Legal

by Richard Lorenz

# Simple steps to protect your utility if your power supplier is headed for bankruptcy

In the November *Bulletin*, author Chad Stokes explored the topic of a utility's legal rights under the United States Bankruptcy Code in the event that a retail utility customer files for bankruptcy protection. Stokes explained how Section 362 of the Bankruptcy Code creates am "automatic stay" that protects the debtor's assets from certain debt collection efforts. He also described the utilities rights under Section 366, which includes the right to request adequate assurance that the customer will continue to pay for utility service following a bankruptcy. (For further information on this topic, please read "Your utility customer goes bankrupt — now what?" in the November issue of the *Bulletin*, pp 15-16.)

Building on that important discussion, this article focuses on a utility's legal rights in the event that a wholesale power supplier or purchaser files for bankruptcy protection. As many NWPPA members have learned over the past decade, bankruptcies by power marketers, suppliers, and purchasers are not uncommon. The following major energy companies have all recently been through the bankruptcy process: Enron, Mirant, Calpine, Pacific Gas & Electric, NRG Energy, and US Generation of New England Inc. Other major energy companies that have teetered on the precipice of bankruptcy include Southern California Edison, AES, and the Williams Companies. This article will describe a couple of simple steps that utilities can take to protect themselves.

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## Include both adequate remedies and security provisions in the PPA

The first step is to include appropriate remedy and security provisions to ensure that any financial damages can be recovered regardless of a bankruptcy. The security provisions should identify an independent and solvent party that will be responsible for meeting the counterparty's financial obligations in the event of a payment default. Over-the-counter security instruments are available from a wide variety of financial institutions in the form of letters of credits and security bonds. Counterparties can also be asked to post security in the form of escrowed cash or performance guarantees from parent companies that have a favorable credit rating. Whatever the form, utilities should insist that security instruments are irrevocable and payable upon demand of the beneficiary. The failure to provide security when due should be treated as a breach of the PPA.

While negotiating for a security instrument is essential, it is also important to ensure that the security matches the remedy provisions of the contract. The remedy provisions should be crafted so as to limit the total amount of money that the counterparty can owe the utility at any given time, and the security amount should be sufficient to cover that amount. Where there is a gap between remedies and security, the utility essentially has no security.

While counterparties typically balk at providing security instruments on grounds that it adds costs to the transaction, these additional costs are more than justified should the security ever be needed.

## Get out before the bankruptcy happens

The second point is to negotiate for the right to terminate or exit the contract at the first sign of financial distress before the counterparty files for bankruptcy. While utilities are typically prohibited by operation of the automatic stay from terminating a contract after a bankruptcy petition has been filed (absent the applicability of safe harbor provisions or leave from the court), there is generally not a prohibition against a legitimate pre-petition termination.

This can be achieved by including within the definition of "default" certain pre-bankruptcy events that indicate that the counterparty is likely headed for bankruptcy. This could include, for example, a "cross-default" provision pursuant to which the counterparty is in default of the PPA in the event that it is declared to be in default of a material performance or payment obligation under any other contract. This can also include a "credit downgrade event" where the counterparty's credit rating is downgraded by a rating agency. Another example is an "adverse credit event" even if it does not result directly in a credit downgrade. Because these rights require that the utility be in possession of information concerning the counterparties' financial condition, it should be paired with the right to request assurances of the ability to perform any reasonable audit rights.

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### Specifically represent that the parties are "forward contract merchants"

It may also be helpful for a utility to establish its status as a "forward contract merchant." Section 556 of the Bankruptcy Code establishes a "safe harbor" from the automatic stay provisions for forward contract merchants that allows them to exercise certain termination and set-off rights. This puts the utility in a substantially favorable position as compared to other creditors because it can both eliminate incurring additional post-petition losses and it can actually withhold payment of an obligation to the debtor to the extent that the obligation is offset by a payment owed by the debtor to the creditor.

Power contracts are typically viewed as "forward contracts" that may be eligible for the forward contract merchant safe harbor. Many parties make affirmative representations that their PPA is a "forward contract" and that the parties each are "forward contract merchants." Notwithstanding this representation, there are legal questions as to whether a consumer of a commodity purchased pursuant to a forward contract qualifies as a "merchant" in forward contracts. This requires a fact-specific analysis that differs on a case-by-case basis.

It should be noted that governmental entities are now clearly eligible to be forward contract merchants for purposes of the Bankruptcy Code. The Code used to define "forward contract merchants" as "persons." The term "person" was defined, in turn, so as to exclude governmental entities. This created substantial uncertainty as to whether consumer-owned utilities were protected by this particular safe harbor. This confusion was eliminated, however, by the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*. Among other things, this act amended the definition of forward contract merchant so that it is now available to certain "entities," as opposed to "persons." The term "entity" is defined so as to specifically include governmental units.

*Our general advice is to both limit and secure payment obligations, take steps to avoid the bankruptcy altogether, and take advantages of safe harbors that may be available under the Bankruptcy Code.*

In summary, there are certain practical steps that a utility can take in negotiating and drafting PPAs, whether acting as a buyer or a seller, to mitigate the risk associated with counterparty bankruptcy. As with most things, an ounce of prevention is worth more that a pound of cure. Our general advice is to both limit and secure payment obligations, take steps to avoid the bankruptcy altogether, and take advantages of safe harbors that may be available under the Bankruptcy Code. NWPPA

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