

**PUBLIC UTILITIES UNDER THE BANKRUPTCY CODE**

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By

KENNETH N. KLEE

and

THOMAS KRELLER

of

STUTMAN, TREISTER & GLATT  
PROFESSIONAL CORPORATION

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## I.

### INTRODUCTION

The history of bankruptcy legislation as applied to utilities displays a marked shift in the relative roles of the bankruptcy courts and regulatory agencies. Prior to 1978, a public utility was required to obtain regulatory approval of a plan of reorganization before a court could confirm such plan. With the adoption of the Bankruptcy Reform Act of 1978 ("the Code"), the specific statutory requirements for regulatory approval of entire plans were deleted.<sup>1</sup> With respect to public utilities, the Code now requires regulatory approval only of any rate changes provided in a reorganization plan.<sup>2</sup>

Despite the reduced influence of regulatory agencies over the confirmation of a utility's reorganization plan, the regulatory environment in which a utility operates has significant implications for a utility's bankruptcy case. This paper discusses the effects that the regulatory environment has on both the administration of the bankruptcy case and the plan of reorganization.

Part II of this paper sets forth the historical development of the specific statutory provisions affecting a utility's bankruptcy. Part III examines the impact of the regulatory environment on the administration of a utility's reorganization prior to confirmation of a plan. Part IV analyzes

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<sup>1</sup> Bankruptcy Act § 177-78, former 11 U.S.C. § 577-78.

<sup>2</sup> 11 U.S.C. § 1129(a)(6).

the extent to which the Bankruptcy Code preempts regulatory jurisdiction with regard to the contents of a reorganization plan. Finally, Part V addresses unique issues that arise in valuing a regulated utility for reorganization purposes.

## II.

### PRE-CODE HISTORICAL BACKGROUND

Prior to 1934, corporate reorganizations were not covered by the Bankruptcy Act but were handled as equity receiverships in the federal courts.<sup>3</sup> In 1934, the Bankruptcy Act of 1898 was amended to include Section 77B, which dealt with corporate reorganizations. Section 77B included a number of provisions which directly addressed regulatory approval of public utility plans of reorganization.

Section 77B(e)(2) gave regulatory agencies the opportunity to suggest amendments and voice objections to proposed plans. Additionally, Section 77B(e)(2) required regulatory approval of any plan of an intrastate public utility. Section 77B(f) allowed confirmation of a debtor utility's plan only if the court was satisfied that "all authorizations, approvals, or consents of each such [regulatory] commission or

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<sup>3</sup> E.g., Northern Pacific Railway Corp. v. Boyd, 228 U.S. 482 (1913). See Public Serv. Co. v. New Hampshire (In re Pub. Serv. Co.) (hereinafter "PSNH"), 108 Bankr. 854, 863 (Bankr. D.N.H. 1989).

authority required by the laws of such State or States have been obtained."<sup>4</sup>

The Bankruptcy Act was amended again in 1938 by the Chandler Act, which continued to require regulatory approval of public utility plans of reorganization before those plans could be confirmed. Sections 177 and 178 in Chapter X of the amended Act substantially mirrored Section 77B with respect to pre-confirmation regulatory approval, providing as follows:

Section 177. In case a debtor is a public utility corporation, subject to the jurisdiction of a commission having regulatory jurisdiction over the debtor, a plan shall not be approved, as provided in section 174 of this Act, until --

- (1) it shall have been submitted to each such commission;
- (2) an opportunity shall have been afforded each such commission to suggest amendments or offer objections to the plan; and
- (3) the judge shall have considered such amendments or objections at a hearing at which such commission may be heard.

Section 178. In case a debtor is a public utility corporation, wholly intrastate, subject to the jurisdiction of a State commission having regulatory jurisdiction over such debtor, a plan shall not be approved, as provided in Section 174 of this Act, unless such State commission shall have first certified its approval of such plan as to the public interest therein and the fairness thereof. Upon its failure to certify its approval or disapproval within thirty days . . . after the submission of the plan to it, . . . the public interest shall, for the purposes of such approval and of the

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<sup>4</sup> Bankruptcy Act of 1898 § 77B(f), 11 U.S.C. § 207 (repealed 1979).

confirmation of the plan, not be deemed to be affected by the plan.<sup>5</sup>

Additionally, Section 224 provided that, upon confirmation of a plan, "the debtor . . . shall take all action necessary to carry out the plan, including, in the case of a public utility corporation, the procuring of authorization, approval, or consent of each commission having regulatory jurisdiction over the debtor . . . ." <sup>6</sup>

This statutory scheme requiring regulatory approval of plans of reorganization was extinguished with the adoption of the so-called Bankruptcy Reform Act of 1978.

After 44 years of requiring state approval for public utility reorganizations, the statutory law substantially changed with the adoption of the 1978 Code . . . . There is only one reference in chapter 11 of the Bankruptcy Code to any utility regulatory agency approvals and that is for rates. This reference is contained in the section 1129(a)(6) provision . . . concerning confirmation of a plan.<sup>7</sup>

The drafters of the present Bankruptcy Code included provisions explicitly requiring regulatory approval in railroad reorganization cases<sup>8</sup> and in cases restructuring the debts of a municipality.<sup>9</sup> By failing to carry over sections 177 and 178 of

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5 Bankruptcy Act § 177-78, 11 U.S.C. § 577-78 (repealed 1979).

6 Bankruptcy Act § 224(2), 11 U.S.C. § 624(2) (repealed 1979).

7 108 Bankr. at 864.

8 11 U.S.C. § 1172(b).

9 11 U.S.C. § 943(b)(6). Subsection (b)(6) was added to section 942 as part of the 1988 Amendments to the Code.

the Bankruptcy Act, however, they refused to continue to require such approval in chapter 11 public utility reorganization cases. Other provisions of the Bankruptcy Code nonetheless will have significant implications in the chapter 11 case of a public utility.

### III.

#### IMPACT OF THE REGULATORY ENVIRONMENT ON CASE ADMINISTRATION

##### A. PLAYERS IN THE REGULATORY ENVIRONMENT--WHO MAY PARTICIPATE?

###### 1. WHAT IS A PARTY IN INTEREST?

One of the first issues to arise in any reorganization case is the extent to which interested parties may participate in the case and proceedings. Section 1109(b) of the Code governs the participation of parties in interest: "A party in interest, including the debtor, the trustee, a creditors' committee, and equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter."<sup>10</sup>

Nowhere does the Code define "party in interest," and the list provided in section 1109(b) was not intended to be exhaustive.<sup>11</sup> Nonetheless, following the case law interpreting

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<sup>10</sup> 11 U.S.C. § 1109(b).

<sup>11</sup> See 11 U.S.C. § 102(3).

that section, the basic test for party-in-interest status appears to be "whether the prospective party in interest has a sufficient stake in the outcome of the proceeding so as to require representation."<sup>12</sup> A party in interest is granted certain rights within the case by virtue of this stake in the outcome of the proceeding.

The significance of "party in interest" status in a chapter 11 case is that a party in interest may request an appointment of a trustee or examiner under section 1104(a) and (b); may request termination in a trustee's appointment under section 1105; may request conversion of a chapter 11 case to a case under chapter 7 or 13 of the Code pursuant to section 1112(b); may file a plan under section 1121(c) and may request an extension of the debtor's time to file a plan under section 1121(d); may object to confirmation of a plan under section 1128(b); and may request revocation of an order of confirmation under section 1144 of the Code.<sup>13</sup>

Parties who do not have a sufficient stake in the proceedings to warrant party-in-interest status may still obtain the right to be participate in a bankruptcy case under Federal Rule of Bankruptcy Procedure 2018, which provides as follows:

(a) Permissive Intervention. In a case under the Code . . . the court may permit any interested entity to intervene generally or with respect to any specified matter.

(b) Intervention by Attorney General of a State. In a chapter 7, 11, 12, or 13 case, the Attorney General of a State may appear and be heard on behalf of consumer creditors

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<sup>12</sup> In re Amatex, 755 F.2d 1034, 1042 (3d Cir. 1985).

<sup>13</sup> 5 Collier on Bankruptcy ¶ 1109.02, p. 1109-24, n.23 (15th ed. 1991).

if the court determines the appearance is in the public interest, but the Attorney General may not appeal from any judgment from any judgment, order, or decree in the case.

Federal Rule of Bankruptcy Procedure 2018(a) provides that a court may provide for general or limited intervention. General intervention rights provide a party with the same right to appear and be heard as is given parties in interest.<sup>14</sup> Limited intervention allows a court to restrict the participation of parties to only those matters in which the intervening parties have an interest.

It should also be noted that "Rule 2018 applies to intervention in a case under the Code. Intervention in an adversary proceeding is accomplished pursuant to Rule 7024 and not by Rule 2018."<sup>15</sup> Bankruptcy Rule 7024 provides that Rule 24 of the Federal Rules of Civil Procedure governs intervention in adversary proceedings. Thus, the right to intervene in a bankruptcy case under Rule 2018 does not include the right to intervene in related adversary proceedings. Courts have split on whether party-in-interest status under section 1109(b) (as opposed to general intervention status under Rule 2018) confers

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14 8 Collier on Bankruptcy ¶ 2018.03, p. 2018-27 (15th ed. 1990).

15 8 Collier on Bankruptcy ¶ 2018.03, p. 2018-6 (15th ed. 1990), citing 1983 Advisory Committee Note to Rule 2018.



upon a party the right to participate in adversary proceedings.<sup>16</sup>

This party in interest or intervention issue highlights the tension between the policy of providing the opportunity for interested parties to participate in a debtor's reorganization and that of the efficient administration of a reorganization case by excluding parties without a direct economic interest in the reorganization.<sup>17</sup> The discussion below outlines some of the key entities who likely would seek representation in a utility reorganization and also discusses some options to granting such entities full party-in-interest status.

2. ENTITIES LIKELY TO SEEK PARTY IN INTEREST STATUS

a. Regulatory Agencies

A public utility may be subject to the jurisdiction of a number of regulatory agencies. Any agency with such jurisdiction outside of bankruptcy is likely to seek party-in-

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16 See In re Marin Oil, Inc., 689 F.2d 445 (3d Cir. 1982), cert. denied, 459 U.S. 1206 (1983) (holding that parties in interest have the right to take part in adversary proceedings related to the underlying bankruptcy case). But see Fuel Oil Supply & Terminaling v. Gulf Oil Corp., 762 F.2d 1283, 1286 (5th Cir. 1985) (holding that party-in-interest status does not provide any special right to be heard in adversary proceedings).

17 See 88 Bankr. at 554 (stating that "it is equally important that the court take care not to . . . overburden the reorganization process by allowing numerous parties to interject themselves into the case on every issue, to the extent that the goal of a speedy and efficient reorganization is hampered").

interest status within a debtor utility's bankruptcy case and proceedings.<sup>18</sup> Such agencies include:

- State public utility commissions (PUC's) with jurisdiction (outside of bankruptcy) over intrastate and retail rate - setting, transfer of utility assets, issuance of utility securities, etc.;
- Federal Energy Regulatory Commission (FERC), which has jurisdiction over wholesale rate-setting for energy utilities, transfer of certain assets and issuance of securities;
- Nuclear Regulatory Commission (NRC), which may have jurisdiction in cases involving a utility with nuclear power production facilities; and
- Securities and Exchange Commission (SEC), which has jurisdiction with regard to publicly-traded securities of utilities, and, under the Public Utility Holding Company Act of 1935, with regard to transfers of assets and other matters.

Whether these regulatory agencies qualify as full parties in interest is not entirely clear. In PSNH, the court held that the New Hampshire PUC was entitled to full party in interest status in the case of an investor-owned regulated utility company. The court reasoned that the PUC's jurisdiction over rate-setting as provided in section 1129(a)(6) provided the

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<sup>18</sup> See generally In re Pub. Serv. Co., 88 Bankr. 546 (Bankr. D.N.H. 1988).

PUC with a sufficient stake in the utility's reorganization to justify granting party in interest status.<sup>19</sup> Thus, where the Code specifically requires the approval of a plan's provisions by a regulatory agency (as it does in section 1129(a)(6)), that agency will likely be deemed a party in interest.

The court in PSNH, however, refused to decide whether party-in-interest status empowered the PUC to appeal court orders. "[T]his court, in granting party in interest status or intervenor status, does not determine whether the grantee does or does not have standing to appeal any orders of this court. That is a separate question."<sup>20</sup>

PSNH also leaves open the issue whether a regulatory agency without specific rate-setting authority would be deemed to have an interest sufficient to warrant full party in interest status. In the context of a reorganization plan, section 1129(a)(6) is the only Code section which specifically preserves regulatory jurisdiction over a public utility's plan provisions. All other regulatory jurisdiction over plan provisions appears to be preempted by section 1123(a)(5) (see

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19 88 Bankr. at 555.

20 88 Bankr. at 557. The general rule regarding appellate standing in bankruptcy cases is that "only those persons who are directly and adversely affected pecuniarily by an order of the bankruptcy court have been held to have standing to appeal that order." Fondiller v. Robertson (In re Fondiller), 707 F.2d 441, 442 (9th Cir. 1983). Whether a party is "directly and adversely pecuniarily affected" is generally considered to be a question of fact for the district court. In re El San Juan Hotel, 809 F.2d 151, 154 n.3 (1st Cir. 1987).

preemption discussion in part IV below). This preemption of regulatory jurisdiction may sever the connection between the various agencies and the reorganization case and proceedings, thereby precluding the agencies from obtaining party-in-interest status.<sup>21</sup>

During the duration of the chapter 11 case, on the other hand, a governmental unit may commence or continue an action or proceeding, or enforce a judgment (other than a money judgment) resulting from such an action or proceeding, where the action or proceeding is to enforce the governmental unit's police or regulatory power.<sup>22</sup> This police or regulatory power exception to the automatic stay may preserve a regulatory agency's jurisdiction during the chapter 11 case, thereby providing a sufficient connection to render that agency a party in interest. (See discussion of the effect of the automatic stay in part 3.D below.)

Regardless of whether the jurisdiction of a regulatory agency is preserved either in a chapter 11 case or under a chapter 11 plan, the case for allowing regulatory agencies to participate in a utility reorganization in some capacity is a strong one, given the agencies' jurisdiction over the utility's post-bankruptcy activities.

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21 Preemption may require, however, that the regulatory agency be given the opportunity to appear and be heard, since the bankruptcy court will be resolving issues that the regulatory agency would normally decide.

22 11 U.S.C. § 362(b)(4)-(5).

An analogy can be made to the role of the Securities and Exchange Commission (the "SEC") in a reorganization as a representative of the public interest. While the SEC is not a statutory party in interest, it is entitled to raise and be heard on any issue in a reorganization but cannot appeal from any court judgment, order or decree. [11 U.S.C. § 1109(a)] The same status is accorded to various regulatory commissions in a railroad organization. [11 U.S.C. § 1164] It is suggested, therefore, that even if the court holds that they are not true "parties in interest," regulatory agencies (including, perhaps, statutory "consumer advocates" appointed pursuant to state law) should be accorded a status similar to the SEC and railroad regulatory commissions as representatives of the public interest. The court, pursuant to Bankruptcy Rule 2018(a) and its powers as a court of equity, could fashion an order granting such agencies the right to be heard on relevant issues but possibly without the right to appeal from any decision or to propose a plan of reorganization.<sup>23</sup>

The court in In re Eastern Maine Elec. Coop., Inc.<sup>24</sup> permitted just such intervention. The court there denied party in interest status for the state PUC, but granted its motion to intervene under Federal Rule of Bankruptcy Procedure 2018(a). The debtor argued that any interest the PUC had in the reorganization was extinguished for the following reasons:

(1) the Bankruptcy Code preempted the PUC's regulatory jurisdiction within the bankruptcy proceedings; and (2) newly-

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23 Flaschen and Reilly, "Bankruptcy Analysis of a Financially-Troubled Electric Utility," 59 Am. Bankr. L.J. 135, 141 (Spring 1985).

24 121 Bankr. 917 (Bankr. D. Me. 1990).

enacted federal regulations purporting to grant state rate-making jurisdiction to the Rural Electrification Administration would effectively preempt the PUC's post-bankruptcy jurisdiction.<sup>25</sup>

Since neither of these preemption issues had yet been adjudicated, however, the court held as follows:

Because there has yet to be an occasion for a decision defining the vitality and scope of the MPUC's jurisdiction in the context of [debtor's] reorganization, and because MPUC has state law regulatory authority over electric utilities, including [debtor], it is appropriate that the MPUC be permitted to be heard in hearings to consider disclosure statements and proposed plans of reorganization.<sup>26</sup>

Thus, even where a regulatory agency does not have specific authority within the reorganization case which would justify full party in interest status, a court is likely to grant such an agency limited intervention rights based upon the agency's interest in the overall regulatory scheme.

b. Ratepayer groups

Various ratepayer groups also may wish to participate in the reorganization proceedings of a public utility. Interested groups might include consumer groups, public advocates, industry associations, etc.<sup>27</sup> The arguments for

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25 121 Bankr. at 923-24.

26 121 Bankr. at 924.

27 These types of groups are often very active and are almost always present at various PUC hearings. As such, they are quite likely to demand the right to participate in a utility's bankruptcy proceedings.

granting party-in-interest status or intervention rights to such groups are much weaker than for the regulatory agencies.<sup>28</sup>

While clearly interested in the outcome of the utility's reorganization proceedings, ratepayers perhaps lack a strong enough investment in the utility to warrant an independent and unfettered voice in the reorganization. The reorganization process is more concerned with a fair and efficient adjudication of creditor and investor rights in a financially troubled company than it is with the rights of the customers for the debtors' services. . . . In the final analysis . . . ratepayers are primarily concerned with rates, and . . . the bankruptcy court should normally defer to the PUC's jurisdiction in respect of rate-related matters. Therefore, the PUC is probably a more appropriate forum for ratepayer concerns than is the bankruptcy court.<sup>29</sup>

Nonetheless, in both PSNH and Eastern Maine Elec. Coop., the courts granted intervention rights to ratepayer groups. In PSNH, both the state consumer advocate and an industry association were granted limited intervention rights to aid the court by providing expert evaluations of reorganization proposals. In Eastern Maine Elec. Coop., the Maine Public

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28 Note that Federal Rule of Bankruptcy Procedure 2018(b) provides that the Attorney General of a State may be granted limited intervention rights to represent consumer creditors where such intervention is in the public interest. No such provision applies to other entities that purport to protect the public interest. Where such intervention is permitted, a court might determine that the public interest is adequately served by the presence of the Attorney General, such that the participation of any other consumer groups will be deemed unnecessary.

29 Flaschen and Reilly, supra, at 140-41.

Advocate was similarly granted limited intervention rights in the cooperative's reorganization case.

Thus, while in theory ratepayer groups are not true parties in interest, a court is unlikely to deny those groups the right to be heard and to otherwise participate in a limited way. In a large, complex case, the marginal cost of allowing such limited intervention probably is not significant.<sup>30</sup>

**B. EFFECT OF 28 U.S.C. § 959**

The preemptive effects of the Bankruptcy Code with respect to the contents of a chapter 11 plan are discussed in part IV below. With respect to the operation of a business while in a chapter 11 case, section 959(b) of title 28 of the United States Code governs, providing as follows:

[A] trustee, receiver or manager appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.<sup>31</sup>

Thus, "a debtor in possession is not pro tanto excused by virtue of its bankruptcy from complying with valid and

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<sup>30</sup> The court in Eastern Maine also expressly held that since the PUC and the public advocate were not parties in interest, their costs, fees and expenses would not be reimbursed as expenses of administration of the case.

<sup>31</sup> 28 U.S.C. § 959(b).



enforceable state and local regulation. By virtue of 28 U.S.C. § 959(b), it is required to obey them."<sup>32</sup>

Section 959(b) appears to require that a utility abide by all valid state regulations regarding the operation of the utility existing at the time the bankruptcy petition was filed. Such regulations include existing rate structures. Thus, while the automatic stay might prevent a regulatory agency from changing rates during the chapter 11 case (see automatic stay discussion below), section 959(b) appears to require a utility to abide by the regulated rates in effect at the time of filing throughout the pendency of the case.

**C. CUSTOMER ISSUES: PAYMENT OF PREPETITION CLAIMS**

**1. TYPES OF CUSTOMER CLAIMS**

Public utilities, especially electric or energy utilities, engage in a number of different kinds of transactions with customers. For example, electric utilities will often require security deposits from both residential and commercial customers. Electric utilities will also often require prepayments for line extension work, underground service work and interconnection services. Finally, customers of electric utilities will often be owed credits to their accounts for service interruptions, prior overestimates of service charges, etc. These types of items are an ordinary part of a utility's

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<sup>32</sup> Beker Indus. Corp. v. Florida Land and Water Adjudicatory Comm. (In re Beker Indus. Corp.), 57 Bankr. 611, 624 (Bankr. S.D.N.Y. 1986).

ongoing business. Such items can become problematic, however, when a utility files for bankruptcy.

2. TREATMENT OF CLAIMS WHILE IN CHAPTER 11

Security deposits, prepayments and credits due to customers existing at the time of the utility's filing are all prepetition items. The typical recourse for prepetition creditors would be to file their claims in the utility's bankruptcy case and take their place as unsecured creditors.<sup>33</sup> Treating each individual customer of a utility as an unsecured creditor could, however, create an administrative nightmare in a bankruptcy case of a utility serving a large number of customers. An alternative treatment for these types of items is to allow the utility to treat them as if the filing had never taken place.

In PSNH, the debtor utility was essentially allowed to treat security deposits and prepayments as ongoing, ordinary course items. The court allowed PSNH to refund or credit those prepetition commercial and residential security deposits it would have been required to refund or credit in the ordinary course of

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<sup>33</sup> Section 507(a)(6) of title 11 provides priority status for "allowed unsecured claims of individuals, to the extent of \$900 for each such individual, arising from the deposit, before the commencement of the case, of money in connection with the purchase, lease or rental of property, or the purchase of services, for the personal, family or household use of such individuals, that were not delivered or provided." Thus, if treated as prepetition claims, consumer security deposits paid to a utility will at least be entitled to priority to the extent of \$900. However, see the discussion following for an alternative treatment of utility security deposits.

business absent the bankruptcy filing.<sup>34</sup> Moreover, with respect to prepayments for line extension and underground service work and interconnection services, PSNH was allowed to refund overpayments or perform work to the extent of the prepayments in the ordinary course of business (i.e., as such refund or work would have come due absent the bankruptcy filing).

Thus, PSNH treated these items just as it would had there been no bankruptcy case. The PSNH court based its decision in large part on the volume of such claims and the nature of the services provided, asserting that customers had nowhere to turn for alternative service, were required to provide deposits or prepayments to obtain electrical service, etc. Whether this reasoning will still remain valid as alternative energy sources are developed, thereby eroding the monopoly position of public utilities, remains to be seen.<sup>35</sup>

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34 In re Pub. Serv. Co., 107 Bankr. 441 (Bankr. D.N.H. 1989).

35 Prepetition claims have received similar treatment in a variety of other contexts. "Cases have permitted unequal treatment of pre-petition debts when necessary for rehabilitation, in such contexts as (i) pre-petition wages to key employees; (ii) hospital malpractice premiums incurred prior to filing; (iii) debts to providers of unique and irreplaceable supplies; and (iv) peripheral benefits under labor contracts." Burchinal v. Central Washington Bank (In re Adams Apple, Inc.), 829 F.2d 1484, 1490 (9th Cir. 1987). Other courts, however, have refused to follow this flexible approach. "The Bankruptcy Code does not permit a distribution to unsecured creditors in a Chapter 11 proceeding except under and pursuant to a plan of reorganization that has been properly presented and approved. . . . The clear language of these statutes, as well as the Bankruptcy Rules applicable thereto, does not authorize the payment in part or in full, or the advance of monies to or for the benefit of unsecured claimants prior to  
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#### D. EFFECT OF THE AUTOMATIC STAY ON RATE-SETTING

An intriguing question arises as to rate-setting during a Chapter 11 case, i.e., post-filing but pre-confirmation. It seems clear that the regulatory agencies have rate-setting authority both outside of bankruptcy and under a plan of reorganization (see discussion of section 1129(a)(6) in part IV below). Whether this authority continues, however, while a utility a debtor during a chapter 11 case is less clear.

Section 541(a)(1) of the Code defines property of the estate as "all legal or equitable interests of the debtor in property as of the commencement of the case."<sup>35</sup> Public utilities generally are authorized to provide services by state tariffs empowering them to do so. A state tariff thus grants an electric utility the right to sell electricity within that state. This right to sell electricity is similar to the property right created by the granting of a franchise. If a court were to agree with this analogy, the right to sell electricity might qualify as property of the estate.

If the right to sell electricity is indeed considered to be property of the estate, interesting questions arise regarding the applicability of the automatic stay. The automatic

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the approval of the plan of reorganization." Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987) cert. denied, 485 U.S. 962 (1988); see also In re Air Beds, Inc., 92 Bankr. 419, 422 (Bankr. 9th Cir. 1988); In re Conroe Forge & Mfg. Corp., 82 Bankr. 781, 784 (Bankr. W.D. Pa. 1988).

36 11 U.S.C. § 541(a)(1).

stay is designed to protect the estate from a "race to the courthouse" by creditors by staying most actions to recover prepetition claims against the debtor. Among the actions stayed is "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate."<sup>37</sup> A regulatory agency's attempts to change the rates (by altering the tariff) of a utility within a chapter 11 case might be construed as an act to exercise control over property of the estate, and as such would be stayed by section 362(a)(3).<sup>38</sup> A regulatory agency's attempts to revoke a utility's right to sell electricity might likewise be stayed.<sup>39</sup>

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37 11 U.S.C. § 362(a)(3) (emphasis added).

38 The police or regulatory exceptions to the automatic stay contained in sections 362(b)(4) and (5) do not apply to the stay imposed by section 362(a)(3), but rather apply only to the stay imposed by 362(a)(1)-(2). In PSNH, the court preliminarily enjoined the PUC from proceeding with an involuntary rate case, but not on the basis of the automatic stay. Rather, the court there reasoned that the rate case would interfere with the utility's reorganization efforts by diverting time and energy of PSNH personnel away from the reorganization. The court therefore invoked section 105(a) of the Code, which provides that "the court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a). Pub. Serv. Co. v. New Hampshire (In re Pub. Serv. Co.), 98 Bankr. 120, 124 (Bankr. D.N.H. 1989).

39 If attempts to revoke the right to sell electricity are not stayed by 362(a)(3), such revocation may be disallowed under other sections of the Code. Section 525(a) provides that "a governmental unit may not deny, revoke, suspend, or refuse to renew a license, permit, charter, franchise, or other similar grant to . . . a person that is or has been a debtor under this title . . . solely because such bankrupt or debtor is or has been a debtor under this title . . . ." 11 U.S.C. § 525(a). Thus, section 525(a) will protect a utility from revocation of its right to sell electricity if  
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The fact that the automatic stay may bar a regulatory agency from changing a utility's rates does not mean, however, that the utility can unilaterally set its rates during the chapter 11 case. Rather, as discussed above, section 959(b) of title 28 of the United States Code would require that the utility comply with the tariff in effect at the time of the filing of the petition. Indeed, under the state tariff, the utility will have no power to sell electricity at any rates other than those set forth by the tariff.

#### IV.

#### IMPACT OF THE REGULATORY ENVIRONMENT ON THE CHAPTER 11 PLAN OF REORGANIZATION

The preceding discussion examined the effect of the regulatory environment on a public utility during the chapter 11 case, i.e., after the filing of a bankruptcy petition and before confirmation of a plan of reorganization. The following discussion focuses on what a utility may provide in a plan of reorganization. The plan of reorganization defines the utility's rights and obligations post-bankruptcy which, upon restructuring, are expected to allow it to emerge successfully from chapter 11. The Code sections discussed below set the limits within which a utility must act in formulating a plan of reorganization.

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39(...continued)

the regulatory agency seeking revocation does so solely because the utility has filed for bankruptcy protection.

#### A. RATE-SETTING UNDER A PLAN

Outside of bankruptcy, utility rate-setting usually falls directly under the jurisdiction of a state commission. In the case of electric or energy utilities, rate-setting authority lies with either state PUC's or the FERC. The Bankruptcy Code recognizes that rate-setting falls squarely within the domain of such regulatory agencies and thus conditions confirmation of any plan on the agencies' approval of any rate changes proposed in the plan. A court may confirm a plan only if "any governmental regulatory commission with jurisdiction, after confirmation of the plan, over the rates of the debtor has approved any rate change provided for in the plan, or such rate change is expressly conditioned on such approval."<sup>40</sup>

Section 1129(a)(6) clearly preserves regulatory agencies' rate-setting authority under a plan of reorganization. Additionally, utilities likely are bound to abide by rate-setting regulations during the chapter 11 case based on section 959(b) of title 28 of the United States Code (see discussion above). Thus, only if the automatic stay bars the agency from changing rates during the Chapter 11 case (see preceding discussion on the effect of the automatic stay in this context) would a regulatory agency's rate-setting authority be abrogated during the course of a utility's bankruptcy case.

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<sup>40</sup> 11 U.S.C. § 1129(a)(6).

**B. PREEMPTIVE EFFECT OF § 1123(a)(5)**

Outside of bankruptcy, regulatory agencies may control not only rate-setting by a regulated utility, but also other activities such as the issuance of securities by investor-owned utilities and the transfer of utility assets. As discussed above, section 1129(a)(6) expressly preserves regulatory jurisdiction over rate-setting under a reorganization plan. However, section 1123(a)(5) of the Code appears to preempt regulatory jurisdiction over a broad range of other activities in the context of a plan of reorganization.

Section 1123(a)(5) explicitly states that:

Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall provide adequate means for the plan's implementation, such as --

. . . .

(B) transfer of all or any part of the property of the estate to one or more entities, whether organized before or after the confirmation of such plan;

(C) merger or consolidation of the debtor with one or more persons;

(D) sale of all or any part of the property of the estate . . . or the distribution of all or any part of the property of the estate among those having an interest in such property of the estate;

. . . .

(H) extension of a maturity date or a change in an interest rate or other term of outstanding securities;

. . . .



(J) issuance of securities of the debtor . . . for cash, for property, for existing securities, or in exchange for claims or interests, or for any other appropriate purpose.<sup>41</sup>

Thus, section 1123(a)(5) appears expressly to preempt any regulatory power to control such activities where they are provided in a plan of reorganization. Indeed, the court in PSNH held that section 1123(a)(5) preempted New Hampshire state law requirements for regulatory approval of any utility restructuring; the court found that preemption was justified under the standards of both express preemption and implied preemption.<sup>42</sup>

The PSNH court reasoned that the existence of section 1129(a)(6) and the failure of the Code drafters to carry over sections 177 and 178 of the Bankruptcy Act (requiring regulatory approval of the entire plan) makes it clear that Congress intended that only rate-setting provisions in a plan be subject to regulatory approval. The court's holding was also based on its application of the plain meaning rule to section 1123(a)(5) and the doctrine of preemption in general. Furthermore, the court found that its holding provided a reasonable resolution of the issue, because to rule to the contrary would be to grant regulatory agencies almost total veto power over any plan of reorganization proposed by a utility.<sup>43</sup>

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41 11 U.S.C. § 1123(a)(5) (emphasis added).

42 In re PSNH, 108 Bankr. at 881-85.

43 108 Bankr. at 891.

V.

VALUATION OF UTILITY ASSETS

Valuation of a business (or its assets) in chapter 11 may serve a number of different purposes, each of which may require a different method of valuation.<sup>44</sup> The valuation of encumbered assets is required to determine the extent to which claims secured by those assets are secured claims.<sup>45</sup> The calculation of a liquidation value of a debtor business is often necessary to determine whether the "best interests" test of section 1129(a)(7)(A)(ii) is met.<sup>46</sup> Finally, a going concern reorganization valuation may be required to determine whether a chapter 11 plan meets the requirements of section 1129(b) regarding the "cram down" of a plan on a nonconsenting class of creditors.<sup>47</sup> Of these different methods of valuation, the going concern reorganization value and the liquidation value of an

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44 11 U.S.C. § 506(a) ("Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property . . . .").

45 11 U.S.C. § 506(a). See Bankruptcy Rule 3012.

46 Section 1129(a)(7)(A)(ii) provides that a chapter 11 plan may not be confirmed unless each member of an impaired class "will receive or retain under the plan on account of such claim . . . property of a value . . . that is not less than the amount that such holder would receive or retain if the debtor were liquidated under chapter 7."

47 Pachulski, "The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code," 58 N.C.L. Rev. 925 (June 1980); see also Fortgang and Mayer, "Valuation in Bankruptcy," 32 UCLA L. Rev. 1061 (August 1985).

entity are most relevant. Valuation of a public utility under either of these standards is, however, somewhat problematic.

**A. GOING-CONCERN VALUE: DISCOUNTED CASH FLOW METHODS**

Perhaps the most common method of valuing a business entity as a going concern is to use a discounted cash flow approach. This approach estimates future cash flows expected to be realized by the business, which cash flows are then discounted to a present value using an appropriate estimate of the business' blended cost of capital. Clearly the keys to such a valuation are an accurate forecast of future cash flows and a sound estimate of the cost of capital. The accuracy of such a valuation of any business entity depends upon the accuracy of these estimates. In addition to normal estimation problems, however, the valuation of a public utility using a discounted cash flow approach presents additional problems unique to regulated industries.

1. FORECASTING FUTURE RATES

The ability to forecast the future rates of a utility is critical to calculating a going concern value, because such rates will determine a significant portion of a utility's estimated future cash flows. The forecasting of future rates will obviously take place against the backdrop of the regulatory rate-setting process. Regulatory rate-setting is designed to assure that reasonable rates are charged to customers while also

providing the utility with an acceptable rate of return on its investment in certain utility assets (the "rate base"). Thus, the rates charged to customers consist of two components: (1) a charge designed to cover the operating costs of the utility (including depreciation), and (2) an amount representing a specified rate of return on the utility's rate base.<sup>48</sup>

Future operating costs can be estimated fairly accurately based on past operating costs. Estimating the rate of return component is more problematic, because the rate-setting authority has a fair amount of discretion in determining both the rate of return it will allow a utility to earn and the assets which the utility can include in its rate base. Estimating the rate of return that a regulatory agency will allow is simply a matter of guessing what that agency will use as a benchmark in setting the rate. Past history, current interest rates and earnings on any comparable investments may be indicators of the range of rates within which a regulatory agency will likely set the appropriate rate of return.

Determining the rate base on which that rate of return will be allowed involves a similar estimation process. For an asset to be included in the rate base, the rate-setting authority must find (1) that the investment in that asset was "prudent,"

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<sup>48</sup> See generally Appeal of Conservation Law Foundation, 127 N.H. 606 (1986) (where New Hampshire Supreme Court upheld PUC order authorizing PSNH to issue and sell certain bonds; the court's opinion includes a discussion of the rate-making process in the context of determining the reasonableness of the rates that would result from the construction of additional capacity to be financed by the bond issue).

and (2) that the asset is "used and useful" in the operations of the utility. Thus, a utility's rate base consists of all prudently obtained, used and useful assets valued at net book value (cost less depreciation). Estimating future rates thereby requires an estimation of which assets the regulatory agency will include in the rate base as prudent, used and useful investments.<sup>49</sup>

In practicality, these estimation problems may be most easily surmounted through a negotiated rate settlement. A debtor utility and its rate-setting authority are likely to agree upon some acceptable range of future rates and/or some acceptable range of values within which the rate base falls. The parties can then negotiate within these ranges to reach a mutually acceptable valuation of the utility. Nonetheless, these estimation problems do exist and can complicate attempts to formulate a reorganization value for a utility as a going concern.

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49 The problem of estimating the level of rate base assets can be particularly difficult where, as in PSNH, the utility has made significant expenditures towards a major new facility (e.g. a nuclear power plant) which is not yet completed. In such a case, the utility has made a very large investment in assets which are not yet "used and useful," and it may be difficult to estimate how much, if any, of the investment the rate-setting authority will ultimately include in the rate base. This process is further complicated in the case of a nuclear power plant because the local political pressure against such a plant may be strong enough to significantly delay or even completely prevent such a plant from going on-line even after construction is complete.

## 2. ESTIMATING COST OF CAPITAL

A second problem associated with valuing a public utility using a discounted cash flow method is the selection of an appropriate cost of capital for the utility to use as the discount rate to bring future cash flows back to present value.<sup>50</sup> The discount rate should represent the entity's weighted average cost of capital. The calculation of a weighted average cost of capital involves three variables: (1) the weighting factors (which are determined by the capital structure of the entity), (2) the cost of the entity's equity, and (3) the cost of the entity's debt.

The weighting factors to be used in determining an entity's blended rate will be determined by the entity's capital structure. Outside of bankruptcy, regulatory agencies will play a large role in determining a utility's capital structure, because the agencies have control over a utility's financing activities. Under a chapter 11 plan, however, section 1123(a)(5) preempts regulatory jurisdiction over the issuance of debt and securities (see preemption discussion in part IV above). The provisions of the chapter 11 plan will thereby determine the capital structure of the reorganized utility. This reorganized capital structure should thus be the basis for weighting the costs of debt and equity to arrive at a blended rate.

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50 A utility's cost of capital is also important in the determination of the reasonable rate of return to be allowed on the utility's rate base. The weighted average (or blended) cost of capital can serve as a benchmark for the PUC when deciding upon a reasonable rate of return.

The cost of equity for a regulated utility is somewhat artificial. For a non-regulated business, the cost of equity represents the return that stockholders require from that entity's stock. For a regulated utility, the cost of equity incorporated into the cost of capital calculation represents a rate chosen by the PUC as a theoretical cost of capital based on expert opinion. The cost of equity figure is subject to manipulation by the PUC in order to obtain a blended rate which corresponds to an appropriate rate of return allowed by the PUC.

Calculating the cost of debt for a utility outside of bankruptcy is not terribly difficult. The cost of debt will represent a weighted average rate of all outstanding debt instruments issued by the utility. For a utility undergoing reorganization, however, the cost of debt calculation is more problematic. The rates at which a reorganizing utility will be able to borrow will depend on at least two factors: (1) the capital structure of the reorganized entity (i.e. how much debt will the utility be carrying), and (2) the ability of the utility to generate cash to service its debt load (which will be dependent upon the level of future rates). While the capital structure of the reorganized utility will be set by the provisions in the plan (see discussion above), the level of future rates will be subject to PUC approval. Thus, the cost of debt cannot be calculated until the level of future rates is set. Once again, this situation will be surmountable through a negotiated rate settlement between the rate-setting authority and

the utility. Without such a settlement, attempts to calculate the cost of debt (and therefrom the cost of capital) will be circular.

#### **B. LIQUIDATION VALUE**

The "best interests" test of section 1129(a)(7)(A)(ii) essentially provides that, for a plan to be confirmed, impaired creditors must receive at least as much under that plan as they would receive if the business were liquidated rather than reorganized. Part of the "best interests" analysis, then, is the calculation of a liquidation value for the debtor's assets in order to determine how much money would be available for creditors under a liquidation scenario.

While going concern value represents the potential future earnings to be generated by a reorganized business, liquidation value contemplates the amount of funds that could be realized by the immediate sale of the individual assets of the debtor's business. While most of the assets of many types of businesses can probably be sold on some sort of a liquidation market, the same is not necessarily true of the assets of a public utility. For example, if an energy-producing utility operates a nuclear reactor, what is the liquidation value of that reactor? Does a market exist that will assign a monetary value to a nuclear power plant? If no such market exists, what is the liquidation value of that asset?

Energy-producing utilities are illustrative of the liquidation value problem. A limited market does exist for



assets related to the generation and transmission of electrical power. Utilities have purchased and sold generation and transmission facilities to one another. While the market for such assets is a limited one, market information is probably sufficient to assign some sort of liquidation value to generation and transmission assets. However, such utilities also have investments in the distribution systems whereby electricity is "delivered" to the utility's customers. Since no real market for these distribution channels exists, is the liquidation value of these assets zero, or do we assign some arbitrary number?

The problem of attempting to assign a liquidation value to a utility is that it is unlikely that a utility will actually be liquidated. In most instances, utilities provide important or even indispensable services to their customers. It will often be very much in the public interest for the utility to continue to operate. Thus, liquidation of such a utility may simply not be a feasible alternative. Where this is the case, attempts to calculate a liquidation value will be meaningless, because the public interest will dictate that the utility continue to operate regardless of the "best interests" test.