Are The U.S. Bankruptcy Courts Observing State Laws?

By Gilbert L. Hamberg

PUBLIC UTILITIES MAY BE involved in disputes with their debtor customers in the U.S. bankruptcy courts; e.g., (1) under 11 U.S.C. §365(g)(1) and 502(g), over the doctrine of recoupment, over conditions of postpetition service;

(2) under 11 U.S.C. §365, over assumption or rejection of utility c contracts;
(3) under 11 U.S.C. §§365(g) and 502(g), over the measure of damages to which a utility is entitled upon rejection of a utility contract; and
(4) under 11 U.S.C. §553 and the doctrine of recoupment, over setting off and/or recouping against pre or postpetition debts.

Utilities may be encountering bankruptcy judges in these disputes who are not acceding to utility-advocated positions. Assuming that these positions are based upon state statutes or regulations, commission-approved tariffs, rate schedules, and/or service regulations, then utilities may be forced to do business with two kinds of customers: (a) those who are regulated by state laws; and (b) those debtor customers for whom state laws are being disregarded.

This detrimentally impacts utilities and their ratepayers. For every dollar uncollected from a debtor customer translates into a bad debt expense. The other ratepayers suffer, as bad debt expenses typically are allowed, operating expenses which they pay through higher rates. Utilities suffer too, through increased interest and administrative expenses and the time delay on the use of the funds between when the debtor customer should have paid and when they receive actual payment from their other customers.

Non-observance of state utility laws by bankruptcy courts may be improper. Under 28 U.S.C. §959(b):

> ...a trustee, receiver or manager appointed in any cause pending in any court of 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 thereof would be bound to do if in possession thereof.

Section 959(b) requires debtors to manage and operate their businesses according

to the same state laws as if there were no bankruptcy. Once reduced to a commission-approved tariff or rate schedule, a utility practice or policy becomes the equivalent of a state law. As such, bankruptcy judges should heed all state laws governing utilities' practices.

I. Background

Public Utilities

In exchange for receiving a monopoly to supply a service over a specific geographic area, a public utility faces strict regulation from its state public service commission over its rates, quality of service, terms and conditions of service, and the like. Every customer, utility, and state commission operates under this premise.

In Section 366(b) disputes, bankruptcy courts are required to determine what should be the terms of adequate assurance of payment by a debtor customer to a utility. Utilities argue what tariffs allow them: assume double the highest monthly, estimated bill and before service is commenced. Most utilities have security deposit procedures, which are approved by their state commissions. These security deposit procedures are established to protect the utilities against non-payment from the customers.

In Section 365 disputes, utilities want the terms of utility service agreements, which are executory contracts, enforced—just as if the debtor were any other customer. Since the contracts are based upon state-approved rate schedules, tariffs, and/or laws, and are therefore fully enforceable outside of bankruptcy, utilities argue that whether the debtor customer assumes or rejects them, the result predictably should be the same. The terms of the contracts should be enforced.

Many utilities have minimum demand charges for larger commercial customers and industrial customers. Under a minimum demand charge, a customer is required to pay a certain minimum each month. In return, the customer pays a lower per/unit price than if the contract contained no minimum. A dispute may arise when a debtor customer rejects a utility contract, which contains a minimum demand clause. Under state law, it is assumed that the minimum demand charge, which ostensibly is a liquidated damages clause, is enforceable.

In setoff/recoupment disputes, utilities attempt to set off/recoup security deposits, overcharges, and/or refunds against debts owed by the debtor customer. Under state law, it is assumed that such offsetting is permissible.

It is assumed that the collection and credit practices of utilities are based upon state law. It is assumed that but for (6th Cir. 1990), In re Nitec Paper Co., 43 B.R. 492 (S.D.N.Y. 1984), and In re Wengert Transp., Inc., 59 B.R. 226 (Bankr. N.D. Iowa 1986), have addressed whether bankruptcy courts are enforcing Section 959(b) and are acceding to state laws in disputes between utilities and their debtor customers. None even dealt with the aforesaid, illustrative disputes.

In Robinson, an involuntary Chapter 7 was filed against the owner of an apartment building. The bankruptcy court issued an order appointing a trustee and permitting a gas utility to terminate service upon five days notice if the trustee failed to pay for postpetition service. The trustee failed to pay, and the utility terminated. Under state law, there were specific procedures whereby apartment tenants were to be notified and given an opportunity to pay the utility bills if there landlord were unable to do so—prior to termination. Robinson did not address whether the state laws had been observed. Some apartment dwellers sued the utility and the trustee for alleged violations of those state procedures.

Robinson held that Section 366(b) did not preempt all state law procedures regarding termination of utility services and remanded the case for further consideration. It relied heavily upon Section 959(b) in its reasoning:

(1) after the first twenty days postpetition, nothing in Section 366 requires a utility to continue serving a debtor who has not made adequate assurance of payment or has not paid for postpetition service; and (2) Section 959(b) requires a utility to comply with applicable state laws before it actually terminates a debtor. Robinson also should be authority for the proposition that state laws should be followed too when a bankruptcy court has to determine what constitutes "adequate assurance of payment" under Section 366(b).

In Nitec, the debtor had a below-market price, wholesale power contract with its utility. The debtor wanted to assign its rights to a third party at market price, with the cost difference inuring to the debtor. Nitec found that the proposed assignment violated state utility laws and Section 959(b): "the bankruptcy court must give great weight to the laws of the state".

In Wengert, the debtor motor carrier filed an application with its state utility commission to obtain a certificate of public convenience. The debtor received a temporary certificate. Protestants filed objections. The debtor filed for Chapter 11. Upon the debtor's complaint to enjoin the state proceeding, the bankruptcy court stayed the state proceeding temporarily. Ultimately, however, Wengert dismissed the complaint pursuant to Section 959(b) so the state proceedings could continue.

Traditionally, state commissions do not become involved in these disputes. Rather, they involve the utilities against debtors and possibly other parties in interest. But there are valid concerns of state commissions and state legislatures at stake: having state laws enforced by bankruptcy courts.

II. Analysis

Cases Following Section 959(b)

Section 959(b) mandates that a debtor "is subject to the general municipal regulation of the state and most conform to its law in conducting his business." Finn v. 415 Fifth Ave. Co.; 153 F.2d 501, 503 (2d Cir. 1946), cert. den. 328 U.S. 839 (1946). The purposes of a Chapter 11 are the rehabilitation of the business and the payment of creditors. "It is clearly outside the power of the [bankruptcy] court to allow an activity continued after filing in bankruptcy to ignore state or local law which all others in the same activity must comply with." In re Briarcliff, 15 B.R. 864, 868 (D. N.J. 1981).

Under Section 959(b), a debtor: must comply with state law procedures regarding postpetition termination of utility service; upon rejection of residential leases with its tenants, still must comply with local, housing code regulations, which exist independently of the lease provisions; Saravia v. 1736 18th St., N.W., Ltd., 844 F.2d 823, 826-27 (D.C. Cir. 1988);

Although not citing Section 959(b), other cases also have concluded that bankruptcy courts have to observe state regulatory laws: a debtor is not to receive "a windfall merely by reason of the happenstance of bankruptcy."; Butner v. U.S., 440 U.S. 48, 55 (1979).

Two of these decisions warrant special attention.

In Saravia, 884 F.2d 823, a debtor lessor rejected residential leases when the costs of operating an apartment complex vastly exceeded monthly revenues. The bankruptcy court found that rejection also meant sanctioning the debtor's non-compliance with local housing code regulations; e.g., having to provide essential services to the apartments, even though they existed independently of the rejected leases. The appellate courts reversed. They held that while rejection under Section 365 may permit a debtor to discontinue private contractual obligations, it does not, pursuant to Section 959(b), relieve a debtor from complying with obligations created independently by state and local laws. Thus, the debtor lessor still had to provide the essential services to its tenants.

In Briarcliff, 15 B.R. 864, a debtor lessor converted the electric metering in its apartment complex from a master to a per apartment metered system. The tenants brought an action before a local agency, in which they complained that the debtor's meter conversion constituted an increase in their rent in violation of local, rent control laws. Briarcliff, id. at 867, held that section 959(b) permitted the proceeding before the local agency to continue:

> To decide otherwise would lead to irrational results...It's not the province of the bankruptcy court to undertake the role of local agencies. The bankruptcy court is only empowered to preserve the assets of a bankrupt estate and cannot authorize non-compliance with local law.

Collectively, these cases enforcing Section 959(b) establish persuasive precedent that in the aforesaid examples of disputes between utilities and their debtor customers, debtors should not be able to escape compliance with state-approved utility practices simply by filing for bankruptcy.

Cases Not Complying with Section 959(b)

Courts do not always defer to Section 959(b) and enforce the state or local law. Under the Supremacy Clause, U.S. Const., Art. VI, cl. 2. Congress has passed bankruptcy laws, which are designed to supersede and prevail in the event of a conflict between a bankruptcy statute and a state or local law. Under 11 U.S. C. §105(a) ("[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."), Congress has provided bankruptcy courts with an "all powers" statute to issue any order necessary to implement the bankruptcy laws. Thus, where a state law has the effect of requiring a debtor to pay a prepetition debt or obligation as a condition to

obtain a state-provided benefit; e.g., a certificate to do business, such a law would not be enforceable. It would con-flict with the payment scheme provided under the Bankruptcy Code.

Section 959(b) does not prevail always, e.g., where a debtor: which operates an interstate railroad, may not have to pay local taxes; Palmer v. Webster & Atlas Nat'l Bank of Boston, 312 U.S. 156 (1941); when liquidating and not operating a business, may not be liable for local taxes; In re Cusato Bros., Inc., 750 F.2d 887 (11th Cir. 1985); which operates an interstate railroad, may not have to pay a utility the security deposit required under state laws; In re Penn Cent. Transp. Co., 467 F.2d 100 (3rd Cir. 1972); may be able to abandon and/or operate non-hazardous property without complying with state environmental laws when liquidating and not operating a business—especially when it has no assets with which to do so, and spending them on environmental clean-up would not have appreciable results; In re Better-Brite Plating, Inc., 105 B.R. 912 (Bankr. E.D. Wis. 1989); and when liquidating and not operating, may not have to comply with local zoning laws. In re Scott Housing Sys., Inc., 91 B.R. 190 (Bankr. S.D. Ga. 1988).

III. Conclusion

Application of Section 959(b) to utility disputes is direct. Whether or not the specific practice is set forth in the utility service agreement, it is assumed that the specific practice is warranted under state law. Being the equivalent of an independent, state law, the specific utility practice should be enforced under Section 959(b).

In Section 366(b) disputes, bankruptcy courts should comply with state-authorized

utility practices and mold their "discretion" to fit within the scope of Section 959(b).

In Section 365 disputes, if debtors assume their utility contracts, then they must abide by all provisions therein. This also applies if debtors reject. The provisions in the contract, which exist as independent, state laws, still have to be obeyed.

In disputes over the enforceability of minimum demand charges upon rejection, bankruptcy courts should construe only whether such clauses are enforceable under state law. If they are, then they must be enforced.

In setoff/recoupment disputes, bankruptcy courts should analyze whether independent of bankruptcy, state laws would authorize the offset. If so, then that should stop the inquiry. The offset should be allowed.

In this fashion, Congress' intent behind Section 959(b) will be achieved. Debtor customers will not be able to obtain economic advantages over their non-debtor competitors. All utility customers, debtor and non-debtor, should comply with the same state regulatory laws. Rehabilitation and reorganization should not be achieved at the cost of sanctioning non-compliance with state utility laws. □

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NOTE: This article contains these typographical errors:

(1) Page 35, column 1, line 5: Change "365 and 502(g)" to "366(b)".

(2) Page 35, column 1, line 6: Delete "over the doctrine of recoupment".

(3) Page 35, column 1, line 10: Delete "c".

(4) Page 35, column 1, line 11: Change "365(g)" to 365 (g)(1)".

(5) Page 36, column 3, line 1: Insert:

"the bankruptcy case, the utility could implement the specific credit or collection practice without challenge. Consequently, as regulated industries, utilities advocate these positions in these bankruptcy cases, because these are the only positions which they are permitted to advocate under state laws.

Section 959(b) and Utilities

Only Robinson v. Michigan Consol. Gas Co., 918 F. 2d 579".

(6) Page 36, column 3, line 14: Change "Robinson" to "Robinson".

(7) Page 37, column 2, line 7: Change "Nitec" to "Nitec, id. at 499, n. 8".

(8) Page 37, column 3, line 6: Change "Wengert" to "Wengert".

(9) Page 38, column 1, line 10: Change "Co.;" to "Co.,".

(10) Page 38, column 1, line 11: Change "cert. den." to "cert. den.".

(11) Page 38, column 1, line 35: Change "provisions;" to "provisions.".

(12) Page 38, column 1, line 36: Change "1988);" to "1988).".

(13) Page 38, column 2, line 44: Change "id." to "id.".

(14) Page 38, column 2, line 45: Change "section" to "Section".

(15) Page 39, column 1, line 5: Change "con-flict" to "conflict".

(16) Page 39, column 3, line 2: Change "In re Scott Housing Sys., Inc.," to "In re Scott Housing Sys., Inc.,".