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Imagine that a large company operates a national retail chain. In order to meet inventory requirements, the company depends on common carriers and warehouses to ship, transport, store, and deliver goods through its distribution networks. Payments to these vendors are typically made in arrears; assume that, on average, the total monthly amount paid by our hypothetical company to these vendors is approximately $150,000—an amount that is minimal compared to the value of goods in their possession at any given time.

Now imagine that our hypothetical retailer files for bankruptcy protection under Chapter 11[1] of the U.S. Bankruptcy Code.[2] Based upon the foregoing, at the time of the bankruptcy filing, the debtor undoubtedly owes carriers and warehouses substantial sums for services already performed.

Of course, it is also highly likely that our debtor—a bankrupt company, after all—owes many other claimants far larger sums. But not all claims are created equal, and these carriers and warehouses may be entitled to extraordinary rights under state and federal law. Namely, if the debtor fails to pay them, they may be entitled to liens that potentially prime other interests in the same property.

In order to minimize business disruption and preserve the value of the company, our debtor would probably prefer to normalize relations with its carriers and warehouses as soon as possible by paying their prepetition claims and continuing to pay them in due course. Not only would this thwart any exercise of lien rights; it would also allow the debtor to avoid the difficult task of arranging alternative shipping and warehousing services during the pendency of the bankruptcy case.

But in order to pay the prepetition claims of carriers and warehouses, the debtor will need to obtain the bankruptcy court's permission. This Article examines requests of this sort, the objections that commonly arise, and some practical approaches to balancing conflicting interests.

Carrier and Warehouse Liens under State Law

In order to understand why Chapter 11 debtors may wish to prioritize payments to carriers and warehouses, we must briefly consider the remedies these vendors may be entitled to under state and federal law. Under state law, a carrier or warehouse may have a statutory or common-law lien on goods in its possession to secure charges incurred in connection with transportation or storage services provided. These rights are in addition to any Article 9 security interests granted by the customer to the carrier or warehouse.

For instance, U.C.C. §7-307(1) provides that a carrier has a statutory lien on goods in its possession "for charges subsequent to the date of its receipt of the goods for storage of transportation...and for expenses

[1] 11 U.S.C. §§ 1101-1174 (providing for reorganizations and liquidations of bankrupt persons).

[2] All references to the "Bankruptcy Code" are to the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 U.S.C. §§ 101 et. seq.).

necessary for preservation of the goods incident to their transportation or reasonably incurred in their sale pursuant to law." Most states also recognize common-law possessory liens for shipping and transport.[3] These statutory and common-law carrier's liens generally have priority over Article 9 security interests.[4]

Meanwhile, U.C.C. §7-209 provides for a warehouse's lien on goods in its possession and contains rules for determining the priority of that lien. Under that section, a warehouse may have a specific or general lien on goods it is storing, depending upon the language of the warehouse receipt or, in certain states, a storage agreement.[5] A specific lien attaches only to a customer's goods in the warehouse at the time payment is demanded, and secures only fees incurred in respect of those goods. In contrast, a general lien attaches to any of a customer's goods in the warehouse, and secures all of the customer's obligations to the warehouse. U.C.C. §7-209 provides that this warehouse lien takes priority over subsequent claims to the goods.[6] However, the warehouse's lien on goods—other than household goods—does not necessarily have priority over a previously perfected security interest in the goods.[7] Some states also recognize common-law possessory liens for storage, which may have priority over Article 9 security interests.[8]

A holder of a valid carrier's or warehouse's lien may retain and ultimately sell the goods in its possession in order to satisfy its customer's outstanding obligations.

Carrier and Warehouse Liens under the Bankruptcy Code

When a customer has filed for bankruptcy protection, additional protections benefit the holder of a carrier or warehouse lien. For one thing, notwithstanding subsections 545(2) and (3) of the Bankruptcy Code, a trustee or debtor-in-possession may not avoid a statutory warehouse's lien for storage, transportation, or other costs incidental to the storage and handling of goods.[9]

Moreover, pursuant to section 363(e) of the Bankruptcy Code, a carrier or warehouse, as a bailee, may be entitled to adequate protection in the form of a possessory lien. As a result, carriers and warehouses may refuse to deliver or release the debtor's property in their possession before prepetition amounts owed to them have been paid and the liens redeemed.

Debtors' Motions to Pay Carriers and Warehouses

In light of the extraordinary remedies that may be available to carriers and warehouses, these claims have the potential to interrupt our hypothetical debtor's supply and distribution chains. And so, early in the bankruptcy case, our debtor will likely file a motion for entry of an order by the bankruptcy court authorizing (but not requiring) the debtor to exercise its business judgment to pay the prepetition claims of vendors who may be entitled to carrier's and warehouse's liens, and to continue to pay them in the ordinary course of business. A motion of this sort should contain a proposed order in a format that is acceptable to the bankruptcy court.

Of course, not all of the prepetition claims of carriers and warehouses will be secured claims, and thus not all of the debtor's postpetition payments would be made to avoid the exercise of lien rights. Nonetheless, the debtor's requested relief is available under Section 363(b)(1) of the Bankruptcy Code, which provides that a 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." Bankruptcy courts regularly rely on this provision to authorize payment of prepetition claims where debtors demonstrate "some business justification, other than the mere appeasement of major creditors."[10] Permission to pay lien claimants as well as so-called critical vendors is grounded in the "necessity of payment" doctrine, which acknowledges that "if payment of a [prepetition] claim...is essential to the continued operation of the [business]..., payment may be authorized even if it is made out of corpus."[11]

Accordingly, in their motions to pay carriers and warehouses, debtors and their representatives typically allege that the requested relief is necessary to maintain the viability of the debtor's business as a going-concern and to maximize the likelihood of a return to unsecured creditors. Debtors cite not only the potential for these vendors to exercise lien rights with respect to all or some of the outstanding obligations; they also argue that these vendors are critically important to the debtor's business operations.

[3] *See, e.g.,* Navistar Fin. Corp. v. Allen's Corner Garage & Towing Serv., Inc., 153 Ill. App. 3d 574, 106 Ill. Dec. 530, 505 N.E.2d 1321, 1323-24 (1987).

[4] U.C.C. § 9-333; *see also* U.C.C. §7-307 cmt. 1.

[5] The reference to storage agreements was added in 2003 amendments to U.C.C. §7-209.

[6] For example, when a bailor grants a security interest in goods to a secured party while the goods are in the warehouse's possession, the warehouse lien takes priority. U.C.C. §7-209 cmt. 3, example 8.

[7] *See* U.C.C. §7-209(c), (d) & cmt. 3.

[8] *See,* e.g., Charter One Auto Finance v. Inkas Coffee Distributors Realty, 57 UCC Rep.Serv.2d 672, 39 Conn. L. Rptr. 110 (Conn. Super. Ct. 2005).

[9] 11 U.S.C. § 546(i)(1). This prohibition must be applied in a manner consistent with any state statute applicable to such lien that is similar to U.C.C. § 7-209 as in effect on the date of enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 or any successor to U.C.C. § 7-209. 11 U.S.C. § 546(i)(2).

[10] In re Ionosphere Clubs, 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989).

[11] *In re* Lehigh & New England Railway Co., 657 F.2d 570, 581 (3d Cir. 1981).

These assertions help to establish the need to pay all prepetition claims of carriers and warehouse, and also demonstrate that the debtor is exercising its business judgment for the benefit of the estate and its creditors.

But even with such lofty goals, these motions still attract scrutiny. For instance, the U.S. Trustee, any postpetition lenders or other parties with an interest in the debtor's cash collateral, other large creditors, and the Official Committee of Unsecured Creditors (to the extent one has already been formed) may review the debtor's motion and proposed order, along with documents and information provided by the debtor's professional advisors, to determine whether the requested relief is appropriate. To the extent parties have specific concerns, they will typically engage in negotiations directly with the debtor's attorneys in the hopes of resolving conflicts in a consensual manner.

To facilitate compromise, debtors frequently include certain qualifications and limitations in the proposed order. For instance, debtors often agree to cap the total amount of authorized payments of prepetition claims of carriers and warehouses. These caps should comply with any budgets approved in conjunction with the debtor's postpetition financing arrangements or authorization to use cash collateral.

The debtor may also agree to include a provision that, as a condition to receiving any payments from the debtors, carriers and warehouses must waive and release any previously asserted liens on the debtor's assets. Debtors also sometimes agree to undertake efforts to cause carriers and warehouses to acknowledge in writing that any payments they receive from the debtor are conditioned upon the continued provision of services on acceptable terms. Carriers and warehouses who fail to honor these postpetition contractual obligations may be subject to avoidance actions under Section 549 of the Bankruptcy Code with respect to any postpetition payments received.

Finally, acknowledging their broad fiduciary duties to the estate and its creditors, debtors typically include language expressly preserving the right to contest, without prejudice, the validity and amounts of any prepetition claims. Debtors also frequently include disclaimers to the effect that payment shall not constitute postpetition assumption or reaffirmation of any agreements that may be executory contracts under Section 365 of the Bankruptcy Code.

Generally, qualifications and limitations of this sort will be enough to enable the parties to reach consensus, allowing the debtor to ultimately certify to the bankruptcy court that no objections have been received and that the court may enter the proposed order without a hearing. Where parties continue to resist the debtor's motion and proposed order, possible points of lingering discord are the timing of the debtor's request and whether parties have had sufficient time to conduct an investigation, whether relief should be provided on an interim or final basis, the total amount of payments sought to be authorized, and whether the relief solely benefits certain parties.[12]

Conclusion

Chapter 11 debtors frequently file motions for entry of an order by the bankruptcy court authorizing the debtor to pay the prepetition claims of carriers and warehouses. These motions—like many other first and second day motions—are made because the debtor believes that the requested relief is vital to preserving the value of the debtor's business pending sale or reorganization.

In light of the extraordinary remedies that may be available to carriers and warehouses, these requests are typically looked upon as sound business judgments. Nonetheless, whenever the claims of some creditors are privileged over the claims of others, there is a potential for diminution in the value of property available for distribution to all other claimants. Like most resource allocation questions in bankruptcy, the decision typically comes down to building consensus by balancing interests. Debtors are usually able to resolve conflicts in an expeditious manner by including one or more customary qualifications and limitations in their proposed order. ■

[12] For instance, in a recent bankruptcy case filed in the U.S. Bankruptcy Court for the Southern District of New York, the Official Committee of Unsecured Creditors objected to the debtor's warehouse and lien claimant motion on the grounds that it was intended to solely benefit a stalking horse bidder. *See* Omnibus Objection, Request for a Continuance and Reservation of Rights of the Official Committee of Unsecured Creditors to the Debtors' (A) Customer Programs Motion and (B) Warehouse and Lien Claimant Motion, *In re* Advance Watch Company, Ltd., Case No. 15-12690 (Bankr. S.D.N.Y. Oct. 19, 2015), at 3. The Committee also requested that the court continue the debtor's motion on an interim basis pending the Committee's completion of its investigations. *Id.*