By Kenneth A. Rosen, Esq.
Lowenstein Sandler LLP

DEALING WITH BANKRUPTCIES IN THE ENERGY SECTOR

What you don't know about bankruptcy can hurt you. What you do know might help you.

This is an especially important mindset for companies with ties to the oil and gas industry – which has been hit hard by plunging oil prices. The sector has seen dozens of bankruptcies over the past 18 months, reminiscent of painful memories of the telecom sector in the early 2000s.

Of course, there's a domino effect when so many bankruptcies happen. Bankruptcy for companies that sell products or services to exploration companies, drilling companies, and refineries have also skyrocketed. Even companies that sell goods not normally associated with the energy industry (one example: pipe manufacturers) are suffering. With this as a backdrop, here are some bankruptcy law basics.

It's important to understand the difference between chapter 7 and chapter 11. Chapter 7 is liquidation, where a trustee is appointed to take control of the debtor (the bankrupt company) and its assets. Chapter 11 is supposed to be reorganization in which the debtor usually serves as its own trustee, known as a "debtor in possession." When you hear that one of your customers is in bankruptcy, you should stop doing business with them until you learn more.

While chapter 11 is known as the reorganization chapter of the bankruptcy code, many cases ultimately turn out to be liquidations. Not every company that files a chapter 11 petition will emerge successfully.

Companies may get asked to extend credit to customers in bankruptcy, and they'll likely be told not to worry because they'll get an "administrative claim" for credit given after the bankruptcy case begins. Administrative claims get paid "off the top" and are equal in priority to legal and accounting fees. But, they still are secondary to secured debt (creditors that have collateral). And, in many instances, there is little or nothing left after the secured creditor (bank) gets paid. Companies who give credit should check to see how the case is doing periodically.

How do you do that? In larger matters, the debtor will have a claims agent – someone who records and sorts proofs of claim, the document that a creditor can file to have its claim on the record. This agent also might post updates online and it's possible to get information from the attorney for the debtor (or for the creditors committee) or from monthly operating reports debtors must file with the U.S. Trustee (part of the Justice Department).

In some cases, companies might be asked for a large deposit to purchase a piece of machinery or equipment from a company going through bankruptcy. The purchasing company might not know much about the seller's assets, liabilities, or profitability. But, they write a check and assume that delivery will happen when promised. What's the downside?

First, will the deposit be held in escrow? Or, will the seller use the deposit in the ordinary course of its business? If it can be used by the seller, the deposit is effectively a loan. If the seller is in financial distress (unknown to the buyer) and ceases operations, the buyer has a claim for the amount of the deposit. The buyer gets priority status, which means it will get paid ahead of typical trade creditors of the seller – but after any creditor of the seller that has a security interest or lien on the seller's assets. There's no guarantee that, in a seller liquidation, there will be enough money left to make the buyer whole. Buyers in these cases need to understand the seller's financial capability. Otherwise, they should ask that a seller's attorney hold a large deposit in escrow.

For companies extending credit to a customer who commences bankruptcy, pursuing collection of the amount due is enjoined by the Bankruptcy Code. This "automatic stay" acts like an injunction. It can be punishable by contempt of court if companies continue with collection efforts after the commencement of the bankruptcy case, unless the bankruptcy judge grants permission. ►

DEALING WITH BANKRUPTCIES IN THE ENERGY SECTOR

Unfortunately, companies must wait and hope that money will be left at the end of the bankruptcy case for them to be paid. Completing the “proof of claim”– the legal form that a creditor files in order to be on the record as being owed money – is easy, and companies should file them as soon as possible after learning of the bankruptcy. Bankruptcy courts can be very strict when it comes to missing bar dates.

When companies try to collect money, customers might say that paying a past due claim will be a “preference” – a payment on account of a past due obligation made during the 90 days before the bankruptcy date. There are defenses and exceptions, but such payments often can be recovered by the debtor or a trustee after the case commences. Debtors might say that there is no point in paying because bankruptcy is imminent and the payment would have to be returned. But, preferences almost always are heavily compromised and discounted. Companies should collect whatever they can, sooner rather than later.

Of course, most chapter 11s are not successful. Some companies commence chapter 11 to eliminate debt and some commence chapter 11 to liquidate. Some just want to be able to sell their assets in an orderly manner.

The likelihood of creditor companies getting paid will depend on the outcome of the case and also on who is ahead in line for payment. Any entity working with a bankrupt company should use available online information (and, of course, the bankrupt company’s legal representation) to obtain information.

Big picture, companies need to do their best to make sure they’re not caught off guard when entities they work with file for bankruptcy. If they are caught off guard, companies should make sure they don’t get burned twice. igm

The views expressed herein are those of the author alone and are not necessarily those of Lowenstein Sandler LLP or of any attorney at the Firm.