Legal Notes

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Grafton Partners v. Superior Court, 115 Cal. App. 4th 700, 9 Cal. Rptr. 3d 511 (2004)(Pre-dispute jury waiver clauses are unenforceable under the California Constitution.)

In a decision last February, the Court of Appeals of California diverged dramatically from accepted case law and commonly accepted principles concerning the enforceability of waivers of a jury trial in agreements. While the case did not arise in the context of litigation between a borrower and lender, the court's finding has clear implications for lenders who might find themselves in litigation in California. Many may remember the raft of jury decisions in the 1980s, particularly in California, where lenders were subject to damages in lender liability suits that were completely disproportionate to the amounts of the loans. With this new decision the specter of jury trials for lenders in California looms large again.

The decision arose in a dispute between Grafton and its accountant, PricewaterhouseCoopers ("PwC"). Grafton retained PwC to perform an independent audit on the accounting records of two limited partnerships, Grafton and Allied. The parties' engagement letter contained an express waiver of a jury trial in the event of any litigation between the parties:

> In the unlikely event that differences concerning PwC's services or fees should arise that are not resolved by mutual agreement, to facilitate judicial resolution and save time and expense of both parties, the parties agree not to demand a trial by jury in any action, proceeding or counterclaim arising out of or relating to [PwC's] services and fees for the engagement.

Notwithstanding the suggestion that differences were "unlikely," a dispute arose between Grafton and PwC. Grafton sued PwC alleging, among other things, breach of contract, concealment, professional negligence, aiding and abetting, and conspiracy to breach fiduciary duty. In its complaint, Grafton demanded a jury trial. PwC moved to strike the jury demand based upon the jury waiver contained in the engagement letter. The trial court granted PwC's motion, striking the demand by Grafton for a jury.

When Grafton appealed the decision of the trial court to the Court of Appeals of California, First Appellate Division, it argued that the California Constitution specifically authorized only the State legislature to specify the circumstances when a waiver of a jury trial would be enforceable, and there were no statutes enacted by the legislature that allowed for contractual waivers of a jury trial. Grafton took the position that California statutes only allowed a party to waive its right to a trial by jury by: (i) failing to appear at the trial; (ii) a written consent filed with the clerk or judge; (iii) an oral consent, in open court, entered into the minutes; (iv) failing to announce that a jury is

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required in a timely fashion after the commencement of an action; (v) failing to deposit with the clerk, or judge, advance jury fees; and (vi) by failing to deposit with the clerk, or judge, at the beginning of the second and each succeeding day's session, a sum equal to that day's fees and mileage of the jury. None of these circumstances applied to contractual waivers and therefore, the Court held, such waivers were invalid and unenforceable under the California Constitution.

In response, PwC pointed to the 1991 decision of the Court of Appeals of California, Second Appellate District, Division Two in *Trizec Properties, Inc. v. Superior Court*, 229 Cal. App. 3d 1616, 280 Cal. Rptr. 885 (1991). In *Trizec*, the Second Appellate District held that a contractual pre-dispute jury waiver was enforceable and that the California Constitution could not be read to prohibit individuals from waiving, in advance of any pending action, the right to a trial by jury in a civil case. In *Grafton*, the Appellate Division rejected this argument, finding that the court in *Trizec* had ignored California's constitutional history, which reflects a commitment to the principle that the right to a civil jury trial may be waived only as the state legislature prescribes.

PwC argued that the waiver in the engagement letter complied with the methods of jury waiver enacted into law by the state legislature because PwC filed the written waiver "with the clerk or judge" as an exhibit to PwC's motion to strike the demand by Grafton for a jury trial. PwC suggested that there was nothing in the language of the law or its legislative history that explicitly provided for a "temporal limitation on when the 'written consent' referred to should have been executed." According to PwC, under this reasoning, a written pre-dispute waiver of a jury trial filed following the commencement of a civil lawsuit was valid.

In response, the Appellate Division in Grafton cited *Madden v. Kaiser Foundation Hospitals*, 17 Cal.

3d 699, 131 Cal. Rptr. 882 (1976). In *Madden* the California Supreme Court determined that only parties to a pending civil action may utilize the jury waiver methods set out under California law. Thus, if only parties to a pending action may waive a trial by a jury, the execution of the written consent and the filing of that consent must occur during the pendency of the civil action. In addition, the Appellate Division noted that the other methods for waiving a jury trial approved by the State legislature as required by the Constitution to effectuate a waiver required an act of omission in the midst of an ongoing lawsuit.

PwC argued that, because the California Arbitration Act permits pre-dispute jury waivers by allowing parties to agree to arbitration, parties should likewise be entitled to a pre-dispute jury waiver before the court. However, the Court found that the state legislature's authorization of arbitration agreements was not the same as approving of agreements to change the forum from a court to an arbitration. The Appellate Division also identified a public policy distinction between arbitration and court adjudication. There is both a federal and state public policy in favor of arbitration; there is no comparable policy favoring non-jury trials.

PwC asserted that the "freedom to contract" permits parties to enter into binding, bargained-for agreements "to do or not...do" anything not [proscribed] by law. The Court disagreed with PwC on the ground that the state legislature had approved specified agreements to waive a jury, and this specification would be rendered meaningless if all other agreements to waive a jury were authorized.

A decision like *Grafton* may cause lenders to examine carefully the option of including an arbitration

provision in loan agreements in situations where there is a risk of a jury trial in California.

S*harp International Corp. v. State Street Bank and Trust Co. (In re Sharp International Corp. & Sharp Sales Corp.)*, 302 B.R. 760 (E.D.N.Y. 2003) (Court affirms dismissal of aiding and abetting and fraudulent transfer claims against secured lender.)

In 1993, Herbert, Lawrence, and Bernard Spitz (the "Spitzes") purchased 100 percent of the common stock of Sharp International Corp. ("Sharp"), a company engaged primarily in the business of importing, assembling and distributing wrist watches, clocks, pens and mechanical pencils. The Spitzes served as Sharp's sole officers and managed its affairs until the commencement of a Chapter 11 bankruptcy proceeding against Sharp in 1999.

Beginning some time prior to 1997, the Spitzes fraudulently inflated Sharp's reported sales and revenues in order to borrow increasingly large sums of money from a succession of banks and other lenders. For example, the Spitzes reported Sharp's net sales as $52.1 million in 1997 and $118.1 million in 1999, when in fact the figures were closer to $24 million and $19 million, respectively. The Spitzes looted Sharp of the funds they had caused it to fraudulently borrow, as well as other corporate funds. In 1998 and 1999 alone, the Spitzes took more than $44 million from Sharp, diverting the funds to companies affiliated with the Spitzes.

State Street Bank and Trust Company ("State Street") provided a $20 million line of credit to Sharp in December 1996. Notwithstanding the $20 million credit limit, State Street permitted Sharp's indebtedness under the facility to rise to nearly $26 million in 1997. In July 1998, the Spitzes raised $17.5 million through the issuance of subordinated notes to a group of investors (the "Noteholders"), a portion of the proceeds of which were used to pay down the State Street debt to $15 million.

State Street began to suspect possible fraud by the Spitzes in the summer of 1998, when Sharp breached the loan and security agreement in numerous respects, including failing to direct customers to use State Street's lockbox, to provide proper reporting to State Street, or to implement a required accounting system. As State Street grew increasingly concerned with these breaches, as well as with what appeared to be Sharp's alarmingly rapid growth rate, State Street brought in its workout department, outside counsel, and a firm specializing in investigating financial fraud, contacting Sharp's largest customers, and requesting Sharp's audit papers and access to Sharp's facilities to evaluate inventory and receivables. Although Sharp was uncooperative and refused such requests, State Street independently learned that several of Sharp's supposed largest customers were either no longer in business or were engaged in businesses having nothing to do with watches.

In November 1998, when State Street demanded that Sharp repay the credit facility in full, the Spitzes caused Sharp to raise an additional $25 million from the Noteholders. Sharp alleged that while it was arranging to borrow this $25 million, State Street repeatedly avoided phone calls from the Noteholders, whom State Street knew would be inquiring about Sharp's credit. In March 1999, State Street consented to Sharp's borrowing of the $25 million, and shortly thereafter Sharp paid to State Street $12,250,024 of the proceeds of $25 million, reducing the State Street debt to $2.7 million. State Street released Sharp from the balance in return for personal promissory notes from the Spitzes. In September 1999, the Noteholders filed an involuntary Chapter 11 bankruptcy case against Sharp, ultimately obtaining a judgment of approximately $44 million.

In May 2001, Sharp initiated claims in the Chapter 11 case alleging that State Street had aided and abetted in the Spitzes breach of their fiduciary duties to Sharp, that the $12 million payment to State Street constituted a fraudulent conveyance, and that if such payment were ordered by the court to be returned by State Street, State Street's claims should be equitably subordinated to claims of Sharp's unsecured creditors. The bankruptcy court dismissed Sharp's suit for failure to state a claim, and Sharp appealed to the U.S. District Court.

In addressing Sharp's first claim, the district court noted that, to state a claim under New York common law for aiding and abetting a breach of fiduciary duty, a plaintiff must plead (i) breach of fiduciary obligations to another, (ii) that the defendant knowingly induced or participated in the breach, and (iii) that plaintiff

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The underlying basis for the claims of Unicredito and Bank Polska against the Agents arose as a result of the multiple roles that the Agents played in their relationships with Enron and its affiliated entities.

suffered resulting damages. After finding that the first and third elements had been adequately pled by Sharp, the court focused on whether State Street knowingly induced or participated in the fraud.

To satisfy this second element of aiding and abetting, the court observed that a plaintiff must allege both actual knowledge and participation by the defendant. Citing the principle that suspicions of fraudulent activity alone do not raise an inference of actual knowledge, the court found that Sharp pleaded sufficient facts that, if proven, could lead to an inference that State Street knew of the Spitzes' fraud. State Street's extensive investigation, its discovery of sales reportedly made to customers who had gone out of business or were not in the watch business, along with Sharp's persistent refusal to comply with reporting requirements and to allow access to its books or facilities, took State Street across the line from constructive to actual knowledge.

The district court nonetheless affirmed the bankruptcy court's dismissal of the aiding and abetting claim on grounds that Sharp had failed to identify any affirmative act of participation by State Street. New York case law identifies two forms of actionable participation — either (i) providing substantial assistance (*i.e.,* where one affirmatively assists or helps conceal, or fails to act when required to do so) or (ii) inducing or encouraging a fiduciary to breach its duties. The court found that allegations as to either form of participation were absent from the complaint. Relying on the doctrine that without an independent duty to disclose, mere inaction does not amount to substantial assistance, State Street successfully argued that since the allegations were based on its inaction, and because State Street did not have a duty to protect Sharp or the Noteholders, Sharp's complaint was deficient. Although State Street could have anticipated that the Spitzes would continue to loot the company, it had neither a duty to intervene to protect Sharp, nor a duty to respond to the Noteholders' inquiries. The Court found equally unpersuasive Sharp's theory that State Street had induced or encouraged the fraud.

Turning to whether State Street's acceptance of the $12 million repayment gave rise to a constructive fraudulent transfer claim under New York fraudulent conveyance law, the Court noted that a conveyance is constructively fraudulent under this statute if made without fair consideration and one of several other conditions is met, such as that the transferor is insolvent at the time of the transaction or will be rendered insolvent by the transaction. Sharp contended that, since the statute provides that fair consideration is given when property is conveyed "in good faith" in exchange for a fair equivalent of property or satisfaction of antecedent debt and State Street was aware of the Spitzes' fraud, State Street did not receive the payment in good faith. However, the court found that State Street's awareness of the fraud was not enough to support a lack of good faith under the statute. Without allegations of participation in fraud, State Street's knowledge of the fraud and the illegitimate source of the funds does not negate good faith.

The court also struck down Sharp's claim that State Street's conduct constituted an intentional fraudulent conveyance. A critical element of intentional fraud is an actual intent of a transferor to hinder, delay or defraud creditors, an analysis of which focus on "badges" (*i.e.,* indications) of such actual intent, and the court found no allegations of such badges in Sharp's complaint.

Because the court found no basis for the fraudulent conveyance claim, it was unnecessary for the Court to address Sharp's equitable subordination claim.

Among other lessons, this case validates State Street's failure to respond to the inquiries of the Noteholders. Given that State Street had no duty to the Noteholders, State Street's evasiveness could not be taken by the Noteholders as an endorsement of their proposed extension of credit to Sharp. However, the court does note that if State Street had made false or misleading statements to the Noteholders, it might have had a duty to correct any resulting misleading impressions.

UniCredito Italiano SpA v. JPMorgan Chase Bank, 288 F. Supp. 2d 485, 2003 U.S. Dist. LEXIS 18262 (S.D.N.Y. 2003) (Lenders cannot hold agent banks liable for the lending bank's failure to conduct adequate independent due diligence on the borrower's creditworthiness or intentions with respect to the use of borrowed funds.)

UniCredito Italian SpA and Bank Polska Kasa Opieki SA were both lenders, along with other financial institutions, in a series of credit facilities provided to Enron. JPMorgan Chase, Citigroup, Inc. and certain of their subsidiaries were agents for the lenders under such facilities (the "Agents"). When confronted with significant losses under the credit facilities with the demise of Enron, the two banks asserted a number of causes of action against the Agents in the District Court for the Southern District of New York.

The underlying basis for the claims of Unicredito and Bank Polska against the Agents arose as a result of the multiple roles that the Agents played in their relationships with Enron and its affiliated entities.

As described in the decision of the District Court, Enron entered into business relationships with partnerships, known as the LJM partnerships, in which former Enron CFO Andrew Fastow was both the manager and an investor. The LJM partnerships created special purpose entities to remove from Enron's balance sheet assets that had lost, or were at risk of losing, value, giving Enron the appearance of a healthier financial condition. The Agents each invested at least $10 million in the LJM partnerships. The two lenders claimed that the Agents knew of Enron's misleading, inaccurate, and inadequate disclosures with respect to the LJM partnerships and that the two lenders relied upon such disclosures in deciding to participate in the credit facilities.

Enron also conducted a large number of "prepays." Prepays are commodities trading transactions in which parties arrange for the prepayment for commodities to be delivered at a later date. According to the claims of Unicredito and Bank Polska, Enron used prepay transactions designed by Chase and Citigroup to disguise loans to Enron using an offshore special purpose entity called Mahonia, Ltd. Unicredito and Bank Polska maintained that Chase was aware that Enron used these transactions to disguise its debt and that Chase received substantial revenues from Mahonia's dealings with Enron.

Citibank set up a trust called Yosemite, which transferred funds to a Citigroup-controlled, special-purpose entity named Delta. Delta purportedly used funds from Yosemite to engage in prepay transactions with Enron in which no commodities actually changed hands and Citigroup and the Yosemite investors received the equivalent of interest from Enron. Citigroup also assisted in Enron in keeping $125,000,000 in bank loans off its books through other prepay transactions known as the Roosevelt transaction.

The thrust of the complaint by Unicredito and Bank Polska was that because of these various relationships with Enron, JPMorgan Chase and Citigroup knew the facts concerning Enron's financial condition, particularly that the actual amount of Enron's debt and Enron's actual debt-to-capitalization ratio did not satisfy the requirements of the credit facilities in which the two banks were lenders, that Enron was in violation of the representations in the agreements that it was in compliance with applicable laws and that there had been no adverse change in its financial condition.

Based on these allegations, Unicredito and Bank Polska asserted common law claims against the Agents of: (i) fraudulent concealment, (ii) fraudulent inducement, (iii) aiding and abetting fraud by Enron, (iv) negligent misrepresentation, (v) civil conspiracy, (vi) breach of implied duty of good faith, (vii) unjust enrichment.

The District Court first addressed the claims of fraudulent concealment, fraudulent inducement, and negligent misrepresentation by the Agents. For each of these three categories of claims, the party bringing the action must show, among other things, that it reasonably relied on the representation of the defendant. In addition, for fraudulent inducement, the plaintiff must show that the defendant had a duty to disclose the information.

The District Court dismissed the claims of fraudulent concealment, fraudulent inducement, and negligent misrepresentation because, in Court's view, the Agents did not have a duty to disclose information regarding their business dealings with Enron and the plaintiff banks were not justified in relying on any representations from the Agents. The Court reached this conclusion based on the express disclaimers and waivers that are typical in syndicated loan documents, citing the leading case in this area, *Banque Arabe et Internationale D'Investissement v. Maryland Nat'l Bank,* 57 F. 3d 146 (2d Cir. 1995), out of the Second Circuit.

The credit agreements provided that lenders were not entitled to rely on the Agents as a substitute for their own due diligence in making credit decisions about Enron. The agreements contained many of the standard provisions used in syndicated documentation stating that the Agents did not have a "fiduciary relationship with respect to any Bank" or "any duty to inquire as to the performance or observance of any of the terms, covenants or conditions of any Loan Document." The agreements provided that: "Each Bank...will, independently and without reliance upon the [Agent] or any other Bank and based on such documents and information as it shall deem appropriate at the time, continue

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to make its own credit decisions...” Enron agreed to furnish to each bank “such other information respecting the condition or operations, financial or otherwise, of the Borrower or any of its Subsidiaries as any Bank through [Agent] may...request.”

While the general rule as stated by the courts is that a party cannot, as a matter of law, be held to have reasonably relied on any misrepresentation or omission by another when the documents expressly provide otherwise, there is an exception in the doctrine of “peculiar knowledge.” Under this doctrine, express waivers or disclaimers of reliance will not be given effect “where the facts are peculiarly within the knowledge of the party invoking them.” In general, the cases invoking this doctrine involve concealment or misrepresentation of material information by the other parties to the transaction. In the context of a loan transaction, this would mean, as against the Agents and lenders, the borrower. The District Court found that information as to the true nature of Enron’s financial condition was “not the exclusive province of the Defendant banks...” Enron even agreed in the loan documents to provide access to its books and records directly to all of the lenders. Moreover, the Court did not accept that the peculiar knowledge exception to the justifiable reliance requirement should be extended to third parties such as the Agents, especially where the lenders seeking the benefit of the doctrine were themselves sophisticated financial institutions.

Interestingly, the District Court did *not* dismiss the claims by the two banks against the Agents for aiding and abetting the fraud of Enron. The elements of a claim for aiding and abetting fraud include: the existence of an underlying fraud, knowledge of the fraud, and substantial assistance by the aider and abettor in achieving the fraud. As to this cause of action, the Court found that the two plaintiff banks had the alleged facts with sufficient particularity to survive a motion to dismiss.

As to the claims of breach by the agents of the implied duty of good faith and fair dealing, according to the District Court, “no obligation can be implied that would be inconsistent with other terms of the contractual relationship.” The court found that the loan agreement specifically absolved the Agents from any duty to disclose financial information regarding Enron, and that the plaintiff banks had agreed to rely on their own credit analyses in making the relevant decisions.

The Court rejected the unjust enrichment claim on the basis that such a claim requires that the subject matter of the claim not be subject to a written contract. But the Court did *not* reject the cause of action based on “civil conspiracy” by the Agents. A “civil conspiracy” requires (i) an agreement between two or more persons, (ii) an overt act, (iii) an intentional participation in furtherance of a plan or purpose, and (iv) resulting damage. In addition, New York law only recognizes “civil conspiracy” if there is evidence connecting the actions of separate defendants with an otherwise actionable tort. The Court would not dismiss the claim because the plaintiff banks adequately described fraud by Enron and the Agents’ knowing participation in Enron’s fraudulent accounting scheme.

This decision, like many of its predecessors, confirms that courts will enforce the express disclaimers and waivers with respect to the duties and liabilities of agents to their syndicate lending group, notwithstanding multiple relationships with the borrower. This is, of course, good news for agents, but confirms what lenders that are part of the syndicate should have known: do your homework or take the risk.

In re Kmart Corporation, __ F.3d __ (7th Cir. 2004) (Seventh Circuit affirms reversal of Kmart critical vendor orders.)

On February 24, 2004, the United States Court of Appeals for the Seventh Circuit affirmed the district court’s reversal of the three critical-vendor orders (collectively, the “CVO”) entered in the chapter 11 cases filed by Kmart, Inc. and its affiliates (“Kmart”). The district court’s reversal of the CVO (291 B.R. 818 (N.D. Ill. 2003)) was discussed in the July/August 2003 issue of *The Secured Lender* (p. 76).

On the first day of the chapter 11 cases, Kmart requested the entry of orders authorizing it to pay the prepetition claims of domestic creditors it deemed to be “critical vendors” in consideration for their agreeing to extend credit to Kmart, as debtor in possession in the chapter 11 cases. Identical authority was requested with respect to the payment of certain foreign vendors and liquor suppliers. The evidentiary basis for the relief was the testimony of Kmart’s chief executive officer that in Kmart’s opinion, such payments were necessary to assure continued delivery of merchandise and to promote the prospects for a successful reorganization. Pursuant to the CVO, Kmart paid about $300 million in prepetition debts to some 2,330 suppliers. The 2,000 vendors not deemed critical by Kmart and its 43,000 other general unsecured creditors ultimately received a 10% dividend (mostly in stock of reorganized Kmart).

The CVO was appealed to the district court which, in April 2003, reversed its entry. The district court concluded that neither Bankruptcy Code § 105(a) nor the “doctrine of necessity” supported the CVO. An

appeal was taken to the Seventh Circuit, which affirmed the district court in an opinion authored by Circuit Judge Frank Easterbrook.

The Seventh Circuit was troubled by the fact that disfavored creditors were not given notice of the requested relief, the sketchiness of the record, and the failure of the bankruptcy court to make any finding of fact that disfavored creditors "would gain or come out even" from the payment to the critical vendors. The Court also noted that the CVO did not explain or contain any legal analysis as to why its entry was "in the best interests of the Debtors, their estates and their creditors."

In addressing the legal arguments advanced on appeal, the Seventh Circuit rejected the Appellants' contention that, because the payments had been made, they could not be refunded. The Court held that, if the CVO is invalid, then the critical vendors received "preferences" that Kmart is entitled to recoup for the benefit of all creditors.

The balance of the opinion addressed the Appellants' legal arguments that the CVO was justified under various sections of the Bankruptcy Code or the "doctrine of necessity." Regarding §105, the Seventh Circuit observed that its purpose "is to implement rather than override sections of the Code" and that the three circuit courts considering the question held that §105 does not allow a bankruptcy judge to authorize full payment of any unsecured debt, unless all unsecured creditors in the class are paid in full.

The opinion proceeded to describe the "doctrine of necessity" as "a fancy name for a power to depart from the Code." It observed that the doctrine was developed in 19th Century railroad cases antedating both the Bankruptcy Act and Bankruptcy Code and that the propriety of a CVO is to be determined by the Code.

The Court then posed the question whether the Code granted debtors authority to prefer some vendors over others? In answering this question, the Circuit Court noted that three sections of the Code — §507, §1122(a), and §1123(a)(4) — expressly require equal treatment of claims or specify the priority when the estate is insufficient to satisfy all claims. The Court then addressed the applicability of the Code sections relied upon by the Appellants, i.e., §363(b), §364(b), and §503(b)(1). Section 364(b) was deemed inapplicable because it pertained to the procurement of post-petition financing and not to how the loan proceeds may be used. Section 503(b) was similarly found "unpersuasive" because it deals with post-petition expenses — the "antithesis" of a prepetition claim.

The most significant aspect of the decision was the Court's discussion of §363(b)(1). The opinion states:

> That leaves §363(b)(1): "The trustee [or debtor in possession], after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." This is more promising, for satisfaction of a prepetition debt in order to keep "critical" supplies flowing is a use of property other than in the ordinary course of administering an estate in bankruptcy. Capital Factors insists that § 363(b)(1) should be limited to the commencement of capital projects, such as building a new plant, rather than payment of old debts — as paying vendors would be "in the ordinary course" but for the intervening bankruptcy petition. To read §363(b)(1) broadly, Capital Factors observes, would be to allow a judge to rearrange priorities among creditors (which is what a critical-vendors order effectively does), even though the Supreme Court has cautioned against such a step. *See United States v. Reorganized CF&I Fabricators of Utah, Inc.,* 518 U.S. 213 (1996); *Noland, supra.* Yet what these decisions principally say is that priorities do not change unless a statute supports that step; and if §363(b)(1) is such a statute, then there is no insuperable problem. If the language is too open-ended, that is a problem for the legislature. Nonetheless, it is prudent to read, and use, §363(b)(1) to do the least damage possible to priorities established by contract and by other parts of the Bankruptcy Code. We need not decide whether §363(b)(1) could support payment of some prepetition debts, because *this* order was unsound no matter how one reads §363(b)(1).

Despite having disposed of the appeal before it, the opinion proceeds to establish two tests for the grant of a critical-vendor order assuming §363(b)(1) provides a statutory basis for doing so.

> [I]t is necessary to show not only that the disfavored creditors *will* be as well off with reorganization as with liquidation — a demonstration never attempted in this proceeding — but also that the supposedly critical vendors would have ceased deliveries if old debts were left unpaid while the litigation continued. If vendors will deliver against a promise of current payment, then a reorganization can be achieved, and all unsecured creditors will obtain its benefit, without preferring any of the unsecured creditors.

Having set up its own straw man, the opinion questions whether a vendor would refuse to make post-petition sales for cash.

> Each new delivery produced a profit; as long as Kmart continued to pay for new product, why would any vendor drop the account? That would be a self-

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inflicted wound. To abjure new profits because of old debts would be to commit the sunk-cost fallacy; well managed businesses are unlikely to do this. Firms that disdain current profits because of old losses are unlikely to stay in business. They might as well burn money or drop it into the ocean.

Appellate courts appropriately avoid decisions producing an "always" or "never" result. The Kmart opinion recognizes that unique situations may exist, identifies a statutory basis for a critical-vendor order, and establishes two apparently stringent tests for its entry. While the Kmart decision only binds courts within the Seventh Circuit, the opinion is forceful precedent for the denial of

critical-vendor motions in other jurisdictions. The opinion serves as a guideline for when a critical-vendor order would be appropriate and details alternatives to the grant of preferential treatment. In any event, a critical-vendor order involving numerous vendors or a large payment is unlikely to be entered as a first day order.

This new *Kmart* decision leaves a number of issues unanswered. Practically speaking, are the Kmart tests for the entry of a critical-vendor order so stringent as to limit its use to situations involving only a few specially situated creditors, *e.g.,* a foreign supplier with no jurisdictional ties to the United States? *See In re CoServe, L.L.C.,* 273 B.R. 487, 499-500 (Bankr. N.D. Tex 2002). Does the opinion, particularly its comments regarding the "smarts" of a supplier refusing to sell for cash, present a dilemma for the supplier? At what point would a refusal to sell for cash or its equivalent subject the supplier to contempt of court for violating §362(a)(6)'s prohibition against any act to collect or recover a prepetition claim? Other than reconsideration of the order or a stay pending appeal, what is a supplier to do upon entry of a mandatory injunction requiring it to sell for cash? *See Blackwelder Furniture Co., Inc.,* 7 B.R. 328 (Bankr. W.D.N.C. 1980).

General Counsel will keep you advised of new developments in this important area.