critical-vendor motion.[4]

Recent decisions from the *Windstream Holdings Inc*. and *Murray Metallurgical Coal Holdings LLC* bankruptcies have followed the trend in New York and Delaware that evidence is not required on a creditor-by-creditor basis. In the pending cases of *Windstream*[5] and its affiliates, Hon. Cathy Seibel of the Southern District of New York affirmed a bankruptcy court order entered by Hon. **Robert D. Drain** of the U.S. Bankruptcy Court for the Southern District of New York granting a critical-vendor motion. In its opinion, the district court described Windstream's methodology for determining critical vendors, which is generally consistent with current practice in the critical-vendor context in New York and Delaware, and the facts and factors considered by Judge Drain, thereby setting forth a framework for the consideration and formulation of critical-vendor motions in future cases. There is a pending appeal of that ruling before the Second Circuit.[6]

Two weeks before the district court's decision in *Windstream*, Hon. **John E. Hoffman, Jr.** of the U.S. Bankruptcy Court for the Southern District of Ohio had granted a critical-vendor motion in the bankruptcy cases of *Murray Metallurgical Coal Holdings LLC*, effectively following Judge Drain's ruling.[7] The recent decisions in *Windstream* and *Murray* are important for at least two reasons.

First, *Windstream* sets forth a detailed protocol for consideration and formulation of critical-vendor motions endorsed by the district court on appeal. Prior to this opinion, there were no cases that detailed an appropriate critical-vendor protocol to the extent set forth in *Windstream*. Second, both of these decisions expressly recognized that, notwithstanding the requirement laid out by Judge Easterbrook in *Kmart* that critical-vendor payments

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1 *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, 125 S. Ct. 495 (2004).

2 *Id.* at 874.

3 *Id.* at 873.

4 *See, e.g., In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004); *J.M. Blanco Inc. v. PMC Mktg. Corp.*, Case No. 09-1781 (GAG), 2009 U.S. Dist. LEXIS 119063, at *13 (D.P.R. Dec. 22, 2009); *In re Goodrich Quality Theaters Inc.*, Case No. 20-00759, 2020 Bankr. LEXIS 610, at *7-8 (Bankr. W.D. Mich. March 4, 2020); *In re GVM Inc.*, 606 B.R. 220, 227 (Bankr. M.D. Pa. 2019); *In re Pioneer Health Servs.*, 570 B.R. 228, 235 (Bankr. S.D. Miss. 2017); *In re News Publ'g Co.*, 488 B.R. 241, 244 (Bankr. N.D. Ga. 2013); *In re O&S Trucking Inc.*, Case No. 12-61003, 2012 Bankr. LEXIS 3271, at *17 (Bankr. W.D. Mo. June 29, 2012); *In re Corner Home Care Inc.*, 438 B.R. 122, 128 (Bankr. W.D. Ky. 2010).

5 *GLM DFW Inc. v. Windstream Holdings Inc. (In re Windstream Holdings Inc.)*, Case No. 19-CV-5854 (CS), 614 B.R. 441 (S.D.N.Y. 2020) (on appeal to the Second Circuit as Case No. 20-1275 (2d Cir.)).

6 *See* Case No. 20-1275 (2d Cir.).

7 *See* Case No. 20-10390, 613 B.R. 442 (Bankr. S.D. Ohio 2020).

should only be considered where "supposedly critical vendors would have ceased delivery if old debts were left unpaid,"[8] creditor-by-creditor evidence is not required for approval of a critical-vendor motion.

The *Windstream* Protocols

To determine which vendors were critical (*i.e.*, the loss of which would "immediately and irreparably harm their businesses, by, among other things, shrinking their market share, reducing enterprise value, and ultimately impairing [a debtor's] viability as a going concern"), the debtors and their professionals undertook a robust process[9] of "reviewing and analyzing their books and records, consulting operations managers and purchasing personnel, reviewing contracts and supply agreements, and analyzing applicable law, regulations, and historical practice."[10] In connection with that process, the debtors considered the following factors:

1. whether certain specifications or contract requirements prevent, directly or indirectly, the debtors from obtaining goods or services from alternative sources;
2. whether a vendor is a sole-source, limited-source or high-volume supplier of goods or services critical to the debtors' business operations;
3. whether an agreement exists by which the debtors could compel a vendor to continue performing on pre-petition terms;
4. whether alternative vendors are available that can provide requisite volumes of similar goods or services on equal (or better) terms and, if so, whether the debtors would be able to continue operating while transitioning business thereto;
5. the degree to which replacement costs (including pricing, transition expenses, professionals' fees and lost sales or future revenue) exceed the amount of a vendor's pre-petition claim;
6. whether the debtors' inability to pay all or part of the vendor's pre-petition claim could trigger financial distress for the applicable vendor;
7. the likelihood that a temporary break in the vendor's relationship with the debtors could be remedied through use of the tools available in these chapter 11 cases;
8. whether failure to pay all or part of a particular vendor's claim could cause the vendor to hold goods owned by the debtors, or refuse to ship inventory or to provide critical services on a post-petition basis;
9. the location and nationality of the vendor; and
10. whether failure to pay a particular vendor could result in a contraction of trade terms as a matter of applicable nonbankruptcy law or regulation.[11]

The debtors' consultants subsequently reviewed the debtors' financial documents and interviewed the debtors' employees to answer the following questions:

1. If a specific vendor were to cease providing service or to stop shipping product, would that cause disruption to the business and would that disruption cause irreparable harm?
2. Could that vendor be re-sourced?
3. Can the debtors could go out and find an alternative for the vendor?[12]

The debtors maintained a matrix summarizing amounts paid on account of the critical-vendor claims, which they provided every week to the U.S. Trustee and the unsecured creditors' committee's professionals, including (1) the critical vendor paid; (2) the amount paid to each; (3) the total amount paid to each to date; (4) the debtor who made the payment; (5) the payment date; and (6) the purpose of the payment.[13] They also provided the complete list of critical vendors to the U.S. Trustee, the professionals for the committee of unsecured creditors and the bankruptcy court for *in camera* review. After explaining this comprehensive process to the bankruptcy court, the court permitted the debtors to determine who would be a critical vendor based on their own business judgment.

It appears that the protocols employed by *Murray* were substantially similar to those of *Windstream*[14] and to those employed by debtors in numerous other cases in New York, Delaware and various other jurisdictions. Objections to the proposed critical-vendor payments in *Windstream* and *Murray* were nevertheless asserted on the basis that the motion should not be granted absent disclosure of the critical vendors and evidence on a creditor-by-creditor basis that each of the applicable vendors would cease doing business with the debtors absent payment of their pre-petition claims.

Evidence that a Specific "Critical Vendor" Will Refuse to Do Business with the Debtors Absent Payment of Its Pre-Petition Claims Should Not Be Required

In *Kmart*, Judge Easterbrook noted that to approve critical-vendor payments, a court must find that "creditors who are not critical vendors *will* be as well off with reorganization as with liquidation," and that "supposedly critical vendors would have ceased deliveries if old debts were left unpaid while the [bankruptcy case] continued."[15]

Following the language in *Kmart*, some courts have held that a critical-vendor motion should not be granted absent evidence that the vendor had refused, or would refuse, to provide the critical product or service without payment of its pre-petition debt.[16] In contrast, as noted in *Murray*, other courts (including courts in New York and Delaware) "have regularly approved critical-vendor motions in cases in which the debtors have used protocols similar to the one employed by the Debtors here without identifying the vendors or providing specific evidence as to each one."[17]

In *Windstream*, the district court noted that §§ 105(a) and 363(b) of the Bankruptcy Code, as well as the case law concerning the doctrine of necessity, form the basis for authorizing critical-vendor payments. The district

8 *Kmart*, 359 F.3d at 873.
9 This section is not intended as a complete description of the protocols.
10 *Windstream*, 614 B.R. at 445.
11 *Id.*
12 *Id.* at 447.
13 *Id.* at 446.
14 *See Murray*, 613 B.R. at 446-50; *see also* Declaration of Amy Lee, Senior Director at Alvarez & Marsal North America LLC, in Support of First-Day Motions, *Murray Metallurgical Coal Holdings LLC*, Case No. 20-10390 (Bankr. S.D. Ohio Feb. 12, 2020), ECF No. 5.
15 *Kmart*, 359 F.3d at 873 (emphasis added).
16 *See supra*, n.4.
17 *Murray*, 613 B.R. at 453.

court embraced the three-factor test set forth in the *United American Inc*. bankruptcy case,[18] which requires the following findings: (1) the vendor must be necessary for a successful reorganization; (2) the transaction must be in the debtor's sound business judgment; and (3) the favorable treatment of the vendor must not prejudice other unsecured creditors.[19] This test does not require a formal refusal to provide services by the vendor.[20]

In the Sixth Circuit, where the *Murray* appeal is pending, critical-vendor motions are considered under § 363(b)(1), which requires a finding of a "sound business purpose" for approval of transactions outside the ordinary course of business.[21] The vendor "must (1) be in a position to cease providing goods or services to the debtor because it is not a party to a contract with the debtor; and (2) refuse to provide goods and services unless its pre-petition claim remains unpaid."[22] Next, payments to critical vendors must leave creditors "at least as well off as they were before."[23] In considering the foregoing standard in the critical vendor context, Judge Hoffman observed:

> The Court concludes that requiring proof on a vendor-by-vendor basis is not required by the Bankruptcy Code and would be detrimental to the interests of the Debtors' estates and creditors, including the unsecured creditors. In fact, the [objectors'] approach likely would result in the Debtors' paying *more* to their critical vendors than they will pay if the Motion is approved. That is, requiring evidence on a vendor-by-vendor basis would drain value from the bankruptcy estate to the detriment of all creditors. This is true for several reasons. For one, in order to provide particular evidence that each critical vendor would fail to do business with the Debtors, what are the Debtors to do? Ask their creditors if they will cease doing business with them if they do not pay their pre-petition claims? If asked, most creditors will certainly say "yes," increasing the amount of critical-vendor payments [that] the Debtors would make. As the court stated in *Windstream*, "the reason [the debtors have] only paid 12 [creditors under the interim critical-vendors order] to date is because [the others] haven't asked. [The Debtors are] only going to deal with them if they do ask. You want them to pay a blank check for the full amount." *Windstream*, Tr. of Hrg. at 92; *see also id*. at 106-07 (noting that this approach would create a "run on the bank"). And if the Motion is not approved, are the Debtors to wait until the critical moment when the creditors inform the Debtors that they are soon to be cut off, filing motions on an emergency basis each time this happens? On top of all that, are the Debtors, by filing a list of "critical vendors" and providing evidence regarding why each vendor is critical, to deprive themselves of any leverage they have in negotiations with the vendors? Such an approach would not only increase the costs incurred by the Debtors' estates for professional fees, but also would increase the risk of harm to the Debtors' business.[24]

Similarly, the district court in *Windstream* agreed with Judge Drain that evidence of "a formal refusal" was "impractical."[25] In so noting, the district court observed that a creditor-by-creditor determination of a "formal refusal" would harm the bankruptcy estate because it would be unduly time- and resource-consuming and would adversely impact the estates' leverage in negotiations, which would ultimately do harm to the entire estate.[26]

As Judge Drain noted, requiring evidence of critical-vendor status on a creditor-by-creditor basis would create the "type of disruption" that critical-vendor motions are intended to prevent.[27] It would, in many cases, result in unnecessary costs, expenses and distractions, or worse: require multiple additional emergency motions that may, or may not, prove to be timely.[28]

Conclusion

In certain respects, the *Windstream* and *Murray* decisions are not noteworthy insofar as they reflect what has become routine practice in chapter 11 cases in New York and Delaware. Nevertheless, they are important to bankruptcy courts, practitioners and chapter 11 debtors, because they provide (1) persuasive support for the proposition that evidence on a creditor-by-creditor basis is not necessary for approval of a critical-vendor motion; and (2) precedent to justify established practices that can be used as a road map to consider, formulate and implement critical-vendor protocols and, if necessary, payments. abi

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18 *In re United Am. Inc.*, 327 B.R. 776 (Bankr. E.D. Va. 2005).
19 *Id.* at 782.
20 *See Windstream*, 614 B.R. at 452, 458, n.10.
21 *Murray*, 613 B.R. at 450 (quoting *Stephens Indus. Inc. v. McClung*, 789 F.2d 386, 390 (6th Cir. 1986)).
22 *Id.* at 451 (citing, *e.g., Kmart*, 359 F.3d at 872-73).
23 *Id.* at 452.
24 *Id.* at 453-54.
25 *See Windstream*, 614 B.R. at 452, 458, n.10.
26 *Id.* at 458, n.10.
27 *See* Hr'g Tr., *In re Windstream Holdings Inc.*, Case No. 19-22312 (RDD) (Bankr. S.D.N.Y. April 16, 2020), ECF No. 1457 at 104:11-116:17; 108:15-109:17.
28 *Murray*, 613 B.R. at 455.