

# Legally (Relevant



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## Foreclosure and Bankruptcy: Legal Problems for Utility Providers

**T**he recent recession has hurt the housing market particularly hard. This downturn has affected water and wastewater systems in a number of ways. One of those has been in a dramatic slowdown in new housing units, and as a result, fewer new customers for these systems. The second place this is seen is in an equally dramatic increase in the number of foreclosures and bankruptcies involving utility customers.

Foreclosures and bankruptcies can have a profound effect on utilities. The most obvious effect is the loss of revenue that can occur when customers have not paid for services delivered. Both foreclosure and bankruptcy can present unfamiliar, and potentially serious legal issues for utilities, the answers to which may be very different for rural water districts than they are for cities. The purpose of this article is to discuss the basics that surround these cases.

### Understanding the basics

Two preliminary matters bear mentioning here. First, this article is specific to Kansas. Foreclosures are done very differently from one state to the next (for example, Missouri uses an entirely different system, as do many other states). So, readers beware! Second, as with all articles in this column, the contents of this article do no represent legal advice to anyone. Particularly as regards bankruptcy, the discussion below is simplistic in order to make it generally helpful, but by no means does it cover the field. There is no substitute for getting legal advice from your attorney specific to your situation.

The words “foreclosure” and “bankruptcy” are familiar to most people, but not widely understood. “Foreclosure” refers to a lawsuit filed in court in which a lender is asking the court to foreclose its mortgage so that it can sell the mortgaged property to pay the debt. These cases are usually filed in the district court

of the county where the land is located. A foreclosure may take a variety of turns. However, in most cases the foreclosure will be concluded by a sale of the property with the bank or other lender ultimately being the buyer by its bidding the amount owed to it on the mortgage at that sale. The bank will then offer the property for resale and, sooner or later, a new owner will take possession.

“Bankruptcy” is also a type of lawsuit, but unlike a foreclosure, a bankruptcy is filed in one of the United States Bankruptcy Courts for the District of Kansas located in Kansas City, Topeka or Wichita. Whereas, a foreclosure is begun by a bank or other lender against the owners and occupants of the property, a bankruptcy is begun by individuals (in bankruptcy terms, called the “Debtors”) in order to affect their relationships with their creditors. While a utility will almost never receive any formal legal notice of a foreclosure, and may never know that a foreclosure was filed until a new owner applies for service, a utility will frequently be given notice that a bankruptcy has been filed. Bankruptcies present their own set of challenges, because not only do they contain the same risks of nonpayment as presented by a foreclosure, they present a special kind of legal risk to a utility that violates the court rules.

The unique challenges that foreclosures and bankruptcies present to cities and rural water districts are discussed in more detail below.

### **Foreclosure: Cities**

As noted above, a city may never receive notice that a foreclosure has been filed; the first news it may get of a foreclosure is the request to change service from the former owners to the purchaser of the property at Sheriff’s Sale. There is nothing about a foreclosure that changes the way the city’s

ordinances apply to its customer while the foreclosure is pending. Nonpayment may result in the city discontinuing service and attempting to collect for the unpaid bills under usual procedures. Nothing would change the way the city deals with the new owner following the foreclosure, so that process will be the same as in any case of a change in ownership.

### **Foreclosures: Rural Water Districts**

All of the above pertaining to cities in foreclosures would be true for rural water districts, with one notable exception. Most rural water districts interpret

their by laws to create a very different relationship between the landowner/customer that is much different from the way cities and other utilities regard their customers. An owner’s right to receive water from the district’s system is a property right that is attached to the land being served, and failure to pay for that service (including monthly minimum fees) can result in forfeiture of that right. In the case of a city, if a customer fails to pay his or

her utility bill and the property is then sold at Sheriff’s Sale, the city will offer utility service to the new owner on the same terms it would offer service to any other new customer. The new owner will have no responsibility for payment of the old utility bills not paid by the former owner.

This is not the case with a rural water district, where the unpaid bills on that service (benefit unit) stay with the unit and will have to be paid by the new owner. This relationship is a powerful collection device, and one that should ordinarily result in rural water districts having little or no loss of revenue from foreclosure or other events of nonpayment by a water customer.

**Foreclosures present different challenges to RWDs than they do for cities, but both cities and RWDs are financially affected by their customers’ bankruptcies, and both are subject to bankruptcy rules that can radically alter their options in collection of past due accounts.**

## The “Gotcha” Technique!

Legislation was introduced in the Kansas Senate during the 2010 Session to ensure that landowners would effectively put an end to the RWD practice of holding landowners liable for unpaid bills on a benefit unit even if not incurred by them. The problem originated from a case in an east-central Kansas RWD that had forfeited a benefit unit for non-payment of a few hundred dollars in charges and late fees, then forcing the buyer of the home to purchase a new benefit unit for a few thousand dollars. While some RWDs seem to take great delight in using this “gotcha” technique, KRWA considers it a totally inappropriate action. Some districts view the bylaw as “requiring” forfeiture of the unit after six months, even if the property is in foreclosure limbo. Several RWDs have actually amended their bylaws in order to have their boards of directors and managers to stop believing they must forfeit a unit for non-payment.

The following was the proposed legislation. KRWA was involved in providing suggestions for moderation. The bill was not heard. It is printed here to illustrate the type of remedy that can be sought when landowners feel they are unreasonably charged.

“When land to which a water benefit unit is attached is the subject of an action for judicial foreclosure and sale, any benefit unit attached to that land shall not be forfeited, or if forfeited, such benefit unit shall be reinstated upon the following conditions:

- “(1) In the previous twenty-four months prior to the date of foreclosure, the benefit unit has received a payment of any water use charge or other monthly charge payable to the rural water district; and
- “(2) The foreclosing creditor, its assignee, or the purchaser of the property to which the benefit unit is attached, pays all charges associated with such unit including charges for water purchased, monthly minimum fees, monthly debt service fees or similar charges, late payment fees and any reasonable disconnect and reconnect fees properly charged to such benefit units.”

However, foreclosure can present some complications for rural water districts. If the foreclosure takes an especially long time, particularly in cases where the owner has vacated the property during the foreclosure process, the district may actually reach that point under its by laws (usually six months) in which forfeiture for nonpayment is to occur. Under these circumstances, every reasonable effort should be made to try to notify the foreclosing bank, its attorney or agent in order to make them aware of the potential for forfeiture if nonpayment extends over a considerable time. Benefit units cost several thousand dollars in some districts, so forfeiture of that unit is a severe penalty for nonpayment of a few hundred dollars in water usage and late fees over a few months. Under no circumstances should foreclosure be viewed as a way to take advantage of the forfeiture rules in order to make the new buyer purchase a new benefit unit from the district. This kind of opportunism is unfair, and may result in the district being drawn into litigation with a very unhappy lender or the house buyer who finds that the only way to get water to the house is by the purchase of a new water benefit unit.

## Bankruptcy

The rules that apply to cities and rural water districts as relates to bankruptcies are largely the same. In those cases where the utility receives notice (either from the court or actual notice from some other means), the utility is subject to certain important rules under the bankruptcy laws. The most important of these is what is referred to in bankruptcy terms as the “automatic stay”. What this means is that creditors, such as utilities, are prohibited by bankruptcy law from taking any action to try to collect a past due debt from a customer who has filed bankruptcy. This takes effect the instant the bankruptcy case is filed, and remains in effect until the bankruptcy court orders otherwise. Prohibited collection action includes meter shut off, sending letters or other notices demanding payment, beginning or continuing of court or administrative proceedings aimed at collecting amounts owed, etc. Violations of the automatic stay are regarded as

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serious matters, and can result in the utility being ordered to pay fines and penalties, as well as the Debtor's (customer's) attorney's fees.

Special note should be paid by rural water districts to the effect of the filing of a bankruptcy on their customers. Despite the unique relationship that rural water districts have to their water customers as described in the section on foreclosure above, bankruptcy law does not allow for forfeiture of benefit units for nonpayment at the time the bankruptcy was filed. This is a case of federal law preempting, or overruling, state law and RWD by-laws, so that not only may water customers not be shut off for nonpayment but the benefit unit serving that property may not be forfeited.

Also note that the rules that prevent shut off and other collection actions upon the filing of a bankruptcy for amounts owed at the time of filing do not apply to bills incurred after the bankruptcy is filed. As a general matter, the simplest and most accurate way to deal with a bankruptcy filing is to create a separate sub-account for the amount that was owed at the time of the bankruptcy filing that corresponds to the bills owed/meter reading as of that date. That sub-account needs to be set up so that it does not trigger past due notices or shut off notices and does not incur late payment penalties or fees, but is simply preserved on the books of the city or district. The customer's account can then be reopened with a "zero" balance beginning with the date following the bankruptcy filing. If that account becomes past due, the utility may charge late payment penalties and fees, send late payment and shut off notices, and shut off service (and in the case of RWDs, forfeit benefit units) for nonpayment for

these amounts that came due after the date the bankruptcy was filed.

Bankruptcy law allows for utilities to require special deposits when warranted. In Kansas it is common for the courts to approve of a deposit that is equal to two and a half months average utility service. In appropriate cases, particularly where usage is extraordinarily high, it may be worthwhile for the utility to negotiate with the Debtor's attorneys for an order of the court that specifies this deposit.

There are few areas of utility business that delve into matters outside the experience of most utility managers, or are more complicated or fraught with risk, than the area of bankruptcy. Systems are strongly encouraged to contact their attorneys whenever receiving a bankruptcy notice, or at least to work with their attorneys to develop a checklist to follow in the case of bankruptcies in order to adequately protect the utility against loss without getting into serious legal trouble.

## Conclusion

Foreclosures have been occurring at record levels in the past two years, and bankruptcies are also nearing all time records. Water and wastewater utilities are not immune from consequences of these problems. Foreclosures present different challenges to RWDs than they do for cities, but both cities and RWDs are financially affected by their customers' bankruptcies, and both are subject to bankruptcy rules that can radically alter their options in collection of past due accounts. These rules are complicated, and cities and RWDs need to involve their legal counsel as soon as possible in order to make sure they are complying with the applicable rules.