SELECTED TRADE CREDITOR ISSUES

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I. RECLAMATION

A. Introduction

"Reclamation" describes the right of a seller of goods to reclaim goods delivered to a buyer that the seller subsequently determines is insolvent. Section 546(c) of the Bankruptcy Code prohibits a bankruptcy trustee or debtor-in-possession from avoiding any prepetition or postpetition reclamation of goods delivered to the debtor within 45 days prepetition (under any avoidance theory, including preferential, fraudulent, unperfected, or otherwise unauthorized transfer), provided that certain requirements are met.

This right has the **potential** to be very powerful, in that it effectively converts an unsecured seller into a secured creditor for goods delivered to the debtor within 45 days prepetition. However, reclamation rights are fragile because (1) the debtor can defeat them by consuming or materially altering the goods and (2) reclamation rights are subject to the prior rights of a holder of a security interest in the goods or their proceeds. Disagreements among courts as to whether § 546(c) creates reclamation rights, as opposed to merely preserving state law reclamation rights, may further reduce the effectiveness of reclamation rights in many states.

B. Text of Bankruptcy Code § 546(c)

(1) Except as provided in subsection (d) of this section and in section 507(c), and subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of the trustee under sections 544(a), 545, 547, and 549 are subject to the 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, within 45 days before the date of the commencement of a case under this title, but such seller may not reclaim such

goods unless such seller demands in writing reclamation of such goods--

(A) not later than 45 days after the date of receipt of such goods by the debtor; or

(B) not later than 20 days after the date of commencement of the case, if the 45-day period expires after the commencement of the case.

(2) If a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in section 503(b)(9).

C. Origin and Nature of Reclamation Rights

As a consequence of the 2005 Amendments to § 546(c), it has become important whether § 546(c) creates a federal reclamation right or whether it merely preserves sellers' state law rights. If § 546(c) as amended creates a federal right, reclamation under the Bankruptcy Code and under the UCC could be interpreted differently from one another.

1. Differences Between State and Federal Statutes

The two major differences between the texts of § 546(c) and Section 2-702(2) and (3) of the Uniform Commercial Code (UCC) are:

(1) Number of days to send reclamation demand

a. Section 546(c) gives the seller **20 days after the petition date to reclaim goods delivered to the debtor within 45 days prepetition**.

b. The UCC permits reclamation within a **"reasonable time"** (though many states have retained an old version of Section 2-702(2) that only gives the seller 10 days from delivery to reclaim goods[1]).

(2) Whose rights trump reclamation

[1] Jurisdictions that still limit reclamation to ten days from delivery include Alaska, California, the District of Columbia, Georgia, Hawaii, Idaho, Illinois, Iowa, Maine, Massachusetts, Minnesota, Montana, Nebraska, New Hampshire, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, and Wyoming.

a. The Bankruptcy Code provides that reclamation rights are "subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof." § 546(c)(1).

b. The UCC provides that the seller's right to reclaim is "is subject to the rights of a buyer in ordinary course of business or other good-faith purchaser for value under Section 2-403." Some courts, though not all, have interpreted this language as including secured lenders whose security interest extends to after-acquired property; see below.

Until the 2005 Amendments to the Bankruptcy Code, it was clear that § 546(c) preserved sellers' state law rights and did not create any federal rights. The most common state law right of reclamation arises under Section 2-702(2) and (3) of the UCC, which provides:

(2) Where the seller discovers that the buyer has received goods on credit while insolvent, the seller may reclaim the goods upon demand made within a reasonable time after the buyer's receipt of the goods. Except as provided in this subsection, the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

(3) The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course of business or other good-faith purchaser for value under Section 2-403. Successful reclamation of goods excludes all other remedies with respect to them.

Section 546(c) of the Bankruptcy Code was significantly revised as part of the 2005 Amendments. The pre-2005 version contained several differences from the current version, including:

- The text expressly stated that the trustee's avoidance powers were subject to **any statutory or common-law** reclamation right, as opposed to the current text, which says that such powers are subject to **the** reclamation right of a seller.

- The reachback period was 10 days, not 45. The 10-day period was consistent with the text of UCC Section 2-

- The bankruptcy court was authorized to deny reclamation if it granted the seller an administrative expense claim for the value of the goods. Now, § 503(b)(9) gives sellers an administrative expense claim for all goods delivered within the 20 days prepetition, whether or not the buyer was insolvent at the time of delivery and whether or not the seller makes a reclamation demand for the goods.

  Note: it appears that courts are no longer authorized to deny reclamation simply by granting administrative expense priority to the seller for the value of goods delivered between the 20th and 45th days prior to the petition date. This interpretation stems from the deletion of the administrative expense language from § 546(c) and the fact that the new 45-day reachback period for reclamation is not coextensive with the 20-day reachback period for administrative claims under § 503(b)(9). Stated differently, a seller is automatically entitled to an administrative claim for goods delivered within the 20 days prepetition, but absent a court order to the contrary (e.g., a critical vendor order), the seller is not entitled to administrative priority for goods delivered between 20 and 45 days prepetition.

2. Does Section 546(c) Create a Federal Reclamation Right?

A majority of courts have held that, notwithstanding the removal of the phrase "subject to any statutory or common-law right," § 546(c) as amended does **not** create a federal reclamation right. <u>In re Dana Corp.</u>, 367 B.R. 409 (Bankr. S.D.N.Y. 2007); <u>see</u> <u>In re Circuit City Stores, Inc.</u>, 416 B.R. 531 (Bankr. E.D. Va. 2009) (arguably dicta); <u>In re First Magnus Fin. Corp.</u>, 2008 WL 5046596 (Bankr. D. Ariz. 2008); <u>In re Magwood</u>, 2008 WL 509635 (Bankr. M.D. Ala. 2008).

But see, e.g., In re TI Acquisition, LLC, 410 B.R. 742 (Bankr. N.D. Ga. 2009) (in dicta, stating "The combination of these changes [i.e., amending § 546(c) and creating § 503(b)(9)] suggests that Congress intended to recognize a reclamation right for sellers that was no longer exclusively dependent upon state law. Alternatively, and at a minimum, these two changes expanded certain aspects of state law reclamation").

In courts where there is no binding precedent as to whether the Bankruptcy Code trumps the applicable state law regarding the number of days the seller has to reclaim goods, sellers should attempt to reclaim within the shorter state law-prescribed period if possible. If the state law period has expired prior to the petition date, however, the seller should nevertheless send a reclamation demand for all goods delivered to the debtor within 45 days prepetition, understanding that it may not be successful.

D. Requirements for Reclamation

1. Seller of "Goods"

Both § 546(c) and UCC Section 2-702 are limited to sellers of goods. Although the Bankruptcy Code does not define the term "goods," bankruptcy courts have relied on the UCC definition, which is things that are "movable at the time of identification to the contract for sale other than the money in which the price is to be paid." E.g., In re Circuit City Stores, Inc., 416 B.R. 531 (Bankr. E.D. Va. 2009) (interpreting Bankruptcy Code § 503(b)(9)). "Goods" include "an undivided share in an identifiable bulk of fungible goods," though such goods are often difficult to reclaim due to the identifiability requirement, discussed below. In re Charter Oil Co., 54 B.R. 91 (Bankr. M.D. Fla. 1985).

This definition includes not only tangible things, but also semi-tangible and intangible items such as natural gas, intellectual property, and financial instruments (provided they are sold in the ordinary course of the seller's business; see below).

2. Identifiability

As a general rule, a seller cannot reclaim goods that have been commingled or are not identifiable. E.g., Scotts Co. v. Hechinger Co. (In re Hechinger Inv. Co.), 274 B.R. 402 (Bankr. D. Del.

2001). Some authority suggests that a seller may reclaim **fungible** goods that have been commingled, provided they are still under the debtor's control and traceable. E.g., Eighty-Eight Oil Co. v. Charter Crude Oil Co. (In re Charter Co.), 54 B.R. 91 (Bankr. M.D. Fla. 1985) (oil that debtor-buyer had pumped into pipeline, where it was commingled with other companies' oil but still traceable to debtor).

3. Received While Buyer Was Insolvent

Technically, the burden is on the seller to prove that the buyer was insolvent at the time of the sale. In re Adventist Living Centers, Inc., 52 F.3d 159 (7th Cir. 1995). Unlike in Section 547 of the Bankruptcy Code, there is no presumption of insolvency for reclamation rights.

In reality, however, insolvency is seldom contested—perhaps because there are so many other grounds for defeating reclamation.

4. Written Demand

The Bankruptcy Code, unlike the UCC, requires a reclamation demand to be in writing. See 11 U.S.C. § 546(c)(1). Some suppliers' attorneys file a notice of reclamation demand in the bankruptcy case, in addition to sending the letter. It is common practice to send a reclamation demand to multiple addresses (e.g., corporate headquarters, the location where the goods were delivered, debtor's counsel, etc.) in anticipation of a potential defense of improper service of the demand.

A reclamation demand should describe the goods as specifically as possible. Many courts require the seller's strict compliance with the applicable statutes for reclamation to be granted. E.g., Scotts Co. v. Hechinger Co. (In re Hechinger Inv. Co.), 274 B.R. 402 (Bankr. D. Del. 2001). As a practical matter, though, most courts permit reclamation provided that the seller provides sufficient information for the buyer, **using information otherwise at its disposal**, to identify the goods. See id. (not granting reclamation but denying debtor's motion to dismiss).

5. Timing of Demand

Although the language of § 546(c) is capable of multiple interpretations, the commonly accepted view is that a supplier has 20 days from the date the bankruptcy petition is filed to

send a reclamation demand for any goods delivered to the debtor within 45 days prepetition.

As discussed below, though, in order to reduce the debtor's potential defenses to reclamation – namely, that the goods have been consumed – a seller should send the reclamation demand as soon as possible after the filing of the bankruptcy case.

6. Forcing Compliance with Reclamation Demand

The usual means of forcing a debtor to comply with a properly sent reclamation demand is to file an adversary proceeding, sometimes when it first becomes clear the debtor will not comply with the demand (in which case the complaint typically seeks an emergency TRO); sometimes much later. In chapter 11 cases where the court has entered a reclamation procedures order, relief may also be available by motion.

E. Defenses to Reclamation

1. Bought by Good-Faith Purchaser

The UCC provides that a seller's reclamation rights are subject to the rights of a buyer in the ordinary course of business or other good-faith purchaser for value.

a. Definition of "Buyer in Ordinary Course of Business"

Usually, it will be relatively uncontroversial whether the buyer resold goods in the ordinary course of business. Notable exceptions include bulk sales. See In re Storage Tech. Corp., 48 B.R. 862 (Bankr. D. Colo. 1985).

Article 1 of the UCC defines "buyer in ordinary course of business" as "a person that buys goods in good faith, without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course from a person, other than a pawnbroker, in the business of selling goods of that kind," with the following clarifications and exceptions:

- Good faith means "honesty in fact and the observance of reasonable commercial standards and fair dealing." UCC § 1-201(b)(20).

- The sale must comport with the usual or customary practices in the kind of business in which the seller is engaged or with the seller's own usual or customary practices.

- A person that sells oil, gas, or other minerals at the wellhead or minehead is a person in the business of selling goods of that kind.

- The method of payment usually does not affect the buyer's status as an ordinary course buyer.

- In order to be an ordinary course buyer, the buyer must take possession of the goods or have a right to recover the goods from the seller under Article 2,

- "Buyer in ordinary course of business" does not include a person that acquires goods in a transfer in bulk or as security for or in total or partial satisfaction of a money debt.

See UCC § 1-201(b)(9).

b. Other Good-Faith Purchaser for Value

The UCC's statement that reclamation rights are subject to the rights of a buyer in ordinary course of business **or other good-faith purchaser for value** suggests that a buyer need not satisfy all of the requirements in paragraph a., above, in order to defeat the seller's reclamation rights. See UCC § 2-702(3).

Nevertheless, bankruptcy courts have held that purchasers in bulk sales do not qualify as purchasers whose rights prime the seller's reclamation rights. E.g., In re Storage Tech. Corp., 48 B.R. 862 (Bankr. D. Colo. 1985).

2. Prior Security Interest in Goods to Be Reclaimed

Under the Bankruptcy Code, a seller's reclamation right is subject to the rights of a holder of a prior security interest. 11 U.S.C. § 546(c)(1); In re Dana Corp., 367 B.R. 409, 419 (Bankr. S.D.N.Y. 2007) (though finding no federal reclamation right, giving effect to language in § 546(c) that reclamation right is subject to prior security interest).

Nevertheless, it is worth noting that the UCC does not expressly provide that reclamation rights are subject to a prior security interest—only buyers in the ordinary course of business and other good-faith purchasers for value. Some courts have held that a holder of a security interest can qualify as a good-faith purchaser. E.g., In re Bridge Information Sys., Inc., 288 B.R. 133 (Bankr. E.D. Mo. 2001) (treating secured party under security agreement containing an after-acquired property clause as a good faith purchaser); cf., e.g., Phar-Mor, Inc. v. McKesson Corp., 534 F.3d 502 (6th Cir. 2008) (holding that DIP lender, and **possibly** any secured lender, is not a buyer in the ordinary course of business or other good faith purchaser for value, and therefore cannot prevent reclamation by seller of goods even where they would be subject to lender's security interest).

Sellers need to be very attentive to the terms of DIP financing motions and orders in chapter 11 cases. Debtors frequently propose DIP financing orders that would grant liens to DIP lenders without regard for any reclamation rights in the collateral for those liens. In some cases, the collateral would not have been reclaimable anyway, as it was pledged to a prepetition secured lender as well. To the extent the debtor is offering otherwise unencumbered collateral to a DIP lender, however, sellers need to be prepared to object. (The result may be an exception in the DIP financing order that is specific to that seller, so a seller should not rely on other sellers' objections.)

3. Use, Consumption, or Substantial Modification

In addition to the defense that the seller's rights are subject to rights of a lien creditor or good-faith purchaser, a common response to reclamation demands is that the goods have been used or consumed. This assertion is more properly characterized as part of the seller's prima facie case than a defense of the debtor. (See "Identifiability" above.)

F. Reclamation by Grain Producer or U.S. Fisherman: § 546(d)

Special rule applies to two types of sellers:

- Producer of grain sold to grain storage facility owned or operated by debtor in the ordinary course of producer's business

- U.S. fisherman who has caught fish sold to a fish processing facility owner or operated by debtor in the ordinary course of fisherman's business

In addition to other requirements of reclamation, grain producers and fishermen have absolute right to reclamation (likely not subject to prior rights of holder of security interest) unless the seller's claim for value of the grain or fish is secured by a lien.

10-day limitation, not 45-day limitation, applies.

APPENDIX 1—RELEVANT STATUTES

Text of 11 U.S.C. § 546(c) (Oct. 1, 2005):

(1) Except as provided in subsection (d) of this section and in section 507(c), and subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of the trustee under sections 544(a), 545, 547, and 549 are subject to the 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, within 45 days before the date of the commencement of a case under this title, but such seller may not reclaim such goods unless such seller demands in writing reclamation of such goods--

   (A) not later than 45 days after the date of receipt of such goods by the debtor; or

   (B) not later than 20 days after the date of commencement of the case, if the 45-day period expires after the commencement of the case.

(2) If a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in section 503(b)(9).

Text of 11 U.S.C. § 546(c) (pre-2005):

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; and

(2) the court may deny reclamation to a seller with such a right of reclamation that has made such a demand only if the court--

   (A) grants the claim of such a seller priority as a claim of a kind specified in section 503(b) of this title; or

   (B) secures such claim by a lien.

APPENDIX 2—SAMPLE RECLAMATION DEMAND

Dear Sir or Madam:

This letter constitutes notice of demand for the return of certain goods purchased by Acme Debtor, Inc. ("Debtor") from Seller Supply, Inc. ("Seller"). Please take notice that pursuant to Uniform Commercial Code § 2-702 and Section 546(c) of title 11 of the United States Code (the "Bankruptcy Code"), and by virtue of the Debtor's insolvency, the Seller hereby reclaims all of the goods received by the Debtor currently in its possession and delivered to it during the applicable period set forth in Section 546(c)(1) of the Bankruptcy Code (the "Goods"). This demand includes, but is not limited to, the Goods described in the invoices attached hereto as Exhibit A.

In light of Debtor's recent bankruptcy filing, you are further notified that all Goods subject to Seller's right of reclamation must be protected and segregated by Debtor and shall not be used for any purpose whatsoever except those specifically authorized following notice and a hearing by the Bankruptcy Court.

Seller expressly retains any and all additional rights, including, but not limited to, additional reclamation rights under the applicable Uniform Commercial Code.

Seller also expressly asserts and reserves its rights to an administrative expense claim for the value of all goods received by Debtor within twenty (20) days before the date of the commencement of the Chapter 11 case in accordance with Section 503(b)(9) of the BAPCPA.

Please call the undersigned to arrange for the immediate return of the Goods.

Sincerely,

[Seller's attorney]

II. ORDINARY COURSE DEFENSE POST BAPCPA

1. Generally

11 U.S.C. § 547(c)(2) setting forth the ordinary course of business defense to a preference action was amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), and the changes are applicable to cases filed on or after October 17, 2005.[2]

Prior to the effective date of BAPCPA, § 547(c)(2) required a creditor to affirmatively demonstrate that the transfer made within the preference period 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 (*i.e.*, the preamble);

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee (*i.e.*, the subjective test); **and**

(C) made according to ordinary business terms (*i.e.*, the objective test).[3]

Under revised § 547(c)(2), a creditor must affirmatively demonstrate that the transfer made within the preference period was:

> (2) …in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee (*i.e.*, the preamble), and such transfer was --
>
> (A) made in the ordinary course of business or financial affairs of the debtor and the transferee (*i.e.*, the subjective test); **or**
>
> (B) made according to ordinary business terms (*i.e.*, the objective test).[4]

As revised, former paragraph (A) has been moved to the preamble of § 547(c)(2), and the remaining text previously found in paragraphs (B) and (C) has now been re-designated as paragraphs (A) and (B). **The most significant change to the statutory text is that the "and" between former paragraphs (B) and (C) has become an "or" in the revised code**.

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[1] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat 23.

The amendments apply to main cases commenced after the effective date of BAPCPA. If the adversary proceeding was filed after the effective date of BAPCPA, but the main case was not, then the former statute still applies. *In re Weaver*, 2007 WL 4868302, fn.2 (Bkrtcy. D.N.D. 2007); *In re Gawronski*, 411 B.R. 139, fn.4 (Bkrtcy. W.D.N.Y. 2009).

[3] Former 11 U.S.C.A. § 547(c)(2).

[4] 11 U.S.C.A. § 547(c)(2)(A-B) (West 2010).

2. Change from the Conjunctive to the Disjunctive

a. Generally

Under the former code, the ordinary course of business defense consisted of three parts, all of which had to be established in order for the creditor to successfully assert the defense. Under the revised statute, assuming that a transfer was made in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and transferee, a creditor asserting the ordinary course of business defense need only show **either** that the transfer was made in the ordinary course of business or financial affairs of the debtor and the transferee **or** that it was made according to ordinary business terms.[5]

It should be noted that when Congress enacted BAPCPA, it apparently intended to limit the use of the "ordinary business terms" prong of the statute to those circumstances when there was "insufficient pre-petition conduct between the parties to establish a course of dealing." [6] The revisions to the statute, however, do not state that limitation, but rather, the amendment simply changed the word "and" to word "or."[7]

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[5] A House of Representatives Report, issued prior to the passage of the revised code, stated:

> [A] trustee may not avoid a transfer to the extent such transfer was in payment of a debt incurred by the debtor in the ordinary course of the business or financial affairs of the debtor and the transferee and such transfer was made **either** (1) in the ordinary course of the debtor's and the transferee's business or financial affairs **or** (2) in accordance with ordinary business terms. **Present law requires the recipient of a preferential transfer to establish both of these grounds in order to sustain a defense to a preferential transfer proceeding.** (emphasis added)

H.R. REP. NO. 109-31(1), at 154 (2005). While the legislative history emphasizes that the word "or" is to be read in the disjunctive, it gives no guidance as to how to interpret the statute. *In re National Gas Distributors, LLC*, 346 B.R. 394, 400 (Bkrtcy. E.D.N.C. 2006).

In the first case interpreting revised § 547(c)(2), *In re National Gas Distributors, LLC,* the court stated that the "ordinary business terms" defense is now a separate and independent defense. *Id.* at 396. *See e.g.*, *In re Gawronski*, 411 B.R. 139 (Bkrtcy. W.D.N.Y. 2009); *In re Enron Corp.,* 357 B.R. 32 (Bkrtcy. S.D.N.Y. 2006); *In re Montgomery Ward, LLC*, 348 B.R. 662 (Bkrtcy. D.Del. 2006); *In re Mastercraft Interiors, Ltd*., 2009 WL 5219724 (Bkrtcy. D.Md. 2009); *In re Pure Weight Loss, Inc.*, 2009 WL 3769671 (Bkrtcy. E.D.Pa. 2009); *In re Wild West World, L.L.C.*, 2009 WL 348544 (Bkrtcy. D.Kan. 2009); *In re Tilton Corp*., 2008 WL 6192252 (Bkrtcy. N.D.Ohio 2008); *In re Firstline Corp*., 2008 WL 2246902 (Bkrtcy. M.D.Ga. 2008); and *In re Hardwood P-G, Inc*., 2007 WL 2329811 (Bkrtcy. W.D.Tex. 2007).

[6] Timothy J. Howard, *What are "Ordinary Business Terms" after BAPCPA?*, 26-SEP AM. BANKR. INST. J. 24 (2007) (*citing* Charles J. Tabb, *The Brave New World of Bankruptcy Preferences,* 13 AM. BANKR. INST. L. REV. 425, 442 (2005)). The change to the ordinary course of business defense had its beginnings with a study sponsored by the American Bankruptcy Institute, in which recommendations to change preference laws were set out, including clarification to the ordinary course of business defense. *In re National Gas*, 346 B.R. at 400-401. The National Bankruptcy Review Commission ("NBRC") followed with its Recommendation 3.2.3, stating 11 U.S.C. § 547(c)(2)(B) should be amended to provide a disjunctive test in which the preference defendant could prevail by showing either conformity to prior conduct between the parties or conformity to industry standards. *See id.* at 401; *see also* Charles J. Tabb, *The Brave New World of Bankruptcy Preferences,* 13 AM. BANKR. INST. L. REV. at 441. The intent of the NBRC report was that the conduct between the parties should prevail to the extent that there was sufficient pre-petition conduct to establish course of dealing and that only in the event there was not sufficient pre-petition conduct to establish a course of dealing, <u>then industry standards should supply the ordinary course benchmark</u>. *Id.* (emphasis added). In BPACPA, Congress adopted the proposed NBRC Recommendation only as to the change from "and" to "or." *Id.*

[7] *See* 11 U.S.C.A. § 547(c)(2)(A-B); *In re National Gas*, 346 B.R. at 401.

Regardless of Congressional intent, under the revised statute, a creditor has protection from preference recovery if the transfer was made according to ordinary business terms,[8] regardless of whether it was made in the ordinary course of business or financial affairs of the debtor and creditor; and a creditor is protected if the challenged transfer was in the ordinary course of its dealings with the debtor, whether or not common in the industry.[9] This conjunctive test may substantially lighten the creditors' burden of proof since it now must only prove either the subjective test or the objective test.[10] One commentator speculated that the change to the disjunctive may reduce recoveries to other creditor groups and increase litigation by causing creditors who might have otherwise settled to defend against preference demands.[11] Whether the speculation is accurate is not yet clear.

b. Effects of the Change to the Disjunctive

i. Evidentiary Hurdles Possibly Removed

One of the problems with the ordinary course of business defense under the former statute was the evidentiary hurdle for the objective test, which required preference defendants to hire an expert or present evidence of a competitor's payment practices to meet the objective test.[12] Under the revised statute, unlike the former statute, a preference defendant does not have to meet both the subjective and objective test, but rather if a creditor can prove that the subjective test was met, it will save itself from the time, money and difficulty of meeting the evidentiary hurdles of the objective test. From a practical standpoint, a creditor that can meet the subjective test may wish to defend its case under this prong, since it lacks the evidentiary standards of the objective test (and the cost associated with presenting such evidence).[13] (However, as discussed in Section 3(c)(ii) of this outline, if creditor is required to establish both the creditor's and debtor's industry practice under the objective test of § 547(c)(2), the evidentiary burden may not be reduced for the creditor.)

ii. Bankruptcy Planning for Creditors

For bankruptcy planning purposes, a creditor may be able to structure its payment transactions in ways that it can be paid according to the more beneficial terms provided by **either** the subjective test **or** the objective test.[14] Because the creditor does not need to prove the

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[8] The court *In re Natural Gas* required the creditor to also prove that the transfer meet general business standards. *See* section 3(c)(ii) of this outline for a full discussion of revised § 547(c)(2)(B).

[9] Richard Levin and Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 603, 637 (2005); 11 U.S.C.A. § 547(c)(2). *See also In re National Gas*, 346 B.R. at 402 ([O]bjective standard could be invoked by a creditor even in instances where a course of dealing existed between the parties and the transfers at issue clearly deviated from that course of conduct).

[10] Richard Levin and Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. at 637.

[11] *Id.*

[12] Kevin C. Driscoll, Jr., *Bankruptcy 2005: New Landscape for Preference Proceedings*, 24-JUN AM. BANKR. INST. J. 1, *56 (2005).

[13] *Id.*

[14] Roberto Cortez and Eli O. Columbus, *"The Ordinary Course of Business" Defense Post-BAPCPA*, 26-FEB AM. BANKR. INST. J. 14, *70 (2007).

payment was made according to ordinary business terms, it may elect a payment method that does not align with industry (or as required by at least one post BAPCPA court, general business practices) as long as the transfer was made in the ordinary course of business or financial affairs of the debtor and the creditor.[15] The inverse may also apply.[16]

For example, assume that applicable industry practice is to have 15-day terms for payment. If the debtor were an important customer of the creditor, however, then payment outside those industry terms may still satisfy the revised ordinary course of business defense if the payment falls within the ordinary course of business or financial the affairs of the debtor and the creditor. As such, a transaction may be structured on the front end with decreased concern for establishing that the transaction fell within industry standards. Now assume that a debtor has paid a creditor within the terms of industry custom. The creditor may structure the transaction on the front end with decreased concern for whether the transaction was within the ordinary course of business or financial affairs of the debtor and the creditor.[17]

A note of caution – currently there are no cases analyzing the revised § 547(c)(2) ordinary course of business defense when a creditor establishes credit terms, that while technically meet either the subjective or objective test of § 547(c)(2), clearly were designed to give "preferential" treatment to the particular creditor. Courts may find a means by which to strike such a payment transfer as a preference given the policy behind preference defenses.

3. Applicable Case Law

There are few cases interpreting revised § 547(c)(2) (most of which are unreported), and of those cases that discuss the revised code, there are some trends that may be emerging with respect to § 547(c)(2)(A), but the analysis of § 547(c)(2)(B) varies from court to court. In addition, courts interpreting § 547(c)(2)(A) have consistently applied pre-BAPCPA case law, however, at least one court has questioned the applicability of pre-BAPCPA case law to § 547(c)(2)(B).

a. Few post-BAPCPA cases discuss the factors that a court must review when determining whether a creditor has met the standard set out in the preamble of § 547(c)(2). And those that do apply pre-BAPCPA case law.[18] This general lack of discussion and focus on

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[15] *See In re National Gas*, 346 B.R. at 402 (objective standard could be invoked by a creditor even in instances where a course of dealing existed between the parties and the transfers at issue clearly deviated from that course of conduct).

[16] *See id.*

[17] *See* Hon. William Houston Brown and Lawrence Ahern, III, *Other Case Administration Issues - Preferential and Fraudulent Transfers – the "Ordinary Course" Defense*, 2005 BANKR. REFORM LEGIS. WITH ANALYSIS 2D §9:45.

[18] *In re Firstline*, 2008 WL 2246902 at *3 (Courts are generally interested in whether or not the debt was incurred in a typical, arms length commercial transaction); *In re Walterman Implement, Inc.*, 2007 WL 4224041, *2 (Bkrtcy. N.D.Iowa 2007) (Creditor must first prove debt was incurred in ordinary course of business or financial affairs of both parties. Transaction creating the debt must be ordinary for both parties. First time transactions must be typical compared to the parties past dealings with similarly situated parties.); *In re Ameri P.O.S.,* 355 B.R. 876, 883 (Bkrtcy. S.D.Flo. 2006) (Court must examine whether the debt was typical and whether it occurred in an arms length transaction); *but see In re Hardwood*, 2007 WL 2329811 at *3 (applying the test applied by most post-BAPCPA courts to § 547(c)(2)(A) to the preamble of the revised code).

this prong of the ordinary course of business defense is not unusual given that the current preamble is merely a re-designation of text found in the prior statute.

b. Ordinary Course of Business: Pre-BAPCPA § 547(c)(2)(B) and Post-BAPCPA § 547(c)(2)(A) - The Subjective Tests

i. Pre-BAPCPA

As stated previously, prior to BAPCPA, in order to establish an ordinary course of business defense, a creditor had to prove that the transfer was made (1) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee (*i.e.*, the preamble), (2) in the ordinary course of business or financial affairs of the debtor and the transferee (*i.e.*, the subjective test), and (3) according to ordinary business terms (*i.e.*, the objective test). There was general consensus as to the factors for the subjective test.

ii. Post-BAPCPA

There is also consensus among cases decided post-BAPCPA interpreting the revised subjective test (*i.e.*, § 547(c)(2)(A)). Generally, in order to determine if a creditor satisfies the subjective test, courts look at the length of time the parties engaged in the transaction, whether the transfer was in an amount more than usually paid, whether the payments were tendered in a manner or form different than prior payments, whether there was any unusual action by the debtor or creditor to collect or pay the debt, and the circumstances under which the payment was made (*e.g.*, whether the creditor did anything to gain an advantage in light of the debtor's deteriorating financial condition).[19] When no established relationship exists between the parties, the creditor must show conformity with contract terms.[20]

All of the above referenced cases cite pre-BAPCPA case law for these factors, indicating that at least as to revised § 547(c)(2)(A), pre-BAPCPA is still good law and indicate that the factors for the subjective test pre-BAPCPA still apply to post-BAPCPA cases.

c. Ordinary Business Terms: Pre-BAPCPA § 547(c)(2)(C) and Post-BAPCPA § 547(c)(2)(B) - The Objective Tests

i. Pre-BPCPA - § 547(c)(2)(C)

While there may have been little dispute over the subjective test of the pre-BAPCPA ordinary course of business defense, courts were split on how to address the objective test.[21] A few courts considered paragraphs (B) and (C) as identical and applied the ordinary

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[19] *See In re Wild West World*, 2009 WL 348544 at *5; *In re Pure Weight Loss*, 2009 WL 3769671 at *5; *In re Walterman*, 2007 WL 4224041 at *2; *In re Mastercraft Interiors*, 2009 WL 5219724; *In re Ameri P.O.S.*, 355 B.R. at 883-84; *In re Firstline*, 2008 WL 2246902 at *4; *but see In re Hardwood*, 2007 WL 2329811 at *3 (applying these same factors to the preamble of the revised code and stating court must determine whether payment was in the ordinary course of business of debtor and transferee). *See also In re Pickens*, 2008 WL 63251, *3 (Bkrtcy. N.D. Iowa 2008) (creditor must show that the transfer was consistent with the pattern of previous transfers between the parties) (order amended on other grounds by *In re Pickens*, 2008 WL 346147 (permitting defendant to assert a new value defense)).

[20] *In re Walterman*, 2007 WL 4224041 at *2; *In re Pickens*, 2008 WL 63251 at *3; *In re Wild West World*, 2009 WL 348544 at *5.

[21] Section 547(c)(2) was amended in large part to alleviate the ambiguity of courts decisions regarding paragraphs (B) and (C). Jonathan P. Friedland, *Preferential Transfers – Litigation over the Statutory Exceptions to Avoidable*

course of business defense when payments were made solely pursuant to the past practice of the debtor and creditor (*i.e.*, the subjective test).[22] Other courts analyzed the objective "ordinary business terms" test in conjunction with, and often subordinate to, the subjective test. In effect, a court weighed the objective and subjective test, giving more or less weight to the objective test depending on the history of the parties' past dealings (*i.e.*, the more established the parties history, the less the court looked to whether the payment was made according to industry practice).[23] The majority of courts required the payments to meet both the subjective and objective tests.[24]

While courts agreed that payment was made "according to ordinary business terms" if the payment practice at issue aligned with the standards of the industry, courts struggled with the issue of what relevant industry standard was to be applied when determining whether a certain transfer satisfied the objective test. Some courts focused on the debtor's industry while other courts applied the standard in the creditor's industry.[25] One commentary states that prior to the revised statute, the norm was to examine ordinary business terms in light of the creditor's perspective.[26]

ii. Post-BAPCPA - § 547(c)(2)(B)

While post-BAPCPA cases analyzing 547(c)(2)(A) may consistently apply pre-BAPCPA case law and may reach consensus as to the factors to be applied to the revised subjective test (*i.e.*, § 547(c)(2)(A)), the analysis of the revised objective test (*i.e.*, § 547(c)(2)(B)) varies from court to court. In addition, at least one court has questioned the applicability of pre-BAPCPA case law to revised 547(c)(2)(B);[27] however, two additional courts stated that cases interpreting former § 547(c)(2) were instructive as to interpreting the revised statute[28] and because the relevant language of § 547(c)(2) remained unchanged, case law interpreting [the former code] remains viable.[29]

Preferences – Ordinary Course Obligations and Payments, COMMERCIAL BANKR. LITIG. § 11:22 (2009).

[22] Robert E. Ginsberg, Robert D. Martin and Susan V. Kelley, *Preference Defenses*, GINSBERG & MARTIN ON BANKR. § 8.03 (2009) (internal case citations omitted).

[23] *See* Jennifer L. Hertz, Paul D. Moore, Michael D. Sousa and Christopher M. Winter, *Ordinary Course of Business Exception*, 3 BANKR. LITIG. § 16:28; Jonathan P. Friedland, *Preferential Transfers – Litigation over the Statutory Exceptions to Avoidable Preferences – Ordinary Course Obligations and Payments*, COMMERCIAL BANKR. LITIG. § 11:22; and Roberto Cortez and Eli O. Columbus, *"The Ordinary Course of Business" Defense Post-BAPCPA*, 26-FEB AM. BANKR. INST. J. at *70.

[24] Robert E. Ginsberg, Robert D. Martin and Susan V. Kelley, *Preference Defenses*, GINSBERG & MARTIN ON BANKR. § 8.03 (internal case citations omitted).

[25] Roberto Cortez and Eli O. Columbus, *"The Ordinary Course of Business" Defense Post-BAPCPA*, 26-FEB AM. BANKR. INST. J. at *70.

[26] Douglas Deutsch and David LeMay, *BAPCPA: Review and Analysis of Business Bankruptcy Provisions after One Year*, JNL. OF BANKR. L. 2007.01-2 (2007).

[27] *In re National Gas*, 346 B.R. at 404.

[28] *In re Horob Livestock Inc.*, 238 B.R. 459, 486 (Bkrtcy. D.Mon. 2007).

[29] *In re Firstline*, 2008 WL 2246902 at *fn.3.

1. Industry of the Creditor or Debtor

The *In re National Gas* court departed from pre-BAPCPA case law and held that "ordinary business terms" had to be examined from both the creditor and debtor's perspective.[30] According to the court:

> [I]f the ordinary business terms defense only requires examination of the industry standard of the creditor, there would be no review or check on the debtor's conduct. Now that the "ordinary business terms" is a separate defense, the court must consider the industry standard of both the debtor and its creditors.[31]

Furthermore, the court stated, "there are **general business standards** that are common to all business transactions in all industries that must be met."[32]

While the court agreed with commentators that BAPCPA was designed to lighten the creditor's burden of proof by allowing the creditor protection from preference recovery if the transfer met industry standards, regardless of whether it was in the ordinary course of business between the debtor and creditor, the court's holding, that a preference creditor must provide admissible proof for both the creditor and debtor's industry, increases, not decreases, the creditor's burden.[33]

With respect to the requirement that courts consider the industry standard of both the debtor and its creditors, three unreported cases decided after *In re National Gas*, while interpreting § 547(c)(2)(B) to require the creditor to establish that the payment was made according to industry practice, are silent as to whether this requires the court to consider the industry standard of both the creditor and debtor (or merely the creditor, as with pre-BAPCPA cases).[34] While these cases may not require inquiry into both the debtor and creditor's industry, it should be noted that *In re National Gas* has not been overruled. As such, creditors and lenders should not, perhaps, expect to win based solely on the testimony of witnesses who have the perspective only of the creditor's industry.[35] A creditor may also have to locate and present

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[30] *In re National Gas*, 346 B.R. at 404 (emphasis added).

[31] *Id.*

[32] *Id.* (emphasis added).

[33] *See id.* at 405; Timothy J. Howard, *What are "Ordinary Business Terms" after BAPCPA?*, 26-SEP AM. BANKR. INST. J. 24.

[34] *See e.g.*, *In re Pickens*, 2008 WL 63251 at *3 (Creditor must identify the relevant industry, provide evidence of industry practice, and demonstrate that the transfer was made in a manner falling within those practices. Only extraordinary dealings fall outside ordinary business terms.); *In re Hardwood*, 2007 WL 2329811 at *3 (Court must compare credit arrangements between other similarly situated debtors and creditors in the industry) (*citing Gulf City Seafoods, Inc. v. Ludwig Shrimp Co., Inc.*, 296 F.3d 363, 368 (5th Cir. 2002) (creditor was the relevant industry); *In re Walterman*, 2007 WL 4224041 at *3 (Creditor must identify the relevant industry, provide evidence of industry practice, and show that the transfer was made in a manner falling within these practices. Only extraordinary dealings fall outside of ordinary business terms.) (*citing*, in part, *In re Tolona Pizza Products Corp.*, 3 F.3d 1029, 1033 (7th Cir. 1993) (creditor was the relevant industry).

[35] Timothy J. Howard, *What are "Ordinary Business Terms" after BAPCPA?*, 26-SEP AM. BANKR. INST. J. 24.

witnesses who can testify to the debtor's industry and the standards applicable to business in general.[36]

2. Healthy Debtor/Debtor in Financial Distress

The court in *In re Wild West* stated that in interpreting the objective test, ordinary business terms are those used in "normal financing relations" including the kinds of terms that creditors and debtors use in ordinary circumstances when debtors are healthy.[37] However, the court in *In re Horob Livestock* stated that the creditor must establish the broad range of business terms employed by similarly situated creditors and debtors, including those in financial distress during the relevant period.[38]

3. General Business Standards / Weighing Subjective and Objective Tests

Interesting to note is that none of the post *In re National Gas* cases require the creditor to meet general business standards that are common to all business transactions in all industries as did the *In re National Gas* court.

Also noteworthy is the decision of the *In re Firstline* court, which held that a payment made according to ordinary business terms must be a transfer made in accordance with standards of the relevant industry, but that in some cases, a lengthy prior business relationship between the parties may offer a basis for departing from a strict analysis of industry standards.[39] When the prior business relationship is brief, however, the court has no choice but to evaluate their dealings strictly according to industry standards.[40] With this court's decision, the pre-BAPCPA weighing of objective and subjective tests appears to be alive and well.

The court in *In re Norsworthy* held that the plain language of the statute precluded a finding that the ordinary course of business defense applied to the transfer of a security interest (citing pre-BAPCPA cases as authority),[41] noting that the security interest merely served to secure debt and not "pay" the debt.[42] The court noted, however, that there may be times when a creditor could receive a security interest in the payment of debt.[43] If, for example, a debtor assigned its right to a mortgage to a creditor in satisfaction of a debt, the transfer of the security interest would then be in payment of a debt.[44]

<u>What We Know/Practical Pointers</u>

- The consensus among courts interpreting revised § 547(c)(2) is that the test is disjunctive, and that each prong has equal footing with the other. This may allow

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[36] *Id.*

[37] *In re Wild West World*, 2009 WL 348544 at *5.

[38] *In re Horob Livestock*, 382 B.R. at 487.

[39] *In re Firstline*, 2008 WL 2246902 at *4.

[40] *Id.*

[41] *In re Norsworthy*, 373 B.R. 194, 205 (Bkrtcy. N.D.Georgia 2007).
[42] *Id.* at fn.4.
[43] *Id.*
[44] *Id.*

creditors to structure payments in ways that the transfer can be made according to the more beneficial terms provided by either the subjective or objective test.

- Evidentiary standards and costs may be lower for a post-BAPCPA creditor, particularly one that satisfies the subjective prong of §547(c)(2). However, if a creditor is required to establish both the creditor's and debtor's industry standards, for § 547(c)(2)(B) defenses, the evidentiary burden may not be reduced.
- So far, courts interpreting revised § 547(c)(2)(A) (*i.e.*, the subjective test) are doing so consistently – generally looking at the same factors as courts evaluating the subjective test under the pre-BAPCPA code.
- Courts interpreting revised §547(c)(2)(B), the objective test, have been less consistent.
    - One case required the defense to be examined from both the creditor's and debtor's perspective, as well as general business standards applicable to all business transactions. Still other courts seem to only be requiring an inquiry into the creditor's industry.
    - One court stated that only healthy debtors should be considered, while another court stated that debtors in financial distress during the relevant period should be considered.
    - One court held that payment made according to ordinary business terms must be a transfer made in accordance with standards in the industry, but that in some cases, a lengthy prior business relationship of the parties may offer a basis for departing from this strict analysis – thus indicating the pre-BAPCPA weighing of the subjective and objective test has not gone away completely.

III. CRITICAL VENDOR PROTOCOLS

A. Legal/Statutory basis for critical vendor orders

1. Section 105(a), which provides, in relevant part, that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."

a. In re Just for Feet, Inc., 242 B.R. 821 (D. Del. 1999).

(i) The District Court held that "Section 105(a) of the Code provides a statutory basis for the payment of pre-petition claims," over the objections of creditors who argued that section 105(a) "does not permit the court to adjust the statutory priorities established by the Code." Id. at 824.

(ii) Relying on the Third Circuit's decision in In re Lehigh & New England Railway Co., 657 F.2d 570 (3rd Cir. 1981), the Court concluded that the "necessity of payment

doctrine" authorizes the payment of pre-petition claims if such payment is "essential to the continued operation of the debtor." Id. at 824-25.

2. Section 363(b)(1), which provides, in relevant part, that "[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course, property of the estate."

   a. In re Tropical Sportswear Int'l Corp., 320 B.R. 15 (Bankr. M.D. Fla. 2005).

      (i) The Court found that a bankruptcy court may utilize sections 105(a) and 363 of the Bankruptcy Code to justify the grant of critical vendor status under appropriate circumstances. Id. at 20.

      (ii). "Satisfaction of a pre-petition debt in order to keep 'critical' supplies flowing is a use of property other than in the ordinary course of administering an estate in bankruptcy under section 363(b)(1) of the Bankruptcy Code." Id. at 16 (citing In re Kmart Corp., 359 F.3d 866 (7th Cir. 2004)).

3. Section 364(b), which "authorize[s] the trustee to obtain unsecured credit or to incur unsecured debt other than under [section 364(a)], allowable under section 503(b)(1) … as an administrative expense."

   a. In re Payless Cashways, Inc., 268 B.R. 543 (Bankr. W.D. Mo. 2001).

      (i) The Court authorized the payment of pre-petition debt under section 364(b) over the objection of the U.S. Trustee who argued that nothing in the Code authorizes the payment of pre-petition debts prior to confirmation of a plan of reorganization. Id. at 546-48.

4. Section 1107(a)

   a. In re Coserv, LLC, 273 B.R. 487 (Bankr. N.D. Tex. 2002).

      (i) The Court concluded that "[i]mplicit in the duties of a Chapter 11 trustee or debtor in possession … is the duty of such a fiduciary to protect and preserve the estate, including an operating business's going concern value." Id. at 497.

5. But see In the Matter of Kmart Corp., 359 F.3d 866 (7th Cir. 2004).

a. Concluding that section 105(a) does not authorize the approval of critical vendor orders.

(i) "[Section 105(a)] does not create discretion to set aside the Code's rules about priority and distribution; the power conferred by section 105(a) is one to implement rather than override." Id. at 871.

(ii) "A 'doctrine of necessity' is just a fancy name for a power to depart from the Code. Although courts in the days before bankruptcy law was codified wielded power to reorder priorities and pay particular creditors in the name of 'necessity', today it is the Code rather than the norms of nineteenth century railroad reorganizations that must prevail." Id.

b. Finding that Section 364(b) does not grant authority for debtors to prefer some vendors over others.

(i) "[Section 364(b)] authorizes the debtor to obtain credit but has nothing to say about how the money will be disbursed or about priorities among creditors." Id. at 872.

c. The Seventh Circuit left open the possibility that Section 363(b)(1) provides a authority to grant critical vendor orders.

(i) "[Section 363(b)(1)] is more promising, for satisfaction of a pre-petition debt in order to keep 'critical' suppliers flowing is a use of property other than in the ordinary course of administering an estate in bankruptcy." Id.

B. Evidentiary Standards Adopted by Court for Determining Whether to Grant Critical Vendor Orders

1. In the Matter of Kmart Corp., 359 F.3d 866.

a. A debtor must establish two elements for a bankruptcy court to approve a critical vendor motion: (i) the disfavored creditors will be as well off with reorganization as with liquidation; and (ii) that the critical vendors will cease deliveries if old debts are left unpaid. Id. at 872-73.

2. In re Coserv, LLC, 273 B.R. 487.

a. The debtor must show three elements are present.

(i) First, it must be critical that the debtor deal with the claimant. To meet this requirement, debtor must show that,

for one reason or another, dealing with the claimant is virtually indispensable to profitable operations or preservation of the estate.

(ii) Second, unless its deals with the claimant, the debtor risks the probability of harm, or, alternatively, loss of economic advantage to the estate or the debtor's going concern value, which is disproportionate to the amount of the claimant's prepetition claim.

(iii) Third, there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim; for example, a deposit, collect on delivery terms, or payment on shipment. Id. at 498-99.

3. In re United American, Inc., 327 B.R. 776 (Bankr. E.D. Va. 2005).

a. A debtor must satisfy three tests:

(i) The vendor must be necessary for the successful reorganization of the debtor.

1. The Court explained that "[n]ecessary requires that there be no alternative. There must be no substitute vendor available even at a greater expense. Alternative means of obtaining the vendor's cooperation in supplying his goods or services must be exhausted. There must be no other 'practical or legal alternative' with which the debtor can deal with the claimant. This means that the vendor's goods or services are essential and that the critical vendor will, in fact, not provide them without exceptional treatment." Id. at 782.

(ii) The transaction must be in the sound business judgment of the debtor.

1. To satisfy this test, "the remedy must be crafted to the circumstance of the case." In order to craft a complete remedy, the debtor must assure that the critical vendor payment assures the vendor's future performance. Id. at 784.

(iii) Favorable treatment of the critical vendor must not prejudice other unsecured creditors. Id. at 782.

C. The typical protocol adopted by bankruptcy courts is to grant critical vendor orders, if at all, on an interim basis, and schedule an evidentiary hearing, after the

unsecured creditors' committee has been appointed, before granting entry of a final order.

D. Critical Vendor Orders

1. Examples of a recently approved critical vendor orders.

a. In re Visteon Corp., Case No. 09-11786 (Bankr. D. Del. 2009)

(i) Visteon's critical vendor order authorized them to pay, in their sole discretion, prepetition claims of: (1) certain suppliers that are not party to executory contracts; (2) certain financially distressed suppliers; and (3) on a provisional basis, certain suppliers that may seek to discontinue supplying products or providing services in breach of their agreements with Visteon.

1. For the latter group of vendors, Visteon also received approval of a procedure whereby the vendor must justify the payment. The procedure provides that Visteon may file and serve a notice of show cause on the vendor on or within three days of making the critical vendor payment. If Visteon files such a notice, the Court will schedule a hearing to consider whether the vendor violated the automatic stay. If the Court concludes that the vendor violated the stay, the vendor will be required to disgorge the payment made by Visteon and pay attorneys' fees and interest accrued on the critical vendor payment.

(ii) The critical vendor order provides that the critical vendor payments shall be made in exchange for the extension of normal and customers post-petition trade terms, practices and programs, including, credit limits, pricing, cash discounts, timing of payments, allowances, rebates and other applicable terms and programs.

b. In re Smurfit-Stone Container Corp., Case No. 09-10235 (Bankr. D. Del. 2009).

(i) The Critical Vendor Order authorized the debtors, in their discretion, to pay the prepetition claims of critical vendors up to the amount of $50,000,000. The order also provided that the debtors may seek authority to increase the cap to $60,000,000 based on a motion upon seven business days notice.

(ii) The Critical Vendor Order also provided that the debtors "shall undertake all appropriate efforts to cause each critical vendor to enter into an agreement with the Debtors" that includes the following terms:

1. The critical vendor's agreement to provide goods and/or services to the debtors upon customary trade terms (including, but not, limited to, credit limits, pricing, cash discounts, timing of payments, allowances, rebates, coupon reconciliation, normal product mix and availability and other applicable terms and programs), or such other favorable trade terms as mutually agreed to by the debtors and such critical vendor.

2. The critical vendor's agreement that it will not separately assert or otherwise seek payment of any reclamation claims.

3. If the critical vendor who has received payment of a prepetition claim subsequently refuses to supply goods to the debtors on customary trade terms or other favorable trade terms, any payments received by the critical vendor will be deemed to have been in payment of then outstanding postpetition obligations owed to such critical vendor, and that such critical vendor shall immediately repay to the debtor any payments received on account of its critical vendor claims to the extent that the aggregate amount of such payments exceed the postpetition obligations then outstanding, without the right of setoff or reclamation.

(iii) Unless otherwise agreed to by the debtors, in their sole discretion, any payment of critical vendor claims shall be applied first to the critical vendor's claims for goods received by the debtors within twenty (20) days of the petition date with the remainder, if any, being applied to the critical vendor's claims for goods received by the debtors prior to the twenty (20) days of the petition date.

IV. POST-PETITION COMPLIANCE WITH PREPITION EXECUTORY CONTRACT-MUST A SUPPLIER KEEP SUPPLYING?

A. There are no reported decisions directly on point that address the question of whether a supplier must provide goods or services on credit to a debtor post-petition pursuant to a pre-petition executory contract.

B. General Rule: Most courts agree that before an executory contract is assumed or rejected under Section 365(a), that the contract is enforceable by the debtor-in-possession, but not enforceable against the debtor-in-possession. In re National Steel Corp., 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004); See In re Rhodes, Inc., 321 B.R. 80, 91 (Bankr. N.D. Ga. 2005); In re Public Service Company of New Hampshire, 884 F.2d 11 (1st Cir. 1989); Matter of the Travelot Company, 286 B.R. 462, 466 (Bankr. S.D. Ga. 2002); But see In re Lucre, Inc., 339 B.R. 648 (Bankr. W.D. Mich. 2006).

1. The Courts that have propounded this view have generally not addressed the right of a counterparty to withhold performance under the pre-petition executory contract or unexpired lease that the debtor-in-possession seeks to enforce post-petition on the credit of the counterparty. Instead, Courts have stated this position in determining other issues relating to an executory contract or unexpired lease. In the Matter of the Travelot Company, 286 B.R. 462 (motion to compel debtor to make an expedited decision on whether to assume or reject contract); In re Rhodes, Inc., 321 B.R. 80 (motion of landlord to compel payment of rent under unexpired leases). Courts, in general, have concluded that a debtor-in-possession that elects to receive the benefits of an unassumed executory contract or unexpired lease pending a decision whether to assume or reject must pay the reasonable value for the goods or services as an administrative expense, but such Courts were not addressing the issue of whether the counterparty must extend credit in the first instance. See In the Matter of the Travelot Company, 286 B.R. at 466; In re Rhodes, Inc., 321 B.R. at 91; In re Collins & Aikman Corp., 384 B.R. 751, 759 (Bankr. E.D. Mich. 2008)("… when third parties are *induced* to supply goods or services to the debtor-in-possession the purposes of § 503 plainly require that their claims be afforded priority.").

C. The Continental Energy Court expressed a position that is clearly mindful of the interests of the counterparty to an executory contract. In re Continental Energy, 178 B.R. 405 (Bankr. M.D. Pa. 1995).

1. In Continental Energy, the debtor-in-possession sought a preliminary injunction requiring a fuel supplier to provide the debtor with a continuous supply of natural gas until such time as the debtor decided whether to assume or reject the fuel supply contract. The debtor offered to pre-pay for the usage of natural gas, however, reserved the right to seek the return of the payments to the extent the contract price exceeded the reasonable value for the gas. The counterparty maintained that the court had no power to compel the supplier to furnish gas to the debtor at a price mandated by the court.

2. The Court stated that "at first glance, the concept that a contract should not be enforceable by either side to a contract until it has been assumed by the debtor make imminent sense. If it is accepted that the non-debtor party to

a contract is stayed from enforcing the terms of that contract on a debtor prior to assumption, then fairness would seem to suggest that the converse should also be true. .. This approach, however, minimizes the impact that nonperformance may have on a debtor. … [I]t pressures the Debtor to surrender the "breathing space" normally allowed to it to consider the assumption or rejection of the contract." Id. at 408.

3. The Court held that, pursuant to section 105, it "can issue an order that would allow such debtor to enforce the contract until such time that it accepts or rejects the contract, *provided that we diligently guard the interests of the non-debtor party to the contract.*" Id. (emphasis added). The Court concluded that the debtors proposed payments in advance protected the supplier from any pitfalls that could befall it by the enforcement of the natural gas supply agreement. Id. at 409.

4. See also In re Ike Kemper & Bros., Inc., 4 B.R. 31 (Bankr. E.D. Ark. 1980) (shoe manufacturer can be compelled to fulfill orders for shoes conditioned on debtor in possession issuing check prior to shipment); In re Sportfame of Ohio, Inc., 40 B.R. 47, 52-53 (Bankr. N.D. Ohio 1984) (pursuant to section 105(a), debtor granted injunctive relief and counterparty compelled to fill order for goods on cash basis).

D. The Lucre decision advanced a view, albeit a minority view, that a debtor-in-possession cannot compel performance under an pre-petition executory contract under which the debtor-in-possession is in breach. In re Lucre, Inc., 339 B.R. 648.

1. Citing the Restatement (Second) of Contracts § 237, the Court stated "the right of one party to cease performing under an agreement if the other party is in material breach is fundamental to any contact where both parties have ongoing performance obligations." Id. at 652.

2. The Court recognized that executory contracts and unexpired leases are property of the bankruptcy estate under section 541(a). But, the Court explained that the "debtor-in-possession can have no greater or different rights than the debtor with respect to an executory contract or unexpired lease unless the Bankruptcy Code itself provides those rights. If the Bankruptcy Code is silent, then the trustee or debtor-in-possession is subject to the same laws and regulations as those that had constrained the debtor pre-petition." Id. at 654-55.

3. The Court then ask the question what, if any, section of the Bankruptcy Code empower the debtor-in-possession to compel performance under a pre-petition executory contract notwithstanding the debtor's alleged pre-petition breach of the agreement. Id. at 655. The Court addressed certain Bankruptcy Code provisions typically invoked by a debtor seeking to enforce a pre-petition executory contract post-petition. The Court

concluded that nothing in the Bankruptcy Code permits the debtor to ignore the counterparty's rights under the contract if the debtor were not in bankruptcy.

a. With respect to Section 365, the Court concluded as follows:

(i) "[C]ourts have tended to read in Section 365 more than that section actually provides." Id.

(ii) "Section 365 is nothing more than a set of rules concerning various issues which arise in connection with the trustee's decision to permanently retain (i.e., assume) the debtor's rights under an executory contract or unexpired lease or to abandon (i.e., reject) those rights …." Id. at 656.

(iii) "[N]one of [Section 365's] subsections permit the trustee to ignore the terms of an executory contract or unexpired lease during the post-petition interval when she is deciding whether to assume or reject it." Id.

b. With respect to Section 362(a)(6), the Court concluded as follows:

(i) The counterparty cannot be found to be violating section 362(a)(6) when it is the debtor that is seeking to compel performance and it is the counterparty that is accused of doing nothing. Id. at 658.

(ii) "The mere commencement of the bankruptcy case and the attendant imposition of the automatic stay do not by themselves empower a debtor, as debtor-in-possession, to compel from the other party to an executory contract performance the day after the commencement of the bankruptcy case when the debtor had no right to compel that performance the day before." Id. at 660.

c. With respect to Adequate Protection under Section 361, the Court concluded that:

(i) "[E]ach of the subparts of Section 361 reference protecting the value of the other entity's value in property. Protecting value makes sense in instances where the bankruptcy estate is in possession or control of property in which another party claims a lien or some other interest. A secured creditor or other interest holder who is stymied by the automatic stay is entitled to adequate protection as compensation for the property's deterioration while it remains with the bankruptcy estate. However, the concept of protecting value through the award of adequate

protection does not fit well in the realm of executory contracts. … [T]he bankruptcy estate's retention of the debtor's rights under the executory contract does not detract from the value of the other party's rights in the contract." Id. at 659.

E. In a matter involving the sale of goods, a supplier may attempt to invoke its rights under the Uniform Commercial Code.

1. Contracts for the sale of goods are governed by Article 2 of the Uniform Commercial Code. See Pittsburgh-Canfield Corp., 283 B.R. 231, 236 (Bankr. N.D. Ohio 2002); Reich v. The Republic of Ghana, 2002 WL 142610 *2 (S.D.N.Y. 2002).

a. A number of Bankruptcy Courts have recognized a counterparties' right to refuse delivery of goods under UCC Section 2-702. See e.g., In re Kellstrom Industries, Inc., 282 B.R. 787 (Bankr. D. Del. 2002); In re Morrison Industries, L.P., 175 B.R. 5 (Bankr. W.D.N.Y. 1994).

(i) UCC Section 2-702(1) provides that "[i]f the seller discovers that the buyer is insolvent, the seller may refuse delivery except for cash including payment for all goods theretofore delivered under the contract, and stop delivery under Section 2-705."

b. UCC Section 2-609—The Right to Adequate Protection

(i) § 2-609 Right to Adequate Assurance of Performance

(1) A contract for sale imposes an obligation on each party that the other's expectation of receiving due performance will not be impaired. If reasonable grounds for insecurity arise with respect to the performance of either party, the other may demand in a record adequate assurance of due performance and until the party receives the assurance may if commercially reasonable suspend any performance for which it has not already received the agreed return.

(2) Between merchants, the reasonableness of grounds for insecurity and the adequacy of any assurance offered shall be determined according to commercial standards.

(3) Acceptance of any improper delivery or payment does not prejudice the aggrieved party's right to demand adequate assurance of future performance.

(4) After receipt of a justified demand, failure to provide within a reasonable time not exceeding 30 days such assurance of due performance as is adequate under the circumstances of the particular case is a repudiation of the contract.

(ii) A debtor's bankruptcy filing, and the risk of administrative insolvency, is a reasonable basis for demanding adequate assurance. In re JW Aluminum Company, 200 B.R. 64, 67 (Bankr. M.D. Fl. 1996).

(iii) See also Panasonic Automotive Systems Company of America's Motion for Order Under Michigan Uniform Commercial Code § 2-609 and 11 U.S.C. § 105(a) and 365(d) Compelling the Debtors to (I) Provide Adequate Assurance of Performance of (II) Assume or Reject the Pre-Petition Contract (Panasonic sought adequate assurance of performance in the nature of cash-in-advance payment terms or, alternatively, an irrevocable stand-by letter of credit) In re Visteon Corp., Case No. 09-11786 (Bankr. D.Del. 2009) (Dkt. No. 275).

F. In advancing the principle of providing a debtor-in-possession a "breathing space," and pursuant to sections 105(a), a Court may conclude that it has authority to compel performance of a pre-petition executory contract and to require the extension of credit by the counterparty to the contract on the basis that the counterparty is adequately protected by the administrative expense priority afforded under Section 503 of the Bankruptcy Code.