

Utility Bankruptcy Basics

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Introduction

Recent bankruptcy cases involving offspring of the former Montana Power Company (Touch America and NorthWestern Energy) have necessitated a high-speed ascent of the steep learning curve associated with bankruptcy law.

This article was written for the layperson who wishes to understand the potential implications of a voluntary filing¹ by a utility under Chapter 11 of the federal Bankruptcy Code, as well as actions that are taken or decisions that are made during a bankruptcy proceeding. It is not intended to be a legal resource.

U.S. Bankruptcy Court judge Robert Grant wrote:

The Bankruptcy Code is not a fragmented and disconnected collection of miscellaneous rules. It is a complex tapestry of ideas. The colors and patterns that are woven into its fabric combine to compliment [sic] and reinforce each other, in order to create a single unifying theme--the equitable treatment of creditors and financial relief for over-burdened debtors.^a

Judge Grant noted that the tapestry balances and harmonizes the tensions between seemingly inconsistent objectives. He further emphasized that interpretations of the federal Bankruptcy Code must reflect the interplay between all of its parts, so the code can operate as a coherent whole.

Leaving the picturesque metaphor aside, bankruptcy law is complex and interpretation of the law requires experience. Furthermore, as a practical matter, bankruptcy cases are different from other legal proceedings. Readers should heed the following caveats:

- This article discusses general concepts. The federal Bankruptcy Code is full of exceptions that are generally not identified in this brief piece.
- The case law for utility bankruptcy is not well developed. This means that disputes about the law have generally been decided by lower courts. If these questions are appealed to higher courts, the case law may evolve.
- The advice of an attorney who specializes in bankruptcy and has experience with utility

¹A petition initiating a bankruptcy case may be filed by either the debtor or creditors. A petition filed by the debtor is a “voluntary” petition.

bankruptcies is invaluable.²

Basic Concepts

What is the goal? The bankruptcy laws provide a way for debtors that cannot pay off their debts to make a fresh start.³ In a nutshell, the process leads to a determination of how much of the debt will be paid, to which creditors, and under what terms. A utility that petitions for bankruptcy under Chapter 11 is usually striving to continue its operations by restructuring its debt. However, Chapter 11 also provides an orderly process for liquidation of assets, if liquidation is in the best interest of the creditors.

With respect to creditors, the goal is equitable treatment of creditors within the same class.

Who's on first? Under the U.S. Constitution, the federal government has jurisdiction over bankruptcy. Bankruptcy cases are adjudicated in bankruptcy courts, which are part of the federal district court system. State and federal nonbankruptcy laws may be preempted under certain conditions.

Different chapters for different debtors. There are five different types of bankruptcy cases that are addressed in separate chapters of the U.S. Bankruptcy code. Chapter 7 and Chapter 11 are the two options for an investor-owned utility. In general, Chapter 7 governs cases where the debtor's assets are liquidated and the proceeds are used to pay creditors. Chapter 11 cases usually involve reorganization of the debtor's assets. When a Chapter 11 petition is filed, the debtor usually wants to continue operating the business post-bankruptcy. Future earnings of the debtor may be used to pay creditors.

As noted earlier, there are always exceptions. The debtor may liquidate its assets under Chapter 11 as was done in the Touch America case.

The petitioner chooses the chapter that will govern its case at the time of filing. However, the law provides for conversion of a Chapter 11 case to a Chapter 7 case or vice versa. The switch may be voluntary (initiated by the debtor) or involuntary.

Terms

A layperson observing a bankruptcy case will quickly become entangled in jargon. A few frequently used terms are explained below.

Claim. A right to payment. Claims are divided into classes of substantially similar claims.

²I acknowledge the sage advice of my "little" brother, Dave Vandenbosch, who unlike his sister, has practical experience with bankruptcy proceedings.

³Interestingly, the legal term for this "fresh start" is "rehabilitation."

Cram down. Confirmation of a plan that is not accepted by every class of claims.

Creditor. A party that is owed money by the debtor.

Debtor. The utility that owes money to persons, corporations, governments, etc., and that seeks to reorganize its debts through bankruptcy.

DIP. An acronym for debtor-in-possession, which is a debtor that is in possession of the assets and that operates the business during the bankruptcy proceeding. In some cases, a trustee is appointed; however, this is rare in Chapter 11 cases. (Occasionally used to refer to the Cubs fan who deflected the baseball from Moises Alou during the 2003 National League Championship series. I have avoided the use of this acronym to minimize confusion.)

Discharge of debt. If a debt is discharged, the debtor has no further liability with respect to that debt. The creditor may not try to collect the debt from the debtor; however, the discharge does not cancel the obligation. Other parties may still have an obligation with respect to the discharged debt. A discharge does not eliminate liens. Once the case is concluded, the creditor may seek to obtain its collateral.

Executory contract. A contract that is unfulfilled on both sides. For example, NorthWestern Energy has unfilled contracts with energy suppliers. The supplier still has an obligation to provide gas or electricity and NorthWestern Energy has an obligation to pay the supplier for the energy.

Lien. Defined in the U.S. Bankruptcy Code to mean a “charge against or interest in property to secure payment of debt or performance of an obligation.”

Secured claim. A claim secured by a lien or that is subject to setoff.⁴

Setoff. Under certain circumstances, a creditor may offset a mutual debt owed by the creditor against the creditor’s claim.

Policies, Principles, and Power

The rules change when a petition is filed. Significant policies and principles are described below.

Management goal. Before the utility files for bankruptcy, the company is operated to maximize profits

⁴The amount owed by the debtor is considered a secured claim only to the extent that it is secured. For example, if the debtor owes \$100,000 and \$50,000 of that is secured, then the creditor has a \$50,000 secured claim and a \$50,000 unsecured claim.

for shareholders. However, after the petition is filed, the utility must be operated to maximize the value of the bankruptcy estate primarily for creditors.

The filing of a bankruptcy petition operates as an automatic stay that prohibits several categories of activities. Two of these are highlighted below:

An act to obtain property of the estate or to exercise control of property of the estate is prohibited. For example, a creditor may not contact a debtor to demand repayment, take action against a debtor to collect money owed, take property of a debtor, or start or continue foreclosure actions or repossessions. Not all property is considered property of the estate.

The commencement or continuation of a judicial, administrative, or other action or proceeding against the debtor, whether or not the action was initiated prior to the filing, is also prohibited, subject to several exemptions. There are varying interpretations of what this provision means. Several motions and objections have been filed regarding the automatic stay in the NorthWestern Corporation case.

The stay can be terminated or modified for cause.

Preemption. The federal bankruptcy code preempts *certain* nonbankruptcy laws, but not all bankruptcy laws. Generally, the courts have held that nonbankruptcy laws otherwise applicable to the "restructuring transactions necessary to an effective and feasible reorganization" are preempted by the bankruptcy code.^b Based on the current case law, a state law or regulatory order or a federal law cannot prevent a restructuring transaction or take an action that diminishes the value of the estate. However, other laws still apply.

Ratemaking. The Public Service Commission can continue its normal ratemaking activities during the bankruptcy case. However, orders that reduce the value of the estate may be prohibited by injunction.

A done deal can be *undone*. The debtor-in-possession may avoid certain transfers of money or property and may even recover certain transfers that occurred before the bankruptcy petition was filed. The debtor must assume, assign⁵, or reject executory contracts. Court approval is required for assumption or rejection. For example, NorthWestern Energy could reject contracts with energy suppliers, including qualifying facilities.⁶ A party to a breached contract may file a claim.

Priority of claims. The U.S. Bankruptcy Code establishes a priority for payment of expenses and claims. If each class of claims corresponded to a floor of a building, with the first floor having the first

⁵Transfer to another.

⁶Qualifying facilities that meet certain criteria under federal and state law qualify for special prices.

priority, all claims on the first floor would be paid before any claims on the second floor, and so on. The claims on the top floor would only be paid after claims on all other floors have been paid in full. (Assume there is no basement.)

The priority of expenses and claims for a voluntary case is established in the law as follows:

1. Secured claims.
2. Administrative expenses. This category is broader than normal usage of this phrase implies. It includes the expenses necessary to continue the operation of the utility during the case.
3. Unsecured claims. Claims that are likely in a voluntary utility bankruptcy are listed in order of priority below.
 - a. Wages, salaries, commissions, and related costs.
 - b. Allowed claims for contributions to an employee benefit plan.
 - c. Deposits for services not provided.
 - d. Amounts owed governmental units for certain taxes and associated penalties.
 - e. Commitments to a federal depository institutions regulatory agency to maintain the capital of an insured depository institution.
 - f. Other unsecured claims.

Process: Steps in a Voluntary Chapter 11 Bankruptcy Proceeding

Key steps in a bankruptcy proceeding are listed below.^c The debtor-in-possession usually continues to operate the business for the duration of the proceeding. Alternatively, a trustee may be appointed to operate the business; however, this is not common in Chapter 11 cases. Transactions that are not in the ordinary course of business must be approved by the bankruptcy court.

1. The debtor files a petition. Filing of the petition triggers the automatic stay.
2. Creditors are notified and organized. The court appoints one or more committees to represent creditors and may appoint a committee of equity security holders.
3. A reorganization plan is filed. The debtor is the only party that has the right to file a plan within the first 120 days of filing the petition. If the debtor files a plan within 120 days, no other plan may be filed within 180 days of commencement of the case. The court may extend the period during which the debtor has first dibs on filing a plan. More than one plan may be filed, but only one plan may be confirmed.
4. Those with allowed claims vote to accept or reject the plan. Acceptance of the plan requires approval by at least two-thirds in amount and more than one-half in number of the allowed claims in the class.
5. The bankruptcy judge confirms the plan if it meets statutory criteria. The judge may not approve an accepted plan if it does not fulfill the requirements. The judge may confirm a plan that has not been accepted by all classes if: at least one impaired class of claims has accepted the plan; the plan does not discriminate unfairly; and the plan is fair and equitable with respect

to each class of impaired claims that has not accepted the plan. The judge is not required to consider the public interest.

6. If a rate change is part of the plan, the plan may not be confirmed unless the Public Service Commission approves the rate change.

A Chapter 11 case often lasts three years or more.^d

The NorthWestern Corporation Case

NorthWestern Corporation, the parent company of NorthWestern Energy, filed a bankruptcy petition under Chapter 11 on September 14, 2003.

Entities subject to restructuring. NorthWestern Energy was included in the bankruptcy petition while two nonutility subsidiary companies (Blue Dot Services, Inc. and Expanets, Inc.) were not. NorthWestern Corporation officials have explained that they intend to sell these businesses and believe that they would obtain better value by selling the companies outside of bankruptcy. The sale is subject to approval by the Bankruptcy Court.

Status. The deadline to file proofs of claim is January 15, 2004. (Coincidentally, the deadline is April 15, 2004 (tax day), for governmental units. Several new documents (motions, orders, etc.) are filed each week. An update on the status would be outdated before *The Interim* arrives in subscribers' mailboxes. An interested person can track the case online at this website:

www.kccllc.net/northwestern/

Effect on energy services. When NorthWestern Corporation filed for bankruptcy, the corporation's cash flow improved for two reasons: Northwestern was able to obtain "DIP financing," which is only available to debtors in a reorganization case; and the automatic stay prevents collection of debts. Like other utilities that have reorganized under Chapter 11, NorthWestern Energy should continue operating in the near future as it did before the bankruptcy. The long-term effect of bankruptcy on provision of services and rates depends on the plan of reorganization that is confirmed by the judge.

State participation. Montana's Consumer Counsel and Public Service Commission are already participating in the case. These government entities can make motions, object to motions, and even propose a plan of reorganization. They cannot vote on the plan.

Any government entity that is a creditor may participate in the case and vote on the reorganization plan. For example, in mid-September NorthWestern Energy owed money to the Department of Natural Resources and Conservation for power purchased from the Broadwater Power Project. If the Department filed an allowed claim, the Department could participate as a creditor.

The Energy and Telecommunications Interim Committee sent a letter requesting the following information from parties that may represent the state's interests in the NorthWestern Corporation bankruptcy proceeding: parties participating and the capacity in which they are participating; the cost of participation in the bankruptcy proceeding; and the parties' plan to coordinate efforts in order to maximize efficiency and minimize counterproductive actions.

More Information

More information about bankruptcy in general, and the NorthWestern Corporation bankruptcy in particular, is available on the website for the Energy and Telecommunications Interim Committee:

www.leg.mt.gov/css/committees/interim/2003_2004/energy_telecom/bankruptcy.asp

Endnotes

- a. In re Depew, 115 BR. 965 (Bankr. N.D. Ind. 1989), 123
- b. In re Pacific Gas and Electric Co, 283 B.R. 41 (N.D. Cal. 2002)
- c. David G. Epstein, Bankruptcy and Related Law in a Nutshell, West Group, St. Paul, Minnesota, 2002.
- d. *ibid*, p. 268.