

STRATEGIES TO REDUCE PRE-PETITION LOSSES

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When a commercial customer files for chapter 11 under the U.S. Bankruptcy Code, utilities and debtor customers alike now are familiar with the options for the assessment of adequate assurance; i.e., “assurance of payment”; for active, post-petition accounts, which, in 2005, Congress defined in Section 366(c) (1)(A), as follows:

- “ (i) a cash deposit;
- (ii) a letter of credit;
- (iii) a certificate of deposit;
- (iv) a surety bond;
- (v) a pre-payment of utility consumption; or
- (vi) another form of security that is mutually agreed on between the utility and the debtor or the trustee.”

That was fifteen years ago. By now, utilities with material amounts of active, post-petition exposure to debtor commercial customers are seeking to obtain fair and reasonable amounts and forms of assurance of payment, instead of the paltry proposals being proffered by debtors in the large commercial chapter 11 cases; e.g., to place fifteen days’ worth of charges into an escrow account maintained at their own banks – as if that possibly could provide adequate protection to a utility, with a sixty day billing cycle (charges from first day of billing period until last day; assume no pay and issuance of standard disconnect notice).

What prudent credit/collection steps are smaller, water utilities (confronted only occasionally with a customer with a material monthly bill that files for bankruptcy) taking **before** the customer files for bankruptcy? Smaller water utilities may not require security deposits or other forms of adequate assurance for the largest customers. And so, the argument goes: we do not expect XYZ, Inc., which has been our customer for years and has paid timely for years, to file for bankruptcy. That view is extremely short sighted and exposes the utility to considerable risk of loss. With monthly billing, a utility is at risk at all times for non-payment for about sixty (60) days of charges. Typically, when a large customer files for bankruptcy, a utility could confront a large pre-petition debt. Many chapter 11 cases crater or pay only pennies on the dollar for general, unsecured debt (what an unpaid pre-petition claim is without a security deposit or other form of adequate assurance). Thus, assuming a monthly invoice of \$20,000, this translates into a loss of about \$40,000. For a small utility, a loss that size could precipitate its own chapter 11.

What is the small utility to do? Based upon experience representing many large and small utilities in many bankruptcy cases filed across the country, the author recommends that each utility implement the following steps; do not accede to the

mantras: (a) the utility has operated without deposits for years and still is in business; and (b) do not expect us to assess a deposit on XYZ, Inc. or shut it off for non-payment: its President plays golf with our President, and/or they are hunting buddies. No, No, and No.

These are the recommendations:

1. Establish state/local credit/collection laws as utility-favorable, as possible.
2. Obtain a security deposit/commercial equivalent; e.g., letter of credit or advance payment agreement, equal to the number of days in billing cycle, calculated at the highest monthly bill formula, not the average monthly bill formula; require for all large customers, whether existing or new.
3. Semi-annually, monitor amount of current charges; adjust amount of deposit/commercial equivalent -- equal to current charges.
- 4. Retain deposit/commercial equivalent as long as account is active.**
5. Repeal state/municipal laws requiring utility to refund deposits to prompt-paying customers.
6. Pay interest upon deposits in amount equal to average rate paid by local banks on savings checking accounts; adjust rate semi-annually.
7. Reduce length of monthly billing cycle to extent practicable:
 - A. Issue invoice as close to last day of billing cycle as possible.
 - B. Reduce number of days until due date.
 - C. Issue proper default notice, as warranted, as close to due date as possible.
- D. Actually terminate, as close as possible to last day in cure period.**
8. Besides monthly billing, offer alternate billing cycles and security deposit/commercial equivalents. The customer chooses an option. The goal of each is to avoid selling upon 100% unsecured basis. The customer consents in advance to less time in which to make payments and cure periods in default notices and a lower deposit. With more frequent due dates in a month (with amounts lower than one standard monthly invoice), and therefore, more frequent chances of issuing default notices, customers are more aware of amounts due and when and may be more likely to pay. This arrangement requires more administrative work for the utility; however, for large

monthly amounts, the extra work is worth it in terms of likelihood of payment.

9. Require each commercial customer pay for all charges it incurs, without having to increase rates through bad debt expense adjustments imposed upon all other customers. Lower bad debt expense can inure to benefit all customers, through lower rates.
10. Implementing alternative billing procedures can enhance a utility's cash working capital requirements.
 - A. Reducing number of days outstanding for invoices for large customers could impact lead/lag studies positively.
 - B. Lowering borrowing requirements could benefit all customers; i.e., lower rates.

By implementing all or some of these recommendations, the person(s) with credit/collections responsibility at your utility can sleep better -- knowing that the likelihood of obtaining payment in full for large invoices is greatly improved. By and large, investor owned utilities are requiring commercial customers to post large deposits – whether or not in bankruptcy, whether or not an existing or a new customer. Why should your small utility be saddled with a potential large pre-petition claim, due to non-implementation of these recommendations? Armed with a pre-petition security deposit, Section 366(c)(c)(4) of the Bankruptcy Code permits a utility to setoff/apply it against unpaid, pre-petition charges automatically and without an order from the Bankruptcy Court.

You never know when XYZ, Inc. will file for chapter 11. The prudent small, water utility needs to be prepared. Many neighboring IOU's certainly are doing so.

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