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PROTECTING YOUR UTILITY AGAINST VENDOR BANKRUPTCIES

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INTRODUCTION

As a result of bankruptcy filings by suppliers, power marketers, vendors, independent power producers, and customers, bankruptcy law has impacted utilities on a far-reaching scale. A general understanding of bankruptcy issues merits particular importance for APPA members.

In this hour-long presentation, we intend to cover three specific bankruptcy concepts and discuss how those concepts affect utilities, particularly in the event of a vendor or customer bankruptcy. After discussing each topic, we will offer some suggestions or best practices to lessen or avoid the adverse impacts of bankruptcy.

Note on source of the law: Bankruptcy law is governed by a federal statutory scheme, the Bankruptcy Code, which is set forth in Title 11 of the United States Code. Bankruptcy also has its own set of procedural rules, the Federal Rules of Bankruptcy Procedure. Unless otherwise noted, all statutory references herein are to the Bankruptcy Code, 11 U.S.C. § 101 – 1532.

I. AUTOMATIC STAY

What is the primary effect of a bankruptcy filing?

A. Introduction to the Automatic Stay - § 362 of the Bankruptcy Code

Section 362 of the Bankruptcy Code addresses the automatic stay, arguably the most powerful bankruptcy provision. "[N]ot only does this stay arise by statute without any court action, but Congress has also made it far-reaching in nature." *In re Rollins*, 200 B.R. 427, 434 (Bankr. N.D. Ga. 1996) rev'd, 243 B.R. 540 (N.D. Ga. 1997) aff'd sub nom. *Campbell v. Rollins*, 140 F.3d 1043 (11th Cir. 1998); *see also Dalton v. New Commodore Cruise Lines Ltd.*, No. 02 CIV. 8025 (DLC), 2004 WL 344035, at *3 (S.D.N.Y. Feb. 24, 2004) (explaining that "the stay is, as its name implies, automatic and therefore requires no action by the debtor to be enforced").

Upon the filing of a bankruptcy petition, all collection activities for amounts due prior to the date of filing are prohibited. The automatic stay also serves to halt actions that may disrupt the debtor and its bankruptcy estate, subject to further review by the court at the creditor's initiative. For example, the automatic stay will stop a lawsuit in mid-session; it will also stop service termination due to payment default.

B. Breadth of the Stay

When does the automatic stay go into effect? The automatic stay begins the moment that the bankruptcy petition is filed. It applies regardless of knowledge of the bankruptcy.

When does the automatic stay end? For actions against property that is property of the bankruptcy estate (defined in § 541 of the Bankruptcy Code), the automatic stay applies until that property is no longer property of the estate. For all other acts that are stayed, the stay continues until the earliest of: i) the time the case is closed; ii) the time the case is dismissed; or iii) if the case is an individual Chapter 7 case or a case under Chapter 9, 11, 12 or 13 of the Bankruptcy Code, the time when a discharge is granted or denied. 11 U.S.C. § 362(c).

1. Why must I monitor the case? For several reasons: (a) dismissals and denials of discharge (individuals) will cause the automatic stay to no longer be in effect for a particular case; and (b) claim payments and objections to claims affect your books and records.

2. How do I track the service provided after the bankruptcy? Accounts should be adjusted as of the date of the bankruptcy filing, either by removing the amount of pre-bankruptcy charges or creating a second account to track services provided from the date of the bankruptcy forward.

C. Limits on the Automatic Stay

Although the automatic stay is wide-ranging, it contains certain exceptions. In particular, the automatic stay does not apply to stay actions or proceedings by a governmental unit to enforce such governmental unit's or organization's police and regulatory power. 11 U.S.C. § 362(b)(4).

1. What part of the police/regulatory power exception applies to a utility?

   (a) Service termination due to safety concerns would seemingly fall under this exception.

   (b) Regulatory proceedings continue.

D. Relief from the Automatic Stay

Subsection (d) of § 362 provides for relief from the automatic stay, in particular, "for cause, including the lack of adequate protection of an interest in property of such party in interest." 11 U.S.C. § 362(d)(1). "Cause" is not defined in the Bankruptcy Code and "courts must determine when discretionary relief is appropriate on a case-by-case basis." *Mac Donald v. Mac Donald (In re Mac Donald)*, 755 F.2d 715, 717 (9th Cir.1985).

1. Is relief from the automatic stay necessary for a power company? In most instances, abiding by the automatic stay will not significantly impact a utility and this step should not be necessary. An example where relief from the automatic stay may be needed is to permit pending litigation to move forward (to help liquidate the parties' claims).

E. Violations of the Stay

A violation of the automatic stay can result in damages, including punitive damages. There are actions that a utility can take to minimize such violations and the corresponding risk of sanctions.

1. Provide a correspondence address. Section 342(c)(2) of the Bankruptcy Code contains a bankruptcy notice address provision.

   (a) If a creditor provides an address for notices and the current account number in at least two correspondences in the 90 days prior to a bankruptcy filing, the debtor should provide notice of the bankruptcy to that address.

(b) The debtor’s failure to provide notice in accordance with § 342(c)(2) provides a defense to a monetary penalty for violation of the automatic stay. *See* 11 U.S.C. § 342(g)(2).

2. Create a system of matching bankruptcy notices with customer data. Ideally the system should employ multiple points of comparison that can account for:

(a) Debtor name changes,

(b) Debtor moves,

(c) Debtor name misspellings.

3. Speed is key. Delay in responding to notice of a bankruptcy filing will lead to violations of the automatic stay as pre-petition collections continue.

4. Monitor the collection of A/R by third parties. Promptly communicate notice of bankruptcy filings to any third party collection agencies.

5. Adjust credit reporting. Consumer bankruptcy filing should be noted in any credit reporting to avoid violations of the automatic, Fair Credit Reporting Act, or consumer protection statutes.

F. Certain Effects of Automatic Stay

1. For utilities, the automatic stay does not prevent the application of a security deposit against the pre-bankruptcy balance owed. § 366(c)(4).

2. Other set-off outside of § 366 is permitted, but subject to the automatic stay. As a result, such setoff is prohibited during the bankruptcy without relief from the automatic stay.

3. In the majority of instances, creditors may pursue letters of credit or security/guarantees posted by non-debtors without running afoul of the stay.

G. Automatic Stay Important Take-Aways

Below are lessons to best address the issues created by the automatic stay in bankruptcy:

1. Establish a robust system to promptly recognize a bankruptcy filing and match the filing with a customer.

(a) Take advantage of § 342(c) address provision.

(b) Have a system for matching names, misspellings, addresses.

(c) Act quickly to stop all collection (third party, credit reporting, etc.).

(d) Create a system to track the progress of the bankruptcy.

2. Strong credit procedures reduce your risk.

(a) Collect customer deposits.

(b) Add credit provisions to agreements.

(i) Supplier contracts are checked against forward markets.

(ii) When market price exceeds contract price, supplier posts collateral.

(iii) Credit limits are monitored against net worth/credit rating.

(c) Monitor payment defaults and act promptly.

II. PAYMENT RIGHTS DURING BANKRUPTCY

It is one thing to "write off" the pre-bankruptcy amount, but now that the bankruptcy has been filed, what protections do I have to get paid?

A. Claims

In any relationship, the utility may find its pre-bankruptcy debt part of the bankruptcy claim process. This claim should reflect the amount that was contractually owed prior to the day of the bankruptcy filing. It is important to review the bills in the months before and immediately after the bankruptcy to separate the charges between pre-bankruptcy and post-bankruptcy. Only those amounts related to services rendered before the bankruptcy should be included on the proof of claim. The remaining amounts would be re-billed in the post-bankruptcy period.

There are deadlines to monitor in order to timely submit a claim and potential jurisdictional waivers in the act of filing a claim. Here is a brief overview of the claim process, which is set forth in Bankruptcy Rules 3001, 3002, and 3007.

1. Deadline – In a Chapter 7 case, proofs of claim are due within 90 days of the Meeting of Creditors, which occurs 20-40 days after the case is filed. In other chapters of bankruptcy, debtors and trustees typically ask the Bankruptcy Court to set a deadline for filing claims, although some Bankruptcy Courts automatically set a deadline by local rule.

2. Process – There is an official bankruptcy form for proofs of claim, Form No. B 410. Claims are usually submitted to the Bankruptcy Court, but debtors in large bankruptcy cases may employ a third party claims agent that handles the claim intake. This information should be provided in the initial bankruptcy notice (although the notice may say that a deadline will

be set at a later time). Some claims agents and certain Bankruptcy Courts are equipped accept electronic claim submissions. These "E-POC" systems do not require registration with the bankruptcy court electronic court filing ("ECF") system.

3. Objections – A party in interest can object to claims. This is most commonly the debtor or trustee when the debtor's books and records do not match with the submitted proof of claim. This type of objection usually involves a simple reconciliation. Others may require complex dispute resolution by the Court.

4. Jurisdiction – Filing a proof of claim may be construed as consenting to jurisdiction by the Bankruptcy Court. If jurisdiction is an issue, you may want to consider whether the likely distribution from the claim is worth potentially conceding it.

B. Rights to Payment Depend Upon Status

The relationship between the debtor and the creditor will dictate how a creditor is treated in bankruptcy. For example, when the debtor is a customer, certain rights are given to the utility to protect it against future default. When the debtor is a vendor or supplier, the rights are dictated by contract. If there is no contract, other rules govern the right to payment.

C. When the Debtor is a Customer

Section 366 of the Bankruptcy Code contains specific provisions governing utility service in bankruptcy. Subsection (b) of § 366 permits a utility to "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." 11 U.S.C. § 366(b).

1. Adequate assurance of payment – Section 366(c) of the Bankruptcy Code defines "assurance of payment", which can include, among other things, cash deposit, letters of credit or prepayment.

2. Can I terminate for non-payment after bankruptcy? Courts are split on this question.

   (a) Bankruptcy Court may not have jurisdiction over a post-petition termination for payment default. *Begley v. Philadelphia Elec. Co.*, 760 F.2d 46 (3d Cir. 1985) (bankruptcy court may not have jurisdiction over post-bankruptcy default). *Robinson v. Michigan Con. Gas Co.*, 918 F.2d 579 (6th Cir. 1990).

   (b) Termination permitted for post-bankruptcy payment default so long as utility first follows state and local termination provisions. *In re Weisel*, 426 B.R. 185 (Bankr. W.D. Pa. 2010) (no violation of the automatic stay in doing so); *In re Conxus Communications, Inc.*, 262

B.R. 893 (Bankr. D. Del. 2001); *In re Sheehan Memorial Hosp.*, 301 B.R. 777 (Bankr. W.D.N.Y. 2003); *In re C.T. Harris, Inc.*, 295 B.R. 405 (Bankr. M.D. Ga. 2003); and *In re Best Prod.* Co., 203 B.R. 51 (Bankr. E.D. Va. 1996).

(c) Termination not permitted when services are supplied through a contract. *In re Computer Communications, Inc.*, 824 F.2d 725 (9th Cir. 1987) (non-debtor liable in damages to debtor for violation of the bankruptcy stay for terminating contract without first seeking relief from the bankruptcy court).

Beware of a court order entered early in the case that attempts to alter the normal utility/customer relationship such as prohibiting termination for default without first seeking court approval.

The deposit and termination procedures are often set by court order early in the case. Monitoring those procedures is the best way to avoid a surprise later in the bankruptcy proceeding.

D. Contractual Vendor Relationships

When the Debtor is a vendor and it has a contract with the utility, the contract will normally govern the payment rights, except that termination may require bankruptcy court approval. In the next section, we discuss how contracts rights are treated in bankruptcy.

E. Non-contractual Vendor Relationships

When the Debtor is a vendor and it has no agreement with the utility, payment rights depend upon the invoice terms and how the deal was negotiated.

Without a contract, no one can be forced to do business with an entity that is in bankruptcy.

While the automatic stay prohibits you from attempting to collect your pre-bankruptcy debt, it should not stop you from seeking pre-payment or COD terms for any post-bankruptcy interactions with a vendor.

Keep an eye on the bottom line:

1. Regularly monitor your A/R.

2. Use a monitoring service, such as Dunn and Bradstreet (D&B) to provide you with commercial data on credit history is an important tool to helping reduce credit risk.

3. Recognize the tension between sales and finance teams.

III. CONTRACTS AND BANKRUPTCY

What happens to my contract with the debtor in bankruptcy?

A. Executory Contracts and Leases

One reason an entity may choose to file bankruptcy is to shed unwanted or burdensome contracts or leases. Section 365 of the Bankruptcy Code allows a trustee or debtor-in-possession to assume or reject executory contracts and unexpired leases in the course of the bankruptcy proceeding. Although not defined in the Bankruptcy Code, the commonly accepted test for whether a contract is "executory" is whether there is performance due on both sides of the contract.

1. Time Limits for assumption or rejection.

2. Obligations and Rights during pendency of Chapter 11 bankruptcy:

    (a) Administrative Expense Claim

    (b) Relief from the Automatic Stay

    (c) Motion to Compel Assumption or Rejection

B. Assumption and Rejection

A trustee or debtor-in-possession has certain obligations to a contract or lease counter-party depending on whether they wish to assume, assume and assign, or reject an executory contract or unexpired lease. The standard for doing so is the debtor or trustee's business judgment.

1. Assumption – The Bankruptcy Code allows debtors, in most cases, to "assume" i.e., keep, the agreement. To assume, however, the debtor will need to "cure" i.e., pay for, all defaults, and provide adequate assurance of future performance under the agreement.

    (a) Cure amounts – During the bankruptcy proceeding, usually close to the end, the debtor will present a list of contracts to the court with a "cure amount" proposed. That is the amount that the debtor intending to assume a contract seeks to pay in order to keep the contract.

        (i) The "cure amount" should include all amounts then due under the contract/license.

        (ii) The debtor would then make a lump sum payment (or stipulate with you for different treatment) to keep the agreement.

        (iii) Debtors often try to move quickly on the cure issue hoping to take the creditor off guard and get a court order with a lower number on it than the amount due. Debtors will send notice to a payment lock box, for example, and then set a hearing on expedited notice.

        (iv) The cure claim is your best chance for full recovery.

2. Assignment – Instead of keeping the agreement, a debtor can assume and then "assign" the executory contract or unexpired lease to someone else. This also requires both a cure of defaults and adequate assurance of future performance, in this case from the assignee.

3. Rejection – If a contract or lease is burdensome or below market, the debtor or trustee may reject it in bankruptcy. The counterparty to the agreement can submit a rejection claim or object to the proposed timing of the rejection, but since the decision is a matter of the debtor or trustee's business judgment, rejection itself cannot generally be avoided.

    (a) Rejection Claims – A rejection damages claim involves all amounts owed under a contract through the end of the contract. Generally, the amounts due through the date of the rejection are calculated and then the lost profit through the balance of the contract term (reduced to a present value) is added to this amount. A rejection damage claim is usually treated as a pre-bankruptcy claim and given a lower priority for payment.

    (b) Failure to Remove Equipment post-Rejection – In some instances, a debtor may reject an agreement, but fail to remove its equipment from a utilities' property.

        (i) File a motion for allowance and payment of an administrative claim for damages from failure to remove the equipment. *See* 11 U.S.C. § 503(b)(1)(A).

            (1) Administrative claims have a higher priority in bankruptcy than rejection claims, and in most instances are paid in full.

C. Forward Contracts

When a contract is considered a "forward contract" as defined by the Bankruptcy Code, a number of the traditional bankruptcy rules are ignored. For example, the automatic stay prevents the non-debtor party from terminating performance under a contract without bankruptcy court permission. Further, § 365 of the Bankruptcy Code establishes a procedure for the treatment of contracts that can extend the debtor's decision on whether to keep a contract to the end of a reorganization case.

However, when the contract is a "forward contract" and the parties are "commodity brokers" or "forward contract merchants", these rules do not apply. Sections 362(b)(6) and 556 of the Bankruptcy Code provide exceptions to both the automatic stay and the contract assumption/rejection structures set forth in § 365. These Code sections permit the non-debtor party to immediately treat the forward contract as breached, resell the commodity in to the marketplace, and offset against any amounts recovered.

Another exception is to the "strong arm" powers of a bankruptcy trustee to recover payments made to settle amounts due under forward contracts. Section 546 provides this exception. For example,

§ 546(e) protects a purchaser of petroleum products who agreed to purchase fuel below cost in an effort to provide the seller (debtor) with immediate cash. When the Chapter 7 bankruptcy trustee seeks to avoid the transfers as potentially fraudulent, the purchaser can use Bankruptcy Code § 546(e) to argue that the exchange is protected as a settlement payment under a forward contract. *See DeGirolamo v. McIntosh Oil Co. (In re Laurel Valley Oil Co.)*, Bankruptcy No. 05-64330, Adversary No. 12-6014, 2013 WL 832407 (Bankr. N.D. Ohio Mar. 5, 2013).

1. A forward contract is defined in the Bankruptcy Code as

> (A) a contract (other than a commodity contract, as defined in section 761) for the purchase, sale, or transfer of a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase transaction or reverse repurchase transaction (whether or not such repurchase or reverse repurchase transaction is a 'repurchase agreement', as defined in this section)(**) consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any other similar agreement;
>
> (B) any combination of agreements or transactions referred to in subparagraphs (A) and (C);
>
> (C) any option to enter into an agreement or transaction referred to in subparagraph (A) or (B);
>
> (D) a master agreement that provides for an agreement or transaction referred to in subparagraph (A), (B), or (C), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a forward contract under this paragraph, except that such master agreement shall be considered to be a forward contract under this paragraph only with respect to each agreement or transaction under such master agreement that is referred to in subparagraph (A), (B), or (C); or
>
> (E) any security agreement or arrangement, or other credit enhancement related to any agreement or transaction referred to in subparagraph (A), (B), (C), or (D), including any guarantee or reimbursement obligation by or to a forward contract merchant or financial participant in connection with any agreement or transaction referred to in any such subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562.

11 U.S.C. § 101(25).

2. Forward Contract Merchant – A forward contract merchant is "a Federal reserve bank, or an entity the business of which consists in whole or in part

> of entering into forward contracts as or with merchants in a commodity (as defined in section 761) or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade." 11 U.S.C. § 101(26).

The definitions of "forward contract" and "forward contract merchant" set forth in the Bankruptcy Code have been litigated, particularly in the case of natural gas supply agreements. These meanings need to be read in the context of case law interpreting same. *See e.g., In re National Gas Distributors, LLC*, 556 F.3d 247 (4th Cir. 2009); *In re Olympic Natural Gas Co.*, 294 F.3d 737 (5th Cir. 2002); *In re Borden Chemicals and Plastics Operating Ltd. P'ship*, 336 B.R. 214 (Bankr. D. Del. 2006); *Mirant Americas Energy Marketing, L.P. v. Kern Oil & Refining Co. (In re Mirant Corp.)*, 310 B.R. 548 (Bankr. N.D. Tex. 2004).

D. 363 Sales and Utilities

Sales are common in the bankruptcy context. Debtors may sell a portion or substantially all of their assets in either Chapter 7 or Chapter 11 cases.

Section 363 of the Bankruptcy Code allows for the sale of estate property free and clear of liens and interests. In the case of a bankruptcy sale, utilities should be aware of the following issues that may arise in connection with executory contracts.

1. Cure Payments – As noted above, a debtor must pay contract defaults in full if it intends to assume and assign the contract in a bankruptcy sale.

   (a) Transition Services Agreement – Beware of these types of agreements, which in some instances could be used in an attempt to circumvent the requirement to assume and cure all defaults in the agreement.

2. Obligation to assume entire agreement. Some debtors may attempt to assume only a portion of an agreement. This is not permissible unless the agreement counterparty consents.

E. Contractual Provisions to Minimize Risk in Bankruptcies

Although it is not possible to "contract around bankruptcy" there are certain provisions that can be added to contracts to minimize bankruptcy risks. These provisions include:

1. Notice address for bankruptcy communications. (Section 342(c)(2) discussed above).

2. Setoff rights. Courts will look to the contract when interpreting setoff rights between the parties.

   (a) Breadth of setoff is important – if feasible, include the right to set off between subsidiaries or affiliated entities.

3. Provisions to address treatment of deposits, payment dispute procedures, etc.

4. Corporate parent guarantees.

5. Never pre-pay.