

# Building Blocks

BY ANDREW L. BROWN

## “Critical Vendor”: The Courts Don’t Think It Means What You Think It Means

Picture the following scenario: You are a small business owner and a supplier of goods to a customer who has failed to pay for the goods that you provided to them. You call to inquire about the missed payments. The customer is very apologetic and seeks to maintain this critical business relationship, so the customer sends a check as partial payment, which is promptly cashed. A month later, that customer files for bankruptcy. The customer seeks to continue doing business with its vendors, as that is critical for them to survive. The bankruptcy court enters an order allowing the customer to pay its critical vendors. You receive payment on the rest of the money owed. A year later, you receive a letter from a law firm that represents the estate of the bankrupt customer, which demands that you return the partial payment received before the bankruptcy, or they will file a lawsuit against you. What is going on, you ask yourself? I thought I was critical?



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### Preference Payment Rule and Typical Defenses

Welcome to the world of bankruptcy, where § 547 of the Bankruptcy Code permits a debtor to demand that creditors return payments they received within 90 days before the debtor filed for bankruptcy.<sup>1</sup> These payments within 90 days are known as “preference payments.” In theory, this section is supposed to ensure that all creditors are treated equally in bankruptcy and to discourage a creditor from pressuring the debtor into paying them ahead of other creditors on the eve of bankruptcy. In practice, preference claims can be unfair to defendant creditors.

For those creditors who find themselves in the middle of, or being threatened with, a preference lawsuit, there are several defenses that can help minimize exposure. The two most common defenses are the “ordinary course of business” and “new value” defenses.<sup>2</sup> The ordinary-course-of-business defense looks at the historical interactions between the two parties and the typical range between invoice date and payment date. Payments falling within an ordinary range are protected from preference claims. However, the new-value defense pro-

fects both payments made contemporaneously with an exchange of goods or services and subsequent transfers of goods or services. For example, a customer pays a creditor \$1,000 for a prior shipment of goods received not within the ordinary course of business. This would be a clear preference payment. However, the creditor then sends the customer another \$1,000 worth of goods. This subsequent transfer of new value would offset the previous \$1,000 preference payment.

### Critical Vendors

On the other hand, a creditor can obtain favorable treatment if it is classified as a “critical vendor.” Creditors deemed “critical” by the debtor are entitled to have their prebankruptcy claims paid, but the “critical vendor” concept is not explicitly spelled out in the Code. Rather, the critical-vendor doctrine stems from the doctrine of necessity and the Code’s overall goal of trying to preserve the debtor’s value.<sup>3</sup> The idea is that some creditors may stop dealing with a financially distressed company out of fear that they will not be paid for any goods or services provided. If a vendor is particularly important to the debtor maintaining its business, then the bankruptcy court can authorize payment of pre-petition debts of that vendor. In exchange, the vendor typically must continue doing business with the debtor.

### Critical-Vendor Status as a Defense to a Preference Claim

The existence of preference claims and critical vendors in bankruptcy leads to a predictable question: Are pre-petition payments received by a critical vendor still subject to later preference claims? Many creditors deemed “critical” and later hit with a preference lawsuit argue that their critical-vendor status is a complete defense. They usually argue there was no preferential treatment because even if they had not been paid pre-petition, they would have been paid in full post-petition by virtue of being a critical vendor. However, two recent court cases have answered the question affirmatively, leaving critical vendors with potentially significant preference exposure.

<sup>1</sup> 11 U.S.C. § 547(b).  
<sup>2</sup> 11 U.S.C. § 547(c).

<sup>3</sup> See, e.g., *In re LCI Holding Co.*, No. 12-13319 (KG), 2013 WL 1101111 (Bankr. D. Del. March 15, 2013).

## Critical-Vendor Defense in Delaware

In *In re Insys Therapeutics Inc.*,<sup>4</sup> Hon. **John T. Dorsey** held that critical-vendor status alone is not enough to bar preference claims against a creditor. In *Insys*, the debtors were a specialty pharmaceutical company that developed drugs and drug-delivery systems. McKesson Corp., RelayHealth Pharmacy Solutions and McKesson Specialty Arizona Inc. (collectively, the “defendants”) had entered into pre-petition contracts to distribute drugs manufactured by the debtors and implement certain programs related to the debtors’ drugs.

Prior to the bankruptcy filing and within the 90-day preference period, the defendants had received more than \$150,000 in payments on their contracts. After the debtors filed for bankruptcy, they filed a critical-vendor motion naming the defendants as critical vendors. The critical-vendor motion was granted by an order (the “critical-vendor order”), which provided that “[t]he debtors are authorized, but not directed ... to maintain and administer the Customer Programs which counsel for [the] Defendants confirmed during the [first-day] hearing included those involving [the] Defendants.”<sup>5</sup> Almost two years after the critical-vendor motion had been granted, the bankruptcy trustee sought to recover the payments by filing a preference complaint. The defendants filed a motion to dismiss.

The defendants argued that there was no preferential treatment, because the critical-vendor motion authorized the debtors to pay the defendants. Even if the debtors had not made the payments to the defendants pre-petition, the debtors would have been obligated to pay them post-petition under the critical-vendor order. The trustee argued that the critical-vendor order was discretionary, not mandatory, and therefore there was no obligation to pay the defendants. The trustee also argued that the critical-vendor order also expressly reserved all preference claims.

Judge Dorsey agreed with the trustee. Relying heavily on Hon. **Mary F. Walrath**’s *Hayes Lemmerz*<sup>6</sup> opinion and surveying other case law, Judge Dorsey held that the “critical vendor defense” to preference claims has only been successful in the Third Circuit where either (1) the debtor is required to pay the pre-petition claims, either by order, stipulation, agreement or statute; or (2) the creditor against whom the preference action is asserted holds a priority claim.<sup>7</sup> Because the critical-vendor motion at issue was discretionary, the defendants did not have a critical-vendor defense to the preference action.

## Critical-Vendor Defense in New York

In *In re Pers. Commc’ns Devices LLC*,<sup>8</sup> Hon. **Alan S. Trust** also held that a creditor was not entitled to a critical-vendor defense on their preference claim. In *Devices*, Devices Liquidation Trust (the “plaintiff”) sought to recover as preferential payments nearly \$4 million from KMT Wireless LLC (the “defendant”). The debtors in the bankruptcy case were in the business of distributing mobile phones and accessories.

As part of the sale of mobile phones, the debtors promised their customers certain repair services pursuant to various guaranties. The defendant was a third party that the debtors contracted with to provide these repair services.

During the 90-day preference period, the debtors paid the defendant almost \$4 million in payments under those repair contracts. After filing for bankruptcy, the debtors filed a critical-vendor motion seeking to continue using various third-party repair services, including the defendant, and deeming them critical vendors. The court granted the motion and authorized, but did not require, the debtors to honor pre-petition obligations to the defendant.<sup>9</sup> The court later confirmed a liquidating plan, and a liquidating trustee was appointed.

The liquidating trustee filed an adversary complaint to avoid the almost \$4 million in transfers to the defendant. In a case of first impression in the Second Circuit, the defendant argued that because the critical-vendor order entitled it to be paid for its pre-petition claims, the court should engage in a hindsight analysis, and ask itself whether it would have granted preference immunity to the defendant had it been asked to do so in the critical-vendor order.

The court surveyed case law and found that courts have been skeptical of a critical-vendor defense to a preference action when (1) the court had not required payment of the preference amount, (2) the court had not approved a waiver of preference liability, or (3) the debtor had not assumed or assigned an executory contract with the creditor where the cure provisions of § 365 would come into play. The court then noted that the critical-vendor order in this case did not require payment of the defendant’s pre-petition claim, there was no mention of preference liability waiver, and the debtors were not trying to assume and assign an executory contract of the defendant. As such, the court rejected the defendant’s critical-vendor defense and denied summary judgment on the preference action.

## Conclusion

The two cases outlined herein demonstrate that bankruptcy courts will likely apply the critical-vendor defense to preference actions narrowly. Creditors hoping to take advantage of such a defense should pay careful attention to the language in a critical-vendor motion and the proposed form of order. Specifically, creditors should make sure, at a minimum, that the critical-vendor order requires payment of pre-petition claims of those creditors deemed critical and should make sure that preference liability release language is present in the order.

While a debtor will likely push back on including a broad release for all critical vendors, certain vendors might have enough commercial leverage to negotiate a waiver from the debtor of specific claims against the vendor. However, not all vendors will be so favorably postured, and the optimal approach would be for a critical vendor to negotiate for language in the critical-vendor order permitting, but not requiring, the debtor to agree to a preference waiver in its sole discretion. **abi**

<sup>9</sup> *Id.* at 664.

<sup>4</sup> Adv. No. 21-50176 (JTD), 2021 WL 3083325 (Bankr. D. Del. July 21, 2021).

<sup>5</sup> *Insys*, 2021 WL at \*1 (internal quotations omitted).

<sup>6</sup> *In re Hayes Lemmerz Int’l Inc.*, 313 B.R. 189 (Bankr. D. Del. 2004).

<sup>7</sup> *Insys*, 2021 WL at \*4.

<sup>8</sup> 588 B.R. 661 (Bankr. E.D.N.Y. 2018).