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Section 366(c) Does Not Require DIPs to Satisfy Adequate Assurance Demands of Utilities

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Under § 366(c)(2), is every company filing for chapter 11 required to satisfy the adequate assurance demands of its utility providers within 30 days of the petition as a pre-condition to asking the bankruptcy court to determine the reasonable amount of adequate assurance? If so, not only would debtors in possession (DIPs) be required to pay the amount of adequate assurance demanded by the utility upfront, DIPs would be forced to negotiate potentially thousands of utility accounts with electric, gas, telecommunications and water companies immediately upon the bankruptcy filing—when time, money and resources are in limited supply. Although bankruptcy courts have been split on this issue, two recent district court decisions have answered the question with "no."[1]


Gerald H. Gline

Prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), this was not an issue; DIPs simply filed first-day motions seeking authorization from the bankruptcy court to prohibit utility companies from discontinuing service. With the addition of subsection (c)(2) to § 366, however, this procedure has been called into question. Subsection (c)(2) provides in pertinent part:

> (c)(2) Subject to paragraphs (3) and (4), with respect to a case filed under chapter 11, a utility referred to in subsection (a) may alter, refuse or discontinue utility service, if during the 30-day period beginning on the date of the filing of the petition, the utility does not receive from the debtor or the trustee adequate assurance of payment for utility service that is satisfactory to the utility.
> (3)(A) On request of a party-in-interest and after notice and a hearing, the court may order modification of the amount of an assurance of payment under paragraph (2).[2]

The language of subsection (c)(2) appeared to many bankruptcy commentators to create "a significant shift in the balance of power toward utilities."[3] They concluded that this subsection altered the procedures, requiring that debtors pay what the utility provider deems satisfactory adequate assurance of future payment before going to court to seek modification.[4]


Grant L. Cartwright

Bankruptcy courts have disagreed over the correct interpretation of subsection (c)(2). The bankruptcy courts in *In re Lucre Inc.* and *In re Viking Offshore (USA) Inc.* held that only after the DIP satisfies the utility's demand does a DIP have the right to have the adequate assurance payment modified by the bankruptcy court.[5] In contrast, other courts have found that such an interpretation of subsection (c)(2) is "unworkable" and would lead to "absurd results."[6] These courts concluded that subsection (c)(2) must be considered along with subsection (c)(3), and when considered together, they support the notion that a court may order modification of the adequate assurance payment whether or not the utility first receives the adequate assurance it requests.

In *In re Crystal Cathedral Ministries*[7] and *In re The Great Atlantic & Pacific Tea Co. Inc. (A&P)*,[8] the U.S. District Courts for the Central District of California and the Southern District of New York held that a DIP has 30 days

Cover Feature

1 *In re The Great Atl. & Pac. Tea Co., Inc., et al.*, No. 11-CV-1338, 2011 WL 5546954 (S.D.N.Y. Nov. 14, 2011); *In re Crystal Cathedral Ministries*, 454 B.R. 124 (C.D. Cal. 2011).

2 11 U.S.C. § 366(c)(2)-(3)(A).

3 Bertrand Pan and Jennifer Taylor, "Sustaining Power: Applying 11 U.S.C. § 366 in Chapter 11 Post-BAPCPA," 22 *Emory Bankr. Dev. J.* 371, 381 (2006) (citing William Houston Brown and Lawrence R. Ahern III, 2005 Bankruptcy Reform Legislation with Analysis 93 (2005)); *see also* Kenneth M. Miskin and Sarah Beckett Boehm, "Utilities: After BAPCPA: What's Changed?, 26-March *Am. Bankr. L. J.* 36 (2007); Bruce H. White and William L. Medford, "Utilities and the New (and Improved?) Section 366," 24-June *Am. Bankr. Inst. L. J.* 36, 37 (2005).

4 *See* 3 *Collier on Bankruptcy* ¶ 366.03[2] (Alan N. Resnick and Henry J. Sommer eds., 16th ed.).

5 *In re Lucre Inc.*, 333 B.R. 151, 154 (Bankr. W.D. Mich. 2005); *In re Viking Offshore (USA) Inc.*, No. 08-31219-H3-11, 2008 WL 782449, at *3 (Bankr. S.D. Tex. March 20, 2008).

6 *See, e.g., In re Circuit City Stores Inc.*, No. 08-35653, 2009 WL 484553, at *3 (Bankr. E.D. Va. Jan. 14, 2009); *In re Beach House Property LLC*, No. 08-11761-BKC-RAM, 2008 WL 961498, at *1 (Bankr. S.D. Fla. April 8, 2008); *In re Syroco Inc.*, 374 B.R. 60, 61 (Bankr. D. P.R. 2007).

7 454 B.R. 124 (C.D. Cal. 2011).

8 2011 WL 5546954 (S.D.N.Y. Nov. 14, 2011).

after the bankruptcy filing to either reach an agreement with the utility provider as to adequate assurance of payment under § 366(c)(2) or obtain a court order determining what constitutes adequate assurance of payment under § 366(c)(3).

Crystal Cathedral Ministries

On June 30, 2011, the district court in *In re Crystal Cathedral Ministries* affirmed the bankruptcy court's decision that it had authority to modify the adequate assurance demanded by a utility prior to the debtor's payment of the amounts demanded by the utility under § 366(c)(2). Crystal Cathedral Ministries filed an emergency motion for an order (1) prohibiting utility providers from altering, refusing or discontinuing service; (2) deeming utility providers adequately assured of future performance; and (3) establishing procedures for determining adequate assurance of payment under § 366. As adequate assurance, Crystal Cathedral proposed to deposit $52,500 into a newly created segregated interest-bearing account in the amount equal to two weeks of utilities expenditures (the "utility account"). California Edison Company (SCE) opposed the motion and demanded that Crystal Cathedral provide SCE with an $80,460 deposit for adequate assurance of future payment. SCE asserted that the debtor must first provide the adequate assurance requested by a utility before a bankruptcy court could enter an order modifying that amount. The bankruptcy court disagreed and granted Crystal Cathedral's utility motion, and SCE appealed.

The district court observed that Crystal Cathedral and SCE had fundamentally different interpretations of § 366(c). SCE argued that the bankruptcy court erroneously ignored the plain meaning of § 366(c)(2). SCE argued that a debtor must first ask the utility provider what form and amount of assurance of payment it finds adequate and the debtor must then provide the form of assurance of payment requested by the utility. Only at that point in time may the debtor seek relief from the bankruptcy court by requesting an order modifying that amount.

In contrast, Crystal Cathedral asserted that § 366(c) provides that a debtor within 30 days from the filing of its petition must either reach agreements with its utility providers under § 366(c)(2) with respect to adequate assurance or obtain an order under § 366(c)(3) establishing adequate assurance. Crystal Cathedral further asserted that SCE's interpretation of the so-called plain meaning of § 366(c) could lead to absurd results and would be unworkable especially where utilities fail to respond to debtors' offers of adequate assurance or debtors have so many different utility providers and accounts across the country that it would be nearly impossible to negotiate and distribute adequate assurance payments "satisfactory" to each provider.[9]

The courts in both Crystal Cathedral and A&P recognized that interpreting § 366(c)(2) in the manner advocated by the utilities would simply be unworkable. Frequently, DIPs have accounts with a large number of utility providers in many different areas around the country.

The district court affirmed the bankruptcy court's decision and held that § 366(c)(2) did not require a debtor to first accede to the utility provider's proposal before a court could grant a modification of that request under § 366(c)(3). Rather, the court held that a debtor can move and a court may intervene prior to a utility provider receiving what it demands.

The court also addressed SCE's remaining grounds for appeal. SCE argued that under § 366(c)(3), a bankruptcy court may only modify the amount of the cash deposit and not the form. Section 366(c)(3)(A) provides "[o]n request of a party-in-interest and after notice and a hearing, the court may order modification of the amount of an assurance of payment under paragraph (2)." SCE asserted that the bankruptcy court erred by authorizing the utility account to be controlled by the debtor and not SCE as a form of adequate assurance. SCE argued that because it was different than the form of assurance requested by SCE, the bankruptcy court lacked the authority to modify the manner in which the adequate protection funds would be held. SCE requested that it control the adequate-assurance funds. The district court affirmed the bankruptcy court's conclusion that even though the debtor controlled the utility account, it was still a "cash deposit" and was therefore the form requested by SCE, and thus the bankruptcy court ultimately only modified the amount of the adequate assurance.

A&P

On Nov. 14, 2011, the district court in *A&P* affirmed the bankruptcy court's determination that if a debtor and a utility disagree on the amount of the adequate assurance of payment, either party may request within 30 days of the bankruptcy filing that the bankruptcy court modify the amount the utility provider deems to be satisfactory.

On Dec. 12 , 2010, The Great Atlantic & Pacific Tea Company Inc. and certain of its affiliates (the "debtors") filed for bankruptcy. Among the first-day motions, the debtors filed a motion (the "utility motion") seeking entry of an order from the bankruptcy court "determining adequate assurance of payment for future utility services and prohibiting utility providers from altering or discontinuing service on account of outstanding pre-petition invoices and establishing procedures for determining adequate assurance of payment for future utility services pursuant to section 366." In the utility motion, the debtors explained that approximately 350 utility providers rendered electric, natural gas, water, sewage, telecommunications and other utility services to the debtors' stores through approximately 1,500 utility accounts. The debtors proposed to deposit $7.45 million, representing the estimated cost of two weeks of utility service, into a segregated, interest-bearing account as an adequate assurance payment for utility services.

Certain of the utilities objected to the motion and argued that the debtors were obligated in the first instance to provide the assurance of payment in the amount and form demanded by the utilities before moving to modify these amounts. The bankruptcy court disagreed and granted the utility motion. The utilities appealed to the district court, relying on *In re Lucre Inc*.[10] In *Lucre*, the bankruptcy court determined that under § 366(c), the debtor was in no position to modify the adequate assurance payment the utility is demanding until the debtor or trustee first actually accepts it.[11]

9 *Crystal Cathedral Ministries*, 424 B.R. at 129-30.

10 133 B.R. at 151.

11 *Id.*

The district court declined to follow *Lucre*. Instead, the court found that § 366(c) does not "intimate that the utility provider in the first instance is afforded the opportunity to set the form and amount of adequate assurance."[12] The court found that if a debtor and utility provider disagree as to what constitutes adequate assurance, either party may petition the court to modify the amount without first requiring that the debtor meet the utility provider's demand. The district court determined that this interpretation "best balances the protections afforded debtors and utility providers by providing substantial protection to a utility while at the same time providing an avenue of relief for debtors, who believe a utility's request is unreasonable or unworkable."[13] The district court agreed with the bankruptcy court, the court in *Crystal Cathedral* and other courts declining to follow *Lucre* and found that the interpretation of § 366(c) advocated by the utilities would be unworkable and would lead to absurd results.

The district court next addressed the utilities' argument that the amount deposited into the adequate assurance account should cover two months of service as opposed to two weeks. The utilities also argued that the state law utility regulatory scheme governs what should be the amount of adequate assurance.

In addressing the utilities' arguments, the court found that other courts have consistently held that the determination of what constitutes adequate assurance of payment is a federal bankruptcy law question.[14] The court also determined that adequate assurance is not the equivalent of a guaranty of payment in full. Rather, the court held that the amount required is the amount that is adequate to insure against unreasonable risk of nonpayment.[15]

Finally, the district court considered whether a "newly created, segregated, interest-bearing bank account" controlled by the debtor constituted adequate assurance of payment under § 366. The utilities argued that actual payment of a deposit to them was required. After examining the relevant case law, the district court rejected this argument and held that the bank account was the equivalent of a letter of credit within the meaning of § 366(c)(1)(A).

12 *Great Atl. & Pac. Tea Co. Inc.*, 2011 WL 5546954, at *4.

13 *Great Atl. & Pac. Tea Co. Inc.*, 2011 WL 5546954, at *4 (quoting *In re Crystal Cathedral Ministries*, 454 B.R. at 130).

14 *Great Atl. & Pac. Tea Co. Inc.*, 2011 WL 5546954, at 5; *In re Adelphia Bus. Solutions Inc.*, 280 B.R. 63, 80 (Bankr. S.D.N.Y. 2002); *Steinebach v. Tucson Elec. Power Co. (In re Steinebach)*, 303 B.R. 634, 644 (Bankr. D. Ariz. 2004).

15 *Great Atl. & Pac. Tea Co. Inc.*, 2011 WL 5546954, at *5.

Conclusion

Two district courts have now addressed and answered the question of the requirements for adequate assurance under § 366(c), concluding that a DIP may comply with § 366(c)(2) and (3) by proposing adequate assurance in a first-day motion and depositing the court-ordered amount into a segregated account the DIP controls by the 30th day without first making an adequate assurance payment satisfactory to the utility. The courts in both *Crystal Cathedral* and *A&P* recognized that interpreting § 366(c)(2) in the manner advocated by the utilities would simply be unworkable. Frequently, DIPs have accounts with a large number of utility providers in many different areas around the country. It would be virtually impossible for DIPs to negotiate and make adequate assurance of payment "satisfactory" to every single utility during the 30-day window. It is also possible that DIPs could receive a utility provider's demand at the end of the 30-day period and be compelled to consent to the demand immediately or face termination of critical utility services.[16] Moreover, DIPs conceivably could receive no demand at all from utility providers and be subject to the same fate. The *A&P* and *Crystal Cathedral* holdings are consistent with the overarching policy behind § 366: protecting DIPs from cancellation of vital utility services that could scuttle the prospects for reorganization before the case even gets started, while still providing reasonable assurance that utility bills will be paid during the reorganization process. ■

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16 *Circuit City Stores*, 2009 WL 484553, at *4.