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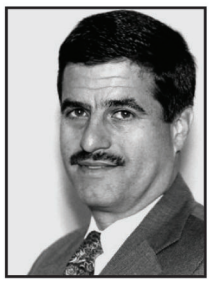
New Section 366(c) of the U.S. Bankruptcy Code: Safeguard for utilities that use its protections

By Gilbert L. Hamberg



Gilbert L. Hamberg

Introduction

Effective for Chapter 11 cases[1] filed on or after October 20, 2005, new Section 366(c) of the U.S. Bankruptcy Code, 11 U.S.C. § 366(c), is designed to protect utilities[2] from incurring post-petition losses from their debtor customers and to counteract some prior bankruptcy cases that, in essence, held that mere administrative expense priority could constitute adequate assurance under Section 366(b).[3] [The new version made no changes to Sections 366(a) or (b).]

The dilemma at the outset of a Chapter 11 case is which Chapter 11 debtors will be administratively solvent and which will not? Where a Chapter 11 debtor ultimately turns out to be administratively solvent and pays in full all post-petition trade creditors (for example, utilities) for post-petition invoices, there may be no real need for tangible, post-petition relief such as a post-petition security deposit, because the post-petition security deposit, plus interest (less outstanding, post-petition charges), may be returned to the Chapter 11 debtor.

Where, however, the Chapter 11 debtor is administratively insolvent,[4] the debtor does not pay in full post-petition trade creditors, who then incur post-petition losses. For utilities, these losses generally are allowed in rates as operating expenses and/or other adjustments. This may result in other customers paying these costs.

Section 366(c) may enable utilities to obtain tangible, financial relief, which can avoid the situation of having other customers paying higher rates because of administratively insolvent, Chapter 11 debtors.

New Section 366(c)

Prior to the new legislation, it was becoming quite difficult for utilities to obtain post-petition security deposits in the larger, contested Chapter 11 cases.[5] New Section 366(c) can help. There are four parts to new Section 366(c).

Section 366(c)(1): In subsection (A), Congress defined "assurance of payment": a cash deposit, letter of credit, certificate of deposit, surety bond, prepayment or other form mutually agreeable between the utility and the debtor. Depending on the individual utility and its state laws, e.g., tariffs, rules and regulations, utilities may accept either security deposits or their commercial equivalents from commercially acceptable financial institutions, e.g., a letter of credit or a surety bond. In subsection (B), Congress prohibited a Bankruptcy Court from deeming a mere "administrative expense priority" from being "assurance of payment."

Nonetheless, Congress did not set forth in Section 366(c)(1) the quantum of deposit or its commercial equivalent. It left that to the Bankruptcy Courts to decide on a case by case basis. Based on an analysis of many debtor-filed utilities motions since Section 366(c) went into effect (schedule available upon request), Chapter 11 debtors are proposing these forms of adequate assurance of payment: pay pre-petition invoices, enter advance payment agreements, pay post-petition security deposit of two weeks or more, or other. A prudent utility should scrutinize the "floor" very carefully, consider requesting more, or object to obtain additional components of relief as being 'adequate assurance' — to obtain a higher "ceiling" — either through negotiated settlement or as a litigated matter. Through reasonable negotiations, a prudent utility may obtain more than the low "floor" proffered by debtors. There is no reason why a utility should accept an offer of

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a two-week security deposit as being a sufficient guarantee for 60 days of service.[6]

Section 366(c)(2): Congress provided that unless the utility actually *receives* adequate assurance of payment *satisfactory* [typically, a two-month security deposit, as established by state laws, *see also* 28 U.S.C. § 959 (b)] to it on or before the 30th day from the petition date, then it may alter, refuse, or discontinue service to the Chapter 11 debtor.

Section 366(c)(3): Congress provided that *after* the utility *receives* such payment, the debtor may seek modification of same by filing a motion with the Bankruptcy Court. In Section 366(c)(3)(B), Congress provided that in determining what is to be adequate assurance of payment, a court may not consider: the absence of a security deposit or the like prior to the petition date, timely payment of pre-petition invoices, or the availability of administrative expense priority. What is left is something to eliminate the financial risk to a utility from providing 60 days of service on credit and being unsecured for same.

Section 366(c)(4): Congress provided that a utility may recover or set off a pre-petition security deposit against the debtor's pre-petition debt — without notice or order of the Bankruptcy Court. This was designed to protect utilities from having to incur the transactional costs of seeking Bankruptcy Court approval each time a customer files for bankruptcy with a security deposit and a pre-petition debt outstanding.

In re Lucre Inc., 333 B.R. 151, 154 (Bankr. W.D. Mich. 2005), interpreted Section 366(c) to mean that a debtor "has no recourse to modify the adequate assurance payment the utility is demanding until the . . . debtor . . . actually accepts what the utility proposes." The legislative history of Section 366(c) is similar: first, a Chapter 11 debtor must pay the adequate assurance satisfactory to the utility within 30 days of the petition date; otherwise, the utility can terminate service; then, a debtor can file a motion seeking modification thereof. H.R. Rep. No. 109-31, at 155.

Conclusion

The amount of proposed deposit may be too low in comparison to the utility's potential exposure if post-petition invoices are not paid. Sometimes, debtor-filed utilities motions include other, unfavorable provisions,

Text of Section 366 of the Bankruptcy Code: Utility service

(a) Except as provided in subsections (b) and (c) of this section, a utility may not alter, refuse, or discontinue service to, or discriminate against, the trustee or the debtor solely on the basis of the commencement of a case under this title or that a debt owed by the debtor to such utility for service rendered before the order for relief was not paid when due.

(b) Such utility may alter, refuse, or discontinue service if neither the trustee nor the debtor, within 20 days after the date of the order for relief, furnishes adequate assurance of payment, in the form of a deposit or other security, for service after such date. On request of a party in interest and after notice and a hearing, the court may order reasonable modification of the amount of the deposit or other security necessary to provide adequate assurance of payment.

(c)(1)(A) For purposes of this subsection, the term "assurance of payment" means —

(i) a cash deposit;
(ii) a letter of credit;
(iii) a certificate of deposit;
(iv) a surety bond;
(v) a prepayment of utility consumption; or
(vi) another form of security that is mutually agreed on between the utility and the debtor or the trustee.

(B) For purposes of this subsection, an administrative expense priority shall not constitute an assurance of payment.

(2) Subject to paragraphs (3) and (4), with respect to a case filed under chapter 11, a utility referred to in subsection (a) may alter, refuse, or discontinue utility service, if during the 30-day period beginning on the date of the filing of the petition, the utility does not receive from the debtor or the trustee adequate assurance of payment for utility service that is satisfactory to the utility.

(3)(A) On request of a party in interest and after notice and a hearing, the court may order modification of the amount of an assurance of payment under paragraph (2).

(B) In making a determination under this paragraph whether an assurance of payment is adequate, the court may not consider —

(i) the absence of security before the date of the filing of the petition;
(ii) the payment by the debtor of charges for utility service in a timely manner before the date of the filing of the petition; or
(iii) the availability of an administrative expense priority.

(4) Notwithstanding any other provision of law, with respect to a case subject to this subsection, a utility may recover or set off against a security deposit provided to the utility by the debtor before the date of the filing of the petition without notice or order of the court.

e.g., a proposed injunction against the setoff/recoupment of pre-petition security deposits against pre-petition debts. This contradicts the precise language in Section 366(c)(4). Unless a utility obtains relief in its favor in opposition to a debtor motion, the Bankruptcy Court will issue the debtor's proposed utilities order.

Nothing in new Section 366 or the prior version of Section 366 authorizes the entry of an injunction prohibiting termination of service for nonpayment of post-petition invoices, other than the initial automatic statutory injunction (in a Chapter 11, 30 days post-petition for post-petition charges; otherwise, 20 days). No case under new Section 366 has ruled yet on this issue. Under the prior version, courts granted a utility the right to terminate service for nonpayment of post-petition invoices in accordance with applicable state laws.

Collier, *id.*, ¶ 366.01[1], at 366-7 to 366-8; *Robinson v. Michigan Con. Gas Co.*, 918 F.2d 579 (6th Cir. 1990); *Begley v. Philadelphia Elec. Co.*, 760 F.2d 46 (3d Cir. 1985); *In re Conxus Commun. Inc.*, 262 B.R. 893 (D. Del. 2001); *In re Farley*, 135 B.R. 292 (W.D. Tenn. 1991); *Johnson v Philadelphia Elec. Co.*, 80 B.R. 30 (E.D. Pa. 1987); *In re C.T. Harris Inc.*, 295 B.R. 405 (Bankr. M.D. Ga. 2003); *In re Spencer*, 218 B.R. 290 (Bankr. W.D. N.Y. 1998); and *In re Best Prod. Co.*, 203 B.R. 51 (Bankr. E.D. Va. 1996).

To avoid missing out on an opportunity, utilities need to consider asserting their rights under Section 366(c).

Endnotes

1. It is unclear whether Section 366(c) applies only to Chapter 11 cases or also to other chapters under which debtors can file for bankruptcy. *In re Astle*, 338 B.R. 855 (Bankr. D. Idaho 2006) [Section 366(c) is inapplicable in a Chapter 12].

2. A utility is undefined in new Section 366, the prior version, or the rest of the Bankruptcy Code. 3 *Collier on Bankruptcy*, ¶ 366.05, at 366-11 (15th ed. rev. 2006). A company that provides only cable television service is not a utility under Section 366. *In re Darby*, Case No. 05-20931 (5th Cir. Nov. 14, 2006).

3. The legislative history behind new Section 366, H. Rep. No. 109-31 (Part I), at 89, 109th Cong. 1st Sess. (April 8, 2005), *reprinted in* U.S.C.C.A.N. 88, 155 (June 2005), reports the key features of new Section 366(c) but does not elaborate the reasons for its passage. Still, the net effect of new Section 366(c) was to overrule *In re Caldor Inc.*, 117 F.3d 646 (2d Cir. 1997), *aff'g.* 199 B.R. 1 (S.D.N.Y. 1996) (*Caldor*), "prospectively" for Chapter 11 cases. *Collier, id*, ¶ 366.03[1], at 366-7; *Astle*, 338 B.R. at 861, note 15.

4. Ultimately, *Caldor* resulted in administrative insolvency, *Pearl-Phil GMT v. Caldor Co.*, 266 B.R. 575 (S.D. N.Y. 2001), and even with administrative expense priority, many post-petition trade creditors were not paid in full for all of their post-petition invoices. "The priority given to administrative expenses may 'prove illusive in light of the various [Code] provisions ... for competing or super priorities.'" *In re Flagstaff Food Co.*, 739 F.2d 73, 75 (2d Cir. 1984). Administrative expense priority, a theoretical, legal concept, has meaning only in administratively solvent cases. It is a far cry from tangible relief, e.g., a cash deposit.

5. Utilities were awarded security deposits, ranging from one-half, *In re Best Prod. Co.*, 203 B.R. 51 (Bankr. E.D. Va. 1996), to two or more months, *In re Spencer*, 218 B.R. 290 (Bankr. W.D. N.Y. 1998); *In re Norsal Indus. Inc.*, 147 B.R. 85 (Bankr. N.D.N.Y. 1992); and *In re Smith, Richardson & Conroy Inc.*, 50 B.R. 5 (Bankr. S.D. Fl. 1985); [this was consistent with pre-Code practice: *In re Sec. Inv. Prop. Inc.*, 559 F.2d 1321 (5th Cir. 1977)]; or a reasonable commercial equivalent thereto; i.e., an advance payment, *In re Monroe Well Serv. Inc.*, 69 B.R. 58 (E.D. Pa. 1986); and *In re Marion Steel Co.*, 35 B.R. 188 (Bankr. N.D. Ohio 1983); [this was consistent with pre-Code practice: *In re Penn Cent. Transp.*, 467 F.2d 100 (2nd Cir. 1972)]. The more recent large Chapter 11 cases awarded no deposits. *In re Caldor Inc.*, 117 F.3rd 646 (2nd Cir. 1997), and *In re Adelphia Bus. Solutions Inc.*, 280 B.R. 63 (Bankr. S.D. N.Y. 2002) (adequate assurance can be administrative expense priority, coupled with nonmonetary, procedural relief).

6. Under normal monthly billing, the time gap between the first day of service in a billing period and termination due to nonpayment is approximately 60 days.