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Critical-vendor status key in bankruptcy

Vendors often fare poorly in a bankruptcy setting, usually receiving a fraction of the amount owed on debts accrued before the filing. The Bankruptcy Code, as a general rule, prohibits any payments on unsecured claims that arose prior to the bankruptcy filing. Instead, creditors must wait until the company is reorganized and emerges from bankruptcy, a process that can take years.

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Moreover, the code contains a priority system that ranks general unsecured claims as the lowest class of creditors. As a result, the bankruptcy process usually does not provide a meaningful dividend to unsecured creditors.

There are, however, numerous cases where some vendors get paid more often and to the exclusion of others, often during the course of bankruptcy. What are these fortunate few doing differently than those vendors who wait until the end of a case to recover pennies on the dollar?

In part, they are aggressively utilizing their status as a "critical vendor" to get paid. Although the concept of payments to such vendors is not new, it has become fashionable in recent years in bankruptcy cases large and small.

The basis for payment of a pre-petition claim using post-petition operating funds is that the particular vendor is necessary to a successful reorganization. If payment is not made to that vendor, the debtor will be unable to obtain the goods or services essential to the reorganization. In recent cases, most courts have liberally granted debtors' motions to make payments to critical vendors under the necessity doctrine and the court's broad powers.

Here are some guidelines for pursuing critical vendor status:

•Payment as a critical vendor is essentially at the discretion of the debtor. While a creditor could certainly file its own motion seeking payment as a critical vendor, if the debtor does not support the motion, it would be highly unlikely the creditor would succeed.

•If a debtor is inclined to make payments to critical vendors, it must file a motion requesting the bankruptcy court to authorize payment. Usually such motions by the debtor indicate the aggregate amount of payments contemplated for critical vendors and often categorize vendors into classes, with sub-amounts for each.

•Once the court approves, debtors typically attempt to minimize what's paid to critical vendors by negotiating with individual creditors to determine who is truly critical.

•Usually, creditors who resume shipping post-petition, particularly on credit, are deemed not critical, and the debtors will not find it necessary to pay their pre-petition claims. Conversely, those vendors who withhold shipments, assuming the debtor in fact needs their goods or services, usually receive payment.

•For the vendor, it's a tough management decision to risk future business by withholding shipments to the debtor post-petition, with the goal of receiving payment on the pre-petition debt. The larger the amount of the pre-petition debt, the tougher the decision.

•Vendors who are paid as a critical vendor are generally required to provide credit terms to the debtor during bankruptcy. Since debts owed for post-petition shipments enjoy a priority status under the code, this is usually a worthwhile trade-off. Even if a vendor's overall exposure is not reduced, converting the debt from pre-petition unsecured status to post-petition priority status is a smart move.

•Most bankruptcy courts routinely approve critical vendor payments. However, the Feb. 24 decision in the Kmart case is a notable exception. In that decision, the U.S. Court of Appeals in Chicago ruled that neither the doctrine of necessity nor Section 105(a) of the Bankruptcy Code (allowing a court to issue any order, process or judgment needed to carry out the provisions of the code) was a proper basis to approve payments to Kmart's critical vendors. Despite that ruling, most courts throughout the country continue to support payments to critical vendors.

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