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Article 4

# Forum Shopping, First Day Orders, and Case Management Issues in Bankruptcy

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# Forum Shopping, First Day Orders, and Case Management Issues in Bankruptcy*

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MR. CIERI: We're actually going to try to cover three topics today, forum shopping, first day orders, and case management issues arising in Chapter 11 cases. The first topic that we will cover is venue (or forum shopping). This is a particularly interesting issue to discuss today because of a new decision that has come down out of the United States District Court for the Northern District of Illinois. This court's decisions will certainly affect the desirability of debtors to commence Chapter 11 cases in this district. But before we talk about that decision, we will provide a little bit of background with respect to the issue of venue (or forum shopping).

The statutory framework for choosing where a debtor may commence a case is set forth in 28 U.S.C. Section 1408. The statute provides that a debtor can file or commence a case in five different places: a debtor's domicile, its residence, its principal place of business, where its principal assets in the United States are located for the greater of 180 days before the filing of the bankruptcy petition, or in the same district as a pending bankruptcy case concerning the debtor's affiliate, general partner, or partnership.

Basically you can file a case where you perform a substantial amount of business, you can file a case where you are headquartered, and you can file a case where there is a pending case involving an affiliate company.

On a practical basis, the affiliated company venue basis often times leads debtors to commence a case for a subsidiary that does not have any assets or has limited operations. It's a protective filing. The filing protects a venue in which the debtor may later wish to commence a case.

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For example, if you take *KMart*,[1] KMart could have commenced a case for one of its real estate subsidiaries under this venue basis in Chicago. This action would have protected KMart against an involuntary filing that may have been commenced against it in Southfield, Michigan, where they're headquartered. And then, if that involuntary was ever filed against K-Mart in Southfield, they could have just transferred the case to Chicago as a matter of right because there was a case pending with an affiliate.

While that is the statutory framework for venue, the following factors are what is really important for an understanding of how people go about choosing a venue: first, the differences in the law among the judicial districts on key issues, and Judy Miller is going to touch on that in a few minutes; second, the relative experience and predictability of the bankruptcy courts in the potential districts; third, the convenience of the judicial district to the parties; and finally, the probability that the venue will likely be challenged.

For a long time, bankruptcy practitioners would go to Delaware and commence every case in Delaware. It was very convenient. All the New York lawyers could hop on the train and go to Delaware in the morning and come back in the evening and see their families. It was really a pretty nice thing. Everybody knew what were the good hotels in Delaware, and the one or two good restaurants.

HON. FITZGERALD: I have a room dedicated to me in Delaware.

MR. CIERI: But then we found out that questions of law actually became important in bankruptcy cases, you simply can't file cases based upon a place where it's comfortable to sleep, or a place where you might get a good meal, and Delaware became a less favorable venue to commence a case. And again, Judy Miller will touch on some of this.

But, in the view of some practioners, the Third Circuit has become a bad place to file a case because of some bad law regarding intellectual property, which actually suggests the possibility that the debtor cannot assume a contract that it might not be able to assume outside of Chapter 11. Also, it has become the view of some practioners that Delaware is a bad place to commence a case because of some decisions with respect to how you determine solvency at the time dividend payments may have been made, determining solvency at a time a company may have entered into certain transactions, and how a court may

1. Kmart filed for Chapter 11 bankruptcy on January 22, 2002 in the United States Bankruptcy Court for the Northern District of Illinois.

actually arrive at a solvency determination when you measure a company's contingent tort liabilities.

And, lastly, it may have became a bad place to commence a case because it became really hard for debtors to assign claims to third parties to pursue; a practice that we have all engaged in for many years. And it's the only practical way of trying to deal with claims that a creditors' committee might actually want to bring, that the debtor probably wouldn't want to bring. For example, pursuing claims against former directors and officers.

In choosing a venue, the second thing we focus on as practitioners is the relative experience and predictability of the bankruptcy courts in the potential districts. And again, Delaware was a wonderful place to file because when you went to court on the first day of a case, you knew how far you could push your requests for "first day" relief. Everybody knew what the rules were with respect to "first day" relief.

In addition, when you went to Delaware you knew exactly what the rules were for your DIP financing or debtor-in-possession financing. There were not a lot of negotiations regarding the terms of a 30-page order. You knew what the court would accept and what the court would not accept. In fact, we are going to touch on that whole issue of predictability in the context of a recent decision that just came down in the *KMart* case.[2]

The third factor that is important for practitioners in choosing a venue, is the convenience of the judicial district to the parties. There are some people who would suggest that Mr. Kieselstein's partner, Jamie Sprayregen, commenced the *United Airlines* case in Chicago because, why, he wanted to be able to go home at night and sleep. And if you know Jamie, it's very infrequent for him to get home.

MR. KIESELSTEIN: It's very infrequent for him to sleep.

MR. CIERI: And this whole convenience of the judicial district to the parties is really touched on in the *Enron*[3] decision that is discussed in the materials. In *Enron*, the court basically said New York is something special because all the bankruptcy practitioners, all the banks, and the restructuring professionals are mostly centered in New York. Well, I would like to disagree with that but—

HON. FITZGERALD: Me too.

MS. MILLER: Me three.

2. Capital Factors, Inc. v. Kmart Corp. (*In re* Kmart Corp.), 291 B.R. 818 (N.D. Ill. 2003).

3. *In re* Enron Corp., 274 B.R. 327, 349 (Bankr. S.D.N.Y. 2002).

MR. CIERI: The *Enron* court said that because New York City is so convenient for everyone to deal with these kinds of large scale, mega cases, New York as the venue is presumptively allowed.

MS. MILLER: However, don't you think they preferred certain creditors' convenience over other creditors in *Enron*? I mean, if you really looked at where the majority of the people that were creditors were situated, was New York really convenient for them?

HON. FITZGERALD: But that's true for Delaware jurisdictions, too. I sit in Delaware by designation. Delaware tends to attract cases that are incorporated in Delaware, but have no connection with the state. In some instances, there isn't even a single creditor on the matrix in the bankruptcy case that is from Delaware.

So it is convenient as a location to New York and Philadelphia and Washington, and I guess if you think that the Philadelphia airport is something to go into and out of, it is convenient to that, too. But the reality is that it's convenient for a purpose, but it is not convenient for the parties.

So I'd like to expand Judy's question out of New York to say, isn't that true regardless of the venue in which the case is chosen when it isn't the center of the corporate activities.

MR. CIERI: And that actually goes to the fourth factor practioners utilize in determining which venue to commence a case: the probability that the venue will likely be challenged.

Now, the dirty secret among restructuring professionals is that if you have a case that commences in Delaware or in New York, it is very unlikely that venue will actually be challenged. Now, it was a little different in Delaware when the state was overwhelmed with cases. But there was a period of time perhaps, Martin, what would you say, two years ago, when everything in Delaware came to a stop, and the Delaware courts actually started to boot cases out of there.

In fact, Delaware became a less attractive venue choice — the restructuring professionals went over the top, and cases that involved under $100 million of assets were being commenced in Delaware. I mean, Delaware had a special status among professionals for big, mega cases, and then you saw 30-, 40-, 50-million-dollar cases commenced there; Delaware started to slide in its attractiveness as a filing venue.

HON. FITZGERALD: But is some of that the fact that the district court withdrew the reference involving Chapter 11s and then sent them all back, and then withdrew the reference of all Chapter 11s and then sent them all back? As a result, you lost the continuity judges,

you lost the learning curve perspective, issues didn't get addressed, trials were conducted and opinions weren't issued because the judges kept changing. Did that affect anything?

MS. MILLER: But you also have the practical concerns of changing venue. By the time you get the motion to change the venue filed and actually get before the court, look at what has been decided in the first couple of days of the case. So you have your learning curve with your first judge, and then if you're successful in actually showing that venue wasn't appropriate, then you have to start over and get reeducated again.

HON. FITZGERALD: Sometimes with different counsel.

MR. CIERI: In fact, Judge Fitzgerald, do you want to just touch on your views of the various venues?

HON. FITZGERALD: Do you think there is a factor that is involved with the assignment of cases, I guess is my first comment.

MR. CIERI: I will try to answer that question. I will tell you that when a practitioner tries to determine where to file a case, he looks at every judge. Most of these cases can be filed in multiple jurisdictions, and when we are preparing a case for a Chapter 11 filing, we will actually prepare a chart that will look at each of the districts, it will look at whether or not professionals are being paid, whether or not they are being paid at their normal rates, and how long will it take professionals to get paid. The chart will also reflect how various legal issues may be determined by the court.

Now, each debtor confronts different legal issues. Some debtors have legal issues that are particularly important to it in the environmental area. It might be a debtor who's concerned about its ability to assume certain intellectual property licenses. Other debtors might be mostly concerned about their ability to reject collective bargaining agreements.

For example, I am certain when United Airlines filed for Chapter 11, it looked at all the places that it might commence a case and determined what jurisdiction might have the most favorable law with respect to the ability to reject collective bargaining agreements.

So when we look at venues, we look at a lot of different factors, but the one thing I think that law students need to understand, which I'm certain all the practitioners in the room understand, is that the ability to get paid is quite important.

HON. FITZGERALD: Well, I have heard, I guess since I'm not involved in the practice of law but see only the tip of the iceberg from

the cases, that the consistency in rulings and the ability to make sure that you can get paid on an interim basis is important. The Bankruptcy Code permits interim applications for payment every 120 days. But in mega cases, most of the courts have at least administrative orders, if not local rules, in place that permit more frequent applications, they generally have some sort of a process by which the professional can be paid on a monthly basis a certain percentage of the fee that is uncontested, maybe 75 or 80 percent of the overall fee.

MR. KIESELSTEIN: (Indicating.)

HON. FITZGERALD: Higher now? He's telling me higher. 90 percent, 100 percent?

MR. KIESELSTEIN: In *United* — 100 would be good, but *United* is 90, which, again, depending on the scale of the case—

HON. FITZGERALD: Is a significant issue.

MR. KIESELSTEIN: I would say 10 percent is a significant holdback on a case.

HON. FITZGERALD: And then most of the time there is a prove-up on a quarterly reconciliation basis, so that regardless of what the percentage is that you're paid, on a monthly basis at the quarterly fee application hearing, whatever amount your fees and expenses are allowed, the debtor then has to pay the balance of what's owed on that quarterly basis.

In most jurisdictions, that's happening. The difficulty is that, even when it is by local rule, the judges can always vary that practice in any specific case. And so if you have got a court with, for example, nine judges on it, and eight of them are willing to honor that type of process and one is not, then the kind of analysis that Mr. Cieri is talking about affects whether or not cases will be filed in that district because of the one judge who will not do what the other eight in the district will do. So I have heard that is an issue, and I think that probably is a major issue that drives cases into particular districts.

I think the ability to get your first day motions heard is also very important to both debtors and the lenders. For example, employees who may have some gap period where they haven't been paid their wages, which were owed prepetition, and now the filing hits in the middle of that pay period, obviously they need to be paid. It is crucial to them that they can get their paychecks issued. But because of that time line factor, without being able to get a prompt hearing before the judge, so that those payments can be made, they will be treated like

any other unsecured claim. They have a priority for a certain amount of their wages.

MR. CIERI: Can I interject just for a second? Another good example of the importance of getting timely first day relief occurs with retail Chapter 11 debtors. For example, you place a deposit down on a coat, you know, a layaway purchase and then the company files for bankruptcy; the claim that you have to buy that coat is a prepetition claim.

So think about the impact upon a retailer, for example, that can't honor layaway purchases or warranty claims. You buy a product prepetition. You have a warranty on the claim. The product breaks. You go into the store to return it after the company files for bankruptcy. Technically it's a prepetition claim.

HON. FITZGERALD: And, of course, that is the purpose of Chapter 11, allowing a debtor to reorganize its affairs. So if you don't have a process in place that permits the reorganization, then I would suppose that is not going to be a favorably looked upon venue to file the case.

I think to the extent that certain districts have either rules or very well-advertised procedures in place that deal with first day motions, this is something that drives cases to those districts, too, because debtors, or whoever are filing the first day motions, they're almost always debtors, need to know who to serve. They need to know what motions will be heard. They need to know how long, or short, an interim period of relief they'll be granted before there is a final hearing set up. They need to know how extensive the relief will be. So I think all of those factors affect it as well.

MS. MILLER: If I might interject? There are a number of courts across the country that have appointed rules committees because of the nonexistence of specific local rules to set forth what the processes and procedures were. It used to be dealing in secret or hoping that you associated with someone on a local basis that could grease the skids, so to speak, so that you knew how to go about it.

And I think that there are a number of courts across the country, as I will address, that are not getting the mega cases because there are no specific procedures that are articulated enabling you to know what you have to do to get what you want.

HON. FITZGERALD: I think the issue about the experience of the judges, quite frankly, is a make-weight argument. You only get experience if you have the opportunity to sit on cases, and you don't have

the opportunity to sit on cases if they aren't filed in the district in which you sit.

And, therefore, when I hear an attorney say that the experience of the judge is something that drives the cases to that venue, it sort of raises the hair on the back of my neck because I don't know how you can get that experience.

There are some districts, I think, that are actually out soliciting business, and this is jumping ahead a little, but I really wonder how appropriate it is for a court to be out there soliciting cases that are not cases truly belonging in their district.

You know, do you like the concept of the judge as a rainmaker, because that's what this is. When a court actively goes out and solicits cases, the judge is being a rainmaker. Is that appropriate? Is that what you expect from your independent and fair judiciary?

MR. KIESELSTEIN: Well, can I interject? In our local groups, we have the judges who will occasionally say, "It has been a long time since you filed in Chicago." You would occasionally hear a little comment about it. It was more like keep the home fires burning. If you have got a hometown case, why don't you think more about whether or not you can keep it at home and not so much about where else you can bring it.

MR. CIERI: For example, when Montgomery Ward filed,[4] Jones Day was counsel to Ward. My partner at the time, David Kurtz, led that Chapter 11 case, and the client chose to file the case in Delaware. Well, the particular chief judge at the time in Chicago led an effort attempting to change the venue rules to prohibit filing in the state in which you were incorporated.

HON. FITZGERALD: Frankly, I think the state of incorporation is the least of all relevant places to file a bankruptcy. I understand why it's in the statute as a venue choice, but I think it's the least of all relevant places.

And I'm not in a position to advocate legislation. I don't think there's going to be a change in legislation as long as Senator Biden has anything to say about it, so I want that very clear. I'm not trying to advocate some change. But I do think that a more appropriate focus for where cases ought to be filed would be the chief place of business or the corporate headquarters.

Now, the corporate headquarters is not necessarily much better from the place of incorporation, just because your corporate head-

4. Montgomery Ward filed for Chapter 11 bankruptcy on July 7, 1997 in Delaware.

quarters are, for example, in Pittsburgh that doesn't mean that is where your center of operations really are. I'll use Heinz as a big example. Their worldwide headquarters are in Pittsburgh, but their operations at this point in time are pretty much every place but Pittsburgh. So if they filed bankruptcy and filed it in Pittsburgh, I do not know if that would really be much different from filing in the place of incorporation, which is also not likely to have many creditors there.

But I think in many instances, at least in the below-the-hundred-million-dollar-level cases, it would be a more appropriate place because you would be finding at least some of your creditors with access to the courts in that jurisdiction.

MS. MILLER: There also may be a greater sensitivity to the impact on the community where the case is located.

HON. FITZGERALD: Oh, for sure.

MS. MILLER: For instance, if a major hospital files for bankruptcy and ultimately the result is going to throw out not having a successful reorganization, resulting in the loss of employment to all of its employees, that has to have a different impact when the case is being heard in the community where the interests are actually impacted.

MR. CIERI: Actually, that was the point I was going to make. Let me give you some examples because lawyers are always weighing the value of the home court advantage.

There are times you want to be in your home court, and there are times you do not want to be in your home court. For example, I imagine for United Airlines it was a very difficult choice to decide to file in Chicago. Why do you think it was difficult? Well, you might say why would they not want to file in Chicago? United is such a big part of the Chicago economy. No one wants to see United Airlines not survive in Chicago. Well, the reason they may not have wanted to file in Chicago is because it's a very easy place for all the employees to come to court, make things difficult, and have more of a presence in the bankruptcy proceedings.

We once represented a gentleman, a corporate raider who owned a large company, and the company was very important to the community but we decided not to file the case in that community because the corporate raider was so hated. Likewise, we filed a steel company case in an unexpected venue.

HON. FITZGERALD: Yes.

MR. CIERI: And the reason is because we understood that the court would understand how important that entity was to jobs in the community.

Likewise, in American Airlines, I'm sure if that case ever has to file, the lawyers will struggle in making their venue decision between wanting to file in Dallas, where American Airlines is very important to the local economy, against filing somewhere else which may diminish the impact of the employee voice.

MR. KIESELSTEIN: Since you mentioned *United*, Rick, in fact, you're quite right that the labor component is an important part of the decision. We went back to the Pullman strike. We talked to people who were not even lawyers about the extent to which Chicago is perceived as a labor town. These are all important factors in making your choice in a case.

MR. CIERI: Well, maybe this is a good jumping off point because Marc Kieselstein from Kirkland & Ellis along with his partner Jamie Sprayregen have recently filed many cases in Chicago. Now, in my own view, as a result of yesterday's *Kmart* decision, I think it is very unlikely anybody will file any large case in Chicago for some time. The reasoning behind my view is the lack of predictability for the types of first day relief you are able to actually receive from the court.

And why is that predictability important? Well, because every debtor, when it files a case, struggles to make the actual soft landing into Chapter 11. Chapter 11 is a very disruptive process, and if you can make the soft landing into Chapter 11 so that you do not affect your customers, you do not affect your vendors, and to some extent, do not affect your employees, you minimize the detrimental effects of the Chapter 11 process and maximize the value.

Thus, companies that make a soft landing into Chapter 11 come out much better than companies that make that hard landing into Chapter 11. And you might compare United Airlines as a company that may have made a soft landing in Chapter 11. Everybody expected the case to file. The lawyers had a lot of time to prepare for the filing. I'm certain that they thought about every particular issue they had to deal with on the first day for a long period of time beforehand versus a company that makes a hard landing into Chapter 11.

An example of a company making a hard landing into Chapter 11 is the Fleming Companies that just filed in Delaware. Fleming is a 5- to 6-billion-dollar operation that distributes groceries. I mean, this is a big company. Fleming filed in Delaware last week.

Big company, right? You'd expect the lawyers had a lot of time to prepare the case. You'd expect the lawyers had a lot of time to think through all the issues. Fleming filed with no first day relief and no debtor-in-possession financing.

So the whole question again of hard landing versus soft landing comes, to a great extent, from your ability to prepare that case and also the ability to get necessary first day relief. This leads to the question of what is necessary first day relief and what are the kinds of things people get?

HON. FITZGERALD: May I ask one question before we get there because we sort of skipped over this, and I think it's an issue that ought to be addressed. How much do the lenders have to do with driving the case into a particular district? We've been talking about the debtors, the debtors, the debtors. My perception is, it isn't the debtors. The debtors know they need to file. The debtors need financing. The debtors are going to the banks, and I think the banks have a great deal to do—I've used the word "banks" in a broad sense. The lenders have a lot to do with it. Rick?

MR. CIERI: I'm going to defer to Martin on that question because I see he's raised his head and I'm interested to see what he has to say.

MR. BIENENSTOCK: It became irresistible to break the flow, which was terrific. Rolling over prepetition debt is a key issue. For those people unfamiliar with it, rolling over prepetition debt means that if a bank group is owed $100 million prepetition secured, and the company needs $20 million new money for its Chapter 11 case, the lender group one way or the other would prefer, instead of lending $20 million new money, to lend $120 million with the first $100 million going to repay the old debt. That has the effect of making the old debt new debt, of keeping interest current, of making it administrative, and of avoiding a cramdown.

MR. BAIRD: And repealing what it was supposed to be.

MR. BIENENSTOCK: We can argue about that later, and maybe I'll take first licks now. But I want to get back to your question of how much do they have to do with venue.

If a loan goes nonperforming for 60 or 90 days, most lending institutions are subject to a mandatory write-down of the loan by 50 percent. If they haven't already reserved for it, which normally they haven't if the loan is fully secured, that's a hit to earnings. That is dramatic. I mean, any lending—any banking institution will find it dramatic to write down a fully secured loan 50 percent. And the fact that they

may recoup the money later because it was fully secured, "later" could be two years when the case is over. So it is of incredible importance.

And for that reason, the lending agents—there are only a handful of banks that normally serve as agents in the big credits, are absolutely adamant about where they want a case filed. This is because the venue could mean the difference between a court allowing the rollover and not allowing a rollover, and that hits their earnings big time, and they make no bones about it.

Moreover, it's not just greed or asking for special treatment that's driving their intensity. Their credit committees have to approve the new loan of $20 million. Their credit committees may as well say part of the reason why we're lending the new money is to protect the old. If we can't roll over the old and keep it performing, we don't want to loan 20. Maybe we'll loan 5.

So now it comes back to the debtor. You can file wherever you want, but if you file in a place that doesn't give you a rollover, you're going to get 5 million not 20 million, and that's the dynamic that's set up.

Now, as to, "Is this bad"? If a loan is oversecured, by keeping it current you can avoid default interest rates. That lending group is probably your most likely exit facility. I find the old notion that they're the adversary and we should start fighting on day one, very unenlightened. If that's my exit facility, I'd rather have a good relationship with them throughout the case. Keep them performing, let them avoid their write-down, and avoid the default interest. I'm going to need them for the exit facility anyway. And cramdown of the banking groups' secured loan is normally not realistic because you're going to need an exit facility that has a first lien.

So there's a lot to be said for cultivating the relationship with that group as opposed to going to war. If you have a real defect in their loan or security agreement or lender liability, then you're adversaries. But absent that, it pays to go along with your key lenders' decision.

MR. CIERI: Judge Fitzgerald, I absolutely agree with what Martin said, but I would disagree with you to the extent that you don't have that particular issue in every case. If you are not borrowing money post petition from your preexisting secured bank group, I think the influence of the banks is a lot less than it used to be, and I think banks are more receptive now to filings outside of New York.

Now, for example, if you go back to 1985 when LTV Steel filed its first Chapter 11, they filed a case called *In re Chateaugay*.[5] Chateau-

5. *In re Chateaugay*, 64 B.R. 990 (S.D. N.Y. 1986).

gay was the name of the chairman's daughter's horse, and the venue was based simply upon a bank account in New York City. Well, why did they file in New York City in that particular case? I understand it was something that the banks really insisted on.

HON. FITZGERALD: What I'm seeing is a change in the lending positions. We were talking about the fact that there's an agent. Most of the lending facilities when you're talking in the hundred million dollar ranges, and up, are consortiums that are put together. It's not one bank, and they sell positions. They're actively traded, and that's what I think the issue is. It's not so much where they file at the beginning. It's how easy it is to trade those claims and how those positions will change later.

So in respect to the debtor and the banks, I agree, it's nice to have a good relationship ripe and to be copasetic at the beginning, but what I'm seeing is it doesn't always end up that way. Sometimes very shortly after the filing, it changes significantly.

But, anyway, I didn't really want to get sidetracked too much. I just wanted to get that issue on the table. So, Judy, I'm sorry.

MS. MILLER: No, go ahead. Let me just talk a little more about venue selection. There are four primary courts in which we're seeing the majority of the cases filed. I know Rick has already alluded to the Third Circuit in Delaware based upon speed and previously with the way in which they dealt with prepackaged plans, the Second Circuit based upon their experience and exclusivity and dealing with large financial cases, the Seventh Circuit recently with Chicago based upon experience and speed, and the Ninth Circuit in Los Angeles based upon the first day relief that they generally will grant.

There was recently an analysis done by two attorneys, one being Marcia Goldstein out of New York, from Weil Gotshal, and David Sykes out of Philadelphia, and they went through and they analyzed each of the major substantive issues to be considered as part of filing the case and where to file based upon what the circuit had decided.

Based upon the recent *KMart* decision that came down yesterday in the Northern District of Illinois on critical vendor payments it appears, unless that case is appealed and reversed in the Seventh Circuit, that the Seventh Circuit is no longer going to be a district where you want to file a case. Where you have paying critical vendors or a sole-source supplier is where you're going to file. This is because yesterday the court ultimately said that it is per se a violation to pay a prepetition claim post-petition outside a plan.

MR. FISCHER: Considering the confirmation hearing is the 14th.

MR. CIERI: Judy, do you want to provide some background on the Doctrine of Necessity and how lawyers justify paying prepetition claims. Perhaps after you hear this discussion, you will conclude that the problem is that some debtors just went too far in paying prepetition claims.

MS. MILLER: There is the common law Doctrine of Necessity that really arose out of the number of railroad cases at the turn of the century where the only way to maximize the chances of being able to reorganize was to pay certain creditors that were critical. In essence, if those creditors didn't get paid, they couldn't maximize the recovery. If those certain critical creditors didn't get paid and didn't supply goods and services, they couldn't reorganize; therefore, they would liquidate and there would be very little if any value for unsecured creditors. So the Court posited since it's necessary and essential for the reorganization, it will allow those creditors to be paid.

Section 105(a) of the Code provides that the court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. The cases have gone all over the board in terms of whether or not that provision authorizes the bankruptcy court to authorize payments to critical vendors based upon the fact that there is no absolute prohibition in the Code, and that it is clearly necessary to effectuate the policy of reorganization that's set forth in *Bildisco* and the energy case. As against the other side of the argument saying that unless you can point to a specific provision in the Code that authorizes it, you can't allow that payment to be made. By making that payment to a prepetition creditor, you are in essence preferring certain creditors over other creditors. You are allowing payment of a prepetition claim, which is expressly prohibited outside of a plan, and where there is no guarantee at the front end that ultimately the rest of the creditor body will receive the same percentage at the end of the day.

One of the significant cases that has come down over the last two years is out of Fort Worth. The case is *In re Coserv*.[6] It was issued in January of 2002. What is interesting about this case is rather than just dealing with the policy arguments back and forth as to whether or not the proposed payment should be allowed to prepetition creditors, the court actually set forth a three-prong test that I think established a much more significant burden for the debtor on the first day to come in and to justify that in essence, a particular creditor was critical and necessary and should be paid.

6. 273 B.R. 487 (Bankr. N.D. Tex. 2002).

Oftentimes debtors will file these motions. They'll ask for an aggregate amount to be authorized because that's the amount that has been negotiated with the lender that the lender will allow to be paid to this critical vendor body. But there is no absolute specification as to who's going to get paid what. In fact, the debtor doesn't want to set forth that specification because then it becomes a question of all of the creditors who are not on the list coming to them and saying, "Why aren't I there."

The test that Judge Lynn set forth, which must be demonstrated by a preponderance of the evidence, is that, number one, it must be "critical" that the debtor deal with the claimant. In other words, the debtor must show that the claimant is virtually indispensable to profitable operations or preservation of the estate or is the sole supplier for a given product.

Number two, unless the debtor 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. In other words, the debtor must show meaningful economic harm that will be avoided and materially less than the potential loss to the estate.

And, third, that there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim.

MR. CIERI: So the theory, in effect, being that if you paid a dollar prepetition claim, the debtor's estate grows by more than that dollar, a dollar fifty, for example.

HON. FITZGERALD: Isn't it also the fact in most critical vendor claims that you're not paying 100 cents on the dollar? Almost all of them are negotiated, plus some of the waiver of the unpaid portion of the claim.

MR. CIERI: I actually think only some critical vendor orders are like that.

HON. FITZGERALD: Only some?

MR. CIERI: Yes.

MS. MILLER: Well, and, also, it presupposes as part of most critical vendor motions, and I'm not sure I've seen one that's gone the other way, that if you're going to get paid your prepetition claim, you're going to agree to continue to ship to the debtor on the same credit terms that you did prepetition.

So if your terms were 60 days prepetition, the only way you're going to get paid that prepetition claim is with your agreement to continue to ship on that basis.

MR. FISCHER: Or better.

MS. MILLER: Or better. And ultimately the creditor has to consider, number one, the risk. Is the estate going to succeed? Is there going to be any possibility that they're administratively insolvent at the end of the day where they risk that 60-day portion of not getting paid, and now the further risk, which we've been dialoguing about is there are a number of cases that are coming out now where the debtor on day one comes in and says I'm going to have a hundred percent plan. So, therefore, if we pay all these critical vendors, it's really not going to impact what the creditors are going to get at the end of the day.

Well, all their best predictions on day one were great except for then the case tubes—it ends up in a Chapter 7, as in the case of *Marvel.*[7] And there the trustee comes back and says, wait a minute, all these critical vendors got paid this money. The rest of the unsecured creditors didn't get paid and there has been a material change from the time such payment was authorized and now. We're going to move to vacate the order that was entered to authorize the post-petition payment of these critical vendors under Rule 60(b). And then those creditors that had relied upon the order and got paid, even though it would have been an authorized post-petition payment under Section 549, are now having to argue with the trustee in adversary proceedings of whether or not the amounts they received are subject to disgorgement.

HON. FITZGERALD: But the problem I think in *Marvel*, may be the way first day order was written. Because in some of those first day orders it doesn't say, "the debtor shall pay." It says, "the debtor may but need not pay." And I think that's the significant issue, and almost all of the Delaware orders are written that way.

MR. KIESELSTEIN: The debtor is always seeking authority but not direction, so then they can go out and—

HON. FITZGERALD: Exactly. That's right.

MR. FISCHER: There is a case that we have in Delaware where the critical vendor order went nuts, and they were supposed to pay 10

7. Marvel filed a petition for Chapter 11 bankruptcy on December 27, 1996.

million. Instead they paid 40 million, and it's just a zoo. It's just a zoo and a disaster.

MR. CIERI: Well, we should talk about what really happens, and I think they're touching on it. If you are a debtor's lawyer, you're dealing with a company that is very inexperienced in bankruptcy, scared of what's going to happen, and so your view is that everybody is a critical vendor.

HON. FITZGERALD: Including the lawyers in one of the Delaware cases.

MR. CIERI: I mean, so they believe that when you go to them, you say, look, here's what first day relief is. Here is why first day relief is important to making a soft landing into Chapter 11. Here are the categories of claims that you might consider as being critical vendors based upon our experience.

And then what happens is the debtor sees those categories and everybody becomes a critical vendor. Lawyers forget that it is the lawyer's job at that point in time (and some of us have done it better than others) to push back on the debtor. Because it's very hard for a court who is hearing first day relief, who wants to be receptive and doesn't want to take an action that may destroy the business, to actually engage in the kind of critical analysis necessary to determine whether or not somebody actually is a critical vendor.

So what occurs is that you have certain lawyers, or law firms, who are a lot better about pushing back than others.

HON. FITZGERALD: My view is I require a list of the critical vendors to be either submitted to the United States Trustee's Office or filed with the court under seal because I want to make sure that, in fact, the debtor is doing what the debtor says, and I expect the lawyers to tell me if the debtor's in breach.

And I certainly don't think in the Third Circuit that you can pay lawyers as critical vendors because you've got a whole line of professional appointment cases in that circuit that's very detailed. And I think that's inappropriate, and in a specific case, I required debtor's counsel to get the payments made to the lawyers back, and they had to sue in one instance to do it. Then it got settled, but, nonetheless, they actually had to bring a lawsuit because of that fact. And the order and the motion were quite clear that they didn't cover lawyers.

So I agree that there are critical vendors and I don't think the debtor intends to be abusive. I don't think in making the payments that the debtor's management is thinking that they are violating, they

are not willfully trying to violate a court order. But the fact is, that is what they are doing, and it is a violation of the Bankruptcy Code.

MS. MILLER: An example of a case where this abuse took place was *Murphy Marine Services.* There the debtor said they were going to only pay 3.7 million and ultimately paid 38 million.

HON. FITZGERALD: Well, that's a little unusual.

MS. MILLER: And it is, but some of those terrible abuses have in fact, occurred. If you look at the orders that were entered in terms of critical vendor payments two and three and four years ago as against the orders that are being entered now, most recently in a case called *Superior TeleCom*, it's very specific as to when you can pay, who you can pay, who must be monitoring it, and it's not just providing a list to the U.S. Trustee. In that order it was providing it to the creditors' committee as well because the creditors' committee in the *Murphy Marine* case kept on asking for the information as to what had been paid, and the debtor refused to turn it over until an examiner was appointed.

HON. FITZGERALD: I've been requiring it to the creditors' committee under a confidentiality agreement, but I'm a little leery about doing that. I've only done it once on request because I think the creditors' committee has a fiduciary obligation to all of the creditors in the estate, and I'm really not sure of the interplay between the confidentiality agreement where its professionals can't then share that information with the committee and generally with the estate.

MR. CIERI: I asked Wei Lee for a couple extra minutes from the next panel just because I think we are about to move into something that's very important for people who practice law in the Northern District of Illinois. But I just want to make two points from what Judy Miller and Judge Fitzgerald said, which I think are really important.

The first is in the large Chapter 11 cases, the mega cases, the *KMarts* and *United Airlines* of the world, it is very difficult for a debtor to track specific categories of payments. And some day you're going to have to show that you stayed within the payment guidelines. Debtors have a lot of difficulty in tracking prepetition payments.

And then just following off of what Judge Fitzgerald said, she was referring to the case with the lawyers getting the money back. Well, it's one thing to get money back from lawyers. It's another thing to get money back from vendors.

And that leads us to the *KMart* case. And Judy talked about it, but a decision came down yesterday in an appeal to the district court of *Capital Factors vs. KMart Corporation.*

Capital Factors was a prepetition factor of KMart's accounts receivable, owed about $20 million. On the first day of the bankruptcy case, Capital Factors objected to a wide variety of first day relief sought by KMart. First day relief to pay employees, first day relief to pay prepetition vendors, first day relief to pay foreign vendors, and first day relief to honor certain letters of credit relating to foreign vendors.

Typical kinds of relief, however, the size of the relief one could argue, is unprecedented. We're talking about critical vendor payments being made on the first day of the case approaching $500 million. One of these vendor payments was in excess of $70 million to Fleming.

Fleming you might recall was the grocery store distributor that I referred to a little earlier that recently made a hard landing into Chapter 11. Well, they actually got paid by KMart on day one. They got paid on the basis that Fleming was so critical to KMart's existence that if they didn't make this payment to Fleming, Fleming would eventually file for bankruptcy. You might note, by the way, that they did as we talked about.

So in any event, this was an appeal that was taken by a prepetition creditor of KMart of all of the first day or critical vendor payments.

Well, this appeal sort of meandered around for a while, and as many of you might know from the newspapers, KMart is set to confirm its plan of reorganization on April 14th and 15th of this coming week.

The plan of reorganization provides that any claims KMart might have against people who received post-petition payments that were not properly authorized were going to be waived.

Well, again, many of us involved in the case didn't pay much attention to this appeal. Most of us thought it had little chance of success because ruling in favor of Capital Factors could be very disruptive to the result of the *KMart* case. And, frankly, most of us bankruptcy professionals and most of the judiciary have gotten used to this idea of the Doctrine of Necessity. We haven't actually questioned its underpinnings. We may feel, as Judge Fitzgerald said and how I actually strongly feel, that it may have gotten abused, but nobody actually questioned whether or not it existed. It has been with us for a long period of time.

Well, Judge Grady, a district court judge in Chicago, ruled yesterday that there is no such thing as the Doctrine of Necessity on a per se basis. He says that the bankruptcy court did not either have the statu-

tory or equitable powers to authorize the payment of prepetition unsecured claims outside of a plan of reorganization.

He says as a result of that, he doesn't even need to get to the issue that Judy Miller and Judge Fitzgerald have discussed, which is whether or not a payment is actually necessary to the preservation of the debtor's estate. He would say there's no authority whatsoever to ever, under any circumstances, pay prepetition claims.

Now, I open it up to the panelists and also to the future panelists as to what they believe, but I'll just throw out that I think it's—and I think Marc Kieselstein may have said this—no one will be filing a large case in Chicago until this decision is dealt with.

HON. FITZGERALD: Well, on the issue of assignments, the Third Circuit has taken the matter on appeal *en banc*, so I think that's more positive than Rick had indicated earlier. The solvency determination issue listed by one district court judge in a mass tort case may or may not be followed. It's not binding on anybody else. And the *West Electronics* intellectual property issue seems to be honored more in a breach than not.

So, although I don't really want to be a rainmaker, maybe the Third Circuit isn't such a bad place to file cases based on this.

MR. FISCHER: Well, but this is still the decision of only one district judge.

MS. MILLER: That's right.

MR. FISCHER: I suspect that it won't be around long or the Seventh Circuit will make it the law, one way or the other.

MR. CIERI: How are they going to deal with it quickly?

MR. FISCHER: I wouldn't be surprised if it so badly affects confirmation that it comes back up that way.

MR. CIERI: I'm looking for ideas.

MR. FISCHER: I'm wondering how the confirmation can go ahead. Isn't this a lot of money?

MR. BIENENSTOCK: Why is that a problem? It comes back.

HON. FITZGERALD: It appears to affect even the employee claims. I mean, if that's going to be the ruling, every case is going to have no employees. People will resign. They're not going to get paid prepetition, let alone post.

MR. FISCHER: Well, that will wind up at least getting through the exemption for the small amount, for the small employees that people care about. Nobody cares about other employees.

MS. MILLER: That presumes that is the limit to which they can pay people.

HON. FITZGERALD: But this affects the letters of credit, and it affects the foreign financing, so where are they going to get supplies?

MR. FISCHER: Well, the letters of credit, as I read it, is an invitation to just prove the case, which I guess wasn't done.

HON. FITZGERALD: Maybe that's the issue. Maybe you need an evidentiary hearing for every creditor—

MR. FISCHER: No, no, no.

MR. CIERI: No.

MR. FISCHER: He didn't say that on the critical vendors.

MS. MILLER: No. If anything, he's saying it doesn't matter what you put forth—

HON. FITZGERALD: No, this opinion does.

MR. BAIRD: This opinion should not have come as a surprise to people. There's *Official Committee of Equity Security Holders v. Mabey*.[8] There's a Ninth Circuit case that says the doctrine of necessity just applies to railroads.

Critical vendor orders have been a dirty secret. It's hard to find authority for them in the Bankruptcy Code.

MR. BIENENSTOCK: Well, Professor, let's take *Mabey*. The Fourth Circuit said that 10 percent of the claims he was paying were invalid claims because there wasn't time to find out which women had genuine claims and which not, and there's no authority to pay invalid claims. So that does away with *Mabey*.

MS. MILLER: But the problem is when you don't have the justifiable facts as set—as a bases under *Coserv*, it makes bad law because of bad facts. And the question becomes, "what meaning does § 105(a) have, and what do you do with the Supreme Court precedent that says the policy of being able to maximize assets and reorganize"? Is it as an important policy that underlies the entire Code if you can't pay something under the Necessity Doctrine?

MR. BAIRD: *Mabey* is a bad decision, but I'm not making the point that *Mabey* is a great decision. I'm just saying *Capital Factors* shouldn't have come as a surprise.

The Seventh Circuit has said over and over and over again, that you do not ever just cite Section 105 and think you can get away with it.

8. 832 F.2d 299 (4th Cir. 1987).

HON. FITZGERALD: Almost every circuit has that.

MR. BAIRD: Better arguments may exist. Some people are trying to make Doctrine of Necessity arguments using § 363. All we're doing is using the assets of the estate to enhance the value of the estate. Section 363 authorizes that. Hence, there's authority via § 363 to have critical vendor orders. But *Capital Factors* doesn't address them.

For some reason, maybe failure of advocacy, *Capital Factors* never talked about § 363.

MR. KIESELSTEIN: I would doubt, knowing who the debtor's counsel is, that it was a failure of advocacy.

MR. BAIRD: So would I.

MR. KIESELSTEIN: In *United*, Judge Wedoff who was not a fan of critical trade, thought that he might be the one getting the *United* case before it was filed. So, he sat down and said, "okay, what's an intellectually credible justification because I know I may have a big critical trade motion coming my way." And he said, "don't talk to me about § 105. Talk to me about § 363. Tell me why what you're doing is going to create additional value for your stakeholders down the line."

That was an easy one to tell. We had a rigorous process. We had a witness in court ready to talk about it at whatever length the court wanted. And, in fact, when we came back for the final hearing, we reported to the court that although we had gotten authority to pay $40, $50 million in critical trade, we paid out $8,000 because sometimes your client, when they cross over to the dark side, they enjoy themselves. They did not want to pay anything, and that was, I think, an example of where it was done and done correctly, and the correct intellectual underpinning was put in place for it.

MR. FISCHER: My guess is that there probably wasn't the underpinnings of the record for the bankruptcy court for the § 363 analysis you just went through on the *KMart* first day order. That case has gone through very quickly, and a lot of things just go through. And I think Mr. Cieri was probably there on the first day.

MR. CIERI: No, I actually wasn't. Wei Lee has asked me to wrap up the discussion. I think what you should take from this is, this is a very significant decision. I think most of the panelists believe that it will eventually be overturned because the Doctrine of Necessity is a very critical doctrine.

MS. MILLER: We have one shaking head here.

MR. CIERI: Those academics, what are you going to do.

MR. BAIRD: I'm not talking about what are the good, the true, and the beautiful and about this being unexpected. I'm just making a prediction about how the Seventh Circuit and how the Supreme Court decides bankruptcy cases.

MS. MILLER: Plain language.

MR. BAIRD: If you go with a plain language approach what happens? If you make only a § 105 argument, the Seventh Circuit is not going to say, "That's fine."

MR. BIENENSTOCK: As the professor just stated, and I agree, I just wanted to raise one point not raised yet, Section 365 expressly provides for the payment of prepetition debt. All of these vendors have contracts with the debtor and all of them are subject to adjustments because so many widgets were defective, the wrong color, etc. So there are always things left to do under these contracts to true up.

HON. FITZGERALD: But I insisted in the one case that I get some § 365 motions rather than § 363 for that very reason, and they didn't want to do them because they don't want to assume all of the contracts and—

MS. MILLER: And potentially they have the huge debt to assume as part of the assumption process.

MR. BIENENSTOCK: My point is, there is express authority in the Code to pay prepetition debt. It's wrong when this decision says there isn't any—

HON. FITZGERALD: That's true.

MR. BIENENSTOCK: — because there's a lot, and there are other sections as well. And I have to believe it was briefed, and if it wasn't, it will be in the Seventh Circuit.

MR. CIERI: But I—and I'm not cutting the discussion off because I actually have one more point to make because it's a point that Martin made to me coming over here as we got lost trying to find the Law School. And that is, well, what's the alternative for a debtor?

HON. FITZGERALD: Liquidation.

MR. CIERI: Well, Martin says, and I agree with this, you prepay it all before you file.

MR. BIENENSTOCK: If you have the money.

MR. CIERI: If you have the money.

MS. MILLER: What about preferences?

HON. FITZGERALD: Yeah, then you've got all the preferences.

MR. BIENENSTOCK: That's a different story. They may never get prosecuted.

HON. FITZGERALD: Well, they—yeah, they wouldn't—I would agree with that if most cases actually reorganized, but most cases don't actually reorganize. And then what you get is a Chapter 7 trustee who files preferences by the thousands.

MR. BIENENSTOCK: But those statistics mix in the single asset real estate with the *United Airlines* and *KMart*, and it's not fair.

MR. KIESELSTEIN: You also may need your interim DIP order in place before you got the cash to make the request.

HON. FITZGERALD: That's true, too.

MR. FISCHER: But I think that the problem in this case might be the bankruptcy court record.

MR. KIESELSTEIN: Don't rest on your offer of proof.

MR. FISCHER: Marc and I were just saying, as attractive as it is when you think the judge is just going to sign the order, create the record.

MR. BIENENSTOCK: Absolutely.

HON. FITZGERALD: What happens if all the vendors demand some advance deposit?

MR. FISCHER: Who's the judge?

MR. BAIRD: This is worse than that. There are a lot of prepetition people who are technically prepetition creditors who can never do deals.

In the *Marvel Comics* case, you had all these 12 and 13-year-olds prepaid for subscriptions. Are you going to cut them all off?

MR. CIERI: Well, there was no shortness of discussion.

WEI LEE: Thank you. Obviously a lot of great ideas, great points of view from different perspectives by our other panelists.