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A PRIMER ON BANKRUPTCY LAW

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Over the last year, Jim Baller, Sean Stokes and Casey Lide of the Baller Herbst Law Group, P.C., have represesented the National Association of Telecommunications Officers and Advisors and dozens of municipalities, counties, public power utilities and rural cooperatives in the Adelphia bankruptcy, working with New York bankruptcy counsel Ronald Cohen of Seward & Kissel.¹

The following is an overview of bankruptcy law and practice, with emphasis on the rights of local governments and consumer-owned electric utilities. It is offered merely for general informational purposes is not intended as legal advice.

1. OVERVIEW OF BANKRUPTCY LAW

Bankruptcy law is federal law, codified at 11 U.S.C. A company may choose to file under Chapter 11 (reorganization) or Chapter 7 (liquidation).

A. Chapter 11: Reorganization

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Under Chapter 11 (11 U.S.C. § 1101 et seq.), a debtor receives the protection of the U.S. Bankruptcy Courts to develop a plan of reorganization, and to consolidate and discharge its debts pursuant to an agreed plan. Adelphia chose to file under Chapter 11, and is therefore likely to continue to operate in some form. The company insists that its operations will continue, and that it has taken "extraordinary steps" to continue service to its 3,500 franchises nationwide. <u>http://www.adelphia.com/vendors/index.cfm</u> (July 1, 2002)

- 1. "Voluntary" reorganization -- the debtor keeps possession and control of its assets while undergoing the reorganization.
- 2. "Automatic Stay" -- creditors are generally estopped from engaging in any unilateral collection activities against the debtor or acts to terminate any property rights of a debtor. 11 U.S.C. § 362(a). The stay goes into effect automatically upon the filing of a petition for reorganization.

On June 25, 2002, Adelphia Communications Corp. filed a petition for Chapter 11 bankruptcy in the U.S. Bankruptcy Court in the Southern District of New York (Manhattan).

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3. "Filing of Plan" -- Chapter 11 debtors have the exclusive right, for up to 120 days from the filing of its petition, to develop and submit a plan for reorganization to the bankruptcy court.

- a. The debtor then has an additional 60 days to obtain acceptance of the plan by each class of its creditors. 11 U.S.C. § 1121.
- b. If the debtor fails to file a reorganization plan within 120 days, or if such plan is not accepted by the creditors within 180 days of the filing of the petition, any party in interest may file its own plan of reorganization.
- c. Please note that in complex cases the 120-day period is often extended by the Bankruptcy Court, oftentimes for a year or two.
- d. In the Adelphia bankruptcy, the exclusive period has already been extended until October 20, 2003, and will likely be extended again.
- 4. "Avoidance" -- a debtor (or a trustee) can void a transfer of property made within the 90-day period prior to the filing of a petition in order to protect the interest of creditors. Five conditions must be met for avoidance:
 - a. Transfer must be within 90 day period prior to filing.
 - b. Transfer must be for the benefit of a creditor
 - c. Transfer must be on account of an antecedent debt owed before the transfer was made.
 - d. Transfer must allow the creditor to get a greater percentage of claim than it would have received under a liquidation.
 - e. Transfer must have occurred while debtor was insolvent, although insolvency is presumed.

Transfers in the ordinary course of business of the Debtor to pay debts incurred in the ordinary course of business are not avoidable.

- 5. Termination of "executory" contracts -- with approval of court a debtor can reject certain unfulfilled lease agreements or executory contracts. Such a rejection does not relieve the debtor of liability for damages under the contract, nor does it extinguish possible state law claims for breach of contract, but such claims are classified as pre-petition general unsecured claims that usually receive a modest distribution. Franchise Agreements are in all probability executory contracts.
- 6. A Debtor also has the option of assuming such agreements, and it will presumably do so with respect to franchises that provide valuable rights to sell cable services

in various locales. An assumption decision need not be made until plan confirmation. All defaults must be cured as a condition of assumption.

7. "Claims" -- Section 1123(a)(1) requires a Chapter 11 reorganization plan to designate certain classes of claims and interests for treatment under the proposed plan. A "claim" is a right to payment or a right to an equitable remedy for a failure of performance if the breach gives rise to a right of payment. 11 U.S.C. § 101(5). If a creditor's claim is not listed on the "schedule" of debts and liabilities that the debtor must file with the court or the claim is listed as disputed, unliquidated or contingent, the creditor must file a "proof of claim" with the clerk of the bankruptcy court by the claims bar date that is set by court order. (No bar date has yet been set in Adelphia.)

The classes of claim holders are as follows:

- a. Secured creditors individuals or entities holding claims against the debtor that are secured by a lien on property of the debtor;
- b. Unsecured creditors entitled to priority individuals or entities holding claims with no special assurance of payment but with a court-approved priority over other unsecured creditors (e.g., wages, pensions, taxes);
- c. General unsecured creditors individuals or entities holding claims with no special assurance of payment; and
- d. Equity security holders individuals or entities holding interests in equity securities of a debtor (e.g., stock in a corporation).
- 8. "Disclosure statement" -- required to be developed by the debtor to provide adequate information regarding the affairs of the debtor so as to enable the holder of a claim or interest to make an informed judgment about the proposed plan of reorganization. 11 U.S.C. § 1125(b).
- 9. "Plan Confirmation" -- bankruptcy court must find that the creditors have approved the plan; that its feasible; that it was proposed in good faith; and that it is not likely to lead to liquidation or the need for further reorganization.

B. Chapter 7 -- Liquidation

- 1. "Liquidation" -- Chapter 7 bankruptcy (11 U.S.C. §701) is essentially a dissolution of the debtor and a liquidation of its assets.
- 2. A "Trustee" is appointed to oversee the sale of the assets and the discharge of the petitioner's debt.

- 3. "Automatic stay" a petition for Chapter 7 bankruptcy initiates an automatic stay of actions against the debtor's assets.
- 4. "Schedule of assets" -- A debtor under Chapter 7 must file a schedule of its assets, liabilities, current income and expenditures, executory contracts and unexpired leases.

II. ISSUES OF PARTICULAR RELEVANCE TO UNITS OF LOCAL GOVERNMENT

A. Effect of Automatic Stay

- 1. Government entities are generally treated the same as other creditors under the Bankruptcy Code, except that they are exempt from the automatic stay to the extent they act to exercise their police or regulatory power. As the Adelphia court determined, however, one exception is that a local government cannot serve on a creditors' committee.
- 2. Section 362, the "automatic stay" provision, provides that petitions filed under Chapter 11 "operate as a stay, applicable to all entities" of a variety of acts to collect on or enforce debts. 11 U.S.C. § 362(a).
- 3. The term "entity" is defined under the Code as a "person, estate, trust, *governmental unit*, and United States Trustee." 11 U.S.C. § 101(15).
- 4. A "regulatory power exception" to the automatic stay exists for "governmental unit[s]" acting to enforce their "police or regulatory power, including the enforcement of a judgment other than a money judgment..." This section gives the municipality the ability to enforce construction, performance, build-out or customer service standards, and similar actions to protect the public health, safety and welfare and not undertaken with the objective of collecting a debt. 11 U.S.C. § 362(b)(4).
- 5. Section 362(b)(9) provides an exception to the automatic stay for purposes of a tax audit, a demand for tax returns, and assessments of uncontested tax liability.
- 6. Section 362(b)(18) provides an exception for the creation or perfection of a statutory lien for an *ad valorem* property tax imposed by a municipality if the tax becomes due after the filing of a petition.

B. Local Government as Creditor

1. The locality is a creditor to the extent it is owed franchise fees or the provision of other obligated services or facilities (e.g. PEG or I-Net facilities). As indicated, a local government is not permitted to serve on a creditors' committee.

- 2. To the extent the locality has claim to specific property, lien or bonds it is a secured creditor, otherwise it is an unsecured creditor with a possible right to priority as a governmental claim. Taxes, for example, are a priority claim.² Unpaid franchise fees are also likely to be accorded a priority, but only with respect to amounts coming due after the filing of the petition need to be paid on a current basis. Amounts that were due pre-petition but remain unpaid must await the assumption of the franchise agreement which will in most cases not occur until a plan is confirmed.
- 3. City may collect upon performance bonds for defaults. A surety is not relieved of its obligation as the result of a bankruptcy filing. The issue is making sure that the bond is in effect and remains in effect.
- 4. If it is a condition of the franchise that the debtor post a bond, the bankruptcy filing does not relieve the debtor of that responsibility. Hanover Insurance's efforts to cancel the Adelphia bonds were vigorously and successfully opposed by VML and VACo.

C. Renewal Subject to Set-Aside as a Preference?

- 1. Renewal is not a "transfer" and is not for the benefit of the City and is generally not on account of an antecedent debt.
- 2. An agreement to provide additional compensation to resolve a prior existing debt of franchisee could be viewed as an impermissible transfer.

D. Automatic Default Clauses Not Enforceable

- 1. Filing of bankruptcy petition alone is generally not a permissible grounds for a franchise violation. 11 U.S.C. § 365(e)(1). A possible exception exists if "applicable" law specifically excuses a party from accepting performance from a trustee. 11 U.S.C. § 365(e)(2).
- 2. This does not mean that City cannot enforce default provisions as a result of substantive defaults that occur prior to or during bankruptcy, but in either case the City needs to obtain relief from the stay in order to exercise remedies such as termination.
- 3. A debtor-in-possession must comply with applicable state and local laws in operating its business. *See* 28 U.S.C. §959. Failures to comply can be brought to the attention of the Bankruptcy Court.

² In *City of Dallas v. FCC*, 165 F.3d 341 (5th Cir. 1999), local governments argued, and the court found, that franchise fees are NOT taxes but rent for the use of public rights of way.

4. In *City of Moreno Valley v. Century-TCI California, Inc.*, 2003 U.S. Dist. LEXIS 4490 (C.D. Cal. 2003), in which the City brought a state court action to challenge Adelphia's transfer of a cable franchise without obtaining the City's permission. Adelphia tried to remove the case to the federal district court and then have that court transfer it to the bankruptcy court in New York. The federal district court in California treated the City's suit as an exercise of the City's "police or regulatory power" for the purposes of 11 U.S.C. § 362(b) and remanded the case to the state court pursuant to 28 U.S.C. § 1452(a), which explicitly provides that civil actions by governmental units to enforce police or regulatory powers are not subject to removal.

E. Protection for Debtor Against Discriminatory Treatment

- 1. A "governmental unit may not deny, revoke, suspend or refuse to renew a license, franchise... or other similar grant to ... a person that is or has been a debtor under this title or a bankrupt ... solely because such bankrupt or debtor is or has been a debtor under this title . . . or has not paid a debt that is dischargeable . . ." 11 U.S.C. § 525.
- 2. In Adelphia, the bankruptcy court ordered an evidentiary hearing on whether three New Hampshire towns had violated Section 525 by terminating informal renewal negotiations with Adelphia on the day before, the day of, and the day after Adelphia filed its petition in bankruptcy
 - a. in an unwritten decision, the court ruled that it would not find that the towns had violated Section 525 if the evidence at the hearing showed that the towns had other or additional grounds for terminating renewal negotiations; furthermore, citing *In re Pleasant East Associates*, 286 B.R. 509 (SDNY 2002), for the proposition that a bankruptcy court should be cautious about exceeding the limits of its expertise, the court stated that it would not decide the merits of any such other grounds but would defer to the District Court of New Hampshire to adjudicate them
 - b. the court also stated that, if it found that the towns had violated Section 525, it would not order the towns to award the franchises at issue, as Adelphia had demanded, but would simply order the parties to resume negotiations
 - c. the towns and Adelphia settled the matter before the evidentiary hearing was conducted

d. In *FCC v. NextWave Personal Communications, Inc.*, 537 U.S. 293 (2003), the Supreme Court held that Section 525 precludes a government entity from terminating a bankruptcy debtor's wireless spectrum licenses solely for failure to pay license fees that were dischargeable in bankruptcy (Note that the FCC had treated NextWave's license fees as debts, going so far as to file a security interests in them.)

F. Effect of Assumption or Rejection

- 1. Under 11 U.S.C § 365, subject to the court's approval, a trustee may assume or reject an executory contract or unexpired lease of the debtor. Such agreement must be assumed <u>in toto</u> and can only be modified with the consent of the other party.
- 2. A trustee is required to perform all obligations arising under an existing lease of real property until the lease is assumed or rejected.
- 3. Unexpired leases of real property must be accepted by trustee within 60 days after the date of the order for relief or a motion must be made within that time to extend the period for assuming or rejecting the lease. If the lease is not assumed or the motion not granted, the lease is deemed rejected and the trustee must surrender property back. Note this rule only applies to real property leases, not executory contracts like franchise agreements.
- 4. The time to assume or reject franchise agreements in a chapter 11 case is until confirmation of the plan.
- 5. Trustee can only assume or otherwise assign an executory contract if it assumes such contract and adequate assurance of future performance by the assignee of such contract or lease is provided. Assumption requires curing all monetary defaults, including paying all outstanding pre-petition amounts.
- 6. The Code requires any party to whom the franchise might be transferred to agree to comply with all of the terms of the existing agreement. Importantly, absent the other party's concurrence, bankruptcy law does not allow a trustee or an assignee to modify an agreement to eliminate provisions that it finds objectionable.
- 7. Rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease. 11 U.S.C. 365(g). In such case, a City has a right like any other creditor to seek repayment of any owed fees, in all probability as a pre-petition unsecured creditor.

III. DEVELOPMENTS IN THE ADELPHIA BANKRUPTCY

- A. In August 2002, Adelphia obtained access to a \$1.5 billion loan that has enabled it to stabilize its operations, remain current on all post-petition obligations and move forward with developing a business plan.
- B. A new chief executive and a new chief operating officer has been hired, but no business plan has been developed to date.
- C. We expect Adelphia to seek further extensions of its exclusive period to file a plan into the summer of 2004. That will enable it to see the performance of its business units a full year after the new executive team was hired and provide the necessary financial information that will drive the value of the business that creditors will look to for their recovery. Some franchises may be sold off as part of the process of negotiating or confirming a plan. Localities in states in which Adelphia may sell its systems, such as Virginia, have a keen interest in this issue.