
BERNSTEIN

LAW FIRM, P.C.

TRADITION • TECHNOLOGY • TALENT

CLIENT ADVISORY

(May 2003)

Creditors Beware: Critical Vendor Payments May Supercede Bankruptcy Priorities

Bankruptcy proceedings are supposed to be fair and reasonably predictable. Who gets what and in which order is all set out very neatly in the Bankruptcy Code. If you are a secured creditor, you get the value of your collateral, then the expenses to administer the case are taken care of, and what is left is parceled out first to the unsecured claims with priority (like back tax payments and wages) and the rest goes to the unsecured creditor pool. It is all very equitable and all very predictable. Or is it?

Decisions in recent high profile cases and strategies of some unsecured creditors – you know, the guys who are supposed to be (almost) last in line – have turned the neatly arranged bankruptcy rules on their head. The claims of the *Critical Vendor* – unsecured creditors who, ostensibly, provide goods and services that are critical to the bankrupt business getting back on its feet – have taken priority over even those priority unsecured creditors. When it comes to getting your fair share from the bankruptcy proceedings, where you are in line under the rules of the game may take a back seat to how important you are to the bankrupt's ability to reorganize quickly.

The Critical Vendor payments fall under the Necessity of Payment Doctrine, also referred to as the Rule of Necessity, which basically says that because rehabilitating a struggling business is the fundamental purpose of Chapter 11, the courts can look first at which creditors are essential to the bankrupt's business. They get paid first to avoid a disruption in service and creditors with greater or equal priority interest just have to wait in line and hope that there is something left over after the Critical Vendors are paid.

The recent Kmart case is perhaps a striking example of how Critical Vendor payments are superceding the rules of the bankruptcy game. In the very first days after that the retail giant's Chapter 11 petition was filed, it sought and received, as part of its

(continued)

“first day orders,” authority to pay hundreds of millions of dollars to unsecured creditors which Kmart urged were critical to the company’s ability to reorganize. In the Kmart case, the largest payments were made to its grocery vendors, all unsecured creditors. It was argued, and the court agreed, that Kmart could not successfully conduct business without certain goods being available on its store shelves. First-in-line creditors were left in the lurch, since they were not considered “critical” to the mammoth retailer’s ongoing operations.

The Kmart court, like many others, tried to balance the interests of the reorganization with the payment scheme under the Code. Recently, however, an appellate Court *reversed the ruling* and told Kmart the payments were improper and to get the money back! That decision is on appeal to another level appellate court. Whether the decision will stand and how Kmart can recover the funds is still an open question.

While legal authority to pay the so-called critical vendors is in dispute, the tactic has been employed with greater frequency over the last several years. Often, if unsecured claims are paid early in the case and the attempt to reorganize nevertheless fails necessitating liquidation, lessors and (“noncritical”) unsecured creditors may end up receiving even less.

Given this apparent trend, it is now more important than ever to keep close tabs on bankruptcy proceedings from the start in order to protect your interests. Careful monitoring of the case from its inception, along with active participation, is imperative to ensure that your ability to receive your rightful payments under the bankruptcy rules is not jeopardized. Where your products or services are, in fact, critical, you may be afforded special treatment.

For more information on how you can protect your interests in a bankruptcy, please contact Bob Bernstein at the Bernstein Law Firm, P.C. at 412-456-8101 or toll free at 1-800-927-3197; email: bob@bernsteinlaw.com .

For more information about Bankruptcy and Critical Vendor payments, visit the “Publications” area of our website at www.bernsteinlaw.com.

NOTE: Information contained herein is a summary of complicated matters. It is not intended to convey legal advice. Before you act on any information provided in this document, you should seek professional advice regarding its applicability to your specific circumstances ©2003, All rights reserved.

Bernstein Law Firm, P.C. is a full service creditor’s rights and bankruptcy law firm that can assist clients nationwide regarding enforcement and bankruptcy issues, including preferential payment claims.