In Brief: Disgorging Critical Vendor Payments in the Aftermath of Kmart?

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The Seventh Circuit's invalidation in February of 2004 of nearly $300 million in "first day" payments to Kmart's "critical vendors" was the latest salvo in an all-out assault waged at the circuit court level concerning the controversial "doctrine of necessity" as authority for paying the pre-petition claims of vendors deemed essential to a chapter 11 debtor's prospects for a successful reorganization. Shortly after confirmation of its chapter 11 plan, Kmart filed actions against hundreds of vendors seeking disgorgement of such payments under sections 549 and 550 of the Bankruptcy Code (which provide for the avoidance and recovery of unauthorized post-petition transfers), as well as section 105(a), which confers a bankruptcy court with broad equitable powers to issue any order "that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code.

A substantial bloc of the vendors moved to dismiss Kmart's complaints. Among other things, they argued that: (i) the critical vendor payments cannot be avoided under section 549 because the payments were authorized at the time they were made; (ii) section 105(a) does not provide an independent cause of action for recovery of the payments; and (iii) Kmart's attempt to recover the payments is barred by the doctrine of judicial estoppel, because Kmart previously took the position that such payments were critical to its ability to continue operating and reorganize and would benefit its bankruptcy estate.

In a carefully reasoned opinion spanning over 60 pages, Judge Susan Sonderby of the U.S. Bankruptcy Court for the Northern District of Illinois granted the defendants' motion to dismiss Kmart's claims under section 105(a), but denied dismissal of the remaining causes of action. She rejected the defendants' contention that the plain language of section 549 mandates dismissal because the payments were previously authorized by the court. When Congress intended to insulate parties from the reversal of court orders on appeal, Judge Sonderby emphasized, it specifically incorporated such protection into the statute, as it did in sections 363(m) and 364(e) (providing a safe harbor for good faith purchasers of a debtor's assets and post-petition lenders). Section 549 contains no such safe harbor, and its reference to asset transfers that are "not authorized under this title or by the court" does not preclude actions to recover payment authorizations that are later reversed on appeal.

Judge Sonderby ruled, however, that Kmart's reliance upon section 105(a) as a vehicle for "implementing" the Seventh Circuit's decision is misplaced. Observing that sections 549 and 550 together provide a "comprehensive remedy" for avoiding and recovering unauthorized post-petition transfers, she ruled that no independent action exists under section 105(a), which "is a means to enforce the Code rather than an independent source of substantive authority." Finally, Judge Sonderby rejected the defendants' judicial estoppel arguments, explaining that Kmart had never taken an inconsistent position regarding the essential nature of the payments or the benefit derived by the estate from them, and that even if it had, it would be irrelevant for purposes of section 549.

In re Kmart Corp., 2006 WL 952042 (Bankr. N.D. Ill. Apr. 11, 2006).