"First day" motions accompanying a chapter 11 debtor's bankruptcy petition routinely include an application for authority to pay the pre-bankruptcy claims of vendors and other creditors without whom the debtor could not continue to operate its business. Many bankruptcy judges have authorized such "critical vendor" payments by relying upon a principle commonly referred to as the "necessity of payment" rule or "the doctrine of necessity." Unfortunately, the viability of the principle has been questioned by every circuit court of appeals that has had occasion to rule on the propriety of paying pre-petition vendor claims, critical or otherwise, in a manner departing from the distribution scheme established in chapter 11 of the Bankruptcy Code.

Most recently, the Seventh Circuit Court of Appeals invalidated nearly $300 million in critical vendor payments made at the inception of Kmart Corporation's chapter 11 cases. The ruling was anything but encouraging, given widespread reliance on the doctrine of necessity as a means of assuring an uninterrupted supply of goods and services deemed critical to a chapter 11 debtor's continued operation and reorganization prospects. Still, while the Seventh Circuit unequivocally rejected the doctrine of necessity as a legitimate basis for authorizing critical vendor payments, it did not rule out the possibility that the practice might be sanctioned under section 363(b) as a court-authorized use of property outside the ordinary course of business. Judging by a decision recently issued by a Florida bankruptcy court in *In re Tropical Sportswear International Corporation*, section 363(b) may have filled the vacuum created by *Kmart*. 
The Doctrine of Necessity

Developed in connection with railroad reorganizations under the Railway Labor Act (a predecessor statute to the Bankruptcy Code), the doctrine of necessity was intended to ensure the continued delivery of supplies or services considered essential to the reorganization efforts of railways. It provided that current and necessary operating expenses incurred within six months of the filing of a railroad reorganization case would be entitled to priority in payment over the claims of other general unsecured creditors.

The problem is that the rule, which is now codified in section 1171(b) of the Bankruptcy Code, only applies to railroad bankruptcies. In other reorganizations, the Bankruptcy Code contemplates that claims asserted by all unsecured pre-petition creditors will be satisfied, in whole or in part, at the conclusion of a chapter 11 case in accordance with the terms of a confirmed plan of reorganization. This is in keeping with one of the Code's primary objectives — equality of distribution among similarly situated creditors. Payment to certain creditors, whether "critical" or not, at the outset of a case is clearly inconsistent with this objective. It alters the priority scheme for unsecured claims set forth in the Bankruptcy Code and (perhaps) unfairly prefers a handful of creditors over those forced to wait until the end of the case.

Turmoil in the Courts

Undaunted by the absence of express authority, many bankruptcy courts justified deploying the doctrine as an exercise of their broad powers as courts of equity under section 105(a) of the Bankruptcy Code. That section provides that "[t]he court may issue any order, process, or
recognizing that the success of a chapter 11 reorganization hinges in large part on the debtor's ability to avoid, as nearly as possible, significant disruption in its business operations, these courts have authorized the debtor to pay the claims of pre-petition vendors at the outset of a case, so long as the debtor demonstrates that a vendor is "critical" and the payment is necessary.

Unfortunately, five circuit courts of appeal have expressed the view that neither the doctrine of necessity nor section 105(a) authorizes the payment of pre-petition claims outside of a plan of reorganization. The Ninth Circuit was the first to do so in In re B & W Enterprises Inc., where it ruled that the doctrine of necessity is confined to railroad cases, observing that it is "unwise to tamper with the statutory priority scheme devised by Congress." That same year, the Sixth Circuit noted (but did not rule) in Crowe & Associates Inc. v. Bricklayers & Masons Union Local No. 2 (In re Crowe & Associates, Inc.), that a bankruptcy court cannot authorize a debtor to pay pre-bankruptcy claims prior to confirmation of a plan, even to avoid a strike that would "shut down the debtor's operations."

Four years later, the Fourth Circuit ruled that section 105(a) does not authorize a bankruptcy court to permit pre-plan payment of pre-petition unsecured claims in Official Committee of Equity Holders v. Mabey, reversing a bankruptcy court order that established an emergency fund to pay the medical expenses of Dalkon Shield victims prior to confirmation of the debtor's chapter 11 plan. The Fifth Circuit reached the same conclusion in Matter of Oxford Management, Inc., when it ruled that the bankruptcy court improperly used its equity powers to direct a chapter 11 debtor-broker to pay pre-petition commissions owed to associate brokers.
because the court elevated the status of the associate brokers above that of other general unsecured creditors and deviated from the pro rata scheme of distribution envisioned by the Bankruptcy Code.

Limitations on the scope of a bankruptcy court's equitable powers have also been addressed by the U.S. Supreme Court. In *Norwest Bank Worthington v. Ahlers*, the High Court held that "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." More recently, the Supreme Court ruled in a tandem of cases (*United States v. Reorganized CF & I Fabricators of Utah, Inc.* and *United States v. Noland*), that a bankruptcy court cannot use its equitable powers to reorder the priority scheme created by the Bankruptcy Code. These rulings have been widely interpreted to mean that section 105(a) does not allow a bankruptcy court to override the explicit mandates of other provisions of the Bankruptcy Code.

**Spotlight on Kmart**

The Seventh Circuit's *Kmart* decision in 2004 further undermined the efficacy of the doctrine as a basis for paying vendors' pre-petition claims. As part of its “first day” motions, chapter 11 debtor Kmart sought authority to pay nearly $300 million in pre-petition debts to 2,330 domestic and foreign suppliers, claiming that the payments were necessary to maintain relationships essential to its continued operation and reorganization. Kmart relied upon the doctrine of necessity and Bankruptcy Code section 105(a) as authority for the payments. Capital Factors, Inc., the factoring agent for Kmart’s apparel suppliers (and an unsecured creditor of Kmart to the tune of $20 million), objected to the motion. Bankruptcy Judge Susan Pierson Sonderby
concluded that the suppliers “are necessary to keep this business going as a going concern” and authorized the payments. She subsequently authorized Kmart to pay issuers of pre-petition letters of credit and the pre-bankruptcy claims of certain liquor vendors, reasoning that the L/C issuers “are integral to the reorganization” and that “there is a good business justification” for paying the pre-bankruptcy claims of Kmart’s liquor vendors. Capital Factors appealed.

The district court reversed. Recognizing that there is a split in the courts regarding whether section 105(a) authorizes a bankruptcy court to permit the payment of unsecured claims outside of a plan of reorganization, District Judge John F. Grady held that “we cannot ignore the Bankruptcy Court’s statutory scheme of priority in favor of ‘equity.’” The court acknowledged that application of the rule of necessity through section 105(a) “is well intended and may even have some beneficial results, in that pre-plan payment of certain pre-petition claims allows the debtor to minimize disruptions in doing business, and thus may further reorganization.” Still, Judge Grady concluded, because Congress has not chosen to codify the doctrine or to otherwise permit pre-plan payment of unsecured claims, such payments “simply are not authorized by the Bankruptcy Code.”

Kmart appealed to the Seventh Circuit. The Court of Appeals ruled that section 105(a) does not create discretion to set aside the Bankruptcy Code's rules about priority and distribution. Observing that "[a] 'doctrine of necessity' is just a fancy name for a power to depart from the Code," the court emphasized that "[o]lder doctrines [like the rule of necessity] may survive as glosses on ambiguous language enacted in 1978 or later, but not as freestanding entitlements to trump the text."
The Court then searched the Bankruptcy Code for specific authority to pay pre-petition claims prior to confirmation of a plan. According to the Seventh Circuit, section 363(b)(1), which authorizes a trustee or chapter 11 debtor-in-possession, with court approval, to use property outside the ordinary course of business, is the most promising alternative. The Court found, however, that it need not decide whether section 363(b)(1) could support payment of some pre-petition debts "because this order was unsound no matter how one reads" that provision. It explained that Kmart never even attempted to offer any evidence to support the very premise of its critical vendor motion — namely, that the supposedly critical suppliers would have ceased deliveries if old debts were left unpaid. According to the Court, some of Kmart's vendors were obligated to continue supplying Kmart because the automatic stay precluded them from terminating supply contracts that were in force as of the bankruptcy filing date. In addition, the Court noted, Kmart never explored alternative means of assuring vendors that it would pay for new deliveries on a current basis, such as a standby letter of credit. Finally, the Seventh Circuit faulted the bankruptcy court's determination because it was unsupported by findings that any vendor would have stopped doing business with Kmart if not paid for pre-petition deliveries, that discrimination among unsecured creditors was the only way to facilitate a reorganization, or that Kmart's other creditors were at least as well off as they would have been had the critical vendor order not been entered.

**Life After Kmart**

A Florida bankruptcy court was not long in following the roadmap drawn by the Seventh Circuit. Tropical Sportswear International Corporation, a designer and marketer of casual clothing, filed
for chapter 11 together with its affiliates at the end of 2004. Tropical agreed in principle prior to
filing for chapter 11 to sell its assets to Perry Ellis International, Inc. for approximately $88.5
million. It filed for bankruptcy to facilitate the sale to Perry Ellis or any other purchaser with a
better offer.

Shortly after the filing, Tropical sought court authority to pay four vendors approximately $6.5
million for goods and services provided to Tropical before it filed for bankruptcy. To
substantiate its request, Tropical produced evidence demonstrating that each of the vendors
provided the company with unique products and services used in the production of clothing.
Tropical estimated that it would take four to six weeks to find alternate suppliers — an
interruption in the flow of services and products that would substantially jeopardize the
company's ability to conduct business. The vendors had informed Tropical that they would cease
production and delivery of new product absent immediate payment of approximately 75% of
their pre-petition claims. The vendors agreed to waive the remainder.

The bankruptcy court authorized the payments. Paying Tropical's vendors, the court reasoned,
was clearly justified as a use of estate property under section 363(b) because Tropical's business
would be seriously jeopardized if the vendors stopped doing business with the company. In
addition, the court emphasized, any such disruption could jeopardize Tropical's ability to sell
substantially all of its assets because it might be deemed a material adverse change relieving
Perry Ellis from its obligation to act as a stalking horse in the sale transaction. The bankruptcy
court concluded that all of Tropical's creditors — not merely the favored vendors — would
benefit because "the payments enable a successful reorganization . . . and even the disfavored
creditors will receive greater payments on their respective claims." Finally, the court noted, the vendors' status as critical, and the amount of the payments were negotiated at arm's length between the parties with the participation of the creditors' committee. However, the court conditioned approval of the payments on the vendors' continued willingness to do business with Tropical during its chapter 11 case, failing which they were required to disgorge any amounts received.

According to the court, "the Bankruptcy Code does not contemplate every business crisis that could arise in a bankruptcy case, and this Court is of the opinion that Congress intended that the Code accommodate the economic realities faced by debtors in reorganization cases." The statutory predicates for such an accommodation in this context, the court held, are sections 363(b) and, to the extent that section 363(b) might be found wanting in providing express authority, section 105(a)'s broad equitable mandate. However, the court cautioned that a bankruptcy court's use of its equitable powers to authorize the payment of pre-petition vendor claims is warranted only if:

1. the vendors are indeed critical and have refused to do business with the debtor absent payment; and
2. the court finds that the disfavored unsecured creditors will be at least as well off as a consequence of the payment authorization as they would be without it.

**Analysis**

The Florida bankruptcy court's holding is not groundbreaking, but it may be a harbinger of things to come in the realm of critical vendor payments in large chapter 11 cases. The doctrine of
necessity — once the favorite son of bankruptcy courts trying to cope with the practical realities of chapter 11 cases — appears to be waging a losing battle for legitimacy (at least at the appellate level). The *Tropical Sportswear* solution would appear to have a more promising future. One reason may be that section 363(b) is a more defensible source of authority for the payment of pre-petition claims outside of a plan of reorganization. Among the criticisms leveled at the doctrine of necessity is that the bankruptcy court's equitable powers under section 105(a) are not an independent source of authority. In other words, section 105(a) can only be invoked in aid of other powers expressly given to a bankruptcy court under the Bankruptcy Code. At least on that score, the *Tropical Sportswear* approach appears to be much less vulnerable.

As with other non-ordinary-course transactions, the appropriate inquiry with respect to critical vendor payments under section 363(b) should be whether the payments represent an exercise of sound business judgment. In cases where a reorganization will fail if critical vendors walk away, the answer to that question will almost certainly be yes.

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*In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004).

*In re B & W Enterprises Inc.*, 713 F.2d 534, 537 (9th Cir. 1983).


*Official Committee of Equity Holders v. Mabey*, 832 F.2d 299 (4th Cir. 1987).


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