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Take it to the Bank(ruptcy):
Handling Municipal Claims in Bankruptcy Litigation

Presented to the AAMA/AMJA Spring Municipal Law Conference
April 11, 2014

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I. INTRODUCTION.

If the last few years have taught us anything, there will always be government (and, in all probability, more of it), and there will always be debtors (and, in all probability, more of them).[1] These facts suggest that two of the practices areas of our profession where there will always be a need for sound legal advice are local government and bankruptcy. It is also certain that, as long as there is government and debtors, there will always be debtors who cannot pay their debts to government. Therefore, this paper attempts to offer some explanation of this area of practice where the representation of a local government as a creditor crosses into the bankruptcy courts.

[1] The authors of this paper acknowledge these points only as statements of indisputable material fact. This paper should in no way be considered an endorsement of the inevitability of more government or more bankruptcies any more than Benjamin Franklin was considered to have endorsed death and taxes. *See* Benjamin Franklin, *The Works of Benjamin Franklin,* Letter to Jean-Baptiste Leroy (1817) ("In this world nothing can be said to be certain, except death and taxes.").

Those who have made appearances in the bankruptcy courts know that it is a particularly specialized forum. Many of the principles that apply in civil procedure do not in bankruptcy, and even where there is overlap, the rules do not track one another. The rules and procedures are code based and not particularly intuitive. So, learning to "speak bankruptcy" is a bit like learning to speak a foreign language, even for otherwise learned counsel.

The bankruptcy courts are full of specialized practitioners who spend the great balance of their days doing nothing else. That does not typically fit the mold of a city attorney. At this point, some lawyers may be giving thought to their United States district court admissions and assuming that gives them license to charge head first into a bankruptcy proceeding. While an admission to practice before a United States district court is an admission to practice before the corresponding bankruptcy court, the judiciary has recognized that the skills of one do not equate to the skills of the other. So, as a threshold matter, beware that most bankruptcy courts require completion of a specialized bankruptcy filing course before the attorney may electronically file in the bankruptcy court.

II. TYPES OF BANKRUPTCIES.

The three most common types of bankruptcies are Chapter 7, Chapter 11, and Chapter 13. A Chapter 7 bankruptcy is commonly referred to as a "liquidation" bankruptcy. In a Chapter 7, in most cases, the bankruptcy court appoints a trustee to completely liquidate all of a debtor's assets. *See* 11 U.S.C. § 704. A Chapter 13 bankruptcy is available only to individuals, not corporations or other businesses. *See* 11 U.S.C. § 109(e). Unlike a Chapter 7 debtor, a Chapter 13 debtor files a repayment plan, as opposed to a trustee completely liquidating the debtor's assets. *Compare* 11 U.S.C. §§ 1321-1322 *with* 11 U.S.C. § 704.

A Chapter 11 bankruptcy, commonly referred to as a "reorganization" bankruptcy, is occasionally used by individuals, but primarily used by corporations and other business. *See* 11 U.S.C. § 109(d); 11 U.S.C. § 1101, et seq. The Bruno's bankruptcy is an example.

Less common are Chapter 9, Chapter 12, and Chapter 15 bankruptcies. Chapter 9 applies only to municipalities. *See* 11 U.S.C. § 109(c). The Jefferson County, Alabama bankruptcy, which stands now as the second largest bankruptcy in U.S. history (only behind Detroit), was filed under Chapter 9. Chapter 12 applies only to family farmers or fishermen. *See* 11 U.S.C. § 109(f). Finally, Chapter 15 applies to cross-border cases. *See* 11 U.S.C. § 1502(1).

III. THE AUTOMATIC STAY AND PROOFS OF CLAIM.

Your municipality has received a bankruptcy notice: so what do you do now? One of the most important considerations is the automatic stay of Bankruptcy Code[2] Section 362, which, with limited exceptions, prevents a creditor from taking any actions against the debtor or attempting to collect any debt owed to it. The creditor may ask the Bankruptcy Court to grant it relief from the stay, but only in certain circumstances. Violation of the automatic stay may result in serious consequences, including sanctions.

The automatic stay "does not operate as a stay -- . . . of the commencement or continuation of a criminal action or proceeding against the debtor." 11 U.S.C. §362(b)(1). In addition, the automatic stay does not apply to "the withholding, suspension, or restriction of a driver's license." 11 U.S.C.(b)(2)(D). Therefore, the automatic stay should not interfere with the normal operations of a police department or municipal court.

[2] Title 11 of the U.S. Code.

There is also an exemption from the automatic stay for "an audit by a governmental unit to determine tax liability," for "the issuance to the debtor by a governmental unit of a notice of tax delinquency," and for "the making of an assessment for any tax and issuance of a notice and demand for payment of such an assessment." 11 U.S.C. § 362(b)(9). There is an even more particular exception for "the creation or perfection of a statutory lien for an ad valorem property tax, or a special tax or special assessment on real property whether or not ad valorem, imposed by a governmental unit, if such tax or assessment comes due after the date of the filing of the petition." 11 U.S.C. § 362(b)(18). Therefore, a bankruptcy should not interfere with usual tax activities that occur post-petition.

The consequences of violating the automatic stay are quite severe. In most cases,

> an individual injured by any willful violation of [the automatic stay] shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages.

11 U.S.C. § 362(k)(1). Accordingly, this is a case where conservative caution is best. For reasons laid out in some detail in the Bankruptcy Code, there are many grounds for a Bankruptcy Court, upon the filing of a motion and notice and a hearing, to grant relief from the automatic stay. *See* 11 U.S.C. § 362(d). In this particular situation, it is better to ask permission than to seek forgiveness. So, we would strongly recommend filing a motion to lift the automatic stay before taking any collection action even if there is the *possibility* that the automatic stay might apply.

Generally, a bankruptcy notice will also have instructions for filing a proof of claim, including the deadline to do so. Proofs of claim are almost always required in Chapter 11 and Chapter 13 cases, but may not be required in Chapter 7 cases if the trustee determines that there will be no money after the liquidation to pay creditors. If the city receives notice to file a proof

of claim, it should do so for any debt incurred and/or owed by the debtor to the city before the bankruptcy was filed (i.e., "pre-petition."). Official Form B-10 should be used, and it is available at http://www.uscourts.gov/FormsAndFees/Forms/BankruptcyForms.aspx. The creditor should also provide documentation in support of the claim as an attachment to the claim form. *See* FED. R. BANKR. P. 3001(c). Be mindful that failure to file a proof of claim could result in the debt being discharged (wiped out) by the bankruptcy and the city will recover nothing. Also be sure to file on or before the proof of claims deadline, as failure to do so could result in the claim not being allowed, and, thus, not getting paid.

It is also advisable that the municipality's attorney not sign the proof of claim, but rather, that the mayor or another authorized agent for the municipality do so. This is to avoid any potential attorney disqualification in the event the proof of claim is contested and testimony is required. If the attorney has signed the proof of claim, he may be a material witness. *See, e.g.*, *In re Rodriguez*, 2013 WL 2450925 (Bankr. S.D. Tex. June 5, 2013). Applicable privileges may also be waived. *See id.*

IV. PREFERENCE CLAIMS AND APPLICABLE DEFENSES.

It is not unusual for a debtor (or a trustee) to file what is known as a preference action against a creditor, including municipal creditors. Under 11 U.S.C. § 547(b), with certain exceptions, the bankruptcy

> trustee may avoid any transfer of an interest of the debtor in property—
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made—

(A) on or within 90 days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under chapter 7 of [the bankruptcy code];

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of [the bankruptcy code].

Importantly, preference actions only apply to pre-petition debts, and generally only to those debts incurred within 90 days of the bankruptcy. However, even if a transfer qualifies as a preference, the debtor or trustee may not avoid the transfer if an "ordinary course of business" or "new value" defense applies under 11 U.S.C. § 547(c). One or both of these defenses are generally available to municipalities who regularly provide services (such as electricity) to a citizen. *See, e.g., In re Carled, Inc.*, 91 F.3d 811, 812-13 (6th Cir. 1996) (debtor's payments of utility bills to public utility were incurred in ordinary course of business); *In re: Tenn. Valley Steel Corp.*, 201 B.R. 927 (Bankr. E.D. Tenn. 1996) (discussing applicability of ordinary course of business and new value defenses to public utility and finding the trustee could not avoid preferential payments as a result of those defenses).

To prevail under the "ordinary course of business" defense, the municipality must show that an alleged preferential transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the creditor, and, either (A) that

the transfer was made in the ordinary course of business or financial affairs of the debtor and creditor or (B) that the transfer was made according to ordinary business terms. 11 U.S.C. § 547(c)(2). This defense often comes up in the context of regular provision of electricity.

Under the "new value" defense, the municipality must show (1) that it extended new value to the debtor; (2) the parties intended the new value and the disputed transfer to be contemporaneous exchanges; and (3) the exchanges were, in fact, substantially contemporaneous. 11 U.S.C. 547(c)(1). Some courts have also accepted "new value" arguments with respect to the provision of utilities. *See In re Jet Fla. Sys., Inc.*, 841 F.2d 1082, 1084 (11th Cir. 1988) (recognizing that courts have found "new value" in a number of circumstances, including the value of electricity supplied by a utility to a debtor after preferential payments).

V. DISCHARGEABILITY OF MUNICIPAL DEBTS.

Most debt is dischargeable in bankruptcy. What this means is that any debt owed by the debtor to the municipality prior to the bankruptcy will be discharged by the bankruptcy. Therefore, it is imperative that the municipality preserve any claim(s) it may have in the bankruptcy by filing a proof of claim.

Indeed, most debts are discharged in bankruptcy and the municipality cannot recover that money. However, there are some notable exceptions of which the municipality needs to be aware, including (depending on the type of bankruptcy and applicable discharge provision) property taxes last payable without penalty within one year of the bankruptcy and debts for certain criminal restitution orders. *See* 11 U.S.C. § 523(a).

Finally, an *in rem* lien "rides through" the bankruptcy. Practically speaking, this means that if the municipality has a lien on property owned by the debtor, while it cannot recover the

amount of the debt from the debtor itself, the lien will remain on the property even after the bankruptcy. If the debtor later tries to sell the property, the lien will have to be satisfied to remove the cloud on the property title.

> A discharge in bankruptcy "voids any judgment ..., to the extent that such judgment is a determination of the *personal liability* of the debtor." 11 U.S.C. § 524(a)(1) (1988) (emphasis added). Thus, discharge does not affect liability *in rem*, and prepetition liens remain enforceable after discharge.

In re Wrenn, 40 F.3d 1162, 1164 (11th Cir. 1994). Therefore, where applicable, the municipality should ensure that it obtains a lien on any property to secure a debt. This often arises in the context of the municipality taking a judgment against a citizen and then recording the judgment in the county where the debtor owns property.

VI. SPECIAL CONSIDERATIONS FOR CITY UTILITIES

If municipal utility services were provided before the bankruptcy, but the bill for those services is not due to be sent until after the bankruptcy, do not send that bill. Likewise, do not send past due notices, call the debtor about an overdue utilities payment, or make any attempt to collect any overdue payment related to pre-petition debts. If the municipality provides electricity or water, do not turn off these services or threaten to do so as a result of the pre-petition debt. The Bankruptcy Court will most likely consider those actions an attempt to collect a pre-petition debt and a violation of the automatic stay. Any amounts owed for utility services provided before the bankruptcy, even if a bill has not yet been sent, should be included in a timely-filed proof of claim or as part of an administrative expense claim (in the case of services provided within 20 days of the bankruptcy, discussed in the administrative expense section below).

However, while the debtor does not have to get up to date on payments for utility services rendered pre-petition (as those will be included in the proof of claim and paid through the bankruptcy, if at all), the city is permitted to bill for all utility services provided after the debtor filed bankruptcy (post-petition). *See* 11 U.S.C. § 366. With respect to payments for utility services rendered post-petition, the municipality may send bills for those payments and may also stop providing the service (*i.e.*, turn off the debtor's electricity) if the debtor fails to make those payments. Note again, though, that the municipality may not cease provision of services, such as turning off a debtor's electricity, for not making payments for services rendered prior to the filing of the bankruptcy. Bankruptcy counsel should likely be consulted before a decision to cease provision of utility services is made. For example, as discussed below, if the debtor has provided adequate assurance, the municipality may want to consider collecting the payments from such assurance, rather than ceasing provision of services altogether. Such action may also be preferable from a "public image" standpoint, especially where individual citizens are concerned.

In addition, under Bankruptcy Code Section 366, the municipality "may alter, refuse, or discontinue service if neither the trustee nor the debtor, within 20 days [30 days in a Chapter 11 case] after the [filing of bankruptcy], furnishes adequate assurance of payment, in the form of a deposit or other security, for service after such date." What this means is that the city may request the debtor "to make the adequate assurance payment required by § 366 of the Bankruptcy Code" without violating the automatic stay. If the debtor does not provide the adequate assurance within the applicable time period (20 or 30 days depending on the type of bankruptcy), the municipality may then cease providing the utilities services, such as turning off the debtor's electricity.

Adequate assurance can be anything from a cash deposit, a letter of credit, a certificate of deposit, a surety bond, a prepayment of utility consumption, a security interest in property, or something else. *See* 11 U.S.C. § 366(c)(1)(A). The municipality can file a motion requesting such assurance, or the debtor may opt to address the issue in a first-day motion filed on the same day that the petition is filed and requesting that the Bankruptcy Court set the appropriate amount for an adequate assurance payment. The municipality should get notice of such a motion and, if so, consult counsel about if and how to respond. Finally, if a dispute arises between the debtor and the municipality as to what constitutes "adequate" assurance, the Bankruptcy Court will likely need to be involved.

Debts for post-petition utility services may be entitled to administrative expense priority (*i.e.*, the debt to the municipality for the services will get paid first, before any other creditor gets paid) under Bankruptcy Code Section 503. In addition, the municipality may be able to claim as an administrative expense the value of the services provided to the debtor within 20 days before the bankruptcy case pursuant to Bankruptcy Code Section 503(b)(9).[3] The city will need to "timely file a request for payment of an administrative expense" under Section 503. Be aware that the Bankruptcy Court sometimes, but not always, sets a deadline for filing all motions for administrative expenses.

[3] There is a conflict among the bankruptcy courts regarding whether electricity is a "good" or a "service." If a court considers electricity a "service," it is not entitled to administrative expense priority.