Telecom travesty
What a bankruptcy can mean for customers

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What a bankruptcy can mean for customers

The fortunes of the U.S. competitive telecommunications industry — the intended result of the 1996 telecommunications reform legislation — are in a free fall.

Many erstwhile competitors to the traditional Bell companies (including WorldCom, ICG Communications Inc., Winstar Communications Inc., Rhythms Net Connections Inc., and Global Crossing Ltd.) have filed, or are on the brink of filing, for bankruptcy protection; others will soon follow.

Some will perhaps emerge restructured or reorganized; many will not. Their existing customers will bear the consequences, which, in extreme circumstances, could entail loss of deposits, services or both.

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This industry-wide malaise raises the question of what protections are there, if any, for customers, suppliers or other transaction parties (collectively, customers) having commercial dealings with these distressed telecom carriers (telcos).

The following discussion attempts to answer this question, addressing: first, some implications of a telco's bankruptcy filing (including the possible sale or liquidation of its assets) on customers' rights and remedies and second, suggested contractual measures when negotiating future commercial transactions with a telco.

The customer's concerns typically spring from its existing telco contracts for the purchase, sale or exchange of services, capacity (bandwidth), equipment or use of building space (such as placement of the customer's equipment in the telco's serving office).

When the telco files a Chapter 11 petition, the bankruptcy trustee or debtor-in-possession must determine whether each such contract, if "executory" should be assumed or rejected. The Bankruptcy Code does not define the term "executory contract."

An "executory contract" has been defined under case law as a contract "on which performance remains due to some extent on both sides" and where "obligations of both parties are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." *Mitchell v. Streets (In Re Streets & Beard Farm Partnership)*, 882 F.2d 233, 235 (7th Cir. 1989). See generally, Countryman, "Executory Contracts in Bankruptcy" (pts 1 & 2), 57 *Minn. L. Rev.* 439 (1973), 58 *Minn. L. Rev.* 479 (1974).

If assumed, the telco's assumed obligation becomes an administrative expense of the estate, as opposed to an unsecured claim, which ranks lower in the priority of distribution. If rejected, By Walt Sapronov and Elizabeth Holdrege

the rejection constitutes a breach of the contract or lease, the damages for which have the status of an unsecured claim against the bankruptcy estate relating back to the date immediately preceding the filing of the bankruptcy petition. See 11 U.S.C. 365(g)(1).

Generally, once assumed, a contract can be assigned (provisions to the contrary notwithstanding), subject to the telco providing adequate assurance of future performance by the assignee. The Bankruptcy Code does not describe what constitutes "adequate assurance." Consequently, what suffices here is subject to debate. See, for example, *Everex Sys. Inc. v. Cadtrack Corp* (In Re CFLC Inc.) 89 F.3d 673 (9th Cir. 1996) and *Worthington v. General Motors Corp.* (In re Claremont Acquisition Corp.), 113. F.3d 1029 (9th Cir. 1997).

Unfortunately, even if the customer were to secure some measure of relief prior to the telco's Chapter 11 filing (such as a negotiated settlement of amounts owed to or from the customer) survival of these measures in a Chapter 11 bankruptcy proceeding is by no means assured. For example, a transfer of assets (including settlement payments) from a telco *prior* to the filing of a petition in bankruptcy is subject to scrutiny as to the fairness of the consideration paid under fraudulent conveyance and preferential transfer principles. See 11 U.S.C. 544, 545, 547 and 548.

In particular, transfers of property made within 90 days before the date of the filing of a bankruptcy petition (or up to one year if such creditor is an insider) may be avoided by the telco as a preferential transfer if the creditor receives more than such creditor would receive on liquidation of the telco. See 11 U.S.C. Section 547.

In addition, transfers of property to a person (whether a creditor or not) made within one year before the date of the filing of a bankruptcy petition may be avoided by the telco as a fraudulent conveyance if the transfer had been made with the actual intent to hinder, delay or defraud any creditor. See 11 U.S.C. 548. The telco may also avoid any transfer of property made to any person in exchange for less than its reasonably equivalent value if the telco was insolvent at the time of the transfer.

Sadly, the recent controversies surrounding WorldCom and others now make fraud and insolvency commonplace concerns. Also relevant to the avoidance issue is whether the transfer was in the "ordinary course of business" of the telco; if so, the customer may be able to escape avoidance of the transfer. See 11 U.S.C. 547 (c)(2).

In another variation on this theme, the customer may be materially affected by what happens to the telco's assets (and the customer's related contractual rights and obligations) after the filing: This could involve a sale (so-called "363 sale"), disposition in a plan of reorganization, or — in the worst case — liquidation.

The bankruptcy court must approve all post-petition asset sales (or other disposition of the bankrupt estate) by the debtor that are not in the "ordinary course of business." The Bankruptcy Code does not define the term "ordinary course of business." Whether a sale is in the ordinary course is a question of fact to be determined by the bankruptcy court by examining various factors that may include the following:

- the percentage of the assets sold to the company's overall assets,
- the type of assets transferred, and
- the company's prior course of business dealings.
- The court will determine whether to approve the sale if it is not in the ordinary course by examining such factors as the fairness of the consideration, the availability of competing bids, and the liquidity of the assets. Affected parties (such as customers) usually have an opportunity to be heard.

That a telco's voluntary or involuntary bankruptcy will have repercussions for its customers is axiomatic. Here are some of the possible repercussions:

- Rejection (as executory) of the customer's underlying contract with the telco;
- Discharge of any of the telco's pre-petition payment obligations (such as refunds, credits or liquidated damages);
- Setting aside, as a fraudulent conveyance or preference, any financial benefit granted to the customer within the preference period (usually 90 days preceding the filing date);
- Loss of customer's deposits, payments or other pre-petition consideration, leaving the customer with a typically unsecured claim;
- Subordination of the customer's (typically unsecured) claims to those of secured creditors;
- Assumption and assignment (notwithstanding contractual prohibitions) of the customer's contract to a third party (such as the customer's competitor);
- Automatic stay on any recovery action by customer; and
- Possible loss of service altogether in the event of liquidation.

The effect of these repercussions on the customer will, of course, vary. For instance, in some circumstances, the telco could emerge intact from the bankruptcy under a court-approved plan of reorganization. See 11 U.S.C. 944. In such event, if the customer's agreement were rejected, the right to receive a refund of any down payments or deposits would most likely be lost.

Nevertheless, the customer could conceivably recover these losses through renegotiated benefits or credits under a new agreement with the reorganized telco that, having been shed of its debt burdens, might be eager to resume doing business with the customer.

Alternatively, a worse result could follow if the telco's assets were purchased by a third party, either through a plan of reorganization or a sale. As indicated, under the Bankruptcy Code, the asset sale could be coupled with an assumption and assignment of the customer's executory contract to a third party, subject only to the telco's adequate assurance of future performance by the assignee even if the language of the contract does not permit such assignment. *Worthington v. General Motors Corp. (In Re Claremont Acquisition Corp.)*, 113 F.3d 1029 (9th Cir. 1997) at 1032. The assignee could turn out to be an inferior service provider or, worse, a customer competitor.

The most draconian result for the customer would likely be the liquidation of the estate. Where the contract, for example, is exclusive or does not contemplate or permit a transition to a replacement carrier, the customer may have no way — short of breaching the contract — to secure an alternative supplier of services, even as the telco's operations are dismantled. In a liquidation, the creditors of the telco's estate would likely seek to hasten the process to avoid so-called "cash burn" by the telco, leaving the customer with little time to mitigate an abrupt termination of telecommunications service.

Whether regulatory notice procedures in 47 USC Section 214 (a) (prohibiting a carrier's discontinuation of service without first securing a certificate from the Federal Communications Commission) — designed to give subscribers early warning of such a service shut down — would slow down the liquidation process is uncertain. See, generally, David M. Grimes & Bennett G. Young, "Telco Bankruptcies and Reorganizations," in *Telco Deals Now: Understanding the Interplay of Regulatory, Corporate, Securities and Bankruptcy Issues*, PLI Institute (2001).

In short, the unanticipated prospect of a telco bankruptcy may well leave the customer scrambling for remedies. Given the depressed state of this industry, telco bankruptcies are an unfortunate part of business life. And for the reasons sketched out above, post hoc remedies for dealing with a distressed telco supplier that is winding its way through the bankruptcy process are likely to be of little use. Instead, the customer's proverbial ounce of prevention is perhaps best found in anticipatory contractual remedies, created prior — not after — contract execution.

As a general rule, contractual measures seeking to diffuse the bankruptcy threat are problematic. First, contractual provisions purporting to treat the Chapter 11 filing itself as a breach (so-called *ipso facto* clauses) are unenforceable against the debtor. See 11 U.S.C. Section 365(e). Second, the enforcement of such measures would violate the automatic stay. See 11 U.S.C. Section 922. Nonetheless, anticipation of the telco's bankruptcy could conceivably be addressed without falling into these pitfalls.

As noted above, any deposits made by the customer under the contract would likely not be recoverable on the rejection of the contract by the telco. Possible approaches to avoid this result would be through the use of a letter of credit or a guarantee by a solvent parent or affiliate of repayment of any prepayments or deposits made under the contract.

Case law and commentary suggest that an issuing bank's obligation to pay a beneficiary (customer) under a standby letter of credit, to the extent it is not issued to secure antecedent debt, will survive the account party's (telco's) bankruptcy. See David Grey Carlson & William H. Widen, "Letter of Credit, Voidable Preferences, and the Independence Principle," 54 *Business Lawyer* 4, p. 1662 (August 1999).

Furthermore, while an *ipso facto* clause may be unenforceable *against* the debtor, the clause may nonetheless trigger a default in a separate guarantee (or other collateral instrument) entered into by the telco's (hopefully solvent) parent or other affiliate.

One possible remedy for dealing with unwanted contract assignments may lie in the provisions of the Bankruptcy Code excepting personal service contracts from the telco's unrestricted assignment right. Personal service obligations that are sufficiently unique are generally prohibited from nonconsensual assignment in the event of a bankruptcy. See, for example, *City of Jamestown v. James Cable Partners (In re James Cable Partners, L.P.)*, 27 F.3d 534, 537-8 (11th Cir. 1994) and *In re West Elecs. Inc.*, 852 F.2d 79, 83 (3rd Cir. 1988).

Thus, if the parties agree and stipulate in the contract that the telco's obligations are to be characterized as personal services (such as, maintenance agreements — to the extent they involve customized services, unique customer's equipment, proprietary software or idiosyncratic network features serviced by specially trained maintenance personnel of the carrier), then conceivably the customer could arguably prevent the contract's undesired assignment.

The customer could also conceivably negotiate a contractual definition of "adequate assurance" for purposes of Bankruptcy Code Section 365(f)(2)(B) that requires provision of services by an assignee that is not a customer competitor and has qualifications (measured, for example, in numbers of central office locations, access lines, spare facilities or other key elements) demonstrably comparable to those of the telco. Alternatively, the parties could agree that the contract, on the telco's bankruptcy filing, may only be assigned to certain named alternative suppliers and that all others are conclusively deemed to not meet the "adequate assurance" test.

Perhaps the customer's best approach to mitigating bankruptcy problems is to negotiate for an "early warning" mechanism in the contract that will permit the customer to take remedial action *before* — not after — the telco's Chapter 11 filing. Here, the customer could perhaps use industry-recognized bankruptcy harbingers as the basis of covenants (similar, for example, to debt-coverage covenants in loan agreements), that, if breached by the telco, would give rise to default remedies or other protections. See, for example, Henry Sender, "How to Spot Signs of Companies' Distress," *Wall Street Journal*, Dec. 31, 2001 at C1.

Examples include the following: the telco's substantial draw down of its credit facility; a violation of debt-coverage ratios in the underlying agreement with its lenders; a downgrade in the telco's debt securities (or a widening of the risk premium on the debtor's credit default swaps if the debtor's debt risk trades in the credit-derivatives market); and the telco's hiring of a restructuring adviser.

By treating these as defaults or other triggering events, the contract could, for example, either permit the customer to terminate for breach or, at a minimum, to exercise other remedies. For example, convert an exclusive service contract to a nonexclusive one, exercise partial termination rights, or be automatically relieved from purchase commitments.

As a caveat, given the broad equitable powers of the bankruptcy court, none of these possible safeguards is foolproof. Whether they will survive bankruptcy court scrutiny remains to be seen.

The considerations discussed are a few of the many considerations in a transaction with a distressed telco that have become obvious as a result of painful hindsight in recent months. As much of this area is *terra incognita*, other concerns will inevitably arise as more bankruptcies of telcos occur and additional hindsight will bring new strategies to light.

One lesson for customers is clear, however: Given the depressed state of the current telecom industry, the effect of a bankruptcy should not be overlooked when negotiating agreements with a telco.