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A Special Case for Logoed Packaging

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Walk into any grocery store, and you will see aisle after aisle of cereal boxes, candy wrappers and other logoed materials, which enables consumers to quickly identify the products. The packaging contains trademarks and trade dress that are owned by the product's manufacturer, and they are fiercely guarded to prevent a competitor from "palming off" a similar-looking product to confuse consumers.

The creation of the distinctive packaging is an industry unto itself, known as the packaging industry. Packaging manufacturers work with the product manufacturer to create the iconic packaging. From the perspective of the product manufacturer, *availability* of its unique packaging is essential. Product manufacturers often require that large amounts of their packaging be produced because the packaging is an integral part of the production process. However, the product manufacturer might not take delivery until it is needed (due to cash-flow issues or storage constraints). Consequently, the packaging manufacturer often finds itself in the position of making and holding a large volume of trademarked packaging until the customer asks for it.

What happens when a customer files for chapter 11? Packaging manufacturers are in a more precarious position than other unsecured creditors because they cannot sell the trademarked packaging to anyone besides the debtor (or a designee of the debtor).

Prior to 2000, a packaging manufacturer might try to deliver as much logoed material as possible to the debtor post-petition and then assert an administrative claim, arguing that delivery of the goods post-petition should entitle the vendor to an administrative claim. In *In re Russell Cave Co.*,[1] the label manufacturer did just that, but the debtor objected to the alleged administrative priority of the vendor's claim, arguing that the debt arose from a transaction pre-petition, not one with the estate. Although the case elicited a harsh result for packaging manufacturers, *Russell Cave* reminded vendors and their counsel that there are two predicates to an administrative claim under § 503(b)(1)(A) of the Bankruptcy Code, namely that (1) the debt arose from a transaction with the estate and (2) the consideration supporting the debt was beneficial to the estate.

In the aftermath of *Russell Cave*, counsel for packaging manufacturers have become savvy at quickly determining whether a debtor customer has obtained a bankruptcy court order permitting it to pay, *in the ordinary course of its business and as an administrative expense*, for all goods delivered post-petition pursuant to pre-petition contracts and purchase orders. Until and unless such an order is entered, the packaging manufacturer needs to obtain post-petition orders to ensure that post-petition deliveries will be eligible for administrative-expense treatment.

But what about the second prerequisite to a § 503(b)(1)(A) claim, "benefit to the estate"? If the logoed goods are delivered to a debtor that ordered them post-petition, then the debtor has clearly received the desired benefit and the packaging manufacturer should have an allowed administrative expense claim. What happens, however, if the debtor ordered a significant amount of logoed packaging (on credit) post-petition, then ceased operating before the logoed goods were delivered? The packaging manufacturer will argue that it is entitled to an administrative claim based on the post-petition order. The debtor, however, may object, claiming that the purpose of an administrative claim is to prevent unjust enrichment of the estate, not to compensate the creditor for its loss, and consequently, it should not have to pay for goods that it did not receive.[2] So who's right?

If the debtor issued a post-petition purchase order for logoed goods, then the packaging manufacturer should have an allowed administrative claim, even if the debtor did not receive the goods, because the *availability* of those logoed goods constitutes benefit to the debtor. After all, the debtor's production would come to a grinding halt if the logoed packaging was not available.

The use of "availability" as the paradigm for determining that the debtor received "benefit" for purposes of § 503(b)(1)(A) of the Bankruptcy Code is not a new idea. In *In re Native American Systems Inc.*,[3] a technical-services vendor that stood ready to provide post-petition services to the debtor was held to have an allowed administrative claim, even though the services were not actually provided. The Tenth Circuit Bankruptcy Appellate Panel stated:

> Either the providing of services under its contracts with the Debtor, or its standing [as being] ready, willing and able to provide those services, constitutes a transaction between Enterasys and the [DIP] that benefited the Debtor in the operation of its business.[4]

Peters v. Pikes Peak Musicians Association[5] reached the same conclusion. The case involved

1 249 B.R. 145 (Bankr. E.D. Ky. 2000).

2 *See, e.g., In re Enron*, 279 B.R. 79, 85 (Bankr. S.D.N.Y. 2002).
3 351 B.R. 135 (B.A.P. 10th Cir. 2006).
4 *Id.* at 142.
5 462 F.3d 1265 (10th Cir. 2006).

the Colorado Springs Symphony Orchestra, which filed for chapter 11. The orchestra's contract with its musicians required them to remain available for rehearsals and performances. In exchange, they were guaranteed compensation for a minimum number of pay periods, regardless of whether performances or rehearsals were held during that time. While in chapter 11, the orchestra continued to plan for concerts because it was trying to reorganize, so the musicians remained available. However, the reorganization effort ultimately failed, all concerts were cancelled, the debtor moved to reject its contract with the musicians, and the case converted to chapter 7.

The musicians sought administrative expense treatment for their claims and the trustee objected, claiming that the musicians never actually rehearsed or performed post-petition, so consequently, they were not entitled to administrative claims. The musicians won and the district court affirmed, as did the Tenth Circuit Court of Appeals, stating:

> [I]t is clear that during this unsettled period, the availability of the musicians was essential to the success of the attempted reorganization. In fact, the mass exodus of the Orchestra's most important assets would have hastened the organization's collapse. Consider a similar attempted reorganization of an entertainment company like the Harlem Globetrotters or the Ice Capades. Nothing could save current operations if the unique talent in those organizations fled upon the filing of a Chapter 11 petition. Musicians possess unique talents and an orchestra has a special chemistry, especially where, as here, the group of musicians has been practicing and performing together over the course of a season. The loss of their services would be insurmountable if some or all of the musicians ceased to remain available to play.[6]

The foregoing language from *Peters* is just as applicable to logoed packaging as it is to musicians. Just as the orchestra's reorganization effort would fail without the availability of its musicians and their unique talents, a debtor's chapter 11 will fail unless its distinctive packaging is readily available — irrespective of whether the debtor actually uses or takes delivery of the packaging.

Although the case law in *Native American Systems* and *Peters* is certainly helpful to packaging manufacturers that seek payment of their administrative claims, the logoed nature of the packaging materials (coupled with customers' "just-in-time" delivery practices) can create a "perfect storm" if a customer files for bankruptcy. Consequently, the packaging manufacturer should speak to its counsel and take appropriate precautions, such as implementing production schedules that are carefully choreographed with the customer's requirements and prepaying for artwork, as well as contract terms that enable the packaging manufacturer to require cash in advance if the customer's credit deteriorates. Of course, knowledge of the customer's financial condition is critically important so that the packaging manufacturer does not overproduce logoed material.

Once a customer files for chapter 11, the packaging manufacturer should not ship any logoed materials to the debtor unless the debtor either issues a post-petition purchase order or obtains a bankruptcy court order permitting it to pay, in the ordinary course of its business and as an administrative expense, for all goods delivered post-petition pursuant to pre-petition contracts and purchase orders. This is counterintuitive to packaging manufacturers that are legitimately concerned about being left with a large quantity of logoed material. However, a post-petition transaction with the estate is a prerequisite to an administrative claim, which the packaging manufacturer needs to understand. The packaging manufacturer also needs to quickly determine how much logoed inventory it has on hand and assess the debtor's financing to see whether the debtor is likely to remain in business long enough to use all of the logoed packaging. If the debtor offers critical-vendor treatment, the packaging manufacturer needs to quickly determine the amount of its pre-petition claim and the amount of credit that the debtor wants in exchange for critical-vendor treatment. Unless the packaging manufacturer is permitted to establish a low post-petition credit ceiling and the pre-petition claim is large, critical-vendor treatment is generally not a good idea for the packaging manufacturer because its post-petition credit exposure may be too large, and the logoed nature of the goods means that they cannot be sold to anyone else if the chapter 11 fails.

The good news is that cases like *Native American Systems* and *Peters* demonstrate that bankruptcy law has evolved somewhat to recognize that *availability* of goods and services constitutes a benefit to the debtor for purposes of § 503(b)(1)(A) of the Bankruptcy Code. In the context of logoed packaging, that can determine whether the packaging manufacturer gets paid or is left holding the bag(s) — literally! abi

6 *Id.* at 1273.