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## The Case Against “Critical Vendor” Motions

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It has become commonplace to seek bankruptcy court approval to pay certain pre-petition unsecured liabilities because of the alleged “critical nature” of certain suppliers, goods and services in order to preserve the going-concern value of the debtor’s business. This generally accepted practice has been rationalized under the “doctrine of necessity.”

Critical vendor motions are unnecessary in most cases. They also increase the funding requirements of chapter 11 cases and circumvent the absolute priority rule, one of the fundamental tenets of bankruptcy law.

First, let’s discuss different types of suppliers of goods or services. In very simple terms, there are suppliers for which there are substitutes (perhaps at differing levels of price, quality and delivery) and those for which there is no practical substitute: the alleged critical vendors. The debtor’s inability to substitute another vendor for the alleged critical vendor may be based on (1) specialized tooling and equipment, (2) specialized knowledge, (3) lack of industry capacity or (4) long lead times.

“Specialized tooling and equipment” is the most frequently used category in which crisis managers encounter vendors and “debtor” management advancing the critical-vendor argument. This type of vendor provides some unique part for which there is no near-term substitute. If the debtor owns the special tools and/or equipment,

production potentially could be relocated to another supplier. But there is time, money and risk inherent in that decision. Therefore, the preferable decision is to deal with the current vendor—who clearly has the leverage to shut down the debtor’s business by not providing the unique product.

For the same reasons that cause the debtor to have no short-term substitute for the critical supplier, that same supplier normally has no short-term substitute customer for that inventory and that production capacity. Rarely does a vendor in this situation want to risk losing the future sales volume/profits—plus inventory (sunk costs) in its process (raw material commitments through finished goods)—as well as any chance to recover on its pre-petition receivables by shutting down its customer. The irony of this category of critical vendors is that the debtor and vendor are often mutually dependent on one another.

“Specialized knowledge” vendors are similar to specialized tooling and equipment vendors, except that their uniqueness lies in people vs. hard assets. The argument is that you can’t replace the ad agency, software programmers, litigators, etc. However, these debtor-vendor relationships also are mutually dependent, and it would be a rare case in which a vendor would exercise its leverage and discontinue doing business with a debtor-customer unless that vendor could rather quickly redeploy their human resources.

Lack of industry capacity does, in fact, create a true critical-vendor situation, because the vendor has near-term ability to recoup its sales volume with customers other than the debtor. This creates significant leverage for the vendor. However, this situation has little to do with the debtor’s bankruptcy, but rather is a function of basic supply/demand economics.

Long-lead-time vendors can also create true critical-vendor situations. This circumstance is becoming increasingly significant due to the growing incidence of retail as well as industrial products being manufactured outside the United States. Container loads shipped from Pacific Rim plants to the United States often take 30-60 days; replenishing that supplier chain with a substitute supplier can be a slow process. This

category is also complicated by the likelihood that the supplier is less familiar with U.S. bankruptcy law than a domestic supplier and has his own culture-driven view of bankruptcy. As a practical matter, vendors in this category often have huge leverage and may not have alternative customers for their products. Vendors with long lead times can be truly critical, especially if they supply commodity products that can be resold elsewhere.

Given this subjective analytical framework, it becomes clear that the practical test for a vendor’s critical nature (assuming the debtor has no near-term vendor substitution option) relative to a debtor is primarily related to an economic standard: *What near-term alternatives does a potential critical vendor have for its product or service?* In practice, there are very few situations that pass this stringent economic test.

So why are critical vendor motions so prevalent? There are three reasons.

First and foremost, *bankruptcy courts are allowing these motions* (notwithstanding the recent K-Mart appellate court decision). Before these motions were in vogue, can you recall any debtor business shut down because vendors didn’t get paid on pre-petition trade debt? Granted, there may have been a side deal or two cut to “make it right;” it’s very clear that *vendors demand critical vendor treatment because they know they can.*

Second, *management has little incentive to say no.* Because management (1) normally remains as trustee in charge of the debtor-in-possession (DIP), (2) is spending creditor’s money and (3) has to work with vendors beyond the bankruptcy horizon, it really wants cooperation from vendors. Frankly, managements prefer that unsecured creditors get paid for pre-petition debts...*even at the expense of the secured creditor(s).*

Finally, *lenders underwriting DIP budgets too easily accept critical-vendor payments* as a necessity. Very few vendors are truly critical in the sense that they could and would shut down a business if their pre-petition debts aren’t paid. Interestingly, many critical vendors are paid only a negotiated fraction of pre-petition debt. *Why would truly critical vendors take anything less than 100 percent?*

The whole critical-vendor approach currently accepted by the bankruptcy courts is flawed in practice. There are few truly critical vendors, vendors demand critical-vendor status because they can, there is little management incentive to just say no, and lenders haven't yet figured out how to negotiate this line item out of DIP budgets. For now, bankruptcy courts seem to have accepted critical vendor motions as the norm.

Financial advisors, banks and unsecured creditors' committees should drill down into the details of such critical-vendor payment plans and to vigorously challenge these payments. Take it from a guy who lives on the front line with debtors as a CRO and financial advisor: *Most of these critical vendor payments don't need to be made.* ■

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