The Last Day for First Day Orders: Attacks on the Practice of Paying Prepetition Claims of Certain "Critical Vendors"

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In order to understand the effects that first day orders\(^2\) can have on small creditors, imagine that you are a corporation. You supply Company A with products that are important to Company A’s business. Company A owes you $300,000, which is a small fraction of what Company A owes to other suppliers. Company A petitions for Chapter 11 bankruptcy and files an emergency motion requesting the ability to pay certain critical suppliers that are necessary to the continuance of its business. You, however, are not on its list. The bankruptcy court, in granting Company A’s motion, allows the creditors paid to receive a greater percentage of what they are owed than it allows you to receive.

There are two major purposes behind the Bankruptcy Code ("Code"). One major purpose of the Code is to assure that creditors receive equal treatment.\(^3\) The other is to give the debtor a fresh start in aiding the reorganization of the debtor’s business.\(^4\) First day orders undercut the first purpose by treating “critical vendors,” those vendors that the debtor believes are necessary for continued operation of its business, differently than those who the debtor does not believe are critical. In granting first day orders based on the debtor’s assertion that payment to certain creditors is necessary to continue operating its business, the bankruptcy court exercises its equitable powers, placing more importance on providing the debtor with a fresh start than on

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1. The author would like to thank Kurt Carlson, a partner at Tishler and Wald, Ltd. in Chicago, Illinois, for his help in developing the topic of this Comment.
2. The phrases “first day orders” and “critical vendor orders” will be used interchangeably in this Comment. The phrase “first day orders” will not be used to refer to any of the other motions that debtors file at the time a bankruptcy petition is filed.
treating creditors equally. The current debate discusses whether or not the Code authorizes the bankruptcy court to make such a choice.

Part II will discuss first day orders as an exception to the general rule that a debtor can not prepetition claims. This section will also outline the general requirements of procedural due process. Part III will review caselaw that discusses first day orders. This section will outline the basics behind the argument that bankruptcy courts lack statutory authority to make such orders. In addition, this section will discuss the background behind the argument that first day orders lack procedural due process. Part IV will analyze both arguments made in Part III and will present the reasoning behind accepting the arguments. Part V will provide the two most feasible solutions to the critical vendor problem: 1) a blanket prohibition of such orders and 2) a revision to the Code that expressly authorizes the bankruptcy courts to enter such orders. Part VI will conclude by summarizing the main points outlined in this Comment.

II. BACKGROUND

This section will explain the meaning first day orders and the history or such orders. It will also discuss general procedural due process principles.

A. What Are First Day Orders?

The general rule is that once a bankruptcy petition is filed, a debtor cannot pay the prepetition claims of creditors.\(^5\) By allowing the debtor to pay part or even all of the prepetition claims of certain “critical” vendors,\(^6\) first day orders act an exception to that general rule.\(^7\)

At one time, the post-petition payment in the ordinary course of business of pre-petition, unsecured trade suppliers to maintain their goodwill and thereby maintain the going-concern value of the dis-

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5. Currie & McCann, supra note 4, at *1. Typically creditors are not paid until after a reorganization plan has been confirmed by the creditors and approved by the court. Gilday, supra note 3, at 417. Every mention of creditors in this Comment refers to general unsecured creditors, and every mention of pre-petition claims refers to a creditor’s right to payment that due to a transaction that occurred before the debtor filed the bankruptcy petition.


tressed company would have been truly extraordinary. . . . Now it has become an inalienable right of debtors and trade vendors alike.\textsuperscript{8}

However, "[t]he concept of 'critical vendors' has gone from an extraordinary remedy to something that is simply done as a matter of course in almost all cases."\textsuperscript{9}

Bankruptcy court authority for these orders is typically gleaned from the Doctrine of Necessity,\textsuperscript{10} which debtors use to argue that the courts have authority to authorize payment of prepetition claims to "ensure continuation of . . . [d]ebtors' operations."\textsuperscript{11} The Doctrine of Necessity grew from case law both prior to and under the Bankruptcy Act of 1978.\textsuperscript{12} The current Doctrine of Necessity is a combination of two separate doctrines: 1) the Six Months Rule and 2) the Necessity of Payment Rule.\textsuperscript{13} The Six Months Rule\textsuperscript{14} was recognized in the Bankruptcy Act,\textsuperscript{15} placed in the chapter that dealt with railroad reorganizations,\textsuperscript{16} and later adopted in the subchapter of the Code dealing with railroad reorganizations.\textsuperscript{17} Historically, both the Six Months Rule and the Necessity of Payment Rule were applicable only to railroad reorganizations cases because the success of those reorganizations was considered essential to the public interest.\textsuperscript{18} However, the Necessity

\begin{quote}
10. Currie & McCann, \textit{supra} note 4, at *1. Because the Doctrine of Necessity is the basis for granting critical vendor motions, this Comment will use the Doctrine of Necessity and critical vendor orders interchangeably.
12. \textit{Id.} at 492 n.7.
13. \textit{Id.}
14. "The Six Months Rule, a rule of priority, originated with the practice of initiating a railroad receivership case with an order appointing a receiver who was authorized to pay certain pre-petition debts for labor, supplies or equipment from post-petition funds." \textit{Id.} It was an equitable rule that only applied to expenses that were necessary for the continued operation of the railroad. \textit{Id.} It was limited to expenses that arose immediately prior to filing the receivership petition. \textit{Id. See also In re Boston & Maine Corp.}, 634 F.2d 1359, 1366-67 (1st Cir. 1980) (providing a history of the Six Months Rule).
15. \textit{Boston & Maine}, 634 F.2d at 1366. The Six Months Rule, although recognized by § 77(b) of the Bankruptcy Act, was not precisely defined. \textit{Id.} The priority rules of the Six Months Rule are incorporated into § 1171(b) by reference. William L. Norton, Jr., \textit{2 Norton Bankr. L. & Prac.} 2d § 42:10 (2003).
\end{quote}
of Payment Rule, although originally limited to railroad reorganizations, has occasionally been extended outside the railroad context.

The Doctrine of Necessity has been considered incorporated into the Code through 11 U.S.C. section 105(a), which states "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." The provisions of the Code are aimed at successful reorganization of companies, which is one of the goals of the Code.

There are three arguments that debtors often make when relying on the Doctrine of Necessity in the critical vendor context. First, the vendor is the only supplier of "essential goods and services." Second, the vendor supplies "essential goods and services at a significantly reduced price." Third, because the vendor will not be able to "survive non-payment of pre-petition claims," it will stop supplying the debtor.

First day orders began as an instrument only to aid railroads in continuing their operations after entering receivership. First day orders have become a tool used by debtors in all industries because "the debtor relies on certain vendors for critical products and services, and

19. The Necessity of Payment Rule was first enunciated by the United States Supreme Court in Miltenberger v. Logansport, C. & S.W. Ry. Co., 106 U.S. 286, 311 (1882). Boston & Maine, 634 F.2d at 1369. The Necessity of Payment Rule, unlike the Six Months Rule, is a rule of compelled payment rather than priority. CoServ, 273 B.R. at 492 n.7; Norton, supra note 15, § 42:11. It developed to protect trustees of a railroad when continued operation of the railroad was being threatened. In re B & W Enterprises, Inc., 713 F.2d 534, 537 (9th Cir. 1983) (citing In re Boston & Marine Corp, 634 F.2d 1359, 1382 (1st Cir. 1980); In re Penn Central Transp. Co., 458 F. Supp. 1234, 1326 (E.D. Pa. 1978), aff'd in part, remanded in part, 596 F.2d 1102 (3rd Cir. 1979)). "The rule may be invoked ... as justification for the payment of pre-petition debts paid under duress to secure continued supplies or services essential to the continued operation of the railroad." Id. (citing In re Boston & Marine Corp, 634 F.2d 1359, 1382 (1st Cir. 1980)). This rule has been used by courts to allow immediate payment to creditors when those creditors will not supply goods or services that are essential to the continued operation of the business until their claims have been paid. In re Penn Cent. Transp. Co., 467 F.2d 100, 102 n.1 (3d Cir. 1972).

20. CoServ, 273 B.R. at 493 n.7. The extension of the Necessity of Payment Rule gave birth to the Doctrine of Necessity. Id. Courts often use the two terms interchangeably. Id. This Comment will, however, use the Doctrine of Necessity.

21. Currie & McCann, supra note 4, at *5. Although the Doctrine of Necessity is not actually codified in the Code, courts have used their equitable powers under section 105(a) of the code to apply the Doctrine of Necessity. In re Just for Feet, Inc. 242 B.R. 821, 824 (Bankr. D. Del. 1999). Some question whether the rule is still valid under the Code. See Norton, supra note 19.


25. Id.

26. Id.

27. Id. Vendors would likely stop supplying the debtor because without payment through a first day order, the vendor will get little or no money in payment of its pre-petition claim.
unless the debtor is permitted to pay its prepetition debts to these essential vendors, they likely will stop supplying the debtor, and the debtor's chances of successfully reorganizing will be impaired."28

B. What is Procedural Due Process?

Due process requires the opportunity to be heard.29 The right to be heard has little meaning unless one is given notice and can decide whether or not to appear and present objections.30 Put together, "the conditions for due process are reasonably calculated notice under all of the circumstances and an opportunity to be heard."31

As one can tell from the definition, notice is the critical factor in determining whether a violation of due process exits. Notice serves to apprise parties of an upcoming hearing as well as to allow time for adequate preparation.32 There are three requirements regarding the sufficiency of notice for procedural due process purposes. First, "[t]he notice must be of such nature as reasonably to convey the required information."33 Second, the notice "must afford a reasonable time for those interested to their appearance."34 Third, "[t]he means employed must be such as one desirous of actually informing the absentee might reasonably adopt to accomplish it."35

Even with the requirements for notice, the Supreme Court has made "clear that 'due' process is flexible and calls for such procedural protections as the particular situation demands."36 The only requirement is that the matter be considered "at a meaningful time and in a meaningful manner."37 If a party is given a meaningful opportunity to be heard but does not take advantage of that opportunity, there is no violation of due process.38

28. Currie & McCann, supra note 4, at *1-*2. See also Catherine A. Vance & Paige Barr, The Facts & Fictions of Bankruptcy Reform, 1 DePaul Bus. & Comm. L.J. 361, 390 (2003) (stating "the justification for [critical vendor claims] is . . . if the prepetition claim is not satisfied, the vendor will not deal with the debtor postpetition, and the debtor will have no viable shot at reorganizing").


30. Id. at 314.


33. Mullane, 339 U.S. at 314 (citing Grannis v. Ordean, 234 U.S. 385 (1914)).

34. Id. (citing Roller v. Holly, 176 U.S. 398 (1900)).

35. Id. at 315.


III. Debate Surrounding First Day Orders

This section will discuss the debate regarding the validity of first day orders. Courts are split on the issue of whether courts lack the statutory authority to issue first day orders. Rather than discussing statutory authority, some courts discuss first day orders in the context of procedural due process.

A. Do Critical Vendor Orders Lack Statutory Authority?

When a noncritical vendor brings a challenge to a first day order, the court must determine whether or not the bankruptcy courts have a statutory basis for issuing such orders. There is a split of authority among the United States Bankruptcy Courts as to whether the Code authorizes bankruptcy courts to order payment of prepetition claims of so-called critical vendors. The two cases that follow demonstrate the competing views among bankruptcy courts.


The argument that first day orders lack statutory authority has recently been accepted by the District Court for the Northern District of Illinois in Capital Factors, Inc. v. Kmart Corp. Kmart Corporation ("Kmart") "filed a voluntary petition for reorganization under Chapter 11" of the Bankruptcy Code ("Code"). Kmart filed a first day motion on the same day, seeking authority to pay the prepetition claims of certain critical vendors. Kmart asserted that these "payments were necessary to maintain relationships essential to its continued operation," thereby invoking the Doctrine of Necessity and 11

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39. See Capital Factors, Inc. v. Kmart Corp. 291 B.R. 818, 823 (N.D. Ill. 2003) (holding that the Code does not authorize such orders); In re Oxford Mgmt., Inc., 4 F.3d 1329, 1334 (5th Cir. 1993) (holding that in ordering payment of pre-petition claims to certain creditors, the bankruptcy court impermissibly altered the Code); Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987) (holding that not only do such orders lack statutory authority, but they also violate the language of the Code); In re B & W Enter., Inc., 713 F.2d 534, 537 (9th Cir. 1983) (declining to apply the Doctrine of Necessity outside the context of railroad). But see CoServ, 273 B.R. at 497 (holding that section 105(a) of the Code does authorize such payments); In re Wehrenberg, Inc., 260 B.R. 468, 469 (Bankr. E.D. Mo. 2001) (granting, pursuant to section 105(a) of the Code, the debtor's motion to pay critical vendors); In re Just for Feet, Inc., 242 B.R. 821, 824 (D. Del. 1999) (holding that "[s]ection 105(a) of the Code provides a statutory basis" for critical vendor orders); In re Chateaugay Corp., 80 B.R. 279, 285 (S.D.N.Y. 1987) (holding that the bankruptcy court has authority to authorize payment of certain pre-petition claims).


41. Id.

42. Id. at 820.

43. Id.
U.S.C. section 105(a).\textsuperscript{44} The same day that Kmart filed its petition and first day motion, the bankruptcy court held a hearing on the motion.\textsuperscript{45} Capital Factors, Inc.\textsuperscript{46} ("Capital") objected to the motion.\textsuperscript{47} The bankruptcy court granted the motion for payments to the critical vendors ("Critical Vendors Motion"),\textsuperscript{48} and Capital appealed to the district court.\textsuperscript{49}

The district court held that the Bankruptcy Code does not confer upon the bankruptcy court the authority to authorize such payments.\textsuperscript{50} The Doctrine of Necessity has been applied to "justify the pre-plan payment of pre-petition claims of creditors who threaten to withhold goods or services believed critical to the debtor’s continued" vitality.\textsuperscript{51}

\textsuperscript{44} Id. Section 105(a) states that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a)(2002).

\textsuperscript{45} Capital Factors, 291 B.R. at 820.

\textsuperscript{46} Capital Factors, Inc. is a factoring agent that "purchases accounts receivable from its customers and assumes the collection responsibilities." Id. at 820 n.1. Capital Factors, Inc.’s clients include several Kmart apparel suppliers. Id. at 820. The claims assumed by Capital amount to approximately twenty million dollars. Id.

\textsuperscript{47} Id.

\textsuperscript{48} Id. The bankruptcy court stated with regard to the Motion:

Motions to pay certain critical trade creditors always present difficult questions for courts. We’re more and more of [critical vendor motions], and our problem is that we to stretch to find some authority to [grant critical vendor motions]. However, I, after hearing this testimony and reading the affidavit [of Charles C. Conaway, Kmart’s Chief Executive Officer], am convinced that Fleming, Handleman and the egg and dairy vendors . . . as well as the advertising concerns, are necessary to keep [Kmart] going as a going concern.

Id. at 820 (internal quotation marks omitted). Fleming Companies Inc. is Kmart’s largest supplier and supplies Kmart with almost all of its food and with its infrastructure for its food businesses. Bruce S. Nathan, Critical Vendors: Elevating the Low-Priority Unsecured Claims of Pre-Petition Trade Creditors, AM. BANKR. INST. J., 2002 ABI JNL. LEXIS 93, at *8-*9. Handleman Co. is Kmart’s sole music supplier and supplies infrastructure for Kmart’s music businesses. Id. at *9.

\textsuperscript{49} Id. at 821. Capital raised several issues on appeal, but the only one relevant to the discussion in this Comment is “whether 11 U.S.C. § 105(a) or the ‘Doctrine of Necessity’ provides a bankruptcy court with either the statutory authority or equitable power to allow the payment of selected prepetition unsecured . . . claims” before confirmation of the Chapter 11 plan. Id. at 821. Capital raised what it thought to be a separate issue, “whether ‘a bankruptcy court may utilize’ § 105(a) or the ‘Doctrine of Necessity’ ‘to circumvent explicit provisions of the Bankruptcy Code.’” Id. However, the district court viewed this issue as the same as the above issue. Id.

\textsuperscript{50} Id. at 823. The district court held that it could not “ignore the Bankruptcy Code’s scheme of priority in favor of ‘equity,’ especially in light of” a statement made by the Seventh Circuit. Id. “The fact that a [bankruptcy] proceeding is equitable does not give the [bankruptcy] judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be.” In re Chicago, Milwaukee, St. Paul & Pac. R.R. Co., 791 F.2d 524, 528 (7th Cir. 1986). Equity in a bankruptcy proceeding functions as a guide for the “division of a pie that is too small to allow each creditor to get the slice for which he originally contracted.” Id.

\textsuperscript{51} Capital Factors, 291 B.R. at 822.
Congress has not codified the doctrine, so "the only way to apply it is through section 105(a)." The Code does not "carve out priority" for prepetition claims based on the critical status of the creditor. The bankruptcy court's order elevated the claims of the so-called critical vendors over claims of other noncritical creditors. The bankruptcy court "altered the priority scheme" provided for by the Code. It is clear that regardless of the usefulness such orders may have, they are not authorized by the Code. Having its order reversed by the district court, Kmart appealed to the Court of Appeals for the Seventh Circuit, which upheld the district court's decision.

2. *In re CoServ, L.L.C*

In contrast to the District Court for the Northern District of Illinois, the Bankruptcy Court for the Northern District of Texas held that section 105(a) of the Code does in fact authorize bankruptcy courts to authorize payment of prepetition claim to certain creditors that are critical to the company's continued operation. On November 30,

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52. *Id.* at 823; see also *id.* at 822. Congress has also not permitted pre-plan payment of prepetition claims under any section of the Code. *Id.* at 822.

53. *Id.* Section 105(a) provides the bankruptcy court with the power to issue any order that is necessary to carry out provisions of the Code. *Id.* at 821.

54. *Id.* at 822.

55. *Id.* The bankruptcy court "subordinate[d] the claims of non-'critical' . . . creditors." *Id.*

56. *Capital Factors*, 291 B.R. at 822. Under the general priority scheme required by the Code, creditors' "claims are paid based on where they are situated on the claims priority ladder." *Nathan, supra* note 48, at *4*. The claims of creditors situated on the same rung of the ladder, which are those in the same class, are entitled to the same treatment. *Id.* Situated on the top rung of the ladder and entitled to payment first are secured and lien creditors. *Id.* (citing 11 U.S.C. § 506(a)). The next rung of the ladder contains administrative priority claims, such claims include those of creditors that provide the debtor with goods and services during the bankruptcy case. *Id.* (citing 11 U.S.C. § 507(a)). Lower-level priority claims occupy the next rungs of the ladder in a designated order and are entitled to payment only after all of the administrative priority claims have been paid in full. *Id.* (citing 11. U.S.C. § 507(a)(2)-(9)). Unsecured prepetition creditors occupy the lowest rung of the ladder and are not entitled to payment until all of the higher priority claims have been paid in full. *Id.* at *4*-*5.

57. *Capital Factors*, 291 B.R. at 823. The district court recognized that such orders may be beneficial. *Id.* "[P]re-plan payment of certain prepetition claims allows the debtor to minimize disruptions in doing business," and this may actually further reorganization. *Id.* The district court focused not on the potential benefits of these orders but focused on the fact that such orders simply are not authorized by the Code. *Id.*

58. Salerno, *supra* note 8, at *8*.

59. *In re Kmart Corp.*, 359 F.3d 866, 874 (7th Cir. 2004). The court based its decision on similar considerations as did the district court. *See id.* at 871-73. The court stated that § 105(a) does not give the bankruptcy court the right to sidestep the Code's priority and distribution rules. *Id.* at 871.


61. *CoServ*, 273 B.R. at 497. According to this court, the Doctrine of Necessity is a "rule of payment not of priority." *Id.* at 493 n.7.
2001, the debtors filed petitions for relief under Chapter 11 of the Bankruptcy Code.62 Debtors claimed that they owe National Rural Utilities Cooperative Finance Cooperation ("Lender") about $26 million in prepetition debt.63 Debtors also claimed that the sale of their assets to Stellar Holdings, L.L.C., in the amount of $90 million, would provide substantial return to all creditors.64 Lender disputed the amount owed to it and asserted the amount was substantially in excess of the $90 million the sale would produce.65

Debtors filed an Emergency Motion for Order Authorizing Payment of Prepetition Claims of Critical Vendors ("Motion") at the same time that they filed their bankruptcy petition.66 The court held the hearing on the Motion on December 20, 2001.67 Only one creditor, designated by Debtors as a critical vendor, participated in the hearing.68

The bankruptcy court held that the Code, through section 105(a), provides the bankruptcy court with the power to authorize payment of certain prepetition claims.69 Only section 105(a) would allow the bankruptcy court to violate the general principle that general prepetition claims of unsecured creditors shall be treated equally.70 Bankruptcy courts can order such payments only under extraordinary circumstances.71 While the court decided that it did not possess the broad power advocated by the debtors,72 it did posses the authority to allow such payments if necessary to the performance of the trustee's fiduciary duty, which includes preserving an operating business's value.73

The court also created a three-element test for determining when such payments will be allowed.74 The test that the court announced

62. Id. at 489.
63. Id. at 490.
64. Id.
65. Id.
67. Id. Debtors, thereafter, narrowed their request to seven creditors to whom Debtors wanted to pay over $500,000. Id. Lender did not announce its support or objection to this reduced request. Id.
68. Id. at 490.
69. Id. at 497.
70. Id. at 493. "Only Section 105(a) offers the equitable muscle that would allow a bankruptcy court to violate one of the principal tenets of Chapter 11." Id. The principal tenet referred to by the bankruptcy court is that prepetition claims of creditors be satisfied on an equal basis. Id.
72. Id. at 495.
73. Id. at 497.
74. Id. at 498-499.
contained three elements that the debtor must meet before the bankruptcy court may authorize payment of prepetition debt to so-called critical vendors. First, the debtor must demonstrate that dealing with the claimant is indispensable to profitable operations or preservation of the estate. Second, the debtor must demonstrate that failing to deal with the claimant will likely cause harm or eliminate an economic advantage that is greater than the amount claimed. Third, the debtor must demonstrate that there exists no practical or legal alternative by which the debtor can deal with the claimant and that payment is the only alternative. These three criteria must be proven by a preponderance of the evidence.

B. Do Critical Vendor Orders Violate Procedural Due Process?

Noncritical vendors argue that the issuance of first day orders offends procedural due process. The basis for this argument stems from the fact that the hearings for first day orders often occur either on the same day or the day after the debtor files its bankruptcy petition. This leaves little or no time for notice to be sent to all interested parties.

75. Id. at 498.
76. CoServ, 273 B.R. at 498. "To meet this requirement debtor must show that, for one reason or another, dealing with the claimant is virtually indispensable to profitable operations or preservation of the estate." Id. This element may be satisfied when the claim sought to be paid is that of either the sole supplier of a certain product or a creditor that has "control over valuable property of the estate." Id.
77. Id. "[A] debtor must show that meaningful economic gain to the estate or to the going-concern value of the business will result or that serious economic harm will be avoided through payment of the prepetition claim, which itself is materially less than the potential loss to the estate or business." Id. at 498-99. This means that if the debtor does not deal with the creditor, the debtor risks the harm or loss of economic advantage to the estate of the debtor's going concern value, which is disproportionate to the amount of the claimant's prepetition claim. Id.
78. Id. at 499. This element will not be met if the payment is merely intended to alleviate the creditor's concern about future payment because there are alternatives that do not violate the principles of the Code. Id. "If payment is intended to assuage the [creditor's] concern about future dealings, a deposit, collect on delivery terms, payment of shipment and countless other devices are available that will not offend the general principle that prepetition claims should not be paid." Id.
79. Id. at 498.
80. See In re U.S. Metalsource Corp., 163 B.R. 260, 266 (Bankr. W.D. Pa. 1993) (explaining that the creditor argues for modification of the first day order "because it is void for lack of procedural due process").
81. See Capital Factors, 291 B.R. at 820 (stating that the hearing on the critical vendor motion was the same day as Kmart filed its bankruptcy petition); Metalsource, 163 B.R. at 262 (stating that the hearing on the first day motion was held the day after the bankruptcy petition was filed). But see CoServ, 273 at 490 (stating that the bankruptcy court held the first day hearings five days after the petition was filed).
Although few courts have addressed the question of whether or not first day orders offend due process, one bankruptcy court has answered in the negative.82 U.S. Metalsource Corp. ("Metalsource") filed a voluntary petition for bankruptcy under Chapter 11.83 On the same day that it filed for bankruptcy, Metalsource filed a motion to authorize payment of prepetition wages ("Wage Motion").84

A hearing was held on the next day, and the Metalsource’s attorney emphasizing that employees are essential to continued operations.85 Even though the U.S. Trustee was the only party to receive notice of the hearing, the largest secured creditor was present at the hearing.86

However, Metalsource did serve a copy of the Wage Order to all parties on the service list.87

Under the Wage Order, Metalsource continued to employ its prepetition severance policies.88 Metalsource continued to operate at a loss and did not have a confirmed reorganization plan until almost three years after its bankruptcy petition was filed.89 The Official Committee of Unsecured Creditors Metalsource, Corp. ("Committee") learned that Metalsource had paid over $1.1 million to employees and paid an average of over $14,000 to twenty-one salaried employees.90

The Court held that where interested parties have prompt notice of the first day order, the requirements of due process are met.91 The United States Supreme Court set forth the requirements for due process as follows: due process is reasonably calculated notice under all of the circumstances, there must be an opportunity to be heard, and these two conditions must be reasonably met.92 In applying these requirements to this case, the court held that actual notice, in the form of the Wage Order, provided within days of the hearing reasonably

82. Metalsource, 163 B.R. at 268. It is important to note that this case involved a wage order to authorize payment of prepetition wages, not a critical vendor order to authorize payment of the prepetition claims of creditors. Id. at 262.
83. Id.
84. Id.
85. Id.
86. Id. at 263.
87. Metalsource, 163 B.R. at 263.
88. Id.
89. Id. at 263–64.
90. Id. at 264. The suit was filed based on the payments made to the salaried employees. Id.
91. Id. at 268. Metalsource did not meet the notice requirements of the Bankruptcy Code because the payments were not in the ordinary course. Id. at 267. The court stated, however, that this did not necessarily deprive the Committee of due process. Id.
met these requirements. The court did recognize that due to the urgent nature of most first day orders, "it is difficult for all interested parties to receive adequate notice of the first day hearings." However, first day orders can be modified or reconsidered by the court upon the request of creditors. Because "opportunity to be heard [is] not lost forever" if a party cannot attend the hearing, the "Wage Order is not void for lack of due process."

IV. ANALYSIS

This section will argue that courts lack statutory authority to issue first day orders. It will also argue that the current process of issuing first day orders violates procedural due process.

A. First Day Orders Lack Statutory Authority

The disagreement between the bankruptcy courts about their ability to authorize payment of the prepetition claims of unsecured creditors can only be resolved by determining who has the power – the bankruptcy courts or Congress. The Code, enacted by Congress, contains a rather complicated system of checks and balances, the purpose of which is to promote numerous interests. However, according to one critic, "[t]he problem arises when the bankruptcy judge believes, rightly or wrongly, that strict compliance with the letter of the statute may defeat rather than further the underlying policy favoring reorganizations." Some bankruptcy judges believe that they have the authority to overrule the letter of the statute in order to promote reorganization. However, some courts, including the Capital Factors court, say that they have no such power.

This section of the Comment discusses the reasons why the District Court for the Northern District of Illinois correctly decided Capital

93. Metalsource, 163 B.R. at 268. "The Salaried Employee's content that the Committee's actual notice of the Wage Order within days of its entry was sufficient to reasonably meet the conditions of procedural due process . . . . After considering all of the circumstances of this case, the Court agrees with the Salaried Employees." Id.
94. Id.
95. Id.
96. Id.
98. Id.
99. Id.
100. Id. at 99–100. The question that must be asked is "does the judge have what amounts to a judicial trump card—the power to override the express terms of the statute to further the reorganizations policy." Id.
101. Id.
Factors when it held that first day orders lack the authority of the Code. Allowing payment of the prepetition claim of a "critical vendor" accords that creditor a preferred status not permitted by the Code.\textsuperscript{102} The critical vendor doctrine is not authorized by any provision of the Code.\textsuperscript{103} Even those who think that section 105(a) does support use of the Doctrine of Necessity agree that it seems to conflict with other provisions in the Code,\textsuperscript{104} provisions such as those setting forth the priority scheme in which creditors will be paid.\textsuperscript{105} As the court in \textit{Capital Factors} stated, courts cannot disregard the Code's "scheme of priority in favor of equity."\textsuperscript{106} Because Congress has not codified the Doctrine of Necessity or provided some other means of allowing payment of prepetition claims of unsecured creditors, the court in \textit{Capital Factors} held that it lacked statutory authority to authorize payment to Kmart's so-called critical vendors,\textsuperscript{107} and to maintain otherwise is "nonsensical."\textsuperscript{108} Until Congress amends the Code and gives creditors with powerful influence over the debtor's business the right to be paid, bankruptcy "courts have no business rewriting the Code themselves in misguided attempts to save the debtor."\textsuperscript{109}

Furthermore, approval of critical vendor motions often may lead to the bankruptcy court paying little or no attention to the Code and one of its fundamental principles.\textsuperscript{110} One bankruptcy court noticed that in approving critical vendor orders, attempts by debtors to evade the

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\item\textsuperscript{102} Vance & Barr, supra note 28, at 391.
\item\textsuperscript{103} \textit{In re Chandler}, 292 B.R. 583 (Bankr. W.D. Mich. 2003). See also Russell A. Eisenberg & Frances F. Gecker, \textit{The Doctrine of Necessity and Its Parameters}, 73 MARQ. L. REV. 1, 5 (1989) (stating that the Code does not "explicitly authorize[ ] the use of the Doctrine [of Necessity]"). In examining the legislative history of section 105(a), one finds nothing about critical vendors or the ability of the bankruptcy courts to act in contravention to the priority scheme set forth in the Code. Gilday, supra note 3, at 432.
\item\textsuperscript{104} See \textit{id.} at 6 (stating that the Doctrine of Necessity "seemingly conflict[s] with some Code provisions" but is supported by section 105(a)).
\item\textsuperscript{105} Currie & McCann, supra note 4, at *9. The agreements authorized by critical vendor orders and through which a debtor agrees to pay prepetition claims of an unsecured creditor in exchange for the creditor's promise to continue to ship goods "essentially result in the conversion of lower priority prepetition general unsecured claims into higher priority administrative claims." \textit{Id.} This conversion obviously conflicts with the explicit Code language setting forth the priority scheme in which general unsecured creditors are paid \textit{only} after all other claims have been paid in full.
\item\textsuperscript{106} \textit{Capital Factors}, 291 B.R. at 823 (internal quotation marks omitted).
\item\textsuperscript{107} \textit{Id.}
\item\textsuperscript{108} Gilday, supra note 3, at 448. "To maintain that courts were given the power to act contrary to the Code's specific [priority] restrictions is nonsensical." \textit{Id.}
\item\textsuperscript{109} \textit{Id.} at 450.
\item\textsuperscript{110} Randolph J. Haines, \textit{Recent Developments in Chapter 11}, 2002 ANN. SURV. OF BANKR. LAW 659 (2002). A critical vendor order specifically contravenes a basic premise of the Code, similarly situated creditors are entitled to equal distribution of the debtor's assets. Bruce H. White & William L. Medford, \textit{The Doctrine of Necessity and Critical Trade Vendors: The Imprac-}
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Code would become the norm rather than the exception. Debtors, in a number of cases, have persuaded bankruptcy courts to extend the doctrine beyond nonrailroad reorganizations despite the specific statutory limitations of the Code. One bankruptcy court noted that “selective repayment of pre-petition debt” would violate the automatic stay required by section 362(a) of the Code. This same court noted that tolerating such payments contradicts a fundamental principle behind the Code – that is, similarly situated creditors receive equal treatment.

In order to circumvent the statutory and policy limitations, bankruptcy courts cite section 105(a), which states that “[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.” Section 105(a) has been called by some “ever-popular” and “apparently omnipotent,” a tone that denotes an overall lack of enthusiasm for the use of section 105(a). Even some bankruptcy judges who grant first day orders believe that their “authority must be tied to something other than Section 105 discretion.” Even courts that have not definitively held that critical vendor orders cannot be supported by section 105(a) have been exceedingly reluctant to grant such orders.


112. Barsalou, supra note 18, at *5. Barsalou noted also the fact that bankruptcy courts that extend the Doctrine of Necessity beyond railroad cases do so in contravention of historical limitations in addition to the contravention of statutory limitations.


114. Id. “Such activity . . . would negate the fundamental principle of equality of treatment among similarly situated creditors.” Id.


116. White & Medford, supra note 110, at *3.

117. Some commentators describe the first day orders as “grounded on questionable legal postulates emanating from § 105 and the Doctrine of Necessity.” Cousins, supra note 111, at 213.

118. Bankr. L. Daily, Views from the Bench: First-Day Issues, Real Estate Bankruptcies, Sec. 363 Sales on Tap at “Views” Program, available on WESTLAW at 9/25/2003 BLD d8 (hereinafter “Views from the Bench”). Many courts rely on section 364 of the Code for their authority. Id. However, discussion of section 364 is beyond the scope of this article.

119. Tabb, supra note 97, at 98. Tabb cites In re Structurlite Plastics Corp., 86 B.R. 922 (Bankr. S.D. Ohio 1983), as an example of such a reluctant court. Structurlite, “a manufacturer of lightweight structural plastic products,” moved for authority to pay the prepetition medical claims of its employees. In re Structurlite Plastics Corp., 86 B.R. 922, 923–24 (1983). Structurlite’s justification was that failure to pay the claims would lead to employee unrest and a decline in productivity. Id. at 924. There was also a fear that the failure would lead to a strike. Id. “Judge Cole examined the two divergent lines of authority on the question of the court’s power to approve such payments, and declined to throw his hate in either camp.” Tabb, supra note 97, at 98.
Although bankruptcy courts that approve critical vendor orders do so under the guise of statutory authority by invoking the equitable power provided in section 105(a), every time a circuit of the United States Court of Appeals ("circuit(s)") has been called upon to decide whether the Doctrine of Necessity should be extended to nonrailroad reorganizations, those courts have "soundly rejected" such an extension. Additionally, these circuits have rejected reliance on the broad language in section 105(a). Instead, without exception, these circuits have disallowed any action that exceeds the authority provided in the Code, which specifically authorizes payment of prepetition claims to unsecured creditors only under a confirmed reorganization plan.

Many scholars suggest that no court should have the authority to approve the payment of an unsecured creditor's prepetition claim prior to confirmation of the reorganization plan. Under the Code, unsecured creditors should not be paid before priority creditors; however, when a critical vendor motion is granted, unsecured creditors are paid while priority creditors are forced to wait for a reorganization plan. Charles Jordan Tabb, an associate law professor at the University of Illinois College of Law, describes such orders as "confer[ring to creditors] substantive rights of uncertain legality." Beyond the uncertain legality of critical vendor orders, such orders as they stand today— that is, without statutory authority and without guidelines for when they should be granted—open the door for ma-

Judge Cole was able to stay out of the controversy because the case for authorizing such payments under section 105(a) has not been made. Structurlite, 86 B.R. at 932.

120. Barsalou, supra note 18, at *6. See B & W Enterprises, 713 F.2d at 537; In re Johnson Bronze Co., 578 F.2d 138, 141 (3d Cir. 1985); Mabey, 832 F.2d at 302; Oxford Mgmt., 4 F.3d at 1334. Although Barsalou was speaking of cases decided up to 1994, there seems still to be no circuit decision approving the extension of the Doctrine of Necessity.

121. Id. The fact that every circuit that has decided a case on the Doctrine of Necessity has rejected its application to general businesses illustrates the fact that the critical vendor orders have no statutory basis. Furthermore, the Doctrine emerged in railroad cases where "the public interest [was] considered paramount." Tabb, supra note 97, at 99. However, many courts that approve critical vendor orders do not rely on the public interest rationale that was so important to the creation of the Doctrine. See id. at 100 (referring to In re Ionosphere Clubs, Inc., 98 B.R. 174 (Bankr. S.D.N.Y. 1989)).

122. Barsalou, supra note 18, at *8. “[I]n the absence of a [sic] express grant, a court may have no power to authorize, outside a confirmed plan, the payment of select pre-petition creditors, regardless of the equities or the economic necessities of the case.” Cousins, supra note 111, at 217.


125. Tabb, supra note 97, at 75. Just a few sentences later, Tabb once again describes such orders as possibly illegal. Id.
nipulation by creditors. Creditors may engage in "economic blackmail," using their influence to extort payment of their prepetition claims. Creditors with powerful influence on the debtor's business negotiate outside the rules in order to avoid limitations provided by the Code. Such coercive tactics used by creditors to secure preplan payments of prepetition claims cause debtors to suffer because rewarding such tactics through authorization of critical vendor motions eliminate protections against such tactics built into the Code. Such tactics also increase the financial burden of Chapter 11 cases.

Additionally, the outcome of a critical vendor motion will depend on the attitude of a particular bankruptcy judge, which in turn may influence the debtor's choice of venue. At this point in time, exactly how far the Doctrine of Necessity will reach is left up to each individual court. One can argue that the CoServ test, if adopted across circuits, would curb this discretion and reduce the possibility for forum shopping. However, the CoServ test itself requires judicial discretion in determining what kind of evidence would be sufficient to satisfy each prong of the three-prong test by a preponderance of the evidence.

126. See Nathan, supra note 48, at *11-*12 (discussing CoServ, which states that critical vendors cannot exert their influence to secure payment of prepetition claims).
127. Barsalou, supra note 18, at *10-*11.
128. Id. at *11. Barsalou posits that if courts routinely denied requests for critical vendor orders, creditors would not have the opportunity to be paid through preferential orders and might help prevent debtors from being in bankruptcy for an excessive period of time. Id. at *11 n.12.
130. Patrick A. Murphy, Initial Stages of the Chapter 11 Case, CREDITORS' RTS. IN BANKR. § 16:4 (2d ed. 2003). Debtors engage in forum shopping to file in districts where the bankruptcy courts accept and apply the Doctrine of Necessity. See id. Where alternative forums are available to a debtor, the forum's receptiveness to critical vendor motions is likely to be an important factor to a debtor in determining in which forum to file the bankruptcy petition. Id. In addition, bankruptcy courts engage in forum selling to entice debtors to file in their district. Bankruptcy courts allow and approve critical vendor motions in order to appear "big chapter 11 friendly." White & Medford, supra note 110, at *4 (internal quotation marks omitted). This is particularly true in the mega-cases, which have several vendors that are allegedly critical. Id.
131. Richard I. Aaron, The Disposition of Encumbered Property, BANKR. L. FUNDAMENTALS § 9:6, n.13 (2003). This also leaves the door open for bankruptcy judges to rule in a way that makes their district attractive to debtors.
132. Although CoServ provides an example of what would satisfy each prong, it does not set concrete evidentiary requirements that each debtor must provide in order to satisfy the test by a preponderance of the evidence. See CoServ, 273 B.R. at 498-99. Take the first element of the CoServ court's test, for example. The first element is that the debtor must deal with the claimant. Id. at 498. The court provided an example of what situation would satisfy this element. The court stated that "[t]he debtor's customers, sole suppliers of a given product and creditors having control over valuable property of the [debtor's] estate would satisfy this element." Id. Although the court said that such claimants would satisfy the first element of the test, it does not provide
In addition, the evidentiary standards that can be gleaned from the CoServ test would be impossible to meet in the “mega-cases,” such as Kmart. These evidentiary standards would also be impractical for emergency first-day hearings at which many critical vendor orders are granted. In order to obtain approval of a critical vendor motion, a debtor would have to prepare its own testimony, prepare expert testimony, solicit live testimony or affidavits from the vendor, and examine and present alternatives to payment to show their impracticability.

There are problems with each of the types of evidence mentioned. First and foremost, the amount of time required to gather such evidence is extraordinary. Gathering evidence to satisfy all three elements of the CoServ test is impossible to do for an emergency hearing, which often occurs on the same day that the bankruptcy petition is filed or on the next day, and is completely impractical to do in a mega-cases, in which there are numerous vendors that are purportedly critical. Second, soliciting expert testimony is expensive for a client who is not going through a bankruptcy proceeding, so imagine the financial impact for a debtor going through bankruptcy. Third, vendors, who are often not legally sophisticated, are not likely to give any guidance about the actual evidence that must be introduced. See id. This leaves open the door for judicial discretion in what evidence is sufficient and what is not.

133. As used in this context, the phrase evidentiary standards refers what the CoServ court stated the debtor must show in order to satisfy each element of the three-prong test. Therefore, those standards are to show: (1) that dealing with the claimant is “virtually indispensable to profitable operations or to preservation of the estate”; (2) that failing to deal with the claimant will likely harm the debtor or eliminate an economic advantage that is greater than the amount of the claim; (3) that there exists no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim. Id. at 498–99.

134. White & Medford, supra note 110, at *2. White and Medford mention “evidentiary pre-requisites.” Id. However, this does not mean that specific types of evidence are required; it merely means that evidence must be introduced that will satisfy each element of the CoServ three-prong test. See id. at *6–*7 (outlining what types of evidence may be used to demonstrate that the “[vendor] is ‘virtually indispensable to profitable operations’”).

135. Id.

136. See id. at *6–*9.

137. White and Medford describe that task of gathering evidence for element two as a “burdensome” one. Id. at *8. Actually, gathering evidence for all three elements is burdensome.

138. See White & Medford, supra note 110, at *11 (stating that the debtor who files an emergency motion has had not time to gather evidence); see id. at *2 (explaining that the evidentiary standards are impractical for emergency hearings).

139. See, e.g., Capital Factors, 291 B.R. at 820.

140. See, e.g., Metalsource, 163 B.R. at 262.

141. White & Medford, supra note 110, at *2.

142. Id. at *4. The number of vendors in a mega-case could “aggregate to hundreds or even thousands.” Id. at *9.
to be very cooperative. Therefore, the evidentiary standards require the debtor to compile an enormous amount of evidence, the practical ramifications of which may turn out to be counterproductive, especially in mega-cases, such as Kmart.

**B. First Day Orders Offend Procedural Due Process**

The debate surrounding critical vendor orders has not been solely focused on the concerns about their legality or illegality. In reality, much of the controversy has surrounded the procedural rights of the creditors and the perception that those rights "have been severely trampled upon." The perception stems from the fact that in many cases the court entered critical vendor orders with little or no notice having been provided to unsecured creditors.

This section of the Comment discusses procedural due process and the *Mullane* requirements for notice to be sufficient in order to ensure due process in the context of first day orders. It is important to remember that procedural due process requires the opportunity to be heard and that the opportunity to be heard means little without sufficient notice. However, "the rapidity with which [critical vendor] orders are entered – often within the first few days of the case, well before . . . notice of the bankruptcy filing, much less of hearing – creates due process concerns that may call the validity of such orders into question." It is also important to remember that the opportunity to be heard must be meaningful.

Having a meaningful opportunity to be heard is the first requirement of procedural due process. A creditor in a bankruptcy proceed-

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143. Id. at *8. If vendors wanted to cooperate with the debtor, they would not require payment of prepetition claims prior to confirmation of the debtor's reorganization plan. Id.
144. Id. at *9.
145. Although the burden of proof is only preponderance of the evidence, the three prongs, as illustrated by the court, still require that a great deal of information be compiled. However, the court does not illustrate how much information would be sufficient to satisfy the burden placed on the debtor. The court leaves this up to each individual bankruptcy judge without providing any real guidance.
146. Tabb, supra note 97, at 102.
147. Id.
148. Id. Another reason for this perception is that payment of unsecured creditors' prepetition claims is preferred by the debtor's management even at the expense of secured creditors' claims. Jo Ann J. Brighton, *The Doctrine of Necessity: Is it Really Necessary?*, 10 J. BANKR. L. & PRAC. 107, 109 (2000).
151. See *Fitzgerald*, 13 F. Supp. 2d at 123.
The court in Metalsource thought that the opportunity to be heard was not lost upon entry of a first day order approved without prior notice to the creditors because such an order can be modified. This presupposes, however, that the debtor has not made any of the payments authorized by the order. If payments have been made, it is very difficult to get money back from creditors.

In re U.S. Metalsource Corp., even though it was a case in which the court held that the critical vendor orders did not violate procedural due process, highlighted the "damage caused by procedural shortcuts on first-day orders and [the] improbability of 'unringing the bell' once an order is entered." The court refused to modify the order because too much time had passed between the entry of the order and when the creditors objected and found it "difficult to undo what has already been done." Although nineteen months had passed between the entry of the order in Metalsource and the creditors' objection, it is possible that even a timely objection would have been too late if the debtor made payments the day that the order was entered. The ability of the noncritical vendors to be heard becomes meaningless because although they can move for modification of the order, such modification would likely not change the fact that the debtor's estate has been reduced.

In addition to the opportunity to be heard, for the entry of a critical vendor order to pass procedural due process muster, the three requirements of notice must be met: 1) notice must reasonably convey the required information, 2) notice must provide parties with a reasonable time to appear, and 3) the way in which notice is given must be one that someone wishing to actually inform the absent party might reasonably adopt. It is likely that any notice sent will convey the required information, thereby satisfying the first requirement. It is also likely that notice will be sent according to accepted procedures, thus satisfying the third requirement.

152. Metalsource, 163 B.R. at 268.
153. See Currie & McCann, supra note 4, at *16 (noting the practical difficulty of recapturing payments made based on a critical vendor order).
154. Barsalou & Mosner, supra note 150, at *3 n.3.
155. Metalsource, 163 B.R. at 271.
156. Id. at 267.
157. Mullane, 339 U.S. at 314 (citing Grannis v. Ordean, 234 U.S. 385 (1914)).
158. Id. (citing Roller v. Holly, 176 U.S. 398 (1900)).
159. Id. at 315.
However, the second requirement, providing reasonable time to appear, is the fatal requirement for first day orders. First day hearings may be on the same day that the motion is filed (it is more likely that the hearings will be held within the first two days). Notice can even be as limited as several hours. This provides the creditors' counsel with little, if any, time to prepare their objections before the hearing takes place. In fact, "[i]t is possible that many creditors [do] not get notice of the hearing in time to attend." Such a limited amount of time does not satisfy the requirement that notice provide a reasonable time to appear. Many courts have recognized this problem and have refused to enter critical vendor orders in the absence of adequate notice being provided to those who would be disadvantaged by entry of such an order.

Some bankruptcy judges who grant critical vendor orders recognize the notice problem that such orders create. Judge Gregory W. Zive, a bankruptcy judge for the District of Nevada, noted that his primary concern about first day motions, which includes critical vendor motions, is whether or not notice has been provided to all interested parties. Judge Zive believes that notice is required so that all interested parties have the opportunity to be heard before money floods out of the bankruptcy estate. Without the prior notice that Judge Zive requires, the matter cannot be heard in a meaningful time and in a meaningful manner because secured creditors would not have the opportunity to be heard.

V. IMPACT: BLANKET PROHIBITION VERSUS CONGRESSIONAL LEGISLATION

There are two ways that this problem can be solved: 1) a blanket prohibition of critical vendor orders or 2) a section in the Code that authorizes the bankruptcy courts to approve such orders. This section of the Comment will discuss the way in which a uniform prohibition could be adopted as well as the possible legislation that Congress could enact to resolve the disparate treatment that bankruptcy courts now provide to first day critical vendor orders.

162. Barsalou, supra note 18, at *2.
163. Tabb, supra note 97, at 103.
164. Views from the Bench, supra note 118.
165. Id.
166. Tabb, supra note 97, at 115.
A. Blanket Prohibition

The first possible solution is for bankruptcy judges to implement a uniform rule against the use of critical vendor orders. The major appeal with this solution is that it provides uniform treatment to critical vendor motions. Uniformity is important because critical vendor motions come up frequently. Also, first day motions are currently decided according to the attitude of the bankruptcy judge presiding over the case, and this influences the debtor’s venue choice. With a uniform rule against approving first day motions, debtors will no longer be influenced by the attitude of a particular judge when deciding where to file their bankruptcy petitions.

A blanket prohibition would also solve the procedural due process problem created by critical vendor orders. If no judge has the authority to approve a critical vendor motion, then there is no problem with creditors being deprived of money that they are owed without receiving adequate notice of the critical vendor hearing. It also would prevent the bankruptcy estate from being almost completely depleted before the noncritical vendors are paid.

In addition, a blanket prohibition would remove the incentive for influential creditors to manipulate the debtor and the entire bankruptcy system. Sophisticated and influential creditors, knowing that there is no possibility of being paid before confirmation of the debtor’s reorganization plan despite the threat of withholding supplies, would be acting contrary to their own interests. Economic harm to the estate caused by a lack of necessary supplies would harm the amount of money they would receive under the reorganization plan.

There is a large problem with a blanket prohibition on authorizing payment to critical vendors. The problem with a flat prohibition on critical vendor orders is the risk that the debtor’s suppliers will stop delivering to the debtor. If this risk is realized, the debtor’s reorganization is jeopardized, and a purpose of the Code is undermined. Because the risk is different for every debtor and every supplier, a statutorily authorized balancing approach in which the debtor’s rights

167. Id.
168. Id. The filing of critical vendor motions has even been described as a common practice for debtors. Joshua W. Cohen, Necessity No Longer Critical in Chicago?, NORTON BANKR. L. ADVISOR (July 2003). Indeed, “it’s very clear that vendors demand critical vendor treatment because they know they can.” Morris, supra note 129, at *5.
169. Murphy, supra note 130.
170. Cousins, supra note 111, at 218.
171. Id.
172. Id.
and needs are weighed against creditors' rights better serves the purposes of the Code than does a blanket prohibition.173

B. Congressional Legislation

The other possible solution to the problem of first day orders is congressional action. Obviously, the lack of statutory authority problem would be solved through legislation because Congress would be providing the courts with the authority. The legislation would have to address the insufficient notice that is provided when critical vendor orders are at issue. In addition, the legislation would have to provide for alterations to the existing priority scheme when critical vendors are at issue.

First, if Congress were to enact legislation authorizing first day orders, it would need to clearly and unambiguously establish that bankruptcy judges have the power to authorize such orders. The judge's power would have to "be unequivocally established so that all judges will consider the use of that power in appropriate circumstances."174 The provision would also have to clearly define what appropriate circumstances for authorizing such orders would be. For example, appropriate circumstances could be defined according to the CoServ test.175 However, concrete evidentiary requirements would have to be established in order to curb discretion that is allowed under the current CoServ test.176

Second, if Congress were to enact legislation authorizing first day orders, it would need to contain notice requirements that allow all creditors to be present at the hearing. To conform to procedural due process, the legislation would have to contain strict procedural guide-

173. The purposes of the Code referred to here include both successful reorganization of the debtor's business and equal treatment of similarly situated creditors.
174. Tabb, supra note 97, at 115.
175. Granting a critical vendor motion is appropriate when (1) dealing with the claimant is "virtually indispensable to profitable operations or to preservation of the estate"; (2) failing to deal with the claimant will likely harm the debtor or eliminate an economic advantage that is greater than the amount of the claim; and (3) there exists no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim. CoServ, 273 B.R. at 498-99.
176. For example, the provision would set out that the debtor had to prove all three elements by a preponderance of the evidence, as the CoServ test does, but also would require specific pieces of evidence to be produced. This would statutorily require that courts require proof of the critical nature of the vendor and prohibit rubber-stamping the debtor's request, which evidence suggests has occurred under the current first day order practices. See Brighton, supra note 148, at 108-09 (explaining that courts lean towards authorizing such payments without actually analyzing whether such payments are in the best interests of creditors). See also Norton, supra note 19 (stating that there is some "anecdotal evidence suggest[ing] that blanket 'first day orders' are signed authorizing immediate payment of many prepetition claims").
lines that provide protection for unsecured creditors and their rights.\textsuperscript{177} Therefore, the legislation would have to prohibit hearings held on the same day as the filing of the petition, the day after filing, and possibly longer. The fifteen day notice required by Bankruptcy Rule 4001(c) is possible as a notice requirement for critical vendor orders.\textsuperscript{178} This will provide all creditors with a meaningful opportunity to be heard because they will have the opportunity to prepare arguments against granting critical vendor motions. While the delay may seem extreme in cases where critical vendor hearings are indeed emergencies – that is, they are immediately necessary to the continued operation of the debtor's business – "procedural due process is not intended to promote efficiency."\textsuperscript{179} Instead, procedural due process protects the rights of those whose property is about to be taken away.\textsuperscript{180}

Finally, if Congress were to enact legislation authorizing first day orders, it would need to state any alteration to the priority scheme provided for elsewhere in the Code is subject to this provision. This would eliminate the attack made by secured creditors that critical vendor orders "create rights not otherwise available under applicable law."\textsuperscript{181} Bankruptcy judges would no longer be creating rights for critical vendors. Applicable legislation would, itself, create those rights. With a provision allowing alteration of the priority scheme reflected in other sections of the Code, bankruptcy judges who authorize first day orders would be respecting the priority scheme created by Congress.\textsuperscript{182}

Of these two possible solutions, it seems clear that the best solution is for Congress to amend the Code. Congress should enact legislation that will provide bankruptcy judges with the power to authorize payments of prepetition claims to critical vendors. This solution would solve both of the problems outlined by this Comment. It would create the statutory authority that the District Court for the Northern Dis-

\textsuperscript{177} Tabb, supra note 97, at 75.

\textsuperscript{178} Id. at 105.

\textsuperscript{179} Fuentes v. Shevin, 407 U.S. 67, 90 n.22 (1971). The Supreme Court stated that "[p]rocedural due process is not intended to promote efficiency or accommodate all possible interests: it is intended to protect the particular interests of the person whose possessions are about to be taken." Id. In the case of critical vendor orders, creditors are the people whose possessions are about to be taken because the debtor is giving to "critical" vendors money that is rightfully owed to noncritical vendors.

\textsuperscript{180} Id.

\textsuperscript{181} Southern Railway Co. v. Johnson Bronze Co. (\textit{In re} Johnson Bronze Co.), 758 F.2d 137, 141 (3d Cir. 1985).

\textsuperscript{182} For the argument that the respect must be given to the Code priority scheme, see Brighton, supra note 176, at 116.
trict of Illinois found lacking in *Capital Factors*. It would also solve the procedural due process problems of lack of adequate notice and the lack of opportunity to be heard by prohibiting hearings held within the first few days of filing of the bankruptcy petition. Although the new legislation would still allow some creditors to be paid in full while others receive just a fraction of what they are owed, it will curb current bankruptcy judge’s discretion in authorizing preplan payments of prepetition claims and will provide bankruptcy judges with guidelines for determining when a vendor is critical and when a critical vendor should be paid. Clear guidance will ease the difficulty of balancing the desire for reorganization against the risk of wasting the assets in the debtor’s estate.¹⁸³

VI. Conclusion

Critical vendor orders lack statutory authority as the Code stands today. Although section 105(a) empowers the bankruptcy courts with certain equitable powers, it does not cure the ills of lacking statutory authority. The circuits are in agreement that this section does not authorize the bankruptcy courts to approve critical vendor orders because such orders, among other things, alter the existing priority scheme.

Due process is also a problem that plagues critical vendor orders. Creditors who oppose the payment of prepetition claims to certain other creditors are not provided with their constitutionally guaranteed opportunity to be heard because the hearings on critical vendor motions occur almost immediately. In addition, such creditors receive almost no notice about these hearings and are, thus, not provided with their constitutionally guaranteed reasonable amount of time to appear, which includes time to prepare.

These two ills that plague critical vendor orders can only be remedied through federal legislation specifically providing bankruptcy courts with the power to authorize payment of prepetition claims before confirmation of the reorganization plan. Such legislation will provide statutory authority. It would also provide notice requirements that must be met before a hearing can take place, and this will cure the due process problem. In order to quell the controversy over such orders, Congress must enact adequate legislation.

¹⁸³. See Tabb, *supra* note 97, at 114 (explaining that judges must balance these competing interests while facing lack of guidance and lack of time).