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GUEST COMMENTARY

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RESPONDING TO DEBTOR-FILED SECTION 366 MOTIONS

Major cases under Chapter 11 of the U.S. Bankruptcy Code (Code), i.e. where the debtor has millions of dollars in assets and liabilities, currently are being filed across the country at a rapid pace. As the economy suffers, major corporations suffer too, with filing for Chapter 11 being their only recourse. Bankruptcy courts have nationwide jurisdiction over all of a debtor's assets, wherever located. A rural electric cooperative (REC) in say Colorado (CREC), whose service territory is in Colorado, could find itself subject to motions and orders issued by a distant federal bankruptcy judge, say in Delaware or New York (approximately 50 percent of the major Chapter 11 cases are filed either in Wilmington, Delaware or New York, New York). Bankruptcies of key accounts customers can have a significant impact on an REC and particularly, its ability to collect payment for utility service. This editorial will explore some of the bankruptcy process and considerations for utilities.

Assume this hypothetical situation: a large commercial customer with operations in many states (BIGCO), including a factory in Colorado, files for Chapter 11, and files one of the typical initial motions, a Section 366 utilities motion. Under Section 366(a) of the Code, a utility is prohibited from terminating service to a debtor solely due to the existence of a pre-petition debt, i.e. before the petition date, owed by BIGCO to CREC. Under Section 366(b), during the initial 20 days after the petition date, CREC must provide service to BIGCO, regardless of the amount of either the pre-petition debt or BIGCO's pre-petition payment performance; however, thereafter, BIGCO has to provide its utilities with "adequate assurance of payment."

The typical debtor-initiated Section 366 order, obtained *ex parte*, that is issued without prior notice to utilities and without an opportunity to contest same, provides: (1) utilities are enjoined from terminating service due to the existence of a pre-petition debt or the very filing for Chapter 11; (2) utilities are granted administrative expense priority for their post-petition invoices; (3) the debtor does not have to pay any post-petition security deposit to utilities (meaning if an estate becomes insolvent during the course of the Chapter 11, then surely, there will be insufficient funds to pay utilities' post-petition invoices; forcing utilities to provide credit to BIGCO ***involuntarily*** on a 100 percent unsecured basis); (4) utilities seeking additional adequate assurance of payment may make requests for same; and (5) procedures are established for resolving requests which the debtor deems to be unreasonable.

When the Chapter 11 is filed, it already is too late for CREC to take two key steps to reduce the pre-petition losses it will incur from BIGCO: (1) obtain a pre-petition security deposit and (2) terminate service, after compliance with applicable state law notice and default procedures, if pre-petition invoices are not timely and fully paid. There are two major benefits of a pre-petition deposit. First, it reduces the amount of the pre-petition debt; pursuant to the doctrines of set off and/or recoupment, a utility can recoup a pre-petition deposit against a pre-petition debt. *See* In re McMahon, 129 F.3d 93 (2nd Cir.

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1997) (existing state laws already must provide for a utility to apply a deposit against the customer's unpaid invoices) and In re Brooks Shoe, 39 B.R. 980 (E.D. Pa. 1984). Second, the utility is a secured creditor up to the amount of the deposit. Therefore, if later in the case the debtor or trustee files a preference action under Section 547 of the Code (seeking to recover payments made to unsecured trade creditors, including CREC, in the 90 days before the petition date) as typically happens in failed Chapter 11 cases, then, up to the amount of the deposit, CREC would be a secured creditor, and therefore, the payments would not qualify as preference payments under Section 547. *See* In re Erin Food, 980 F.2d 792 (1st Cir. 1992) and In re Hagen, 922 F.2d 742 (11th Cir. 1991). Assuming that the amount of two months of service is significant enough to exceed legal fees and costs, e.g., a monthly invoice is $10,000, CREC would be well advised to assert the following points when making its request for additional assurance in response to the Section 366 order:

(1) Frequently, debtor-filed Section 366 motions and orders are ***not served*** upon utilities in accordance with Bankruptcy Rule 7004(b)(3). This rule permits service by first class U.S. mail upon a U.S. corporation, but only in a specified manner, i.e. service upon an officer or agent for service of process, by designated name and title, street address, city, state, and zip code. Generally, debtors only serve the order, and not the accompanying motion, upon utilities by name of utility, P.O. Box, city, state, and zip code. The remedy for improper service is invalidation of any paper or order so served. In re Martin, 763 F.2d 503 (2nd Cir. 1985); In re Pittman, 180 B.R. 453 (Bankr. E.D. Va. 1985); and In re Braden, 142 B.R. 317 (Bankr. E.D. Ark. 1992).

(2) Typically, a utility's state laws; e.g., tariffs, statutes, rules, or regulations, provide that a utility can impose a security deposit equal to either twice the highest monthly invoice in the prior year or twice the average invoice in the prior year. Once duly authorized by its state regulatory body, or for a non-regulated cooperative, by its board of directors, a utility's tariffs ***are the equivalent*** of state laws. McTighe v. New England Tel. & Tel. Co., 216 F.2d 26 (2d Cir. 1954); Dyke Water v. Cal. Pub. Util. Comm'n, 363 P.2d 326, (Cal. 1961), cert. den. 368 U.S. 939 (1961); and Springfield v. Pennsylvania Pub. Util. Comm'n, 676 A.2d 304 (Pa. Cmwlth. Ct. 1996). Thus, for each account on line as of the petition date, CREC should demand a security deposit equal to the state law formula.

(3) Pursuant to 28 U.S.C. § 959(b), a debtor in possession ***must comply*** with the laws of the state in which its property is located as if there were no bankruptcy. Midlantic v. New Jersey, 474 U.S. 494 (1986); Robinson v. Michigan, 918 F.2d 579 (6th Cir. 1990); and Begley v. Philadelphia Elec. Co., 760 F.2d 46 (3d Cir. 1985). Thus, even though the Chapter 11 was filed in Delaware, BIGCO's factory in Colorado must comply with the same Colorado laws as CREC's other customers. Assuming CREC has pro-utility service rules already in effect; e.g., a two month security deposit requirement, then Section 959(b) requires the Bankruptcy Court to enforce that requirement.

(4) Section 364 of the Code and Rule 4001(c)(1) of the Bankruptcy Rules govern ***all*** post-petition extensions of credit to debtors. Each credit extension must be voluntary. Brown v. Pennsylvania State Employees Credit Union, 851 F.2d 81 (3d Cir. 1985); and In re Henry, 129 B.R. 75 (Bankr. E.D. Va. 1991). A motion and court order authorizing the credit extension is required. A copy of the agreement between the creditor extending credit and the debtor must be affixed to the motion. Repayment of credit extensions are ranked by order of priority, ranging from the very lowest (100 percent unsecured, with no administrative expense priority), to the next (100 percent unsecured, with administrative expense priority), and up. Other than for the initial 20 days post-petition, in which Section 366 mandates that utilities provide service, the Code does not exclude utilities from the protections in Section 364 or Rule 4001(c)(1). Therefore, CREC should argue that: it refuses to extend service ***involuntarily*** beyond the initial 20 days; mere administrative expense priority does not constitute any security; and therefore, a two month deposit is warranted. In re Sec. Inv., 559 F.2d 1321 (5th Cir. 1977) (utility does not have duty to provide unsecured service).

(5) Neither Section 366 nor its legislative history defines what Congress meant by "adequate assurance of payment." The closest definition is found in Section 361(3) of the Code, which defines what is "adequate protection" for purposes of credit extensions of creditors in situations other than providing utility service under Section 366. Section 361(3) ***prohibits*** mere administrative expense priority from being "adequate pro-

tection." Its legislative history recognized that administrative expense priority alone was ***too risky*** and might not result in post-petition obligations of the debtor being paid; and therefore, something ***more*** is necessary. 124 Cong. Rec. H11047-117 (daily ed. Sept. 28, 1978); 124 Cong. Rec. S17403-34 (daily ed. Oct. 6, 1978). As for CREC, the something more ***should be*** the two month security deposit.

(6) CREC should be able to provide specific facts; e.g., negative financial circumstances affecting BIGCO, to show that BIGCO presents a substantial financial risk of not paying its post-petition utility invoices. For example, perhaps, in the year before the petition date, BIGCO paid some of CREC's invoices late. This—specific, ***negative financial circumstances***—will be critical to distinguish the facts involving BIGCO and/or CREC from the case now being cited in nearly all debtor-filed Section 366 cases: In re Caldor, 117 F.3d 646 (2d Cir. 1997). In this major Chapter 11 case, no post-petition deposits were assessed; the debtor had an excellent payment record with all of its utilities. Ironically, this case ultimately was converted to a Chapter 7 bankruptcy, and post-petition trade creditors with mere administrative expense priority ***were not paid*** for all of their Chapter 11 invoices.

(7) Many cases substantiate the assessment of post-petition security deposits under Section 366(b). *See, e.g.*, In re Begley, 760 F.2d 46 (3d Cir. 1985) (adequate assurance is to protect a utility for the time period between one billing cycle and termination); In re Cole, 104 B.R. 736 (Bankr. D. Md. 1989) (2 months); In re Smith, 50 B.R. 5 (Bankr. S.D. Fl. 1985) (3 months); In re Stagecoach, 1 B.R. 732 (Bankr. M.D. Fl. 1979) (2 months); and In re Cunha, 1 B.R. 330 (Bankr. E.D. Va. 1979) (adequate assurance is as near as cash on delivery as can be provided).

(8) Finally, in an abundance of caution, even where BIGCO's Section 366 motion and order are silent as to what happens if BIGCO does not timely pay its post-petition utility invoices (this issue frequently arises during the course of the case anyway), CREC should request that if any moneys due post-petition are not timely paid in full, then it should be permitted to terminate service to BIGCO, upon compliance with state termination procedures and ***without*** prior authorization from the Bankruptcy Court. In re Robinson, 918 F.2d 579 (6th Cir. 1990); In re Begley, 760 F.2d 579 (3d Cir. 1985); and In re Conxus, 262 B.R. 893 (D. Del. 2001).

CREC and other RECs should be ever vigilant in establishing and implementing pro-utility credit and collection practices. Bad debt expenses from BIGCO and other commercial customers must be recovered somewhere, and typically are recovered through higher electric charges borne by all other customers. This applies equally to commercial customers before and after they file for bankruptcy. RECs should implement ***aggressive*** strategies to protect their interests. This will promote just and reasonable rates for all customers. If you have any questions or comments, please contact me at 215-321-6909 or ghamberg@erols.com.