BUSINESS LAW

Debtor Adversary Proceeding Is Needed to Stop Service Cutoff

BANKRUPTCY UPDATE

Utility Customer Owing Post-Petition Bills Can't Enjoin by Motion

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Special to the Legal

If a debtor customer does not pay its post-petition utility invoices, the bankruptcy court may not enjoin the utility from implementing its termination procedures — at least where the injunctive relief is sought by mere motion rather than by the filing of a complaint that initiates an adversary proceeding, a judge in the Delaware District Court has ruled.

The case, *In re Conxus Communications, Inc.*, 262 B.R. 893 (D. Del. 2001), involved a utility's commercial customer whose Chapter 11 was converted to a Chapter 7 shortly after the filing of the Chapter 11 petition.

Judge Joseph J. Farnan, in his ruling, decided to follow the directive established by the 3rd U.S. Circuit Court of Appeals in *In re Begley*, 760 F. 2d 46 (3d Cir. 1985) and a bankruptcy court in the 4th Circuit in *In re Best Products Co.*, 203 B.R. 51 (Bankr. E.D.Va. 1996).

The case began on May 19, 1999, when Conxus Communications Inc., a paging company, and its affiliated entities — the "debtors" or "Conxus" — filed for Chapter 11 in Wilmington. Two months later, the case was converted to Chapter 7, and a Chapter 7 trustee was appointed.

Post-petition, Conxus obtained telecommunications services from MFS Telecom Inc. and MFS Datanet Inc. (collectively, MFS). By the time of the conversion, MFS' unpaid post-petition invoices to the debtors amounted to about $500,000.

Shortly after the conversion, MFS notified Conxus that it was about to terminate service because of Conxus' failure to pay the invoices. Conxus' secured lender was Motorola Inc. At Motorola's request, MFS agreed to continue to provide its services for a short time — to accommodate Conxus' paging customers who otherwise would have their services interrupted without notice.

The time expired without payment of the invoices. At a hearing before the Delaware Bankruptcy Court, Motorola, together with the Chapter 7 trustee, verbally moved that the court issue an injunction for four more days to prevent MFS from terminating its services to the debtors.

Motorola offered to prepay the estimated amount of MFS' charges for the extra days. Motorola claimed that the additional time would permit another purchaser to appear to buy Conxus' subscriber list, which thereby would prevent any interruption of service to Conxus' customers.

MFS opposed the injunction. It argued that Section 366(a)[1] of the Bankruptcy Code allowed it to terminate service because of nonpayment of post-petition invoices, that *Begley* expressly permitted it to do so, and that the debtors could not establish compliance with the elements necessary to obtain an injunction and, particularly, the likelihood of success on the merits.

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Section 366(a) states: "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."

MFS conceded that if the injunction were granted and its charges for the extra days of service were prepaid, as Motorola and the trustee represented they would be, it would incur no harm if the injunction were granted.

The bankruptcy court granted the injunction. It reasoned that notwithstanding the *Begley* ruling that a utility has the right to terminate because of nonpayment of post-petition invoices, this did not address a request for the issuance of an injunction under Section 105(a) of the Bankruptcy Code.

In pertinent part, Section 105(a) provides, "The Court may issue any order, process, or judgment that is necessary or appropriate to carry out the provision of this title."

The bankruptcy court also stated these reasons for granting the injunction: The injunction only would last a few days; MFS would be prepaid for all of its charges during that period and, therefore, would not be harmed; and the exigent circumstance that the estate would be harmed if potential buyers did not come forward and purchase the debtors' valuable subscriber list.

MFS appealed to the District Court. Motorola sought to dismiss, saying that the issue was moot. MFS disagreed. The parties entered into an agreement by which MFS secured its right to continue the appeal. Hereunder, the parties acknowledged that the injunction already had expired, the telephone charges while the injunction applied were $38,400, and the manner by which the $40,000 deposit made by Motorola to pay would be applied if MFS won or lost the appeal.

Farnan's analysis consisted of three parts:

- Jurisdiction and standard of review. Jurisdiction existed over the appeal under 28 U.S.C. Section 158(a), which grants a district court the jurisdiction to adjudicate appeals from final judgments, orders and decrees of bankruptcy judges.

The standard for review of an injunction is abuse of discretion. Factual determinations by bankruptcy judges may be set aside only under a clearly erroneous standard. Conclusions of law are subject to plenary review and are subject to de novo review by the reviewing court.

- The appeal was not moot. Motorola argued that because the injunction already had expired and MFS already had terminated service, there was no actual matter in controversy remaining for the district court to decide, relying upon the dissenting opinion in *Klein v. Califano*, 586 F.2d 250 (3d Cir. 1978).

As a threshold matter, Farnan stated that a dissenting opinion of the 3rd Circuit was not controlling upon him. Further, he analyzed the majority opinion in *Klein*, which involved residents of a nursing home who sought to enjoin the federal government from terminating federal funds to the home because the facility did not comply with federal standards.

> *Motorola argued that because the injunction already had expired and MFS already had terminated service, there was no actual matter in controversy remaining for the court to decide.*

After the district court granted the injunction, the government appealed to the 3rd Circuit. While the appeal was pending, the nursing home was recertified, resulting in an elimination of any threat that the funding could terminate.

While *Klein* ruled that the appeal was moot as to prospective application of the injunction, because the government also sought to recoup funds that were disbursed pursuant to the injunction, it was likely that the government would challenge the injunction in a collateral proceeding to recoup the funds.

Under those circumstances, *Klein* held that "a party 'who asserts a colorable claim to compensation from a wrongfully granted permanent injunction whose prospective application has been mooted [may] appeal directly the merits of the injunction, rather than be remitted to a collateral challenge of the injunction in a recoupment action.'"

Applying the injunction principles to *Conxus*, Farnan ruled that since the application of the $40,000 paid by Motorola still had not been resolved, and since the application of the side settlement agreement between Motorola and MFS had not yet been resolved, the question of the disbursement of funds remained despite the fact that the injunction issued by the bankruptcy court had long since expired.

Unless resolved now, it is likely that the parties would contest the issue in a subsequent proceeding. Issues remaining from the issuance of the injunction remained unresolved; and thus, the matter was not moot.

- The bankruptcy court erred in issuing the injunction. Farnan, examining the merits of the injunction, held that it should not have been issued for two reasons:

1. While Section 105(a) confers some equitable powers upon a bankruptcy judge, the breath of the application of those powers is limited by express provisions in the Bankruptcy Code, relying upon *In re Morristown & Erie R.R. Co.*, 885 F.2d 98, 100 (3d Cir. 1989): Section 105(a) does not give a bankruptcy court the power to create substantive rights that would otherwise be unavailable under the code. (See *Southern Ry. Co v. Johnson Bronze Co.*, 758 F.2d 137, 141 (3d Cir. 1985).)

In this situation, the substantive provision of the Bankruptcy Code by which the application of Section 105(a) is to be governed is Section 366. In *Begley*, the 3rd Circuit already had ruled that "Section 366 does not preclude a utility from terminating services based upon a debtor's post-petition default," and further, a utility "may commence termination procedures once a post-petition payment is missed."

As it was undisputed that Conxus had failed to pay about $500,000 of MFS' post-petition invoices, said Farnan, "MFS had the right under Section 366 to terminate service to the Debtors." Here, by expanding debtors' rights beyond the parameters of debtor protections under Section 366, the bankruptcy court misapplied its powers under Section 105(a).

2. The district court rejected the bankruptcy court's reasoning that exigent circumstances favored issuance of the injunction. On the contrary, Motorola was on notice, before the injunction was applied for and granted, that MFS intended to terminate its post-petition services to Conxus.

Therefore, instead of making a mere verbal motion in bankruptcy court with the Chapter 7 trustee, Motorola and the trustee should have filed a formal complaint and thereby instituted an adversary proceeding to obtain the injunctive relief it was seeking. Pursuant to Bankruptcy Rule 7001(7)[3], a party seeking injunctive relief must seek it by filing an adversary proceeding.

Bankruptcy Rule 7001(7) states: "An adversary proceeding is governed by the rules of this Part VII. The following are adversary proceedings: a proceeding to obtain an injunction or other equitable relief."

As authority, Farnan cited *Best Products*, in which the debtor filed a Section 366(b) motion, and not an injunction, seeking to enjoin all of its utilities from terminating their services, even for nonpayment of their post-petition invoices. The *Best Products* court refused to grant such relief, saying that it "could not enjoin utility from pursuing its rights under state law if [the] debtor defaulted in its payments post-petition."

Best Products also relied upon *Begley* as authority for its holding. Although not discussed in *Conxus*, additional authority exists to substantiate the holding that under Sections 105(a) and 366 of the Bankruptcy Code, a utility can terminate its services, in compliance with applicable state law notice procedures, because of a debtor's nonpayment of post-petition utility invoices. (See *Robinson v. Michigan Con. Gas Co.*, 918 F.2d 579 (6th Cir. 1990); *Johnson v. Philadelphia Elec. Co.*, 80 B.R. 30 (E.D. Pa. 1987); and *In re Am. Investcorp & Dev. Co.*, 155 B.R. 300 (Bankr. D. R.I. 1993).)

Consequently, for the reasons discussed, Farnan reversed the injunction granted by the bankruptcy judge. Under Section 105(a), the bankruptcy court did not have the power to apply Section 366 to prevent the utility from disconnecting service to the debtor for nonpayment of post-petition utility invoices. •