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# The Triumph of the Trade Creditor in Chapter 11 Reorganizations

BRAD B. ERENS AND TIMOTHY W. HOFFMANN

*In this article, the authors examine what the changing landscape of Chapter 11 restructuring means for trade creditors of distressed companies.*

Much has been written in the last few years about the changing nature of Chapter 11.[1] A primary focus of these writings has been the rise in importance of hedge funds, private equity funds, and similar players in the Chapter 11 arena.[2] Based upon the perceived increase in the influence of hedge funds and other similar entities in Chapter 11 cases, one may infer that trade creditors now possess less influence in the typical Chapter 11 case. Trade creditors often may not possess the resources or a sufficient economic stake to hire their own advisors and meaningfully participate in a bankruptcy case. As a result, trade creditors generally rely on the actions of official committees of unsecured creditors, which represent the interests of all unsecured creditors. In Chapter 11 cases where hedge funds and other similar entities decide to participate as members of an official committee, trade creditors' influence may even diminish further. One would expect this apparent decreased influence would cause a decrease in trade creditors' recoveries.

Recent developments in Chapter 11, however, appear otherwise. In fact, several different developments in the Chapter 11 process represent a triumph

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for trade creditors. These developments are not necessarily the result of significant influence exerted in the Chapter 11 process by any trade creditor interest group or similar body, although such interests have been successful in certain respects. Instead, it would appear that the growing triumph of trade creditors in Chapter 11 reorganizations actually is closely associated with the rise of hedge funds and other similar entities in the restructuring process. Whereas one traditionally may have viewed Chapter 11 as a process to reorganize a distressed business and discharge debts, Chapter 11 cases today often resemble corporate transactions designed solely to recapitalize a company's balance sheet.[3] In this type of restructuring process, hedge funds and other similar entities often exchange their debt holdings for equity in the reorganized debtor, and trade creditors often act simply as bystanders in the restructuring, their claims unaltered. In fact, as new equity holders of the reorganized debtor, hedge funds and other similar entities commonly view trade creditors' support as critical to the success of the debtor's business and, therefore, seek to negatively impact the reorganized debtor's relationship with its trade creditors as minimally as possible during the restructuring process.

What does the changing landscape of Chapter 11 restructuring mean for trade creditors of distressed companies? First, trade creditors that believe a distressed business will simply restructure its balance sheet (either through a debt exchange offer or through a Chapter 11 plan) may decide to continue providing credit terms as a result of the trade creditor's increased confidence a restructuring will leave its payment rights unaltered. Unfortunately, it may be difficult for a typical trade creditor to predict the likely structure or success of a potential restructuring. Some companies may be able to avoid a liquidation only by selling their assets through a section 363 sale process. Where the assets of the company are fully encumbered, trade creditors may receive very little, if any, recovery as the proceeds of sale may be available only to the secured creditors. Even in these situations, however, buyers of distressed assets often want to ensure continued trade support. As such, in a section 363 sale process, buyers often assume the trade obligations of vendors that the buyer views as important to the future operations of the purchased company.

Ultimately, the increased recoveries for trade suppliers means that other creditors of a distressed business, including secured lenders and bondholders, may need to adjust their recovery models in assessing their workout and re-

structuring strategies for such companies. While the "absolute priority rule" in Chapter 11 tells us that secured creditors are paid before unsecured creditors, that result literally is true only in liquidation, and, as discussed below, various changes in bankruptcy practice and the Bankruptcy Code itself often provide for payment to unsecured creditors at the same time as, or before, secured creditors. As a result, traditional, asset based secured lenders, who typically attempt to ensure that they are fully secured even in the event of liquidation, may need to adjust their collateral reserves upward to some degree to ensure full payment of their secured debt.

Unsecured bondholders, meanwhile, may need to focus on the fact that, while under state law they have the same unsecured status as trade creditors, it is much more likely that a trade creditor will be paid in full, or at least with a higher recovery, than a bondholder in a Chapter 11 case. Where the amount of a debtor's trade debt is relatively small compared to its bond debt, the resulting change in recovery for bondholders may be modest in absolute percentage recovery terms, but potentially much more meaningful in absolute terms. For example, full payment of trade debt in a Chapter 11 case could reduce unsecured bondholder recoveries from 10 percent to 9 percent where the amount of trade debt is modest. While that is only a 1 percent reduction for the bondholder who bought its bonds at par and is suffering large losses regardless, it would constitute a 50 percent reduction in profit for the distressed trader that bought its bonds at 8 cents on the dollar.

## CRITICAL VENDORS

While trade creditors may be enjoying larger recoveries in Chapter 11 reorganizations as a result of recent changes in Chapter 11 practice, the fundamental basis to treat trade claims differently in Chapter 11 than other creditors appears to have arisen from reorganizations in the 19th century. Bankruptcy practice has long contained two fundamental principles: (1) that, upon the occurrence of bankruptcy, the debtor stops making payment on debts that arose prior to the bankruptcy filing;[4] and (2) that similarly situated creditors should be treated equally in the bankruptcy process.[5] For as long as these two principles have existed, however, there also has existed many exceptions. At its core, Chapter 11 functions as a mechanism to resuscitate a failing business.

While equal treatment of creditors is a noble principle and arguably fundamental to bankruptcy liquidations, strict application of the principle in some cases creates the risk of actually undermining the reorganization. Thus, from its earliest days in the 19th century, the bankruptcy reorganization practice has recognized that certain creditors are "more important" than others in the sense that, if such creditors are not paid, they could hurt the reorganization process itself.

The most obvious of such creditors are the employees of a distressed business. Employees typically are creditors in a bankruptcy case, as a Chapter 11 debtor typically will owe its employees amounts for accrued, but unpaid, wages and benefits at the time of a Chapter 11 filing. The failure to pay employee wages simply because a company has filed for Chapter 11 in the middle of a pay period would be foolish for any business seeking to reorganize. As such, not only does the Bankruptcy Code grant a priority for wage and benefit claims,[6] but it is standard in Chapter 11 reorganization practice to obtain from the bankruptcy court authority at the inception of a Chapter 11 case to pay such wage and benefit claims in the ordinary course of business, at least up to such priority amounts.

Allowing a debtor to continue to pay its employees amounts earned prior to a bankruptcy filing typically is not controversial in Chapter 11 cases. This is true even after the enactment of Rule 6003 of the Federal Rules of Bankruptcy Procedure on December 1, 2007. This rule requires that a debtor demonstrate the payment of any prepetition debt within the first 21 days of a bankruptcy filing, including the payment of any prepetition employee wages, is necessary to "avoid immediate and irreparable harm." In most circumstances, a debtor can satisfy the "avoid immediate and irreparable harm" standard of Rule 6003 with relative ease, as payment of prepetition wages with respect to current employees likely is necessary to ensure the debtor maintains the ability to continue business operations after commencing a Chapter 11 case. Thus, it appears unlikely that a bankruptcy court would challenge a Chapter 11 debtor on this issue.

There is a significant distinction between paying priority creditors, such as employees, at the beginning of a Chapter 11 case and paying a distinct set of favored trade creditors. The non-favored trade creditors (i.e. those trade creditors whose prepetition claims the Chapter 11 debtor is not paying) likely

will be quite unhappy receiving such unequal treatment. This unhappiness only will be elevated in cases where trade creditors expect to receive little or no recovery. Further if the Chapter 11 debtor had made the identical payments to the favored trade creditors within 90 days prior to the bankruptcy filing and outside of the debtor's ordinary course of business, the Chapter 11 debtor would have the ability to recover the payments as preferential transfers under section 547 of the Bankruptcy Code. Accordingly, one may take the position that a bankruptcy court essentially is sanctioning the use of preferential payments by authorizing critical vendor payments.

Nonetheless, the need and benefit of paying certain unsecured creditors in a case and not others has been a facet of the reorganization practice for a long time. The issue came before the Supreme Court as early as 1882 in the case of *Miltenberger v. Logansport, Crawfordsville & Southwestern Railway Company*, 106 U.S. 286 (1882). This case involved a railroad receivership. In *Miltenberger*, a railroad company issued $1.5 million of senior bonds to finance the construction of a railway.[7] The bonds were secured by all of the then-owned and after-acquired property used in, and connected with, the operation of the railway.[8] Thereafter, the railroad company issued another $500,000 of junior bonds that were secured by a junior priority interest in the same property as the senior bonds.[9]

After the railroad company was unable to service the railway project's bond debt, the indenture trustee for the junior bonds initiated foreclosure proceedings, and the district court appointed a receiver to take control of the mortgaged property.[10] The district court provided the receiver with the authority to operate the property and pay the railway's operating expenses accruing in the 90 days preceding the receiver's appointment and certain other older obligations for materials and repairs and for ticket and freight balances.[11] With respect to the obligations relating to the materials and repairs and ticket and freight balances, the receiver noted that absent the authority to satisfy these claims, the railway "would suffer great detriment."[12]

The senior bondholders challenged the district court's authority to authorize the payment of debts arising prior to the receivership on appeal.[13] The Supreme Court upheld the district court's order with respect to the payment of the pre-receivership debts and determined that courts possessed the authority to permit a receiver to pay debts arising before a receivership's

commencement, but that courts should exercise their discretion to allow for such payments "with very great care."[14] In its analysis, the Supreme Court explained that the *Miltenberger* facts provided a sufficient basis to justify the receiver's payment of the pre-receivership debts, stating:

> It is easy to see that the payment of unpaid debts for operating expenses, accrued within ninety days, due by a railroad company suddenly deprived of the control of its property, due to operatives in its employ, whose cessation from work simultaneously is to be deprecated, in the interests both of the property and of the public, and the payment of limited amounts due to other and connecting lines of road for materials and repairs and for unpaid ticket and freight balances, the outcome of indispensable business relations, where a stoppage of the continuance of such business relations would be a probable result, in case of non-payment, the general consequence involving largely, also, the interests and accommodation of travel and traffic, may well place such payments in the category of payments to preserve the mortgaged property in a large sense, by maintaining the good-will and integrity of the enterprise, and entitle them to be made a first lien.[15]

As *Miltenberger* was not a bankruptcy case, it provides only general authority for bankruptcy courts to authorize payment of pre-bankruptcy debts outside of a plan of reorganization. However, the general concept of paying such debt has carried forward since its day where it is determined that such payment is clearly for the benefit of the debtor's estate and creditors.

After the enactment of the Bankruptcy Code, the concept of paying critical vendors has become increasingly common in Chapter 11 cases, as, for a debtor trying to reorganize, the concept is quite logical. Parties increasingly began to recognize that a Chapter 11 debtor's ability to obtain trade terms from key vendors often is critical to the survival and success of a struggling business in Chapter 11. From this perspective, one may deem critical vendor dollars as money well spent. This may remain true even from the perspective of an official committee of unsecured creditors, which has the responsibility of representing the interests of the debtor's unsecured creditor body as a whole (although often a bankruptcy court enters an order authorizing critical

vendor payments prior to the formation of an official unsecured creditors committee, thus, practically eliminating a committee's ability to oppose and stop critical vendor payments).

Not surprisingly, once the concept of being able to pay critical vendors became relatively mainstream, the concept itself began to broaden. One of the original concepts was that a debtor needed to pay certain vendors who were the "sole source" of a key good or service.[16] If the payment were not made, such vendor, if it were sufficiently dependent on the debtor, might actually go out of business. Alternatively, absent payment, the key vendor might instead simply refuse to do business with the debtor. In either case, the debtor would be without a vital product or service needed for its business.

As critical vendors programs became more common, however, the justification for such payments often expanded and was described more in terms of it "would be difficult" to replace the vendors that the debtor sought to pay, rather than the replacement of such vendors was impossible. The expansion was not surprising. For the management team of a struggling business faced with the critical task of keeping the business alive, the line between paying vendors that are absolutely critical from an objective prospective, and paying vendors because it was helpful for the business, was difficult to draw. In any case, making such distinction likely was not as critical to a debtor's management as the many other difficult tasks facing it at the beginning of the case. Switching vendors often is difficult and costly for any business, much less a business trying to navigate a Chapter 11 reorganization. Thus, from the perspective of management, the choice between paying a vendor in full to quickly stabilize a business relationship or, alternatively, trying to negotiate with such vendor or simply replace it quickly, often is simple. As such, the pressure to increase critical vendor requests was inevitable.

Once critical vendor programs expanded, vendors soon discovered the benefit of being the squeaky wheel. Take for instance the Chapter 11 reorganization case of *Carmike Cinemas*, which filed for Chapter 11 in Delaware in August of 2000. Carmike operated a chain of movie theaters throughout the country. Its largest trade creditors were the studios that produced the movies shown in Carmike's theaters to the public. At the time of its filing, Carmike owed the movie studios approximately $37 million. Carmike did not seek to pay the studios under a critical vendor program. In fact, at the

time of its filing, Carmike did not seek to make any critical vendor payments at all. The studios, however, had no interest in becoming part of the Carmike bankruptcy process. As such, they threatened to no longer supply movies to Carmike unless Carmike promptly sought to pay their pre-bankruptcy debts in full.[17] While such threats potentially violated the automatic stay under the Bankruptcy Code,[18] that legal nicety likely mattered little to Carmike. Without movies to show in its theaters, its business would have been finished. As such, Carmike soon moved the bankruptcy court to pay the entire $37 million owed to the movie studios, which the bankruptcy court approved.[19]

What if the concept of a "critical vendor" had not existed at the time of the Carmike filing? Would the movie studios have actually stopped supplying movies to Carmike and shut down its business? Would that have made economic sense for them, and, if they had all done it together, would that have attracted the interest of the Antitrust Division of the Department of Justice? No one will ever know the answer to those questions. What is of note, however, is that because it was accepted that a debtor could make critical vendor payments to important prepetition creditors, the movie studios had the leverage to force their way to early and full payment in the *Carmike* Chapter 11 case. The lesson should not be lost on other distressed purveyors of media content from limited outlets, such as the owners of distressed television stations who have to provide certain mainstream content expected by the public in order to remain viable.

The concept of critical vendors hit a few bumps as the first decade of the century progressed. In 2002, Kmart Corporation commenced Chapter 11 proceedings in the United States Bankruptcy Court for the Northern District of Illinois. Though Kmart's operations were immense, with over 2,000 stores nationwide and $37 billion in annual revenue, to some its critical vendor requests were stunning, as Kmart requested authority to make approximately $300 million in critical payments.[20] Capital Factors, an entity that had factored accounts receivable held by Kmart's vendors and held approximately $20 million in prepetition unsecured claims as a result (and who would not be paid under the critical vendor program), objected to Kmart's critical vendor motion.

The bankruptcy court approved Kmart's critical vendor program, but Capital Factors appealed the decision. At issue before the district court on

appeal was whether the program could be approved under section 105(a) of the Bankruptcy Code, as Kmart had sought. Section 105(a) provides bankruptcy courts with the authority to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code.[21] The district court found that section 105(a) allows a bankruptcy court to use its equitable powers to enforce the provisions of the Bankruptcy Code, but not to add to these provisions. As such, since payment of prepetition critical vendor debt nowhere was expressly authorized by the Bankruptcy Code, section 105(a) itself could not provide a basis for such payment.[22]

On further appeal, the Seventh Circuit affirmed the decision of the district court, stating section 105(a) "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."[23] Further, while the Seventh Circuit recognized that the Supreme Court in *Miltenberger* and other cases had held that courts "in the days before bankruptcy law was codified wielded power to reorder priorities and pay particular creditors in the name of 'necessity,'" the court found that now only the Bankruptcy Code determined whether such payments are permissible.[24]

While some may have thought that the Seventh Circuit's *Kmart* opinion was the death knell for critical vendor relief in that circuit, this reaction was incorrect. Simply providing that section 105(a) of the Bankruptcy Code could not be used to support critical vendor relief meant little. In fact, a much more firm basis for such relief always had existed — section 363(b) of the Bankruptcy Code, which states that a debtor can use estate resources out of the ordinary course of business as long as the bankruptcy court approves such request upon proper notice. While some may have thought that a Chapter 11 debtor could use only section 105(a) of the Bankruptcy Code as a legal basis to justify the payment of pre-bankruptcy claims prior to the confirmation of a Chapter 11 plan, that is not the case. The Bankruptcy Code, however, contains no provision that prohibits the payment of claims arising prior to a Chapter 11 filing outside of a confirmed Chapter 11 plan. Instead, such payment is simply out of the ordinary course of business for a debtor in bankruptcy and, thus, must be approved by the bankruptcy court as a proper exercise of the debtor's business judgment.

In *Kmart*, the Seventh Circuit noted that section 363(b) of the Bank-

ruptcy Code provided a potential legal basis to approve the critical vendor program proposed in *Kmart*, although the Seventh Circuit also stated that "it is prudent to read, and use, section 363(b)(1) to do the least damage possible to priorities established by contract and by other parts of the Bankruptcy Code."[25] Ultimately, the Seventh Circuit found that the evidentiary record in the bankruptcy court simply was insufficient to support the critical vendor program under section 363(b) of the Bankruptcy Code. Among other things, the debtor failed to demonstrate that various creditors would stop supplying it with goods absent payment of their prepetition debt, nor that payment of prepetition debt would have been beneficial to unsecured creditors not receiving such payments.[26] Yet, with the guidance provided in the Seventh Circuit's *Kmart* opinion, debtors filing Chapter 11 cases in the Seventh Circuit were soon obtaining critical vendor relief from the bankruptcy court under section 363(b) of the Bankruptcy Code with a proper evidentiary showing.[27]

Another bump in the road for, but necessary limit on, critical vendor relief next occurred in the Delaware bankruptcy court. Critical vendor relief had become sufficiently common and mainstream in Delaware that the typical critical vendor motion only stated that a Chapter 11 debtor "expected" that the amount of critical vendor payments it would make approximated a certain dollar amount. Thus, the motions and corresponding orders typically did not place a hard cap on the total amount a debtor possessed authority to pay to its critical vendors.

On certain occasions, it appears debtors estimated that they were going to make a certain amount of critical vendor payments, but actually made dramatically more payments during the course of a case. As a result, the General Chambers Procedures for the Delaware bankruptcy court now require that all first day motions seeking authority to pay prepetition claims include the maximum amount the debtor seeks to pay.[28]

## THE 2005 AMENDMENTS TO THE BANKRUPTCY CODE

While the recent success of trade creditors in Chapter 11 reorganizations has more to do with the changing landscape of Chapter 11 itself, trade creditor interests were successful in lobbying for important changes to the

Bankruptcy Code as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, 119 Stat., 23 ("BAPCPA"), which have helped trade creditors.[29] Two of the primary changes were to the preference provisions of the Bankruptcy Code and the creation of a new priority for goods supplied to a debtor within the 20-day period prior to bankruptcy, as now set forth in section 503(b)(9) of the Bankruptcy Code.

Prior to BAPCPA, trade creditors faced a difficult dynamic in preference litigation. A trade creditor who continued to supply goods to a debtor prior to Chapter 11 typically had two primary defenses to preference liability. First, the creditor could assert the "subsequent new value" defense set forth in section 547(c)(4) of the Bankruptcy Code. To the extent that a creditor supplied a debtor with new goods after receiving an alleged preference payment (and such new trade credit remained unpaid prior to bankruptcy), the creditor could reduce its preference liability in an amount equal to the value of goods subsequently supplied. While the subsequent new value defense is relatively objective, trade creditors often would lack the defense because they stopped supplying goods to a debtor prior to bankruptcy or provided goods to the debtor only on a prepayment or cash on delivery basis after the alleged preference payment.

Thus, trade creditors more commonly sought to avoid preference liability by asserting that they received an alleged preference payment "in the ordinary course of business," a valid defense to preference liability under section 547(c)(2) of the Bankruptcy Code. To assert this defense prior to BAPCPA's enactment, section 547(c)(2) of the Bankruptcy Code required that a preference defendant demonstrate that the preferential payment was:

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; *and*

(C) made according to ordinary business terms.

11 U.S.C. 547(c)(2) (2004) (emphasis added).

The case law that interpreted the concept of "ordinary business terms" provided that "ordinary business terms" meant what is common in the spe-

cific industry in which the debtor and the creditor operated.[30] The problem with that formulation was that for a trade creditor truly to prove that a payment was in the ordinary course of business for the debtor and creditor's industry, the trade creditor might have to commission a study, or at least procure expert testimony, as to common payment terms in its industry.[31] In most cases, such an effort would be too expensive given the creditor's likely preference exposure. Trade creditors, therefore, often would be required to settle preference liability for a greater amount than their actual potential liability might dictate to avoid the cost of litigation.

BAPCPA modified section 547(c)(2), which now simply requires that a preference defendant demonstrate the alleged preference payment was "made in the ordinary course of business or financial affairs" of the debtor and the transferee" *or* "made according to ordinary business terms." Thus, by changing one word in the statute, from "and" to "or", trade creditors' interests greatly eased their evidentiary burden in preference litigation. As a result of BAPCPA's modification to section 547(c)(2), a trade creditor now only must demonstrate that an alleged preference payment was in the ordinary course of its dealing with the debtor, the far easier prong of section 547(c)(2) to prove.

While the revision to section 547(c)(2) was a relatively minor, but important, change to the Bankruptcy Code, the creation of a new priority for prepetition trade debt in BAPCPA, now set forth in section 503(b)(9) of the Bankruptcy Code, represented a very significant modification to prior practice. Section 503(b)(9) provides administrative expense priority treatment for "the value of any goods (but not services) received by the debtor" within 20 days before bankruptcy, so long as such goods "have been sold to the debtor in the ordinary course of such debtor's business." Pursuant to section 507(a) of the Bankruptcy Code, such administrative expenses have priority over any other unsecured claim in a bankruptcy proceeding, and, pursuant to section 1129(a)(9) of the Bankruptcy Code, such administrative expenses must be paid in full in cash on the effective date of any Chapter 11 plan for the debtor.

Prior to the enactment of section 503(b)(9), prepetition unsecured trade claims did not enjoy any statutory priority under the Bankruptcy Code. Instead, the only benefit to which such claims were entitled was the arguable preservation in bankruptcy of a creditor's state law reclamation rights. The Uniform Commercial Code has long recognized the concept that the supplier

of goods to an insolvent purchaser should have the right to "reclaim" such goods in the event of nonpayment.[32] The underlying concept of reclamation statutes is that an entity that purchases goods on credit without the ability to make payment has essentially committed fraud on the seller, and, thus, the seller should be able to obtain a return of such goods notwithstanding that title already has passed to the buyer.[33] Prior to BAPCPA, seller's reclamation rights effectively were preserved in a bankruptcy proceeding. Section 546(c) of the Bankruptcy Code previously provided that:

> (c) Except as provided in subsection (d) of this section, the rights and powers of a trustee under sections 544(a), 545, 547, and 549 of this title are subject to any statutory or common-law right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods if the debtor has received such goods while insolvent, but — (1) such a seller may not reclaim any such goods unless such seller demands in writing reclamation of such goods — (A) before 10 days after receipt of such goods by the debtor; or (B) if such 10-day period expires after the commencement of the case, before 20 days after receipt of such goods by the debtor…

Assuming a seller of goods satisfied the provisions of section 546(c) of the Bankruptcy Code, a bankruptcy court could deny the seller's right to reclaim its goods only if the bankruptcy court provided the seller with a lien to secure the seller's claim or an administrative claim in the bankruptcy case.[34]

The problem for trade creditors, however, was that reclamation rights typically were not very effective. Often, the goods no longer existed or were sufficiently altered or incorporated with other goods prior to the bankruptcy filing, therefore eliminating the seller's reclamation rights. Other legal impediments also existed. Bankruptcy courts often required sellers to initiate an adversary proceeding or other judicial action to enforce their reclamation rights, as simply sending a reclamation notice was insufficient.[35] In addition, if the goods were subject to a secured creditor's lien, this typically eliminated the seller's reclamation rights.[36]

While amendments to the Bankruptcy Code in 1994 added section 546(h), which allowed a debtor to return goods to a trade vendor, subject to certain sig-

nificant limitations, in exchange for offsetting the claim of the vendor, allowed effectively for "voluntary reclamation," such provision was rarely used. Therefore, reclamation typically meant very little for trade creditors in bankruptcy.

Congress's addition of section 503(b)(9) to the Bankruptcy Code changed the Chapter 11 landscape dramatically for trade creditors. Under that section, a trade creditor receives an administrative expense claim equal to the value of the goods that a debtor receives in the ordinary course of business within 20 days prior to a bankruptcy filing. Unlike reclamation, Section 503(b)(9) of the Bankruptcy Code contains no procedural or other substantive requirements such as proof of the debtor's insolvency upon receipt of goods, deadlines for demand for payment, or the absence of liens on the goods supplied. As such, section 503(b)(9) automatically elevates the claims of 20-day goods suppliers over all other unsecured claims in a bankruptcy case.

When prepetition lenders possess blanket liens on a debtor's assets and the debtor possesses no equity in the assets, the existence of section 503(b)(9) may be problematic. Upon the bankruptcy filing, the debtor already is administratively insolvent, since the value of its business does not exceed its secured debt. Many courts are uncomfortable administering administratively insolvent cases. These courts believe that they should not allow debtors to operate in Chapter 11 if they cannot pay all debts that arise during the Chapter 11 proceeding.[37] In addition, a debtor that is administratively insolvent generally would not be able to confirm a Chapter 11 plan, the main purpose of a Chapter 11 proceeding, as section 1129(a)(9)(A) of the Bankruptcy Code requires that a debtor pay all administrative claims in full in cash at the time of confirmation, unless the holders of such claims agree to lesser treatment.[38]

To the extent that bankruptcy courts are concerned about a debtor's administrative insolvency based on section 1129(a)(9)(A), section 503(b)(9) creates significant issues. Often, a debtor has numerous section 503(b)(9) claims that represent a significant dollar amount in the aggregate. In these circumstances, it may be difficult for a debtor whose assets are fully encumbered to obtain the consents necessary to confirm a Chapter 11 plan under section 1129(a)(9)(C) by paying such creditors less than the amount of their claims in full in cash under a Chapter 11 plan. Section 503(b)(9) is equally problematic to the concern of courts that they not permit a debtor to operate in Chapter 11 if it will not

be able to pay all debts incurred during the Chapter 11 proceeding. Under the Bankruptcy Code, section 503(b)(9) claims and administrative claims arising during the bankruptcy proceeding have equal priority. While a debtor might have the resources to pay all postpetition administrative claims in full, it may not have the ability to pay in full both those claims and all of its section 503(b)(9) claims. Since the two sets of claims share equal priority, this would mean that the debtor would have the ability to pay its postpetition administrative claims only in part. A bankruptcy court might determine that it is not willing to allow the debtor to operate under these circumstances.

Many courts, however, likely will make efforts to allow the Chapter 11 to proceed if it will maximize the value of the estate or allow a sale of the debtor's business as a going concern, thereby preserving jobs, even if the potential for administrative insolvency exists. To allow full payment of postpetition administrative claims, the court could attempt to elevate the priority of such claims above those of section 503(b)(9) claimants even though there is no express authority for such a result in the Bankruptcy Code.[39]

## TREATMENT OF TRADE CREDITORS UNDER CHAPTER 11 REORGANIZATION PLANS

While the advent of critical vendor programs and section 503(b)(9) of the Bankruptcy Code have helped trade creditors in Chapter 11, these developments have not been the only recent benefit for such creditors. Chapter 11 reorganization practice now often greatly favors the payment in full of trade creditors for a variety of reasons.

### Prepackaged Plans

One of the main reasons that trade creditors are faring better today in Chapter 11 reorganizations is the advent of so-called "prepackaged" plans of reorganization. In a prepackaged case, the debtor solicits votes on its plan of reorganization even before it files for Chapter 11, as section 1126(b) of the Bankruptcy Code permits. The main purpose of a prepackaged Chapter 11 plan is to affect the business of a debtor as minimally as possible by entering Chapter 11 with an understanding that a debtor has the plan votes to exit

quickly with a restructuring solution and therefore minimizing the length of a debtor's Chapter 11 case. Debtors with major operational issues, therefore, are not good candidates for prepackaged plans, as a Chapter 11 designed to address operational issues likely will require much more time than a prepackaged case will permit.

In addition, the holders of funded debt may want to ignore a debtor's operational issues during a Chapter 11 case. As future owners of the business, they may believe that most of the needed changes can be effectuated after the reorganization. While contract rejection, for instance, might benefit the debtor and can only be implemented during a bankruptcy, if such creditors want to pay trade creditors in full, rejection provides no benefit, as the debtor would need to pay the resulting rejection claim in full (other than potentially for rejection of real estate leases). Funded debt creditors also may believe that the primary changes to the business simply involve management, strategy, or other operational initiatives that a company can implement regardless of whether it files for Chapter 11. In fact, such creditors may be incentivized to effectuate such operational changes after the bankruptcy process concludes to avoid an increase in the company's going concern value before the funded debt holders possess a controlling interest. If the going concern value of a company increases during a Chapter 11 case, junior creditors, such as the company's second lien creditors, subordinated debt holders, or preferred or company equity owners, may seek to receive value under the debtor's plan where, under a prepackaged plan with no operational changes implemented, such junior creditors or interest holders might be fully eliminated without any material consideration.

As such, a debtor typically utilizes prepackaged plans to fix its balance sheet, with the prepackaged plan itself only effectuating a deleveraging of the debtor's capital structure.[40] The Chapter 11 filing itself is necessitated because, absent bankruptcy, a debtor normally would need near unanimous approval of the debt restructuring by its funded debt creditors, a condition that may be almost impossible to satisfy where numerous bank debt or public bond debt holders exist. Since a prepackaged plan provides only for a balance sheet recapitalization, typically prepackaged plans provide for payment in full to unsecured trade creditors.

There also is another, practical, reason why prepackaged plans do not

seek to impair trade creditors. If a debtor rendered its trade creditors impaired under a prepackaged plan, the debtor likely would need to solicit votes on its prepackaged plan from such creditors prior to any bankruptcy filing. A debtor, of course, may not want to signal to its trade creditor constituency that it intends to file for Chapter 11 prior to the actual filing for fear of losing its trade credit. However, often the fact that such debtor intends to file a prepackaged bankruptcy case may be well known in the financial community, especially as to public company debtors, although the extent of such knowledge in the trade community may be somewhat less.

Another impediment to soliciting trade creditors as part of a prepackaged plan also exists. In a traditional Chapter 11 filing, a debtor's pre-bankruptcy debt is fixed as the bankruptcy filing date. Prior to a bankruptcy filing, however, the amounts owed to trade creditors are in a constant flux. As such, it is difficult to solicit trade creditors for a prepackaged plan, as the creditors who existed as of the record date for voting on the plan likely will not be the same creditors that exist on the bankruptcy petition date. While the difference may be small when the bankruptcy filing quickly follows the plan voting deadline, the sufficiency of such a pre-bankruptcy solicitation of trade creditors may be suspect nevertheless. While a debtor could solicit trade creditors only after its bankruptcy filing, that process will slow down the reorganization and, therefore, detract from the purpose of the prepackaged bankruptcy case itself. As such, in almost every case, trade creditors are simply paid in full.

Once in a while, however, funded debt creditors attempt to become more creative in the prepackaged plan context. The bankruptcy case of Sirva Inc. provides an example.[41] Sirva was a roll up of various moving companies and related businesses, such as National Van Lines, headquartered in suburban Chicago. In addition to contracting with other businesses to provide relocation services, Sirva purchased the relocating employees' homes. As such, the financial downturn in 2008 and corresponding housing crisis affected Sirva's business quite detrimentally. Not only were businesses limiting expenditures to relocate employees, with house prices collapsing, the value of Sirva's inventory of homes dropped dramatically, thereby impairing its solvency.[42]

Sirva needed, as a result, to convert a significant portion of its then $511 million in secured debt to equity in order to right size its balance sheet. A prepackaged plan, therefore, made sense. One problem existed, however.

The value of Sirva's business was less than its secured debt, and the secured creditors that were taking a significant hit on their loans to Sirva, apparently felt that some of Sirva's trade creditors should "share the pain" of the bankruptcy filing.[43] As a result, Sirva developed a novel Chapter 11 plan. Sirva's initial prepackaged plan divided Sirva's unsecured creditors into two classes — what Sirva called its Class 4 "Unsecured Ongoing Operations Claims" and its Class 5 "General Unsecured Claims."[44] In other words, Sirva divided its unsecured creditors into a class of trade creditors that it wanted to pay and support its reorganization, Class 4, and then a class of everyone else that had non-priority unsecured claims.

The treatment of the two classes under the proposed prepackaged plan was polar opposite. Class 4, like the traditional trade creditor class in a prepackaged case, was to receive 100 percent on its claims in cash under the plan. Class 5 was to receive nothing. This structure also fit nicely into the problem of soliciting trade creditors before bankruptcy under a prepackaged plan of reorganization. Under the Bankruptcy Code, Sirva's Class 4 creditors were deemed to have accepted the plan without the need for the debtor to solicit them, because the plan contemplated paying the Class 4 creditors in full.[45] Similarly, under the Bankruptcy Code, Sirva's Class 5 creditors were deemed to reject the plan without the need for the debtor to solicit them, because the Class 5 creditors were to receive no distribution under the plan.[46]

Sirva's wrinkle in the typical prepackaged plan structure had the expected effect. While most prepackaged cases enter and exit bankruptcy in 30-45 days without contention and, in fact, typically even without an unsecured creditors committee appointed, the *Sirva* case became mired in litigation over the treatment of Class 5. The *Sirva* creditors committee objected to the plan and commenced litigation involving extensive discovery and briefing over a period of approximately 90 days that appears to have cost in excess of $5 million in legal fees and other related costs. One of the primary arguments of the *Sirva* creditors committee against the plan was that it failed the "unfair discrimination" test of section 1129(b) of the Bankruptcy Code.[47] Since Class 5 was deemed to reject the *Sirva* plan, the bankruptcy court could only approve the plan under the cramdown provisions of the Bankruptcy Code. For unsecured creditors like Class 5, that meant the plan could not "discriminate unfairly."[48] What that term meant under bankruptcy jurisprudence was

that the plan could not unfairly treat two similarly situated classes of creditors differently.[49] Since Class 4 was receiving 100 percent treatment and Class 5 was receiving nothing, the *Sirva* creditors committee had a straightforward argument that unfair discrimination existed.

Sirva and its secured creditors, however, were ready for the creditors committee's attack on the plan. They argued to some extent that it is not unfair to pay trade creditors that are "needed" 100 percent on their claims and creditors that are not needed something less, even nothing.[50] In fact, one could assert, this proposed disparate treatment has the same effect as a critical vendor order, where "critical" trade vendors receive payment in the ordinary course, while other identically situated creditors wait for whatever payment the reorganization can support, which sometimes may be nothing.

Sirva and its secured creditors' main argument, however, was that unfair discrimination was not relevant at all, because the distribution to Class 5 simply was a gift from the secured creditors' recoveries under the plan.[51] The secured creditors asserted Sirva's value was less than the secured debt, which, under the plan would be converted into the equity of the reorganized company. Since the prospective new owners of Sirva wanted continued trade support, they were willing to pay the Class 4 "ongoing" trade vendors in full under the plan. In this regard, the secured creditors argued it was appropriate to provide full recoveries to Class 4 and nothing to Class 5, because the secured creditors were funding Class 4's recoveries out of the secured creditors' own pockets or, stated otherwise, providing a gift to Class 5.[52]

"Gifting" was not a concept that arose for the first time in *Sirva*. The issue had taken hold after the First Circuit issued an opinion in 1993 in the Chapter 7 case of *SPM Manufacturing*, although the issue well predates that case and, in fact, existed in the early 20$^{th}$ century equity receivership reorganizations.[53] In *SPM*, the debtor originally had filed for reorganization under Chapter 11 of the Bankruptcy Code. In the Chapter 11 proceeding, the debtor's secured creditor, which held a lien on substantially all of the debtor's assets, and the official committee of unsecured creditors entered into a settlement agreement on how to divide the value of the debtor's estate.[54] Ultimately, however, the debtor was not able to reorganize and sold its assets for significantly less than the amount of the secured creditors' debt.[55] Nonetheless, after the sale, the secured creditor agreed to abide by its settlement agreement

with the creditors committee and filed a motion with the creditors committee seeking court approval to distribute the sale proceeds in accordance with the debtor's and committee's original agreement.[56] A problem existed however; the distribution scheme contemplated in the settlement agreement was not in accordance with the distribution scheme set forth in Chapter 7 of the Bankruptcy Code, as the agreement would leave certain priority creditors, such as the Internal Revenue Service, unpaid, while providing distributions to the debtor's general unsecured creditors. As a result, both the debtor and the Chapter 7 trustee objected to the motion.[57]

The bankruptcy court denied the settlement motion as contrary to the distribution scheme of the Bankruptcy Code, and the district court on appeal affirmed the decision of the bankruptcy court. The First Circuit, however, reversed. The First Circuit noted that, since the secured creditor's claim absorbed all of the value of the debtor's estate, "there was nothing left for any other creditor in the case."[58] As a result, the court held, "it is hard to see how the priority creditors lost anything owed them".[59] Instead, "While the debtor and the trustee are not allowed to pay nonpriority creditors ahead of priority creditors…creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including the ability to share them with other creditors."[60]

Emboldened by *SPM*, where a Chapter 11 debtor was arguably worth less than its secured debt, not an uncommon occurrence, debtors and secured creditors started to construct plans that paid other constituencies, be it trade creditors, shareholders, or other constituencies under the guise of "gifting". The practice, however, was controversial and appeared unseemly for the same reason it was frowned upon in the equity receivership practice — it had the air of collusion among a senior interest and a junior interest to the detriment of other interests, some of which might actually be senior to the favored junior class.[61]

The issue came to a head in an asbestos driven Chapter 11 case filed in 2000 *Armstrong Worldwide Industries, Inc.* Armstrong was the largest manufacturer of ceiling tile systems in the United States.[62] In *Armstrong*, the debtors had a legacy asbestos liability that was no longer manageable absent a bankruptcy filing that would allow the debtor to utilize section 546(g) of the Bankruptcy Code and address its asbestos liabilities in a single forum.[63] After

several years of negotiation posturing and litigation, Armstrong filed a plan of reorganization in May 2003. The plan provided that non-asbestos creditors would receive approximately 59.5 percent on account of their $1.65 billion in claims.[64] Asbestos creditors received approximately $1.8 billion in consideration in the form of certain assets contributed to a trust for their benefit.[65] The exact percentage recovery for asbestos claimants was debatable, as most of the asbestos claims were unliquidated.

Armstrong's asbestos creditors argued that they were receiving only 20 percent on account of their claims, but that assumed the allowed amount of their claims and all future asbestos claims against the trust would exceed $9.0 billion. The plan also contemplated that Armstrong's existing equity holders would receive warrants, estimated to be worth between $35 million and $40 million, to purchase the reorganized debtor's stock, contingent upon the non-asbestos creditors voting in favor of the plan.[66] If the class of non-asbestos creditors voted against the plan, the asbestos creditor class was to receive the warrants, but then deemed to waive its right to receive the warrants, which, instead, would be granted to the debtor's equity holders.[67]

Ultimately, the non-asbestos creditors in *Armstrong* voted against the plan and the official committee of unsecured creditors objected to confirmation of the plan on the basis that it did not comply with the absolute priority rule under section 1129(b)(2)(b) of the Bankruptcy Code.[68] The absolute priority rule requires that if a class of unsecured creditors votes against the plan, the plan can be confirmed only if such class is paid in full or no junior class of creditors or interest holders receives or retains any consideration under the plan. Since the equity holders in *Armstrong* were receiving warrants and the non-asbestos creditors were receiving only 59.5 percent on account of their claims, the *Armstrong* creditors committee argued that the plan plainly violated the absolute priority rule.[69]

Armstrong argued, however, that the warrants were a gift from the asbestos creditors to the Armstrong equity holders, and thus, the absolute priority rule was not implicated.[70] Similar to the debtor's argument in *Sirva*, Armstrong argued that the value of the warrants would not be available to the non-asbestos creditors if the value of the debtor was distributed in accordance with the absolute priority rule, as the non-asbestos creditors would receive no more than the proposed percentage recovery on account of their claims

regardless of whether Armstrong's equity holders received the warrants.[71] As such, Armstrong argued that the plan complied with the absolute priority rule.[72]

The bankruptcy court agreed with Armstrong and recommended confirmation of the plan.[73] However, because section 524(g) of the Bankruptcy Code requires that the district court also approve confirmation of the plan, the district court had to find that the plan satisfied the absolute priority rule. Unlike the bankruptcy court, the district court found that the receipt of warrants by Armstrong's equity holders under the plan violated the absolute priority rule. In its decision, the district court applied the "plain meaning rule" to interpret the absolute priority rule codified under section 1129(b)(2)(B)(ii) of the Bankruptcy Code and determined this section prevented the debtor from distributing warrants to equity holders absent payment of more senior creditor claims in full.[74]

Armstrong appealed the district court's decision to the Third Circuit. The Third Circuit upheld the decision of the district court. Finding the language of the absolute priority rule clear and unambiguous, the Third Circuit held that Armstrong's existing equity owners could not receive warrants while Armstrong's non-asbestos creditors were not receiving payment in full.[75] Thus, in the Third Circuit, the plain language of the absolute priority rule applies and no class junior in priority to a class of unsecured creditors may receive or retain any value under a plan if the more senior unsecured creditors are not receiving full payment. The Second Circuit reached the same conclusion several years later in 2011 in the case of *DSBD North America, Inc.*, a company created by ICO Communications to develop a mobile communications network using satellite and land-based transmission towers.[76] While the *DSBD* decision is binding precedent on the Bankruptcy Court for the Southern District of New York, the same court that presided over *Sirva*, the Second Circuit issued the *DSBD* decision several years after the *Sirva* bankruptcy case.

While *Armstrong* would seem to be strong precedent against the conformability of the *Sirva* plan, a critical distinction existed. The Third Circuit Court, and later the Second Circuit in *DSBD*, ultimately decided that the language of the absolute priority rule was straightforward. While the courts that ruled against gifting were wary of the practice, ultimately they found

under the plain language of the Bankruptcy Code a class of junior creditors or interest holders could receive no distribution, even if such distribution was in the form of a gift, without paying the senior creditors in full. The secured creditors in *Sirva*, however, were not gifting to a class that was junior to the unfavored, non-continuing Class 5 creditors under the *Sirva* plan. Instead, they were seeking to provide a gift to a class of creditors with priority equal to that of Class 5. As such, the *Sirva* plan structure did not contradict the straightforward language of the absolute priority rule. Rather, the much more amorphous and hard to define concept of "unfair discrimination" under section 1129(b)(1) of the Bankruptcy Code was at issue in *Sirva*.

The *Sirva* bankruptcy court never ruled on whether the original *Sirva* Chapter 11 plan was confirmable. Prior to any ruling, the parties settled the matter. The amended *Sirva* plan provided Class 5 with a distribution of 25 percent, and the prepackaged plan became consensual.[77] Whether other secured creditors and debtors will adopt the *Sirva* plan strategy in the future is uncertain. While the plan litigation in *Sirva* may have cost millions of dollars in fees and delayed confirmation to some degree, the result for secured creditors in *Sirva* presumably was much better than paying tens of millions of dollars to unsecured creditors that were unnecessary to the reorganized business.

## Administrative Convenience Classes

Another tact that debtors have attempted to use under a plan of reorganization to pay favored trade creditors is an expansion of the "administrative convenience class" concept. Section 1122(b) of the Bankruptcy Code provides that "a plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience." While not actually stated in the statute, it would appear the intent of section 1122(b) of the Bankruptcy Code was to allow a debtor to place small claims in a separate class and pay such claims in full.[78]

In so-called "pot plans", where there is a fixed amount of consideration to be paid to all unsecured creditors regardless of the ultimate aggregate allowed amount of their claims, debtors typically will make several distributions to such creditors as all claims are allowed and disallowed, and, therefore,

the ultimate percentage distribution on such claims remains uncertain until completion of the claims reconciliation process. There is a cost associated with making each distribution to creditors, however, and, the cost of making multiple distributions may exceed the amount of smaller claims. Thus, a reorganized debtor may benefit from paying smaller claims in full soon after the effective date of a plan.

While not clear from the legislative history to the Bankruptcy Code, Congress may have intended administrative convenience classes to contain creditors whose claims might be only a few hundred dollars.[79] However, section 1122(b) itself contains no such limitation or even an indication that this would be an appropriate limit. As a result, over time, debtors sometimes have promulgated plans with very large administrative convenience claim caps for trade claims. Any claim up to that cap would be paid in full. Even claims above such cap could voluntarily elect to reduce their claims to the cap and, to that extent, often receive close to full payment. In this manner, debtors have been able to pay trade creditors under a plan a higher percentage on account of their claims then, for instance, similarly situated unsecured bondholders.

While section 1122(b) contemplates that the bankruptcy court needs to approve the administrative convenience cap in a plan as being "reasonable and necessary for administrative convenience," in practice debtors typically do not request such a finding from the court. Instead, unless a party objects to the administrative convenience class cap, it is approved indirectly by confirmation of the plan itself.

## Preference Waivers

Debtors also have devised other ways to help unsecured trade creditors under a plan. In reorganization cases, it is not uncommon for a plan to waive all preference actions against the debtor's creditors, which typically means actions against its trade creditors. Typically, such a waiver is required by an official committee of unsecured creditors as a condition to its important support for the plan. While stylized as a "waiver," to some extent, such a provision is more accurately a release by a debtor of any trade creditor who might have preference liability for pre-bankruptcy payments. What governs the propriety of releases by a debtor under a plan has been subject to some

confusion in certain jurisdictions.[80]

Most courts find that such a release can be approved if a proper exercise of the debtor's business judgment.[81] The factors that such courts will review in order to assess the propriety of such a release include whether the release is: (i) a valid exercise of the debtor's business judgment; (ii) fair and reasonable; and (iii) in the debtor and its estate's best interests.[82] The Delaware Bankruptcy Court, however, has sometimes applied a more stringent test to plan releases by a debtor.[83] The so-called *Master Mortgage* test includes whether: (i) there exists an identity of interest between the debtor and the third parties receiving the release; (ii) the party receiving the release made a substantial contribution to the debtor's reorganization; (iii) granting the release is essential to the debtor's reorganization; (iv) the releases are essential to the reorganization; (v) a substantial majority of creditors approved of the release or voted in favor of the plan containing the release; and (vi) the debtor's plan provides for payment of all or substantially all of the claims of the affected classes.[84] It is unclear why the Delaware Bankruptcy Court sometimes applies the *Master Mortgage* factors to plan releases by a debtor, as most courts find that the debtor may provide a plan release under the same business judgment standard utilized to determine whether a proposed settlement is appropriate under Bankruptcy Rule 9019. Bankruptcy Courts outside of Delaware apply factors similar to *Master Mortgage* where a debtor seeks to enforce a "*third party*" release under a plan — i.e. a release by a non-debtor (such as a creditor of the debtor) of another non-debtor (such as another creditor). Third party releases are controversial and difficult to obtain in all circuits, and thus the standards for their approval are stringent in all cases.[85]

Perhaps the answer to why the Delaware Bankruptcy Court sometimes applies the more stringent *Master Mortgage* test to debtor releases results from the fact that such releases apply to insiders of a debtor, such as its officers and directors, and there may be some perception that extra scrutiny is required, even though that sentiment is not necessarily expressed in the relevant opinions. To the extent, however, that a court applies the *Master Mortgage* standard to debtor releases under a plan, one could assert that its factors also should be applied to proposed plan preference waivers. In practice, however, the issue rarely, if ever, is addressed in connection with confirmation of Chapter 11 plans that contain such waivers.

## Unfair Discrimination

The best known examples of disputes over alleged unfair discrimination where a plan seeks to pay certain trade creditors are cases such as *Sirva* described above. However, another aspect of the unfair discrimination standard has been developing the case law, again to a potential favorable outcome for trade creditors. In *Sirva*, the plan simply attempted to favor certain trade creditors over others. Sometimes, however, a debtor may attempt to favor trade creditors over other similarly situated unsecured creditors, such as public noteholders. Such a plan, for instance, may seek to pay trade creditors in full or at a high percentage, while paying noteholders at a much lower percentage. If the noteholders vote against the plan, the issue of unfair discrimination again arises.

Unfair discrimination has two aspects. First, there must be discrimination between two similarly situated classes. For example, if a plan pays trade creditors 70 percent of their claims and noteholders 50 percent of their claims, clearly there is discrimination. The real issue, then, is whether such discrimination is "unfair" such that the plan cannot be crammed down on the noteholders under section 1129(b)(1) of the Bankruptcy Code. The case law is still developing as to what is "unfair" discrimination. Given the legally vague nature of the concept, much of the case law has focused on the difference in percentage recovery between the two classes at issue.[86]

What is interesting about such case law is that it does not focus on the absolute dollars that are being paid to the favored class compared to the disfavored class. Where the size of the classes are relatively the same, the magnitude of the disparity of treatment will be roughly the same in both absolute dollar and percentage recovery terms. Where the classes are of a much different size, however, the magnitudes can be very different. For instance, take a debtor that possesses $525 million of value to distribute to unsecured creditors and has $1 billion of public unsecured trade debt, and $50 million of trade debt. If the debtor places all creditors in one class, the class will receive a distribution of 50 percent. However, a debtor, if it wanted to favor its trade creditors, could structure a plan that paid the trade creditors in full and paid the rest of the debtor's value to the noteholders. In that case, the noteholders' recovery would be reduced from 50 percent to 47.5 percent by the transfer of $25 million of value away from the noteholders to the debtor's trade creditors. Under the case

law described above, the debtor could assert that such percentage reduction is simply insufficient to constitute unfair discrimination.

In fact, this type of issue arose recently in the reorganization case of the Tribune Company in the Bankruptcy Court for the District of Delaware.[87] In *Tribune*, the debtor, its official committee of unsecured creditors, and certain large unsecured funded debt creditors proposed a plan of reorganization that, at the level of the parent company of the Tribune family of companies, proposed to pay a class of public noteholders approximately 35 percent and a separate class of trade and other miscellaneous creditors approximately the same percentage recovery.[88] While such a plan might seem to be the opposite of unfair discrimination, the public noteholders argued that unfair discrimination existed, because the noteholders were benefitting unfairly from subordination provisions contained in certain of the parent's other unsecured debt facilities. The noteholders further argued that, while they were the proper beneficiaries of such subordination provisions, the trade creditor class was not, and, as such, the noteholder class should receive more under the plan than the trade creditor class.[89]

The public noteholders asserted that the amount of money at issue — money that they asserted the plan diverted from their class to the Tribune parent's trade creditors — was in the vicinity of $30 million.[90] Since the public noteholders had claims in excess of $1.2 billion, however, even if the noteholders were correct, the difference in their percentage recovery under the Tribune plan as a result was only a couple of percentage points.[91] Thus, the noteholders focused on the absolute dollar amount of the issue, as well as the fact that, under their theory, trade and other unsecured claims only should receive, if they were not the beneficiaries of the subordination provisions, between 20 and 25 percent on account of their claims, rather than the 33 to 35 percent the Tribune plan offered.[92]

While the issue of whether the trade creditors were in fact entitled to the benefits of the subordination provisions was litigated in the bankruptcy court, the court decided not to address that issue, which would have avoided the unfair discrimination issue altogether. Such a determination would not have been easy to make for, among other reasons, the class of trade and other unsecured creditors had several different types of claims and potentially hundreds, if not thousands, of creditors. Determining whether each such credi-

tor, or at least each set of creditors, was entitled to the benefits of the subordination provisions, especially where the issue was hotly contested, could have been extremely time consuming.

The court, instead, found that the Tribune plan did not unfairly discriminate against the public noteholders. Following the case law noted above, the court found that the detrimental change in the recovery for the public note holders was only a few percentage points. As a result, the court found, such detriment was not "material" or, more specifically, was not "unfair" under section 1129(b)(1) of the Bankruptcy Code.[93]

With such a ruling in hand, debtors who want to push value under a plan to trade creditors may be able to do so from recoveries that otherwise would be paid to a large classes of public noteholders. Where a debtor has significant public unsecured debt but relatively minor trade debt, it could attempt to propose a plan that pays the trade debt in full or at a high percentage recovery and the public debt at a lower recovery. The debtor could assert that the disparity is not unfair discrimination since the reduction in the percentage recovery for the public noteholders as a result of the higher payment of the trade creditors is relatively minor. While in many cases a debtor may not want to antagonize noteholders who could be the future owners of the debtor's business, or, alternatively, may not want to undertake cram litigation in order to confirm a Chapter 11 plan, in other cases the desire to favor trade creditors may be more important. The existing law addressing unfair discrimination gives such debtors the legal underpinning to potentially provide greater recovery for their trade creditors than other unsecured creditors in the Chapter 11 case.

## NOTES

[1] *See, e.g,*. Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 Stan. L. Rev. 751 (December 2002); Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 Stan. L. Rev. 673 (December 2003); Kenneth R. Yager II, *Is the Distressed Industry Distressed?*, ABI Journal, July-Aug. 2011; Jim Fleet, *Chapter 11 on Decline? Changes Are Here to Stay*, ABI Journal, March 2012.

[2] *See, e.g.*, Steven R. Strom, *Hedge Fund Power Plays in the Distressed Arena*, The Journal of Corporate Renewal, Dec. 1, 2005; David Peress, Thomas C.

Prinzhorn, *Nontraditional Lenders and the Impact of Loan-to Own Strategies on the Restructuring Process*, 25-3 Am. Bankr. L. L.J. 48 (April 2006); *The Vultures Take Wing*, The Economist, (March 29, 2007).

[3] Kenneth R. Yager II, *Is the Distressed Industry Distressed?*, ABI Journal, July-Aug. 2011.

[4] *In re Kmart, Corp.*, 359 F.3d 984, 987 (7th Cir. 2004) ("Filing a petition for bankruptcy effectively creates two firms: the debts of the pre-filing entity may be written down so that the post-filing entity may reorganize and continue in business if it has a positive cash flow.").

[5] *In re Lakeside Cmty. Hosp., Inc.*, 151 B.R. 887, 893 (Bankr. N.D. Ill. 1993) ("Congress designed the Bankruptcy Code to provide for equal and consistent treatment among similarly situated creditors.").

[6] *See* 11 U.S.C. § 507(a) (granting, respectively, fourth and fifth level unsecured priority for employee wage and benefit claims accruing during the 180-day period prior to bankruptcy up to the limits set forth therein).

[7] *Miltenberger v. Logansport, C. & S.W.R. Co.*, 106 U.S. 286, 288-89 (1882).

[8] *Id.*

[9] *Id.,* at 291.

[10] *Id.,* at 291-92.

[11] *Id.,* at 311.

[12] *Id.*

[13] *Id.,* at 308.

[14] *Id.,* at 311.

[15] *Id.,* at 311-12.

[16] *In re CoServ, LLC*, 273 B.R. 487, 498-501 (Bankr. N.D. Tex. 2002) (analyzing various arguments for the payment of prepetition claims of certain vendors, including that certain vendors would be unable to continue business absent payment and other vendors were sole source suppliers).

[17] *See In Re Carmike Cinemas, Inc.*, Case No. 00-3302, Debtors' Amended Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code, p. 23 (Nov. 14, 2001).

[18] *In re Sportfame of Ohio, Inc.*, 40 B.R. 47, 50 (Bankr. N.D. Ohio 1984) (holding that a refusal to ship goods to a debtor absent payment of prepetition debt was violation of the automatic stay); *In re Ike Kempner & Bros., Inc.*, 4 B.R. 31, 32 (ordering a supplier to supply the debtor with shoes the debtor ordered prior to its bankruptcy filing upon the debtor's issuance of a check prior to shipment).

[19] *See In Re Carmike Cinemas, Inc.*, Case No. 00-3302, Debtors' Amended

Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code, p. 23 (Bankr. D. Del. Nov. 14, 2001).

[20] *In re Kmart Corporation*, 359 F.3d 866, 869 (7th Cir. 2004).

[21] *See* 11 U.S.C. § 105(a).

[22] *Capital Factors Inc. v. Kmart Corp.*, 291 B.R. 818, 823 (N.D. Ill. 2003).

[23] *In re Kmart Corporation*, *supra* at 871 (7th Cir. 2004) (quoting *In re Chicago, Milwaukee, St. Paul & Pacific R.R.*, 791 F.2d 524, 528 (7th Cir. 1986)).

[24] *In re Kmart Corporation*, *supra*.

[25] *Id.*, at 872.

[26] *Id.,* at 873-74.

[27] *In re National Equipment Services, Inc.*, Case No. 03-27626, Second Amended Disclosure Statement for the Second Amended Joint Plan of Reorganization of National Equipment Services, Inc. and Its Affiliated Debtors Under Chapter 11 of the United States Bankruptcy Code, p. 9 (Bankr. N.D. Ill. Dec. 9, 2003).

[28] *See* United States Bankruptcy Court for the District of Delaware General Chambers Procedures, § 2.b.v (June 30, 2011).

[29] Robert J. Landry, III, *The Policy and Forces Behind Consumer Bankruptcy Reform: A Classic Battle Over Problem Definition*, 33 U. Mem. L. Rev. 509, 516-19 (2003) (discussing creditor groups as a "major force" behind the 2005 amendments to the Bankruptcy Code); Philip Shenon, *Hard Lobbying on Debtor Bill Pays Dividends*, N.Y. Times, Mar. 13, 2001, at A1 ("A lobbying campaign led by credit card companies and banks that gave millions of dollars in political donations to members of Congress and contributed generously to President Bush's 2000 campaign is close to its long-sought goal of overhauling the nation's bankruptcy system.").

[30] *See In re Gulf City Seafoods, Inc.*, 296 F.3d 363, 368 (5th Cir. 2002) (holding that defendant could not demonstrate that a payment was in the ordinary course of business by simply offering testimony of payment terms with its own customers, but rather must show evidence of credit arrangements of other creditors and debtors in its industry).

[31] *See In re Shalom Hospitality Inc.*, 293 B.R. 211, 216 (Bankr. N.D. Iowa 2003) (providing expert analysis of "ordinary business terms in the utility industry" to establish ordinary business terms for preference purposes); *In re Brothers Gourmet Coffees, Inc.*, 271 B.R. 456, 462 (Bankr. D. Del. 2002) (same); *but see In re Sibilrud*, 308 B.R. 388, 42 (Bankr. D. Minn. 2004) (holding that although many courts have relied on expert testimony to establish the "ordinary course of business" in an industry, expert testimony is not required, and transferee can

meet its burden of proof through the testimony of its employees as long as the testimony is based on first-hand knowledge); *In re Bridge Information Systems, Inc.*, 297 B.R. 759, 769 (Bankr. E.D. Mo. 2003) (same); *In re Bridge Information Systems, Inc.*, 297 B.R. 759 (Bankr. E.D. Mo. 2003) (same).

[32] *See* U.C.C. § 2-702 (allowing a seller of goods to reclaim those goods if the buyer is insolvent, subject to certain time limitations and notice requirements).

[33] *See* U.C.C. § 2-702, Official Comment ("Subsection (2) takes as its baseline the proposition that any receipt of goods on credit by an insolvent buyer amounts to a tacit business misrepresentation of solvency and therefore is fraudulent as against the particular seller.")

[34] 11 U.S.C. § 546(c)(2) (2005).

[35] *See In re Waccamaw's HomePlace*, 298 B.R. 233, 238-39 (Bankr. D. Del. 2003) (denying reclamation claim when seller failed to preserve its rights through judicial action beyond the providing of a reclamation notice to the debtor); *In re Crofton & Sons, Inc.*, 139 B.R. 567, 569-70 (Bankr. M.D. Fla. 1992) (deciding that a supplier's failure to initiate an adversary proceeding until 8 months after sending its reclamation notice prevented seller from receiving an administrative claim under the pre-BAPCPA version of section 546(c) of the Bankruptcy Code).

[36] *See In re Dairy Mart Convenience Stores*, 302 B.R. 128 (Bankr. S.D.N.Y. 2003) (holding that reclamation claims were valueless because of secured lenders preexisting floating liens); *In re Dana Corp.*, 367 B.R. 409, 421 (Bankr. S.D.N.Y. 2007) (holding reclamation claims were valueless because the "reclaimed goods or the proceeds thereof were either liquidated in satisfaction of the Prepetition Indebtedness or pledged to the DIP Lenders pursuant to the DIP Credit Facility."); *In re Pest Ref. Co.*, 964 F.2d 842, 845 (8th Cir. 1992) ("Since most secured creditors are good faith purchasers under the UCC, [§ 2-702] has the effect, in priority terms, of placing the reclaiming seller behind the insolvent buyer's secured creditors who have security interests in the goods, but ahead of the buyer's general unsecured creditors.... This prioritizing is consistent with the historic roots of the reclamation remedy."); *In re Arlco, Inc.,* 239 B.R. 261, 270–71 (Bankr. S.D.N.Y. 1999) (holding that seller's reclamation claim was valueless, and did not entitle seller to administrative claim or replacement lien, once secured creditor with floating lien on debtor's inventory received the proceeds from the sale of seller's goods).

[37] *See In re BH S&B Holdings, LLC*, 439 B.R. 342, 349-50 (Bankr. S.D.N.Y. 2010) (citing administrative insolvency as a basis to convert cases from Chapter 11 to Chapter 7); Bruce S. Nathan & Bruce D. Buechler, *Who Pays the Freight?*

*Interplay Between Priority Claims and a Debtor's Secured Lender*, Am. Bankr. Inst. L.J., at 26-27, 76 (Nov. 2011) (citing Hearing Transcript, *In re Townsends, Inc.*, Case No. 10-14092 (Bankr. D. Del. Jan. 21, 2011) (bankruptcy court refused to authorize postpetition financing that was insufficient to satisfy claims arising under section 503(b)(9) of the Bankruptcy Code)).

[38] *See* 11 U.S.C. § 1129(a)(9)(A).

[39] *See In re LTV Company, Inc.*, Case No. 00-43866, Order (Bankr. N.D. Ohio Feb. 11, 2003) (order authorizing a wind-down plan that provided a super-priority status to administrative expenses arising after a date certain); *In re Caldor, Inc.*, 240 B.R. 180, 184 (Bankr. S.D.N.Y. 1999) (allowing a super-priority status to administrative claims arising after the commencement of a wind-down process after determining allowing a liquidation to occur within a Chapter 11 proceeding was in the best interests of the estate and "that is unreasonable to expect persons who supply goods and services during the Wind-Down Period to do so without granting a super-priority status").

[40] *The Law and Practice of Restructuring in the UK and the US*, 61-62 (Christopher Mallon & Shai Y. Waisman, eds., Oxoford University Press, Inc., 2011) (hereinafter "[*Sirva*]").

[41] *In re DJK Residential LLC*, No. 08-10375 (Bankr. S.D.N.Y. February 5, 2008).

[42] Disclosure Statement for the Debtors' Prepackaged Plan of Reorganization Pursuant to Chapter 11 of the United States Bankruptcy Code at 8-12, *In re DJK Residential, LLC*, No. 08-10375 (Bankr. S.D.N.Y. January 28, 2008) (hereinafter "Sirva Disclosure Statement").

[43] Objection of the Official Committee of Unsecured Creditors to Debtors' Proposed Joint Plan of Reorganization Pursuant to Chapter 11 of the United States Bankruptcy Code at 20, *In re DJK Residential LLC*, No. 08-10375, (Bankr. S.D.N.Y.).

[44] Sirva Disclosure Statement at 5.

[45] *See* 11 U.S.C. § 1126(f).

[46] *See* 11 U.S.C. § 1126(g).

[47] *See* Objection of Official Committee of Unsecured Creditors to Debtors' Proposed Joint Plan of Reorganization Pursuant to Chapter 11 of the United States Code, 35-42, *In re DJK Residential LLC*, No. 08-10375 (Bankr. S.D.N.Y. April 11, 2008).

[48] *See* 11 U.S.C. § 1129(b)(1).

[49] *In re Johns-Manville Corp.*, 68 B.R. 618, 636 (Bankr. S.D.N.Y. 1986) ("Generally speaking, this standard ensures that a dissenting class will receive

relative value equal to the value given to all other similarly situated classes.") *aff'd in part, rev'd in part on other grounds*, 78 B.R. 407 (S.D.N.Y. 1987), *aff'd*, *Kane v. Johns-Manville Corp.*, 843 F.2d 636 (2d Cir. 1988).

[50] Debtors' Memorandum of Law in Support of Entry of an Order (I) Approving (A) the Debtors' Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code, (B) Solicitation of Votes and Voting Procedures, and (C) Forms of Ballots; and (II) Confirming the Debtors' Joint Prepackaged Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code, 127-31, *In re DJK Residential LLC*, No. 08-10375 (Bankr. S.D.N.Y. April 15, 2008). (hereinafter "Debtors' Plan Support Memorandum")

[51] Debtors' Plan Support Memorandum at 118-19.

[52] *See* Debtors' Plan Support Memo at 131-40.

[53] *In re SPM Manufacturing Corp.*, 984 F.2d 1305 (1st Cir. 1993).

[54] *Id.,* at 1308.

[55] *Id.,* at1309.

[56] *Id.*

[57] *Id.*

[58] *Id.,* at 1312.

[59] *Id.*

[60] *Id.,* at 1313.

[61] H. Ray & J. Daly, *Reverse Cramdown: The Senior Creditors "Tip" to the Lower Classes*, 79th Annual Meeting of the National Conference of Bankruptcy Judges (Nov. 2, 2005) (noting that "give up" plans have been criticized as violating the absolute priority rule, the fair and equitable requirement, and the unfair discrimination prohibition of section 1129(b) of the Bankruptcy Code).

[62] *In re Armstrong World Indus., Inc.*, No. 05-1881.

[63] Section 524(g) of the Bankruptcy Code allows a debtor with asbestos liability to, among other things, confirm a plan that binds not only existing asbestos personal injury claimants but also persons who will become asbestos personal injury claimants in the future, so long as the debtor appoints a "future claims representative" in the case and otherwise complies and satisfies the provisions of section 524(g).

[64] *In re Armstrong World Indus., Inc.*, 432 F.3d 507, 509 (3rd Cir. 2005).

[65] *Id.*

[66] *Id.*

[67] *Id.*

[68] *Id.,* at 509-10.

[69] *Id.,* at 530.
[70] *Id.,* at 513-14.
[71] *See id.,* at 512-13.
[72] *See id.*
[73] *Id.,* at 510.
[74] *In re Armstrong World Indus, Inc.*, 320 B.R. 523 (D. Del. 2005), *aff'd* 432 F.3d 507 (3d Cir. 2005).
[75] *In re Armstrong World Indus, Inc.*, *supra* 432 F.3d 507, 515.
[76] *In re DSBD North America, Inc.*, 634 F.3d 79, 97-98 (2nd Cir. 2011) (denying confirmation of the debtor's plan that provided value to shareholders even though unsecured creditors were not being paid in full and finding that the doctrine of "gifting" did not allow confirmation notwithstanding the absolute priority rule where secured creditors senior to the unsecured creditors purported to gift value under the plan to such equity holders).
[77] Findings of Fact, Conclusions of Law, and Order (I) Approving the Debtors' Disclosure Statement and (II) Confirming the Debtors' First Amended Prepackaged Joint Plan of Reorganization Pursuant to Chapter 11 of the United States Bankruptcy Code, *In re DJK Residential LLC*, No. 08-10375 (Bankr. S.D.N.Y. May 7, 2008).
[78] *See* House Report No. 95-595, 95th Cong., 1st Sess. 406 (1977); Senate Report No. 95-989, 95th Cong., 2d Sess. 118 (1978); *Troy Sav. Bank v. Travelers Motor Inn, Inc.*, 215 B.R. 485, 489 (Bankr. N.D.N.Y.1997) (explaining that convenience classes are authorized under section 1122(b) so that unsecured creditors with relatively small claims can "receive their percentage immediately upon confirmation, rather than making tiny payments over a period of years like the bigger unsecured claims"); *In re Storberg*, 94 B.R. 144, 146 n.2 (Bankr. D. Minn. 1988) (stating that "it has always been assumed that the purpose of § 1122(b) was to allow special treatment for small claims, so that they could be eliminated early and reduce the number of claims that would have to be paid over time"); *In re Jartran, Inc.*, 44 B.R. 331, 397 (Bankr. N.D. Ill. 1984) (finding that "the purpose and intended goal of § 1122(b) is the reduction of administrative costs accomplished by reducing the number of claims to be dealt with postpetition").
[79] *See In re Tucson Self-Storage, Inc.*, 166 B.R. 892 (9th Cir. B.A.P. 1994) ("Generally, an administrative convenience class is one where the claims are so small in amount and large in number as to make dealing with them burdensome.")
[80] Similarly, purchasers of substantially all of a debtor's assets under section 363

of the Bankruptcy Code often include preference actions as "purchased assets," thus preventing a liquidating trust or other entity from pursuing preference actions.

[81] *See, e.g.*, *In re Mesa Air Group, Inc.*, No. 10-10018, 2011 WL 182450, at *11 (Bankr. S.D.N.Y. Jan. 20, 2011) ("The releases by the Debtors set forth in Section 9.1.3 of the Plan represent a valid exercise of the Debtors' business judgment and accordingly are appropriate under section 1123(b)(3)(A) of the Bankruptcy Code."); *In re Bigler LP*, 442 B.R. 537, 547 (Bankr. S.D. Tex. 2010) ("Article 12.4.2 constitutes an acceptable settlement under § 1123(b)(3) because the Debtors and the Estate are releasing claims that are property of the Estate in consideration for funding of the Plan by Amegy."); *In re DBSD North America, Inc.*, 419 B.R. 179, 217 (Bankr. S.D.N.Y. 2009) ("It is a valid exercise of the Debtors' business judgment to include a settlement of any claims it might own against such parties as a discretionary provision of the plan.")

[82] *In re DSBD North America, Inc.*, 634 F.3d 79, 217 (2nd Cir. 2011).

[83] *See In re Zenith Electronics Corp.*, 241B.R. 92, 110-11 (Bankr. D. Del. 1999) (utilizing the so called *Master Mortgage* factors to analyze the appropriateness of certain debtor releases).

[84] *In re Master Mortgage Investment Fund, Inc.*, 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994).

[85] *See, e.g. In re Johns-Manville Corp.*, 517 F.3d 52 (2d Cir. 2008); *In re A.H. Robins*, 972 F.2d 77 (4th Cir. 1992); *In re Zale Corp.*, 62 F.3d 746 (5th Cir. 1995); *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002); *In re Airadigm Communications, Inc.*, 519 F.3d 640, 655-58 (7th Cir. 2008); *In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995); *In re Western Real Estate Fund Inc.*, 922 F.2d 592, 600 (10th Cir. 1990).

[86] *See In re Armstrong World Indus, Inc*, 348 B.R. 111, 122 (Bankr. D. Del. 2006) (noting that a presumption of unfair discrimination arises only "if the dissenting class would receive a 'materially lower' percentage recovery"); *In re Dow Corning Corp.*, 244 B.R. 696 (Bankr. E.D. Mich. 1999) (finding a rebuttable presumption of unfair discrimination arises if the following factors exist in connection with plan confirmation: "(1) a dissenting class; (2) another class of the same priority; and (3) a difference in the plan's treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class (measured in terms of the net present value of all payments), or (b) regardless of percentage recovery, an allocation under the plan of materially greater risk to the dissenting class in connection with its proposed distribution"); *In re Unbreakable Nation*

*Co.*, 437 B.R. 189, 202-03 (Bankr. E.D. Pa. 2010) (focusing a thorough analysis of unfair discrimination on differences in percentage recoveries); *In re Greate Bay Hotel & Casino, Inc.*, 251 B.R. 213, 231 (Bankr. D.N.J. 2000) (finding that no unfair discrimination existed when holders of unsecured deficiency claims received a 76% distribution on account of their claims and other general unsecured creditors received a 80% distribution).

[87] *In re Tribune Co.*, 464 B.R. 126 (Bankr. D. Del. 2011).

[88] *Id.,* at 198.

[89] *Id.*

[90] *Id.,* at 245.

[91] *Id.,* at 242-43.

[92] *Id.,* at 244.

[93] *Id.*