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PERSPECTIVE

Critical vendors can be key to Chapter 11 reorganization

By David Kupetz and Asa Hami

The U.S. Supreme Court has emphasized that the Bankruptcy Code's priority system for payment of claims is "a basic underpinning of business bankruptcy law." *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973, 983 (2017). Creditors holding claims of the same priority are generally to be treated equally. The filing of a Chapter 11 bankruptcy petition results in a cleavage date, with unsecured claims incurred prior to the date ordinarily not to be paid, except pursuant to a plan of reorganization, and claims incurred following the commencement of the case to be paid in the ordinary course.

The bankruptcy court, however, may authorize immediate payment of prepetition claims following commencement of a Chapter 11 case in certain circumstances based on Sections 105(a) and 363(b) of the Bankruptcy Code. Section 105(a), which codifies the inherent equitable powers of the bankruptcy court, empowers a bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." Under Section 105(a), courts may permit pre-plan payments of prepetition obligations when essential to the continued operation of a debtor's business. Section 363(b) governs the use of property of the bankruptcy estate outside the ordinary course of business.

On June 15, the U.S. Bankruptcy Court for the Central District of California (Judge Vincent Zurzolo) entered an order approving the plan of reorganization of Shiekh Shoes, LLC, in the company's Chapter 11 bankruptcy reorganization case (case no. 2:17-bk-24626-VZ). Shiekh successfully emerged from Chapter 11, having beneficially modified dozens of leases, eliminated millions of dollars of debt, obtained new financing and closed unprofitable locations. At its inception, however, Shiekh's Chapter 11 case was dependent upon the court approving a critical vendor and super priority financing arrangement Shiekh reached with its key supplier, Nike.

The 9th U.S. Circuit Court of Appeals has found that immediate payment of prepetition claims is appropriate in

certain circumstances. For instance, in *Burchinal v. Central Washington Bank (In re Adams Apple, Inc.)*, 829 F.2d 1484, 1490 (9th Cir. 1987), the 9th Circuit acknowledged the importance of paying certain prepetition claims in a reorganization case, even when the claimants are provided an advantage over other creditors: "[A] 'fundamental tenet'—rehabilitation of debtors... may supersede the policy of equal treatment. Cases have permitted unequal treatment of pre-petition debts when necessary for rehabilitation, in such contexts as (i) pre-petition wages to key employees; (ii) hospital malpractice premiums incurred prior to filing; (iii) debts to providers of unique and irreplaceable supplies; and (iv) peripheral benefits under labor contracts." *Adams Apple*, 829 F.2d at 1490.

Courts have also authorized payment of prepetition obligations under Section 363(b) of the Bankruptcy Code where a sound business purpose exists for doing so. See, e.g., *In re Ionosphere Clubs, Inc.*, 98 B.R. at 175); *In re Tropical Sportswear Int'l Corp.*, 320 B.R. 15, 20 (Bankr. M.D. Fla. 2005) ("Bankruptcy courts recognize that section 363 is a source for authority to make critical vendor payments, and section 105 is used to fill in the blanks."). Moreover, payment of prepetition claims prior to confirmation of a Chapter 11 plan has been recognized by various courts to be particularly appropriate where creditors provide vital goods to a debtor that would be unavailable if the debtor did not satisfy its prepetition obligations.

The U.S. Supreme Court recently tacitly sanctioned payments on prepetition claims to "critical" vendors and other transactions that do not directly comport with the Bankruptcy Code's payment priority scheme, under appropriate circumstances. In *Jevic*, the Supreme Court referenced *In re Iridium Operating LLC*, 478 F.3d 452 (2nd Cir. 2007), and stated: "We recognize that Iridium is not the only case in which a court has approved interim distributions that violate ordinary priority rules. But in such instances one can generally find significant Code-related objectives that the priority-violating distributions serve. Courts, for example, have approved 'first day' wage orders that allow payment of employees'

wages, 'critical vendor' orders that allow payment of essential suppliers' prepetition invoices, and 'roll-ups' that allow lenders who continue financing the debtor be paid first on their prepetition claims. ... In doing so, these courts have usually found that the distributions at issue would 'enable a successful reorganization and make even the disfavored creditors better off.'" *Jevic*, 137 S. Ct. at 985.

Shiekh is a retailer of shoes, apparel and accessories, with Nike product accounting for more than 60 percent of its sales. The company commenced its Chapter 11 case on Nov. 29, 2017. At the time of the commencement of its case, Shiekh operated 125 retail stores in 10 states, and had annual revenues of approximately \$180 million.

For approximately 25 years, Nike shipped product to Shiekh on credit. In 2017, Nike determined that based upon payment trends, financial conditions and other economic factors, Nike was unwilling to continue to supply Shiekh with product, even on a cash-in-advance basis, without payment on the outstanding debt. Prior to the commencement of the Shiekh's Chapter 11 case, Shiekh and Nike reached agreement on a critical vendor and super priority financing arrangement to be implemented through Chapter 11.

At the inception of its Chapter 11 case, Shiekh sought bankruptcy court approval of the critical vendor and super priority unsecured financing agreement in order to ensure the flow of Nike product to the company. This agreement required Shiekh to tender to Nike \$4 million for every \$3 million in product it purchased, with the payment being applied outside the ordinary bankruptcy priority system to pay down Nike's prepetition debt and the new product being supplied on a super priority unsecured credit basis.

The arrangement Shiekh reached with Nike, required that Nike be granted a super priority claim for the product it provided post-petition. This relief was requested under Bankruptcy Code Section 364(c)(1) on the basis that the credit was not available under less onerous terms. As a result, Nike would obtain priority over other postpetition unsecured claims, subject to a carve-out for professional fees and budgeted

expenses.

Nike held the largest unsecured claim against Shiekh, amounting to more than \$16 million. In addition to accounting for the majority of Shiekh's sales, the Nike product: (i) is premium product that Shiekh is able to sell at a relatively high margin, generating substantially more than the cost of the product; (ii) sells quickly; and (iii) drives more traffic to Shiekh's stores and websites. Further, Shiekh had expended considerable resources over the years in order to maintain its relationship with Nike, including constructing specially-branded space in each of its stores for Nike product, developing special marketing campaigns and launch events, providing dedicated training of store managers and sales associates on Nike product, and remodeling 61 retail stores in a manner geared towards the marketing and sale of Nike product, with the hope that the return on its investment would be realized in years to come.

Only Nike was capable of supplying Shiekh with Nike product. Nike's goods were not replaceable without severe disruption and irreparable harm to Shiekh's business model and overall operations. Accordingly, finding that Nike was clearly a "critical" vendor, the court approved the special treatment afforded Nike in the Shiekh case, initially on an emergency interim basis at a hearing conducted the day following the commencement of the case and, allowing for additional notice to creditors, thereafter on a final basis.

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