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BANKRUPTCY ALERT

The Threat of Telco Bankruptcies Critical Issues to Consider[1]

Charter Communications, Nortel, and other telecom providers/suppliers have recently filed for bankruptcy protection. Sadly, in this economy, they may well not be the last. What should you, as a business customer[2] or as a carrier or other supplier providing services or products (a likely "creditor" in bankruptcy parlance) to such a distressed telecommunications or cable provider/supplier, be thinking about in anticipation of such a bankruptcy filing? We suggest five critical issues to consider below.

1. Assess Your Account Status

Are your accounts receivables with the distressed telco current? If not, any payments made to you in the ninety (90) days prior to a bankruptcy filing may be vulnerable to a "preference" recovery action by the distressed telco once it files for bankruptcy (after which, it becomes the "debtor"). Limit your exposure by (i) applying payments to the most recent invoices, (ii) promptly implementing any deposit, third party guarantee, or other protective measures you may have, and (iii) being prepared to defend against a preference action by demonstrating that the payments have been made in the "ordinary course" for the industry or your particular business relationship, that they constituted a "contemporaneous exchange for new value," or that you provided "new value" subsequent to a payment.

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[1] THIS IS A SPECIAL, COMPLIMENTARY ALERT ON THE IMPLICATIONS OF THE ECONOMIC CRISIS FOR THE TELECOM INDUSTRY. IT IS PROVIDED TO CLIENTS AND FRIENDS OF SAPRONOV & ASSOCIATES, P.C. FOR TUTORIAL PURPOSES ONLY. THIS ALERT IS NOT TO BE CONSTRUED AS A LEGAL OPINION OR LEGAL ADVICE. PLEASE CONTACT US IF YOU HAVE SPECIFIC QUESTIONS REGARDING THE ISSUES RAISED HEREIN. TO OPT OUT OF RECEIVING OUR ALERTS, PLEASE EMAIL US AT INFO@WSTELECOMLAW.COM.

[2] For more information on the implications of carrier bankruptcies for business enterprises, see *Telecom travesty, What a bankruptcy can mean for customers,* Business Law Today, Volume 12, Number 1, American Bar Association, Section of Business Law, September/October 2002

Evaluate the availability of set offs to any claims a potential debtor may bring against you. You can only exercise a set off where there is "mutuality." This means that the mutual debts are (i) the same with respect to when they arose, *i.e.*, both before or both after the bankruptcy filing, and (ii) between the same entities (watch out for multiple distinct entities doing business with you under the d/b/a of the pending debtor).

Explore your regulatory options and requirements regarding possible tariff changes, deposit increases, and the like. Remember, any regulatory delays may limit your opportunities to take protective actions.

2. Beware the "Automatic Stay"

Importantly, any action that you as a creditor may take after the debtor files a petition for bankruptcy relief is subject to the so-called "automatic stay." This provision of bankruptcy law gives the debtor some breathing room to get its affairs in order by automatically stopping creditors (on pain of contempt) from taking any action against a debtor without approval from the bankruptcy court. This also means that creditors may <u>not</u> enforce prior agreements, file lawsuits, take collection action or – in some cases – even terminate their agreements with the debtor. (One possible exception arises under Section 366 of the Bankruptcy Code and is discussed below.) Otherwise, plainly speaking, once the petition is filed, creditors must immediately stop taking any action against the debtor unless and until the court says otherwise.

Accordingly, you should carefully consider perhaps exercising your options, if any, to terminate the agreement with the distressed carrier prior to a bankruptcy filing. Otherwise, your business relationship may remain in limbo pending a decision by the debtor to assume or reject your contract as discussed below.

Note also that contract language making a bankruptcy filing a default – although very common - is typically useless. Under the Bankruptcy Code, so-called "*ipso facto*" clauses, contractual provisions that trigger a default or other remedy upon a bankruptcy filing or similar insolvency event, are generally ineffective. In a word, they are unenforceable against the debtor – although they may be used in so-called "cross defaults" (*e.g.*, a default by a parent corporation upon a bankruptcy filing by its subsidiary).

3. Review Your Contracts

With certain exceptions, a debtor has options as to how it treats an unexpired "executory" contract: one still requiring performance from both parties. Virtually all vendor-carrier, customer-carrier or carrier-to-carrier agreements are executory contracts. A creditor may (i) reject (ii) assume, or (iii) assume and assign such a contract – even if the contract prohibits assignment. Often however, the debtor will not make this decision until the bankruptcy proceedings are largely completed – thus leaving the other (nondebtor) party to the contract in limbo. Worse, once the contract is rejected, bankruptcy law will operate in such a way as to leave the creditor with what is often only a largely worthless, unsecured claim for damages measured as of the date before the bankruptcy filing.

The Bankruptcy Code does state that a debtor must assume or reject an entire contract, and can assume only if it agrees to cure all defaults in its performance. In practice, however, this often proves to be of little use as the carrier's right (and threat) of rejection gives it substantial leverage to renegotiate an agreement to your disadvantage. Accordingly, assumption of your contract with a carrier debtor will often result in a negotiated settlement of any outstanding amounts.

Moreover, as noted, a debtor may also assign your contract to another entity without your consent unless prohibited from doing so by other applicable law, so long as the debtor assumes the contract and cures any defaults. This presents a concern that the carrier (*e.g.*, as part of its reorganization plan) could assign your contract to an unwelcome third party: for example, to your competitor.

4. Utility Services - Section 366 Exception

Under Section 366 of the Bankruptcy Code, a "utility" may terminate "utility service" to a debtor unless it receives "adequate assurance of payment" from the debtor "that is satisfactory to the utility" within thirty (30) days of the bankruptcy filing. Such "adequate assurance" must be in the form of a security satisfactory to the utility, such as a surety bond, deposit, or letter of credit. This is an exception to the automatic stay.

Vendors will probably not qualify for such utility status, but carriers (including resellers) might. However, this issue remains unsettled, and whether communications service provided for resale or via the exchange of traffic between carriers qualifies as "utility service" within the meaning of Section 366 may vary by jurisdiction. Some courts have said no. You should check the law in the relevant bankruptcy jurisdiction and, if permitted, be prepared to promptly seek "adequate assurance of payment" for services you continue to provide the debtor.

5. Regulatory Intervention

And don't overlook possible interference from the FCC and state utility commissions. Regulatory agencies have authority – both express and implied – to exert a powerful influence over the course of a bankruptcy case. In past telco bankruptcies, regulators have not hesitated to voice their concerns – especially over potential disruption of the carrier debtor's services to the public – via both public statements and the initiation of formal reviews. A note of warning: if you as a creditor are also a regulated entity, be prepared to justify any actions you may take against a bankrupt carrier to these same regulators as well.

Should you have any questions concerning these topics, please contact Robert J. Butler at 202-223-0646 or rbutler@wstelecomlaw.com, or Walt Sapronov at 770-399-9100 or wsapronov@wstelecomlaw.com.