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BANKRUPTCY FOR BANKERS

HOWARD SEIFE

COURTS DIVIDED ON DEBTORS' PAYMENTS TO "CRITICAL VENDORS" ON ENTERING CHAPTER 11

When debtors enter chapter 11, they typically file a number of "first-day" motions that they contend are needed to allow them to continue to operate effectively in bankruptcy. One of the most common of these motions seeks an order of the bankruptcy court authorizing payment of prepetition debt to "critical vendors." Debtors maintain that these payments are necessary to ensure that their suppliers continue to provide goods to them while they are in bankruptcy, thus improving the likelihood that they will be able to successfully reorganize.¹

In many instances, lenders and other creditors and parties in interest do not object to these payments. Courts, however, are divided on the ability of bankruptcy judges to approve them.² This division is unlikely to be resolved any time soon, at least without the U.S. Supreme Court's intervention or an amendment to the Bankruptcy Code clarifying the issue — neither of which event is on the horizon. At this point, therefore, it would seem that debtors

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may add this factor to the other factors they consider when deciding where to file their bankruptcy petitions. The courts that are willing to permit debtors to make payments to critical vendors, including those in New York and Delaware, may see more debtors seeking relief in their jurisdiction.

The “Doctrine of Necessity”

Generally speaking, the filing of a petition for reorganization under chapter 11 of the Bankruptcy Code stays “any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case.”³ Notwithstanding that provision, debtors that file “critical vendor” motions usually seek to rely on the “doctrine of necessity,” along with Bankruptcy Code section 105(a), as the statutory basis for the payment of prepetition claims. Section 105(a) states:

“The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent abuse of process.”

The doctrine of necessity stems in part from two well established rules developed years ago in connection with railroad receiverships: the “Six Months Rule” and the “Necessity of Payment Rule.”

The Six Months Rule arose from the historical practice of initiating railroad receiverships with an order appointing a receiver who was granted court authorization to pay certain prepetition debts for labor, equipment, supplies or improvements from postpetition operating receipts.⁴ The rule was equitable in nature and applied to expenses necessary for the continued operation of the railroad that were incurred in the period immediately preceding the petition for reorganization.⁵

The Six Months Rule was given statutory recognition in Section 77(b) of the Bankruptcy Act,⁶ which provided:

“For all purposes of this section unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors.”

The language of section 1171(b) of the Bankruptcy Code⁷ is the same in substance as that of Section 77(b),⁸ and it is clear that Congress intended that section 1171(b) operate to continue the Six Months Rule in granting certain creditors priority.⁹

The Six Months Rule traditionally has been applied in railroad cases,¹⁰ although some cases decided prior to the enactment of the Bankruptcy Code in 1978 suggested that the rule could be extended to other public service companies as well.¹¹

The historical development of the Necessity of Payment Rule parallels that of the Six Months Rule. The U.S. Supreme Court first articulated a “necessity of payment doctrine” over a century ago in a railroad bankruptcy when it stated that “many circumstances may exist which may make it necessary and indispensable to the business of the road and the preservation of the property, for the receiver to pay pre-existing debts.”¹² In essence, the Necessity of Payment Rule was a rule developed for the protection of trustees of a railroad who were faced with threats to the continued operation of the line during reorganization.¹³ The rule may be invoked by trustees as justification for the payment of prepetition debts paid to secure continued supplies or services essential to the continued operation of the railroad.¹⁴ Although this doctrine was not codified in the Bankruptcy Code, courts have used their equitable power under section 105(a) of the Bankruptcy Code to authorize the payment of prepetition claims when such payment is deemed necessary to the survival of a debtor in a chapter 11 reorganization. Consider the decision by the U.S. District Court for the District of Delaware in *In re Just For Feet, Inc.*¹⁵

The *Just For Feet* Decision

Just For Feet, Inc. and its subsidiaries filed voluntary petitions for relief

under chapter 11 in Delaware. Several days later, the debtors, which operated retail stores that specialized in brand-name athletic footwear and related apparel, filed a motion for authorization to pay prepetition claims of trade vendors.

At the hearing, the president of Just For Feet, Helen Rockey, testified that her company was “in the fashion business” and that it needed “new styles, new colors, [and] hot products on the floor to get the customer in the door.” Rockey testified that Just For Feet ordered the majority of its merchandise four to six months in advance and that by its bankruptcy filing the company had not yet received the merchandise it had ordered for the next holiday season. She also testified that since Just For Feet entered chapter 11, many of its largest trade vendors had demanded cash-in-advance and informed Rockey that they would not ship merchandise until their prepetition claims were paid.

Just For Feet owed its trade vendors \$66 million in prepetition claims, with the top ten trade vendors accounting for approximately half of this total debt. Rockey also testified that maintaining favorable credit terms with the trade vendors was critical to Just For Feet’s survival. Even with \$25 million in postpetition financing, Rockey testified, the company did not have sufficient cash to pay creditors on a cash-in-advance basis for merchandise already ordered. According to Rockey, Just For Feet needed to receive \$50 million of new inventory to have a successful holiday shopping season.

To deal with this situation, Just For Feet proposed to pay the prepetition and postpetition claims of “critical” trade vendors as they became due, in exchange for the vendors’ written agreement to extend credit to Just For Feet on similar or better terms than the company had enjoyed in the past.

Without the court’s authority to pay the prepetition claims of the trade vendors, the debtors argued that many vendors would refuse to provide necessary goods and services to the debtors on favorable credit terms. Rockey testified that the inability to acquire sufficient quantities of merchandise might doom the reorganization of Just For Feet.

Five parties — Bank of America, N.A., as administrative agent under a credit agreement, Bank of New York, as indenture trustee of certain subordinated notes (“BONY”), Saatchi & Saatchi Business Communications, Inc., certain noteholders, and the United States Trustee — objected to the debtors’

motion to pay these prepetition claims. Three of the parties, BONY, the noteholders and the U.S. Trustee, argued that, as a matter of law, the court could not authorize payment of prepetition claims of critical vendors because section 105(a) of the Bankruptcy Code does not permit the court to adjust the statutory priorities established by the Bankruptcy Code.

Further, all five parties argued that even if the court had the power to authorize payment of prepetition claims pursuant to section 105(a), the debtors had not described their proposal in sufficient detail to determine if payment of the prepetition vendor claims was necessary.

In its decision, the court said that to invoke the necessity of payment doctrine, a debtor must show that payment of the prepetition claims is “critical to the debtor’s reorganization.”¹⁶ Thus, the court continued, it had to determine whether the payment of prepetition claims of trade vendors in this case was critical to the debtors’ reorganization.

In the court’s view, it was clear that Just For Feet could not survive unless it had name brand sneakers and athletic apparel to sell in its stores. The debtors needed a continuous supply of inventory from athletic footwear and apparel vendors such as Nike, New Balance, Fila, Reebok, Adidas, Asics, K-Swiss, and Converse. As the court noted, Rockey had testified that without new merchandise from these vendors, Just For Feet would not survive. Therefore, the court found, payment of the prepetition claims of the athletic footwear and apparel vendors was essential to the survival of the debtors during the chapter 11 reorganization. Accordingly, the court ruled that the debtors could pay the prepetition claims of athletic footwear and apparel vendors as they became due, in exchange for the vendors’ written agreement to extend credit to the debtors on similar or better terms than the debtors enjoyed in the past.

The *Capital Factors* Ruling

The alternative view is illustrated by a recent decision of the U.S. District Court for the Northern District of Illinois in the chapter 11 case of Kmart Corp.¹⁷

When Kmart Corporation (and certain of its domestic subsidiaries and affiliates) entered chapter 11, it filed its “first day motions,” including one

that sought authority to pay prepetition obligations to certain “critical vendors.” Kmart contended that these payments were necessary to maintain relationships essential to its continued operation and reorganization, and it invoked the “doctrine of necessity” and Bankruptcy Code section 105(a) for the bankruptcy court’s authority to permit these payments.

On the same day, the bankruptcy court held a hearing and heard evidence on these motions. Capital Factors, Inc., a factoring agent for a number of Kmart’s apparel suppliers that held general unsecured claims against the bankruptcy estate of about \$20 million, objected to the critical vendors motion.

The bankruptcy court found that the payments were “necessary,” “integral” and that there was “good business justification” for them, and approved the critical vendors motion. Capital appealed.

The district court examined whether the bankruptcy court had the power to authorize payment of prepetition claims prior to confirmation of a chapter 11 plan by relying on Bankruptcy Code section 105.

As the district court noted, the U.S. Court of Appeals for the Seventh Circuit has stated that the grant of equitable power in Section 105 is limited in that it “allows [bankruptcy] courts to use their equitable powers only as necessary to enforce the provisions of the Code, not to add on to the Code as they see fit.”¹⁸ The district court continued its analysis by pointing out that the Bankruptcy Code sets forth a priority scheme for the payment of claims¹⁹ and does not carve out priority or administrative expense status for prepetition general unsecured claims based on the “critical” or “integral” status of a creditor. However, the district court added, the effect of the bankruptcy court’s orders was to elevate the claims of the “critical” vendors over those of other unsecured creditors and to subordinate the claims of non-“critical” unsecured creditors. “The bankruptcy court altered the priority scheme set forth in the Bankruptcy Code,” the district court observed.

The district court then stated that it agreed with the view that it should not ignore the Bankruptcy Code’s statutory scheme of priority in favor of “equity,” especially in light of the Seventh Circuit’s admonition that “[t]he fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be.”²⁰

The district court acknowledged that the application of the “doctrine of necessity” through section 105 in this situation was well-intended and may even have had some beneficial results, in that pre-confirmation payment of certain prepetition claims allowed the debtor to minimize disruptions in its business, and thus might further reorganization. Nevertheless, it continued, it was “clear” that however useful and practical these payments might appear to bankruptcy courts, they “simply are not authorized by the Bankruptcy Code. Congress has not elected to codify the doctrine of necessity or otherwise permit pre-plan payment of prepetition unsecured claims.

Interestingly, the district court also rejected Kmart’s argument that Capital’s appeal should be rejected because it had not sought a stay of the bankruptcy court’s order, noting that it was highly unlikely that a motion to stay would have been successful. “It would be inconsistent for the bankruptcy court to enter the orders on the theory that prompt payments were necessary to keep Kmart operational, and then turn around and stay those orders.” In any event, the district court added, Capital was not required to seek a stay of the orders to preserve its appellate rights.

The district court in the *Kmart* case also was not persuaded that Capital’s appeal was moot due to the fact that the prepetition claims had been substantially paid and that effective relief on appeal had become imprudent and inequitable. Simply put, the district court stated, it was “not too late” to order that the monies paid be returned, adding that perhaps the bankruptcy court could just order the creditors who had received payments to give them back.

Conclusion

The issue of payments to critical vendors remains in flux. At least one court, the Bankruptcy Court for the Northern District of Texas,²¹ has ruled that section 105(a) allows a bankruptcy court to authorize payment of unsecured prepetition claims where necessary to preserve or enhance a debtor’s bankruptcy estate, and then developed its own three-part test to use to determine whether a general unsecured prepetition claim should be paid.²²

Moreover, some courts have sought to approve payments to critical trade creditors by relying on other provisions of the Bankruptcy Code, including Section 364, which empowers a court to authorize a debtor-in-possession to

obtain unsecured credit out of the ordinary course of business.²³ These courts recognize the need for payments of prepetition debt on occasion, to facilitate the reorganization process.

When considering where to file a chapter 11 case, a company will give great weight to selecting a jurisdiction which would best facilitate its reorganization. One factor in making that decision may well be whether the court will permit payments to be made to critical vendors.

Notes

¹ In certain situations, debtors may seek payments of prepetition obligations to their employees, arguing that these are needed to retain capable staff. See, e.g., *In re Ionosphere Clubs, Inc.*, 98 B.R. 174 (Bankr. S.D.N.Y. 1989) (court authorized payment of active employees' prepetition wages, salary, and benefit claims).

² Cf. *In re Lehigh & New England Railway Co.*, 657 F.2d 570, 581 (3d Cir. 1981) (court could authorize payment of prepetition claims if such payment was essential to the continued operation of the debtor); *In re Penn Central Transp. Co.*, 467 F.2d 100, 102 n.1 (3d Cir. 1972) (holding that the necessity of payment doctrine permits "immediate payment of claims of creditors where those creditors will not supply services or material essential to the conduct of the business until their pre-reorganization claims have been paid"); *In re Just For Feet, Inc.*, 242 B.R. 821 (D. Del. 1999); *In re Discovery Zone, Inc.*, Case No. 99-941 (JJF) (D. Del. April 21, 1999); *In re FF Holdings Corp. and Farm Fresh, Inc.*, Case Nos. 98-37, 98-38 (JJF) (D. Del. Jan. 7, 1998); *In re Chateaugay Corp.*, 80 B.R. 279 (S.D.N.Y. 1987); *In re CoServ, L.L.C.*, 273 B.R. 487 (Bankr. N.D. Tex. 2002); *In re Wehrenberg, Inc.*, 260 B.R. 468 (Bankr. E.D. Mo. 2001); *In re Gross Graphic Sys., Inc.*, Case No. 99-2756 (PJW) (Bankr. D. Del. July 30, 1999); *In re Acme Steel Co.*, Case No. 98-2179 (MFW) (Bankr. D. Del. Sept. 29, 1998); *In re WSR Corp.*, Case No. 92-1241 (MFW) (Bankr. D. Del. June 10, 1998); *In re Columbia Gas Sys., Inc.*, 171 B.R. 189, 191-92 (Bankr. D. Del. 1994) (noting that in the Third Circuit, debtors may pay prepetition claims that are essential to continued operation of business); *In re Ionosphere Clubs, Inc.*, 98 B.R. 174 (Bankr. S.D.N.Y. 1989), with *In re Oxford Management, Inc.*, 4 F.3d 1329, 1333-34 (5th Cir. 1993) (holding that district court improperly used its equity powers to authorize payment of commissions by the debtor to associate brokers); *Official Comm. of Equity Sec. Holders v. Mabey*, 832 F.2d 299 (4th Cir. 1987); *In re B & W Enters., Inc.*, 713 F.2d 534 (9th Cir. 1983); *In re Timberhouse Post & Beam, Ltd.*, 196 B.R. 547 (Bankr. D. Mont. 1996) (prepetition unsecured claims cannot be elevated to administrative expense); *In re FCX, Inc.*, 60 B.R. 405, 410 (E.D.N.C. 1986)

(holding that by authorizing payment of prepetition claims arising from payroll expenses, payroll taxes and purchases of grain, bankruptcy court improperly subordinated claims of remaining creditors).

³ 11 U.S.C. § 362(a)(6).

⁴ See *In re Boston and Maine Corp.*, 634 F.2d 1359, 1366 (1st Cir. 1980).

⁵ *Id.* at 1378.

⁶ 11 U.S.C. § 205(b) (1976) [repealed].

⁷ 11 U.S.C. § 1171(b).

⁸ Section 1171(b) provides: "Any unsecured claim against the debtor that would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the date of the order for relief under this title shall be entitled to such priority in the case under this chapter."

⁹ See H.R. Doc. No. 137, 93d Cong., 1st Sess. 424 (1978) (House Report states that Section 1171(b) intended to continue priority rules of Section 77(b)); *In re Boston and Maine Corp.*, 634 F.2d at 1379-80 n.35.

¹⁰ See generally *In re Boston and Maine Corp.*, 634 F.2d at 1366.

¹¹ See *Dudley v. Mealey*, 147 F.2d 268 (2d Cir. 1945).

¹² *Miltenberger v. Logansport*, 106 U.S. 286 (1882).

¹³ See *In re Boston and Maine Corp.*, 634 F.2d at 1382; *In re Penn Central Transportation Co.*, 458 F. Supp. 1234, 1326 (E.D. Pa. 1978), *aff'd* in part, *remanded* in part, 596 F.2d 1102 (3rd Cir. 1979).

¹⁴ *In re Boston and Maine Corp.*, 634 F.2d at 1382.

¹⁵ 242 B.R. 821 (D. Del. 1999).

¹⁶ *In re Financial News Network, Inc.* 134 B.R. 732, 736 (Bankr. S.D.N.Y. 1991); see also *In re NVR L.P.*, 147 B.R. 126, 128 (Bankr. E.D. Va. 1992) (holding that "proponent of the payment must show substantial necessity"); *In re Eagle-Picher Indus., Inc.*, 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991) (stating that payment must be "necessary to avert a serious threat to the chapter 11 process").

¹⁷ *In re Kmart Corp.*, No. 02 C. 1264 (N.D. Ill. Apr. 8, 2003).

¹⁸ *In re Fesco Plastics Corp.*, 996 F.2d 152, 156 (7th Cir. 1993).

¹⁹ See 11 U.S.C. §§ 503, 507.

²⁰ *In re Chicago, Milwaukee, St. Paul & Pac. R.R. Co.*, 791 F.2d 524, 528 (7th Cir. 1986).

²¹ *In re CoServ, L.L.C.*, 273 B.R. 487 (Bankr. N.D. Tex. 2002).

²² The court's test requires that the debtor demonstrate that it has to deal with the claimant; that a failure to deal with the claimant risks probable harm or eliminates an economic advantage disproportionate to the amount of the claim; and that there is no practical or legal alternative to payment of the claim.

²³ See, e.g., *In re Payless Cashways, Inc.*, 268 B.R. 543 (Bankr. W.D. Mo. 2001).