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Necessity: The Mother of a Bankruptcy Invention

Here's the situation. You are a major supplier to ABC Corporation and have enjoyed a positive business relationship for many years. ABC has hit hard times financially. In the last six months, ABC has not been paying according to terms and now owes you a significant amount of money for your last several shipments. You have other customers who could probably keep you in business, but you would definitely miss ABC if it were to take its business elsewhere or fold altogether. Therefore, when ABC tells you it is considering bankruptcy reorganization, you are willing to continue shipping goods in order to keep one of your best customers. You are, however, concerned about the money that ABC owes you for product already delivered.

Here's the solution. ABC will file a Chapter 11 bankruptcy and continue to operate, but without the daily pressure of trying to pay debt or the threat of a shutdown by its lenders. You will continue to supply ABC on existing terms. To allay your worries about whether you will get paid for your product, ABC will include you on a list of "critical vendors" who will be paid 100 percent of what they were owed before the bankruptcy was filed in order to entice you to continue supplying ABC post-bankruptcy.

Here's the argument. A fundamental purpose of the bankruptcy system is to give business debtors the opportunity to reorganize and continue to contribute to commerce. Some vendors are essential to the successful reorganization, and perhaps the very survival, of ABC. If those "critical vendors" refuse to continue shipping during the bankruptcy case, the reorganization will fail. Whereas unsecured trade creditors rarely get paid in full for any debt owed before the bankruptcy, those "critical" or "essential" vendors deserve special treatment in order for ABC to effectively reorganize. That treatment includes payment in full of pre-bankruptcy debt, even though other trade creditors may receive as little as 5 cents on the dollar under a confirmed plan of reorganization. Under this "doctrine of necessity," the bankruptcy court approves payment to critical vendors, which includes 100-percent payment to you.

Here's the problem. There is no specific authority in the Bankruptcy Code for providing special treatment to "critical" unsecured creditors like you, nor are there any guidelines for determining which pre-bankruptcy creditors are, in fact,

"critical" to ABC's successful reorganization.

Those bankruptcy courts that have recognized the "doctrine of necessity" have relied on the broad power provided to them under Section 105 of the Bankruptcy Code. Section 105 authorizes bankruptcy courts to "issue any order ... that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." Other courts have criticized this expansive use of Section 105, holding that it violates another fundamental policy of the Bankruptcy Code — the fair and equal treatment of similarly situated creditors.

This split in authority was not addressed when the Bankruptcy Code was amended in 2005. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") does, however, contain at least two provisions that may significantly impact critical vendor payments. New Section 503(b)(9) gives administrative priority status to claims for the value of any goods received by the debtor in the ordinary course of the debtor's business within 20 days before the bankruptcy case is filed. Administrative priority status entitles a creditor to payment in full, but the "value" of the goods delivered may not be the same as the purchase price.

BAPCPA also amended Section 546(c) to expand a seller's rights to reclaim goods sold to an insolvent debtor. A seller can now reclaim goods that were delivered to the debtor within 45 days of bankruptcy, assuming written demand for return of the goods is made and certain other conditions enumerated by Section 546 are satisfied.

Here's the bottom line. Although critical vendor payments have not been abolished by BAPCPA, it has been argued that the new act contains a negative inference that such payments should not be authorized. The law now expressly provides some protection for unsecured, pre-petition suppliers, which may result in courts being more reluctant to use the equitable powers granted to them under Section 105 of the Bankruptcy Code. You should not assume that a bankrupt customer will be able to pay you in full under the doctrine of necessity.

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