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# THE AUTHORITY

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## Features

National Engineers Week	6
PUC Regulations of Municipal Authorities' Utility Operations	8
New Accounting Standards Under Consideration for Proprietary Fund Reporting	12
Customer Survey; Your Community Connection	14
A Primer to Reduce Bad Debt Expenses from Non-residential customers	16
Legal Developments in Rates and Charges of Municipal Systems	20

## Departments

EXECUTIVE DIRECTOR'S REPORT	4
SOLICITOR'S CORNER	10
ADVERTISER'S INDEX	21
MEMBERSHIP UPDATE	22-23
BULLETIN BOARD	24-26
P.M.A.A. CALENDAR OF EVENTS	25
ACTIVE MEMBER NEWS	27-28
ASSOCIATE MEMBER NEWS	29
PROFESSIONAL CARDS	30-32
CLASSIFIED ADS	32

### ON THE COVER:

A dedication to the engineer firms and individual professional engineers who have serviced Pennsylvania's municipal authorities over the years. A special thank you to those engineers who have supported the efforts of the Pennsylvania Municipal Authorities Association. (Cover illustration by Paul Flury, freelance artist)



# A Primer to Reduce Bad Debt Expenses

**M**unicipalities or municipal authorities, who provide utility services; e.g., electricity, water, or sewer, to customers according to preset rates ("municipal utilities"), have been, are, or will be incurring bad debt expenses from their non-residential customers who file for bankruptcy under the U.S. Bankruptcy Code. In today's harsh economic times, this occurs more and more frequently. Municipal utilities design the prices for their services; i.e., operating revenues, to satisfy all of their operating expenses, one of which is bad debt expense. This means that when a given non-residential customer owes a PA municipal utility, say \$2,500, the other residential and non-residential customers pay the \$2,500.

This article is written under the premise that PA municipal utilities, their customers, and PA consumer advocate groups want the full costs/expenses of each non-residential, delinquent customer paid by each delinquent and not by all of the other customers.

## ANALYSIS

When a non-residential customer files a petition for relief under the Bankruptcy Code, it may be too late for a municipal utility to do anything about the prepetition debt (that incurred prior to bankruptcy) other than to timely file a proof of claim. The bankruptcy filing should trigger alarms at the municipal utility to take all prudent steps: to have its postpetition (that incurred after bankruptcy) bills paid in full on the due dates set forth therein; to obtain adequate assurance of

payment (often through the payment of a postpetition security deposit); and to terminate service for non-payment of its postpetition bills--upon notice according to PA laws.

These measures should mirror the credit and collection practices already in effect for a municipal utility's non-bankrupt, non-residential customers. As unregulated entities, municipal utilities should promulgate their own tariffs, rules, regulations, and service agreements, which allow them to collect security deposits equal to twice the highest, estimated, monthly bill, and to terminate service, on three days notice<sup>1</sup>, for non-payment of bills on time. Once these provisions are in effect<sup>2</sup>, then they should be enforced for every non-residential customer.<sup>3</sup>

Once a non-residential customer files for bankruptcy, the Bankruptcy Code takes effect, and the relationship between a municipal utility and such customers suddenly becomes subject to the jurisdiction of bankruptcy courts.<sup>4</sup> Other parties; e.g., secured creditors and the unsecured creditors committee, may intervene in the relationship. Three key statutes become operative: 11 U.S.C. § 366(a); 11 U.S.C. § 366(b); and 28 U.S.C. § 959b.

Section 366(a) reads:

*Except as provided in subsection (b) 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.*

Section 366(a) was designed to end the practice which existed before the enactment of the Bankruptcy Code in 1978, whereby some utilities were requiring their customers to pay prepetition debts as a condition precedent to postpetition service. The message behind Section 366(a) is clear. Regardless of the amount of a customer's prepetition debt<sup>5</sup>, a municipal utility still must provide it postpetition service, at least for the first twenty days.

Section 366(b) reads:

*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 deposit or other security to provide adequate assurance of payment.*

Section 366(b) was designed to provide how a utility is to supply services postpetition. A utility must serve during the first twenty days postpetition. Thereafter, if the debtor has not tendered "adequate assurance of payment", and if no party has obtained an order from the bankruptcy court, a utility is free to terminate service to a debtor<sup>6</sup> upon compliance with state laws governing such termination.<sup>7</sup>

Section 959(b) reads:

*...[A] trustee, receiver or manager appointed in any cause pending in any court of*



# from Non-residential Customers

*the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor would be bound to do if in possession thereof.*

Assuming that a municipal utility has tariff provisions and/or can rely upon PA laws for the two key parts of the Section 366(b) relief it should seek; i.e., a security deposit (assume twice the highest, estimated monthly bill) and a termination remedy without having to return to the bankruptcy court (assume upon three days written notice for non-payment), then Section 959(b) should be observed by the bankruptcy judge, and both arts should be granted.<sup>8</sup> Municipal utilities must operate according to their tariffs, rules, regulations, and state laws. Section 959(b) requires debtors to comply with these same PA laws. Section 959(b) applies to state laws governing utilities.<sup>9</sup> To obtain Section 366(b) relief, a municipal utility either should intervene in a Section 366(b) motion filed by its customer or other party or should file its own.<sup>10</sup>

Section 366(b) singles out utilities from other creditors. A non-government creditor can discontinue doing business with a debtor, which owes it money for a prepetition debt; however, a municipal utility, due to Section 366(a)<sup>11</sup> and 11 U.S.C. § 525(a)<sup>12</sup>, cannot. Instead, Section 366(b) was designed to grant to utilities "adequate assurance of payment" to compensate them for the financial risk of selling on credit to debtors,

whom often owe them prepetition debts.

The combination of a two month security deposit and a liberal termination procedure is based upon what constitutes a typical utility's billing practices. Utilities provide service on credit every second of every day. Meters are read, and bills are calculated and mailed only once every thirty days. Bills are due about twenty days after the meter reading date. The gap between the first day's service and when the bill is due to be paid is about fifty days. If the customer pays late, then the gap increases. If a termination notice is sent, then the gap increases by several more days.

A utility should not be "unsecured" for postpetition service. "While a public utility has a duty to serve, neither its history of past service nor its franchise to serve in the future may fix upon it a duty to provide unsecured future service....[and it should not] risk further losses to provide services for the benefit of other creditors."<sup>13</sup> Ample authority exists for the two keys to a municipal utility's Section 366(b) relief: payment of a security deposit<sup>14</sup>; and termination for non-payment in full on the due dates in its bills<sup>15</sup>.

## CONCLUSION

The rationale behind Section 366(b) is the recognition by Congress that unlike unregulated companies who may choose the customers to whom they sell their products, utilities must serve all customers in their service territories, even debtors, who by

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definition are poor credit risks. (Generally, insolvency is defined in bankruptcy as liabilities exceeding assets.) In return, Section 366(b) gave utilities, and not other creditors, "adequate assurance of payment". Municipal utilities should argue that this means that already provided for in their tariff provisions and other PA laws establishing credit and collection practices.

Bankruptcy adds a significant complexity to the credit and collection practices between a utility and its non-residential customers. A prudent utility should have the positive provisions above in its tariffs and should be implementing them. It should intervene in its non-residential customers' bankruptcy cases and seek Section 366(b) relief. Even if a two month security deposit is not much, bankruptcy cases tend to last a long time, even years. The amounts of postpetition bills increase rapidly, especially where debtors perceive that particular utilities are not concerned about termination for non-payment.

*(continued on page 18)*

PA municipal utilities should seek Section 366(b) relief, so that each, non-residential customer pays its own bills in full. If enough utilities intervened in bankruptcy cases and sought the Section 366(b) relief discussed above, as required by Section 959(b), then the message would be out: a bankruptcy court is not the forum to abandon compliance with state utility laws.

#### Footnotes

1. Utilities regulated by the Pa. Public Utility Commission have this requirement. 52 Pa. Code §§ 55.1 to 55.6. It would be a reasonable provision for a PA municipal utility to include in its tariffs.

2. For a municipal utility without favorable credit and collection provisions in its tariffs; e.g., for security deposits, billing practices, and termination procedures, then its first step to reduce bad debt expense is to promulgate such provisions.

3. At anytime, a non-residential customer can file for bankruptcy, so a municipal utility should protect itself against incurring a prepetition debt by: having a security deposit to offset against the prepetition debt; and terminating for non-payment according to PA laws before the customer files for bankruptcy. The set off of a prepetition

security deposit against a prepetition debt generally is permissible. *In re Brooks Shoe Mfr. Co.*, 39 B.R. 980 (E.D. Pa. 1984). Since the Bankruptcy Code protection is not triggered until the bankruptcy filing, prepetition termination for nonpayment is unaffected by the Bankruptcy Code.

4. Once a petition for relief is filed, the bankruptcy court has exclusive jurisdiction over all of the debtor's assets and property—wherever located. 28 U.S.C. §§ 157 and 1334; 11 U.S.C. § 541.

5. There may be ways to have a municipal utility's prepetition debt recovered; e.g., file a proof of claim, or file a motion to assume/reject an executory utility contract under 11 U.S.C. § 365. But this is a topic of its own, beyond the scope of this article.

6. See, e.g., *In re Hanratty*, 907 F.2d 1418 (3d Cir. 1990); and *In re Whittaker*, 882 F.2d 791 (3d Cir. 1989).

7. See *Robinson v. Michigan Con. Gas Co.*, 918 F.2d 579 (6th Cir. 1990); and *Begley v. Philadelphia Elec. Co.*, 760 F.2d 46 (3d Cir. 1985).

8. This is in stark contrast to the type of Section 366(b) relief which many non-residential debtors seek: payment of no security deposits; requiring the utility to return to the bankruptcy court on many days' notice to seek a termination remedy

for non-payment of postpetition bills; and/or no termination of postpetition service.

9. *Robinson v. Michigan Con. Gas Co.*, 918 F.2d 579 (6th Cir. 1990); *In re Nitec Paper Co.*, 43 B.R. 492, 499 (S.D.N.Y. 1984); accord *Begley v. Philadelphia Elec. Co.*, 760 F.2d 46 (3d Cir. 1985); cf. *Slenderella Sys. of Berkeley v. Pac. Tel. & Tel. Co.*, 286 F.2d 488 (2d Cir. 1961) (court deferred to utility's tariff, rules, and regulations).

10. Prudent business practice should dictate this, even though a utility technically appears to have the right to terminate service on the twenty-first day postpetition—if no party has filed a Section 366(b) motion either prior thereto or prior to the decision to terminate.

11. *In re Webb*, 38 B.R. 541, 545 (Bankr. E.D. Pa. 1984); and *In re Hennen*, 17 B.R. 720, 723 (Bankr. S.D. Oh. 1982).

12. Section 525(a) applies only to government entities and generally prohibits them from discriminating against debtors. But this is a topic in itself, beyond the scope of this article.

13. *In re Sec. Inv. Properties, Inc.*, 559 F.2d 1321, 1325-26 (5th Cir. 1977).

14. *In re Hanratty*, 907 F.2d 1418 (3d Cir. 1990) (tariff rate); *In re Lloyd*, 52 B.R. 653 (Bankr. S.D. Oh. 1985) (2.3 times average monthly bill); *In re Smith, Richardson & Conroy, Inc.*, 50 B.R.

5 (Bankr. S.D. Fl. 1985) (3 times monthly bill); and *In re Deiter*, 33 B.R. 547 (Bankr. W.D. Wi. 1983) (2 times highest monthly bill).

15. *Begley v. Philadelphia Elec. Co.*, 760 F.2d 46 (3d Cir. 1985); *Johnson v. Philadelphia Elec. Co.*, 80 B.R. 30, 32 (E.D. Pa. 1987); and *In re Am. Investcorp & Dev. Co.*, 155 B.R. 300 (Bankr. D. R.I. 1993).