In Search of the Meaning of "Utility" in Bankruptcy Code Section 366

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Entities doing business with a customer that files for bankruptcy protection generally have the right to refuse to continue providing goods or services to the chapter 11 debtor, unless such goods or services are covered by a continuing contract, in which case any forfeiture of the debtor's rights under the agreement is generally prohibited to afford the debtor a reasonable opportunity to decide what to do with the contract. Special rules, however, apply to utilities — without essential utility services, the debtor can neither reorganize nor obtain the fresh start that is a fundamental premise underpinning federal bankruptcy law. For this reason, utilities are precluded from discontinuing service to any customer solely on the basis that the entity involved filed for bankruptcy or has not paid for utility services prior to filing a bankruptcy petition. Instead, the Bankruptcy Code requires debtors to provide "adequate assurance" of payment to utilities shortly after a bankruptcy filing.

Exactly what qualifies as a "utility" has become the focus of a broadening debate, as reliance on telecommunications and related services has rapidly expanded to the point of achieving "necessity" status that, up until the last fifteen or twenty years, had been principally the exclusive province of more traditional (and largely monopoly) providers such as gas, electric, water, sewer and telephone companies. The Fifth Circuit Court of Appeals recently had an opportunity to consider this issue in *Darby v. Time Warner Cable, Inc. (In re Darby)*. In a matter of first impression, the Fifth Circuit ruled that a provider of cable television service did not qualify as a "utility."

Continuation of Utility Service in Bankruptcy

A debtor's rights and obligations under agreements existing as of the bankruptcy filing date are governed for the most part by section 365 of the Bankruptcy Code. Among other things, section 365 prohibits termination of most kinds of contracts triggered by a bankruptcy filing and gives the debtor a reasonable opportunity (*i.e.*, 60 days, 120 days or anytime before confirmation of a plan, depending on the kind of contract and bankruptcy case involved) to assume, assume and assign or reject a contract so long as the decision is supported by sound business judgment. Pending the decision to assume or reject, the counterparty to the contract must continue to render performance so long as the debtor honors its post-petition contractual obligations. Assumption of an agreement is possible only if the debtor cures any outstanding defaults and provides adequate assurance of future performance.

Special rules, however, apply to services provided by utilities, whether under contract or otherwise. Section 366 of the Bankruptcy Code provides that "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." However, the section also provides that a utility may alter, refuse or discontinue service if the trustee or the debtor fails to "furnish adequate assurance of payment" within 20 days of the bankruptcy petition date (30 days, if the case is filed under chapter 11). Section 366 was amended in 2005 to clarify that "adequate assurance" may take several forms (*e.g.*, a cash deposit, letter of credit or prepayment)

and that certain other forms (*e.g.*, the prospect of an administrative priority claim for amounts owed for post-petition utility services) do not constitute "adequate assurance."

"Utility" is not defined in the Bankruptcy Code. The legislative history of section 366 indicates that the provision was "intended to cover utilities that have some special position with respect to the debtor, such as an electric company, gas supplier, or telephone company that is a monopoly in the area so that the debtor cannot easily obtain comparable service from another utility." A utility provider's obligation under section 366 to continue uninterrupted utility services post-petition represented a conscious desire to overrule pre-Bankruptcy Code decisions to the contrary. Under the former Bankruptcy Act, a substantial split had developed in the federal circuit courts over whether a utility might be prevented from using the threat of service discontinuance as a collection device.

The absence of any express definition of "utility" in the statute and the legislative history's non-exclusive catalogue of qualifying providers suggest that lawmakers intended the concept to evolve as more or different services came to occupy a "special position" with respect to the debtor. The Fifth Circuit recently examined this idea in *Darby*.

The Fifth Circuit's Ruling in *Darby*

Damon Fitzgerald Darby filed a chapter 13 case in July of 2004. Soon after receiving notice of the filing, Time Warner Cable, Inc. disconnected Darby's cable television service. Darby offered Time Warner a deposit to reconnect his cable service, but Time Warner refused to reinstate his service.

Darby sought a court order under section 366 directing Time Warner to do so upon provision of adequate assurance of payment. Time Warner argued that it was not a "utility" within the meaning of the statute, and consequently, was not obligated to reinstate Darby's cable service even if he offered adequate assurance. The bankruptcy court directed Time Warner to reconnect Darby's service and granted the cable company an administrative priority claim as adequate assurance. The court reversed that determination, however, on reconsideration, ruling that Time Warner was not a utility within the meaning of section 366 and did not have to reinstate Darby's cable television service. The district court upheld that ruling on appeal.

Darby appealed to the Fifth Circuit, which affirmed the rulings below. Noting that the classification of cable service under section 366 is an issue of first impression in the circuit, the Court of Appeals looked for guidance to the provision's legislative history as well as other decisions construing the meaning of "utility." The Fifth Circuit focused on the "special position" status indicated by the legislative history, observing that "it seems logical that a strong justification, such as the need for continued access to essential services, underlies the provision." According to the Court of Appeals, "the necessity of service is what creates a 'special' relationship between a debtor and a utility."

The Fifth Circuit did not fault the bankruptcy court's determination that cable service is not a necessity because it is "not necessary to a minimum standard of living." The Court of Appeals rejected Darby's contention that he could not easily obtain comparable service because he would be required to pay $250 to initiate satellite service. The availability in and of itself of other

options, such as satellite or network service, the Fifth Circuit emphasized, dictates that cable service is not a necessity and that Time Warner is not governed by the strictures of section 366.

Analysis

The Fifth Circuit's restrictive definition of "utility" to encompass only providers whose services are essential comports with the underlying purpose of section 366. Still, applying the "necessary" and "essential" standard may be more complicated than it would appear — certain kinds of services could readily be essential to some debtors, but not others, and the increasing prevalence of service "bundling" (*e.g.*, television, phone and internet service in one package) is likely to make the analysis more difficult. Recognizing that the term "utility" is a fluid concept, the Fifth Circuit stated in a footnote that "[w]e express no opinion on the effect of § 366 on telephone service that is bundled with cable service." As companies and individuals increasingly rely on alternative providers, such as cable companies, for services traditionally offered by phone or television companies, the universe of "utilities" under section 366 is likely to evolve.

Darby v. Time Warner Cable, Inc. (In re Darby), 470 F.3d 573 (5th Cir. 2006).