RIGHTS OF SUPPLIERS
An Oil and Gas Industry Primer

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The continuous and dramatic volatility in prices for oil and natural gas has predictably resulted in financial pressures on oil and gas exploration and production companies ("E&Ps") leading to a precipitous rise in the incidence of bankruptcy filings by E&Ps across the US and elsewhere. The E&P bankruptcies, like those of companies in other industries, raise a number of interesting legal questions which do not subject themselves to easy and straight forward answers. The issues will be played out in bankruptcy courts where creditors jockey for leverage and position and judges decide which creditors share in the spoils and how much. This and a series of blog posts to follow by lawyers in the Financial Restructuring and Bankruptcy Department of Fox Rothschild LLP are designed to highlight bankruptcy, insolvency and creditors' rights issues that should guide creditor and debtor decisions when contemplating and/or working out credit transactions involving E&Ps and their lenders and suppliers. This initial post to the Fox Rothschild E&P blog will identify basic rights in and out of bankruptcy available to those who supply goods and services to exploration and production companies which find themselves in financial distress. Subsequent posts will address other issues and provide guidance on how each will impact creditor recoveries and prospects for E&P company reorganizations.

I. BANKRUPTCY PRIMER

Bankruptcy is generally understood as a mechanism by which business operators can seek relief through the courts from the pressures of day to day stress placed upon the business by demands of creditors and others to be paid. Bankruptcy is a remedy for "debtors" (those who owe money to others called "creditors"), which is governed by a federal law known as the United States Bankruptcy Code or simply the "Bankruptcy Code." This law can be found at 11 U.S.C. §§ 101 *et seq.* Bankruptcy relief is available in three basic scenarios: (1) those who wish to simply liquidate can do so under Chapter 7 of the Bankruptcy Code, (2) businesses and certain individuals who wish to restructure their debts and try to stay in business can reorganize under Chapter 11 of the Bankruptcy Code and (3) individuals with jobs can restructure and repay their debts over time through a wage earner plan under Chapter 13 of the Bankruptcy Code.

The Bankruptcy Code supersedes all other law when it comes to the relationship among a debtor and its creditors. However, the Bankruptcy Code is and must be interpreted and applied in the context of the broader relationship among parties to commercial transactions. When the Bankruptcy Code is silent regarding an issue, as it often is, the parties must look to "otherwise applicable non-bankruptcy law" for guidance. This means that other state and federal laws often play major roles in the outcome of matters that are influenced, but not necessarily determined, by the Bankruptcy Code. In the context of the relationship between suppliers and customers in the commercial context, the otherwise applicable non-bankruptcy law generally consulted is the Uniform Commercial Code of the various states in which parties transact their business.

II. AUTOMATIC STAY

The basic objective of bankruptcy is to allow the debtor to have some breathing room for a time while the business seeks professional advice to first determine the best and most appropriate course of action to exit bankruptcy, and then to develop and implement a plan to do just that.

The mechanism that allows this breathing room to happen is the automatic stay, which goes into effect immediately upon the filing of a bankruptcy petition without any further action by the Bankruptcy Court.

Typically, in the law, action by a party is not stayed unless a court orders such after specific notice and an opportunity to be heard is afforded to the affected parties. Not so in bankruptcy. Under § 362(a) of the Bankruptcy Code, once a bankruptcy petition is filed with the Clerk of the Bankruptcy Court, no action may be taken by any creditor against the debtor or its assets to collect on a debt that arose prior in time. There are some limited exceptions that are beyond the scope of this article, but the general principle stands that once the business operator files bankruptcy, the suppliers and other creditors must cease all efforts to collect on sums due for goods and services supplied prior to the time of filing, which is called the filing date. There are a number of steps suppliers can take to protect their rights and enhance their prospects to ultimately get paid for amounts due for goods and services provided prior to the filing date or pre-petition.

III. SUPPLIER REMEDIES

The relationship between sellers and buyers of goods in the commercial setting is generally governed by the Uniform Commercial Code, which is commonly referred to as the "UCC." The UCC in one form or another has been adopted by all 50 states. The basic rights and remedies of sellers, including suppliers of goods, and their customers generally can be found in Article 2 of the UCC. The remedies for suppliers when a customer is bankrupt or otherwise insolvent can be found in Subchapter 7 of Article 2. These UCC remedies are (1) right to demand adequate assurance of future performance; (2) recall of goods in transit and (3) reclamation of goods received. The Bankruptcy Code expands on these rights by providing special treatment for 20-day claims – sums due for goods and services provided within 20 days prior to a bankruptcy filing – and by allowing setoff and recoupment against sums due by the supplier to the customer which is in bankruptcy.

Adequate Assurance of Future Performance

UCC § 2-609 provides a supplier who has reasonable grounds for insecurity with respect to the performance of its counterparty the ability to demand request in writing adequate assurance of due performance. The supplier may, if commercially reasonable, suspend any performance for which he has not already received the agreed return until he receives that assurance. The reasonableness of grounds for insecurity and the adequacy of any assurance offered are generally determined according to commercial standards. Failure to respond within a reasonable time (not exceeding thirty days) to a request for such assurance will be considered a repudiation (or breach) of the contract.

Recall of Goods

UCC § 2-705 provides suppliers with the right to stop delivery of goods in the possession of a carrier if he discovers the buyer to be insolvent. This right applies to delivery of all sizes, no matter how small or large. A second and related right to recall goods in transit under the same provision of the UCC allows for the stoppage of the delivery by carload, truckload, planeload or larger shipments in the additional situations where the buyer repudiates or fails to make payment due before delivery or if for any other reason, the supplier has the right to withhold or reclaim the goods. In either case, the goods must not yet have been received by the buyer. Thus, once a supplier becomes aware of a buyer's insolvency, the prudent action is to determine immediately whether there are goods in transit that one may wish to recall. Recall under UCC § 2-705 is generally not a violation of the automatic stay for the simple reason that the goods have not yet become the property of the debtor/buyer.

Reclamation

UCC § 2-702 provides a supplier with two very important remedies once it is discovered that a buyer in receipt of goods is insolvent. The basic remedy is that the supplier may refuse delivery, except for cash, or may stop future delivery altogether. Thus, it is common practice for suppliers in a bankruptcy setting to refuse to continue providing goods other than on a COD basis. This right under UCC § 2-702 also serves as the basis for renegotiation of trade terms after a bankruptcy filing. The other right provided to suppliers under UCC § 2-702 is the right to reclaim goods that are already received.

The UCC provides that where a seller discovers that the buyer has received goods on credit while insolvent, he may reclaim the goods upon demand made within 10 days after the receipt. Additionally, if there is a misrepresentation of solvency made to the supplier in writing within three months before the delivery, the 10-day limitation does not apply at all. The Bankruptcy Code was recently amended to extend this 10-day period to 45 days. Bankruptcy Code § 546(c)(1) expands the reach back to 45 days, and also provides additional time – up to 20 days after the filing date – to make a reclamation demand for goods shipped within the 45 days prior to the bankruptcy filing.

On its face, it appears that the reclamation benefits under the Bankruptcy Code substantially improved the position of suppliers in the bankruptcy context. However, court decisions highlight a number of very substantial hurdles confronting a supplier seeking to assert the right to reclaim goods already received. First, in order to recover, the supplier must make a detailed written demand within the required time frame, which is 10 days after receipt outside of bankruptcy and 20 days if the buyer has filed bankruptcy. Second, the supplier must be able to establish that he did not become aware of the insolvency until after receipt of the goods. This would apply to each particular shipment at issue. Third, the supplier must also prove that the goods sought to be reclaimed are still in fact possessed by the counter party in their original form (and not incorporated into another product) in order for reclamation to be effective. This requirement suggests that a supplier act as quickly as feasible in enforcing their reclamation rights. Finally, and most significant are a number of cases recently decided that tend to establish that the right of reclamation is subject to the rights of other creditors who have obtained liens on the buyer's inventory and that extend to the supplier's goods upon receipt by the debtor. Essentially, where the supplier has an inventory finance arrangement by a bank or other financial source, the right to reclamation has proven to be essentially illusory.

20-Day Claims

In 2005, Congress dramatically improved the rights of suppliers by amending the Bankruptcy Code with the insertion of § 503(b)(9) to enhance the standing of suppliers with respect to sums due for goods shipped within 20 days prior to the filing of the bankruptcy. Even though the so-called "20-day claims" continue as pre-petition unsecured claims in the bankruptcy case, § 503(b)(9) elevated the status of these unsecured claims and assigned a priority to these claims in the bankruptcy payment scheme equal to that of all other administrative claims. This special claim status is provided with respect to "the value of any goods received by the debtor within 20 days before the date of the commencement of a case in which the goods have been sold to the debtor in the ordinary course of the debtor's business."

The elevated priority for a supplier's 20-day claims under § 503(b)(9) is certainly a welcomed benefit. However, the suppliers need to temper the expectations for prompt payment. Court decisions since the enactment of § 503(b)(9) have resulted in delays and other roadblocks to the receipt of timely payment by suppliers with 20-day claims. For example, the priority for payment matters only if the customer is successful in reorganizing or is liquidating in Chapter 11. If the customer does not exit from bankruptcy, or is sold and the case converted to a Chapter 7 liquidation, this benefit may be difficult to realize.

Setoff and Recoupment

Generally speaking, if at the time of the filing of bankruptcy there are mutual debts due by both supplier and customer to the other, the supplier can offset the amount it owes to the customer against what the customer owes to the supplier, thereby relieving the supplier's obligation the customer to that extent. The operative provision of the Bankruptcy Code is § 553(a). Before the supplier can take this step, it must give the customer notice and get the court's permission to act. Failure to get permission from the court is a violation of the automatic stay.

If the debt of the supplier to the customer does not arise until after the bankruptcy filing, the right of set off under § 553 does not help the supplier, because it applies only to mutual debts where both arose prior to bankruptcy. However, the supplier whose mutual debt arises post bankruptcy may be able to set off that debt against the money due by the customer for pre-petition deliveries using a remedy called "recoupment." Recoupment is not found in the Bankruptcy Code, but is one of those "otherwise applicable non-bankruptcy law" concepts that apply in the bankruptcy setting, because it is not prohibited by the Bankruptcy Code. To enforce a right to recoup a mutual debt, the law requires that both debts arise out of the same transaction. Recoupment is a useful remedy for a franchisor or other supplier seeking to avoid payment of rebates and other incentive obligations arising out of the same contract when continuing to do business with a franchisee-buyer while in bankruptcy.

Post-Petition Shipments

Contrary to popular belief, there is no guaranty for payment of post-bankruptcy extensions of credit. Suppliers who ship on credit during the Chapter 11 do get paid on a priority basis, over the suppliers with pre-bankruptcy claims, but there still has to be money to pay and the banks, which are likely providing revolving credit to fund the operations in bankruptcy, generally have a super priority claim so that in the event of a post-bankruptcy insolvency, the suppliers could still get stuck. Suppliers are advised to limit the credit balance and watch the payment cycle closely to make sure they do not get extended beyond normal terms during the course of the bankruptcy.

IV. CONCLUSION

Suppliers of goods are cautioned to exercise diligence in these difficult economic times for E&Ps and other buyers of their goods on credit. If a customer becomes insolvent, prompt action is required to take advantage of a few basic remedies available to the supplier. By diligently paying attention to trends and patterns of payment, a supplier can stay in position to take advantage of rights to (1) recall goods in transit not yet received by an insolvent buyer, (2) reclaim goods received by an insolvent buyer within 10 days of delivery outside of bankruptcy and 45 days of delivery to a buyer who has filed bankruptcy, (3) assert an unsecured claim with administrative priority and enhanced prospects for payment on account of goods received by an insolvent buyer within 20 days prior to the filing of bankruptcy, (4) setoff or recoup mutual debts owed to the buyer who has received goods or services without payment, and (5) stop deliveries altogether or demand COD or other payment term modifications when a buyer is found to be insolvent or as a condition for provision of goods or services after a bankruptcy is filed.

There are issues with all of these remedies and a thorough review of all options with competent bankruptcy counsel is recommended before action is taken. Nonetheless, the price of inaction can be dramatic so the watch word for any supplier to an E&P is to remain ever diligent in dealings with customers in an economically distressed economy.

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