

**TELECOM BANKRUPTCIES:  
SWIMMING AGAINST A TIDAL WAVE**

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## I. INTRODUCTION

“The news from the telecom industry will remain unrelentingly negative until a cyclical upturn is in sight possibly not until 2003. In the interim the telecommunications sector will be entering a build-buy or be bought phase where consolidation, restructuring and more than a few bankruptcies can be expected.”<sup>1</sup>

The problems of the telecom industry are driving more and more of its constituents into bankruptcy court. And, they are not coming in willingly, but kicking and screaming and more than a little too late to be reorganized. A telecom bankruptcy is likely to be a quick sale or an even quicker sale scenario with many, many operational issues along the way. More than a few telecom companies have filed chapter 11 only to convert or dismiss only a few months later. The successes are small in scope and far between.

This paper is intended to provide some of the historical backdrop behind the recent evolution of the telecommunications industry and some of the bankruptcy issues that are both prevalent in and unique to telecom bankruptcies. But perhaps the most important lesson learned from telecom and high tech bankruptcies generally, is that cash flow is hugely negative and, with all lifelines extinguished, the runway is extremely short. If the company has enough foresight to come in with a even few months of cash left, it is a good day.

## II. WHAT IS THE TELECOMMUNICATIONS INDUSTRY?

The telecommunications industry can be divided into telecom service providers (such as Qwest and WorldCom) and telecom equipment manufacturers (such as Cisco and Lucent). Although both aspects have been experiencing enormous downturns, this paper focuses on issues unique to a telecom service provider bankruptcy. Although some of the issues are common to both a telecom service provider and a telecom equipment manufacturer, a telecom equipment

manufacturer's reorganization will be generally the same as any other manufacturer. Further, there is a greater proliferation of telecom service providers as a result of the “Internet bubble” and more likelihood that one will wander into your office one day.

Within the framework of telecom service providers, there are three general categories: “Incumbent Local Exchange Carriers” or “ILECs,” “Competitive Local Exchange Carriers,” or “CLECs,” and “competitive emerging backbone carriers” (which apparently do not warrant an acronym and so will be called “New Networks”).

**ILECs:** There are over 1,000 ILECs. Tier-three carriers, the smallest category, have 50,000 lines or less and provide service only in rural areas. The Big Three ILECs are BellSouth, SBC, and Verizon. The big three long-distance carriers, AT&T, Sprint, and WorldCom are also ILECs. Other major ILECs include Broadwing, CenturyTel, and Qwest.

**CLECs:** There are currently 22 or so CLECs - 30 public companies and 191 private companies. They have 7% market share (\$8.4 billion in revenue) of the local telecom market of \$120 billion. Although total CLEC revenues are expected to grow, analysts predict that as a result of the industry shakeout many of the smaller players will be eliminated. Only 2-3 national CLECs and 2-3 regionally focused CLECs will survive. *Crossroads Telecommunications Sector Report*, July 2001, p. 5 (hereinafter “*Crossroads Report*”). Sixty percent of the CLECs' market share is devoted to mid-sized to large businesses, institutional and government customers. However, companies are reducing overall information technology spending resulting in lower overall revenues for the telecom industry.

**New Networks:** New Networks focus on building networks based on newer and newer technology to sell to companies' and individuals' needs and expectations for faster and faster information. Although “backbone” companies are building new networks, they also can act like CLECs by camping onto ILEC and other networks that are compatible with their technology and customer needs.

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<sup>1</sup>A *Sector Report: Telecommunications*, Crossroads, LLC, July 2001, p. 1.

Most New Networks focus on performance measured by speed or combinations of voice and data. The most significant area of growth is network speed through increased bandwidth. *Broadband* is data transmission at a high rate, generally greater than T1 speeds. This allows the transmission of voice, data and video signals over a single medium. The competing wire-line broadband alternatives include DSL, cable, and fiber.

*DSL (Digital Subscriber Line)* is a broadband solution that telecom service providers are offering over traditional phone lines. The advantage of DSL is that deployment costs are reasonable and customers have dedicated, not shared bandwidth. However, DSL has one major drawback. Due to power limitations on the copper infrastructure, homes 3 miles or more away from the central office ("CO") cannot receive high speed DSL service. While there appears to be much interest in broadband, only 3% of the nation's homes are wired to get it.

*Cable Modems*, an always-on Internet access solution, has one major drawback: shared bandwidth. Cable subscribers within a particular area must compete for the same bandwidth, reducing actual modem speed.

*Fiber Optic Cable* uses glass or plastic fibers, rather than copper, to transport data or voice signals. Because of its high bandwidth and lack of susceptibility to interference, fiber-optic is used in long-haul applications.

To understand how the telecom industry evolved to this point, it is necessary to understand the Telecommunications Act of 1996 and its history.

### III. THE TELECOMMUNICATIONS REFORM ACT OF 1996

Prior to the aegis of the Telecommunications Reform Act of 1996, 110 Stat. 56 (1996), Pub. L. No. 104-104, codified at 47 U.S.C. § 151 *et seq.* (hereinafter the "TCA") telephone service was provided by regulated monopolies (or ILEC's), in part because "[s]tate and federal regulators devoted their efforts over many decades to regulating the prices and practices of these

monopolies and protecting them against competitive entry." First Report & Order, *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, ¶ 1 (FCC Aug. 8, 1996) ("*Local Competition Order*"). As regulated monopolies, ILECs (such as Southwestern Bell or GTE) built local telephone networks in their service areas, and exercised exclusive control over the facilities through which consumers place and receive all local and long-distance telephone calls.<sup>2</sup> Although inter-state competition had become a reality, local competition remained stagnated as a result of the monopolies' incumbency. This paradigm changed as a result of the TCA which sought to compel ILEC's to open up their networks to competition, thus begetting the *competitive* local exchange carrier, or CLEC.

The TCA, which created a new subchapter of the Communications Act of 1934, stripped away many of the legal and economic impediments to all forms of local entry so that consumers could enjoy the myriad benefits of competition, including lower prices, higher quality, and greater choices. See *Local Competition Order* ¶ 3 (identifying "opening the local exchange and exchange access markets to competitive entry" as one of the "principal goals" of the TCA).

Congress recognized that even if the legal protections of monopoly were removed, an ILEC's established local telephone network serving nearly every customer in its region gave it a formidable advantage over new entrants. *Local Competition Order* ¶ 10; H.R. Rep. No. 104-204, at 74. This local telephone network begins with "local loops" -- the cables strung on telephone poles or buried under ground -- that connect each telephone subscriber in an ILEC's service area to local or "central-office" switches, which route calls or "traffic" along the network and provide a number of other features, such as call waiting and call forwarding. These switches, in turn, are connected

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<sup>2</sup>See Memorandum Op. & Order, *In re Application of Ameritech Mich.* Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide In-Region, InterLATA Services In Mich., CC Docket No. 97-137, ¶ 12 (FCC Aug. 19, 1997) ("*Ameritech Order*").

to each other through “trunks” and other transport facilities. These and other facilities are integrated by various computer systems and databases that support network operations, the provision of services connections to the facilities of other telecommunications carriers, and the business side of offering telecommunications services (such as billing, marketing, and collection).

No new entrant could effectively compete with an ILEC if it had to install its own loops, switches, trunks, and computer system before it could even provide service. *See* Joint Explanatory Statement of the Committee of Conference, H.R. Rep. No. 104-458, at 148 (1996); *Ameritech Order* ¶ 12; *Local Competition Order* ¶ 10. After all, the ILECs had the advantage of having all of their investments in their networks funded through traditional ratemaking on the backs of captive consumers. Further, an ILEC has strong economic incentives to resist competition and would use its exclusive control over local networks “to discourage entry and robust competition by not interconnecting its network with the new entrant’s network or by insisting on anti-competitive prices or other unreasonable conditions for terminating calls from the entrant’s customers to the ILEC’s subscribers.” *Id.*

Competition would be possible in local markets, Congress realized, only if (1) ILECs were legally required to open their networks to new entrants, allowing them to share in the economies of “density, connectivity, and scale” of the established network, *Local Competition Order* ¶ 11, and if (2) competitors had maximum strategic flexibility to use that network to respond to market conditions. *Id.* ¶ 12. “In the 1996 TCA, Congress sought to hasten the development of competition in local telecommunications markets by including provisions to ensure that new entrants would be able to choose among three entry strategies -- construction of new facilities, the use of unbundled elements of an incumbent’s network, and resale.” *Ameritech Order* ¶ 332; *accord Iowa Utils. Bd. v. FCC*, 120 F.3d 753, 816-17 (8th Cir. 1997). To ensure that each of those strategies would be viable, Congress imposed specific obligations on ILECs in section 251 of the TCA, and developed specific pricing regimes appropriate to each strategy in section 252.

### A. Facilities-Based Competition

Competitors pursuing the first strategy authorized by Congress would build their own network facilities (or convert an existing utility or cable television network) to compete directly with the ILEC. *See Local Competition Order* ¶¶ 13, 26. To ensure that the new entrant’s customers would be able to place calls to anyone else in the ILEC’s service area, without diminished quality or efficiency of service, section 251(c)(2) of the TCA imposes on ILECs the duty to permit other telecommunication carriers to “interconnect” with the incumbent’s network “at any technically feasible point” in a manner that is “at least equal in quality” to that the incumbent provides to itself on “rates, terms, and conditions that are just, reasonable, and nondiscriminatory.” § 251(c)(2).

Given that “the amount of time and capital investment involved in the construction of a complete local stand-beside telecommunications network are substantial barriers to entry,” Congress recognized that full-fledged facilities-based competition would take a long time to develop, *Iowa Utils. Bd.*, 120 F.3d at 816, and might not develop at all in certain markets, *Local Competition Order* ¶ 232. Congress thus authorized the other two entry strategies -- use of unbundled network elements and resale -- “to expedite the introduction of pervasive competition into the local telecommunications [market],” *Iowa Utils. Bd.*, 120 F.3d at 816, by enabling new entrants to compete immediately with the ILEC without constructing their own facilities.

## B. Use of Unbundled Network Elements to Provide Telecommunications Services

As a second entry strategy, the TCA authorizes new entrants to purchase access to “elements” of an ILEC’s network (such as the switches, local loops, and other elements described above) at cost-based rates. Because ILECs “have little incentive to provision unbundled elements in a manner that would provide efficient competitors with a meaningful opportunity to compete,” *Local Competition Order* ¶ 307, section 251(c)(3) of the TCA imposes on incumbents “[t]he duty to provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions that are just, reasonable, and nondiscriminatory.” § 251(c)(3). That section further provides that an ILEC “shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service.” *Id.*

Congress recognized that simply requiring ILECs to provide elements would not secure the viability of this entry strategy; it also had to ensure that the rates incumbents charged new entrants for access to unbundled elements would foster direct competition between incumbents and new entrants, and not promote uneconomic decisions to construct new facilities. Thus, in section 252(d)(1) of the TCA, Congress provided that ILECs may only charge prices for unbundled elements, including combinations of unbundled elements, that are just, reasonable, nondiscriminatory, and “based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the . . . network element.” § 252(d)(1). Cost-based rates allow new entrants to share fully in “the incumbents’ economies of scale and scope,” *Local Competition Order* ¶ 232, and thus leveled the playing field for new entrants. “[T]he ability of new entrants to use unbundled network elements, as well as combinations of unbundled network elements, is integral to achieving Congress’ objective of promoting competition in the local telecommunications market.” *Ameritech Order* ¶ 332.

## C. Resale of Retail Services

Congress provided a third independent route for entry into local markets in section 251(c)(4) of the TCA. That section imposes the duty on ILECs “to offer for resale at wholesale rate **any telecommunications service that the carrier provides at retail** to subscribers who are not telecommunications carriers,” and without “unreasonable or discriminatory conditions or limitations.” Because section 251(c)(4) deals with the sale of a limited category of services to new entrants for resale, and not the sale of access to network *elements* as in section 251(c)(3), Congress provided an entirely different pricing regime applicable only to the resale of those services. All resale services are to be priced at a wholesale discount, § 251(c)(4)(A), which is the retail rate the ILEC charges subscribers for the service less “the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.” § 252(d)(3).

## D. Statutory Procedures for Implementing the TCA

Congress established expedited procedures in section 252 of the TCA to implement the requirements of the TCA and the FCC’s regulations thereunder. Congress directed ILECs to “negotiate in good faith” with requesting carriers seeking interconnection, § 251(c)(1), and the parties are free to enter voluntary agreements, subject to the approval of state utility commissions, § 252(e)(2)(A).<sup>3</sup> Incumbents have little incentive to facilitate competition, however, and Congress therefore provided in section 252(b)(1) that any party to such a negotiation “may petition a State commission to arbitrate any open issues.” The TCA authorizes state commissions to arbitrate any “issues set forth in the petition and in the response,” § 252(b)(4)(A), and obligates the state commissions to “resolve each issue set forth in the petition and the

<sup>3</sup>See Memorandum Op. & Order, In re Application of Ameritech Mich. Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide In-Region, InterLATA Services In Mich., CC Docket No. 97-137, ¶ 12 (FCC Aug. 19, 1997)(“Ameritech Order”).

response, if any, by imposing appropriate conditions” in compliance with sections 251 and 252 and the FCC’s implementing regulations, § 252(b)(4)(C), (c)(2).

#### IV. THE CURRENT ECONOMIC OUTLOOK FOR THE TELECOMMUNICATIONS INDUSTRY

The two major influences on the rapid growth and economic structure of the telecommunications industry are the Internet bubble coupled with the implementation of the TCA. First, the telecom industry was part of the Internet stock and growth boom because of the inextricable relationship between telecom and Internet expansion generally. “Between 1998 and 2000, to build the infrastructure and prepare society for the Internet world, telecom service companies borrowed \$320 billion. These debt obligations represent more than 100% of the industry’s current annual revenues.” *Crossroads Telecommunications Sector Report*, July 2001, p.1. But the role of the TCA was even more influential than the Internet on the growth and structure of the industry:

“Most of the industry’s current problems can be traced to overcapacity. Spurred by the [TCA], which pledged to open the historically regulated industry to competition, the telecom industry went on a building binge. By the time the Internet bubble burst, an estimated 39 million miles of fiber-optic cable stretched underneath the U.S. -- only 10% of which is in use today ... .”

R. Blumenstein, G. Zuckerman, *Domino Effect: Telecom’s Troubles Spread from Upstarts to Sector’s Leaders*, Wall Street Journal, March 13, 2002, at A1, A8.

Each of the categories of telecommunications service providers, ILECs, CLECs and New Networks, are experiencing the effects of overcapacity, overspending and low demand. Of the CLEC market share of 12.7 million lines, sixty percent of these lines are provided to mid-sized to large businesses, institutional and government customers. *Crossroads Report*, p. 5. However, most of the telecom’s customers, some of them Internet providers, Internet enterprise, and even

other CLECs, have exhausted their access to capital. Although some expected that elasticity of demand would compensate for price declines with higher volumes, a lower overall market growth has proven this untrue for the short term.

What is even more apparent is that revenues have been generated in large part not from end user customers but through the trading of lines and services between telecom providers themselves, and recent media reports indicate that the accounting of these line switch transactions is coming under great scrutiny for overstating earnings. The result is that when more than a few telecom companies fell into bankruptcy, the domino effect began with greater force now threatening even the larger carriers such as Williams and Qwest. See, e.g. R. Blumenstein, *supra*.

#### V. WHAT YOU NEED TO KNOW ABOUT TELECOM BANKRUPTCIES

All of the above is a long winded way of saying that telecom companies are different from traditional companies and very likely to be good candidates for bankruptcy. A CLEC or New Network company creates its network by putting some routers and other technical stuff in some cages set aside by an ILEC (or another CLEC) and plugging into its network under the terms of a contract the ILEC may not like. The ILEC was compelled to let them do just that at a “market rate” because of the TCA. The arrangement by which ILECs provide CLECs physical access to their networks is known as a collocation agreement or “colo” agreement. A colo agreement can look like a license, a hotel contract or a very, very small real property lease. The bigger the network, the greater the number of collocation agreements and other contracts that will need to be analyzed and categorized for section 365 purposes.

CLECs also contract with ILECs, other CLECs and New Networks for “termination” which is, essentially, putting calls on another companies’ network. The bigger the “footprint” of the network, the larger area that needs to be covered by accessing other providers’ lines. A “POP” or “point of presence” is the ability to service a particular metropolitan area or “local loop” with access to a network, whether owned or

contracted for by the telecom provider. A telecom company will have a large number of collocation and termination agreements that are essential to its ability to continue to service its customers and make money. So, in addition to keeping the lights on and the employees working, the first part of any telecom service provider's reorganization will be dominated by the need to keep the network "lit."

But, during the Internet stock boom, telecom companies were the beneficiaries of the "collective irrationality" of the investment community and attracted huge amounts of capital. Many of the performance targets were set based on revenue without regard to expense. This mindset led to a remarkable phenomenon that may only be discovered by all involved *after* the bankruptcy is filed and the focus turns to cash flow and profits rather than revenues. Here's the interesting part: telecom service providers often buy network capacity (including termination services, colo services and related costs) at rates *higher* than they can sell it for to customers and other CLECs. This amazing fact leads to two immediate issues in the reorganization. A lit network bleeds cash like a sieve. The runway for the reorganization will be bounded by how long available cash or borrowing will last under this cash stress. How do you get the company from here to there? The answer may be quite complex. Keeping a hugely unprofitable network fully lit will only nosedive the case into chapter 7. Yet, preserving the value of the prior capital expenditures including deployment costs is preferable to a large telecom equipment auction in a glutted equipment market. Early in the case, a careful analysis of profitable or strategically important sectors in the network should be conducted. If a buyer is not already in the wings, the identification of a potential purchaser or investor could take 3 months or more. An initial plan of how to maximize value while minimizing cash drain should be the first order of business. Although analysts predict industry consolidation in a "bought or be bought" environment, in a market with such huge overcapacity, the possibility that there will be no buyer for the network should be explored as well.

### A. Section 366

Assuming that all or some of the network needs to be kept active, the impending (in 20 days or less) doom of section 366 will be the first skirmish in the case with various providers. Certain telecom providers have or may assert that they are "utilities" under 11 U.S.C. § 366, thus entitling them to terminate service to the debtor on or after 20 days after the filing of the petition unless the debtor provides adequate assurance of payment. However, whether the telecom providers are, in fact, utilities or, instead, are non-debtor parties to ordinary executory contracts under 11 U.S.C. § 365 is a critical issue that has not been the subject of a great many reported cases. Although a non-debtor party to an executory contract is still entitled to adequate protection under § 362 (and still prohibited from terminating service by § 362),<sup>4</sup> the largely unanswered question is whether telecom providers are the kinds of entities that Congress had in mind when enacting § 366. *E.g. In re Moorefield*, 218 B.R. 795, 796 (Bankr. M.D.N.C. 1997) ("the legislative history indicates that this section was intended to cover those utilities that have a special position with respect to the debtor 'such as an electric company, gas supplier, or telephone company that is a monopoly in the area so the debtor cannot easily obtain comparable services from another utility.'"). Although *Moorefield* was a chapter 13 case involving Time Warner Cable, it provides the basis for an argument that telecom providers are not "utilities" merely because they provide utility-like services to the debtor. Rather, section 366 may be read to apply only to incumbent, monopolistic utilities such as electric and water companies. This conclusion is bolstered by the very existence of long-term, executory contracts for termination and collocation services properly analyzed under section 365. It is because of competition in this industry that a long term contract is even necessary. Without competition, a simple account and monthly statement would be all that was required for true utility service. *In re Tel-Central Communications, Inc.*, 212 B.R. 342, 343 (Bankr. W.D. Mo. 1997) (referring to prior ruling that telecom services provider was not "utility" for purposes of section 366 but providing adequate protection under order, presumably based on section 361/362).

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<sup>4</sup>*E.g. In re Nat'l Hydro-Vac Indus. Serv.*, 262

If the telecom providers are considered utilities, the provision of adequate assurance provided under many of the true utility cases would likely spell the end of the debtor. Most cases involving utilities under 366 apply a one month or two month deposit requirement particularly if the debtor had paid late prior to the filing of the bankruptcy. In a telecom case, a two month deposit to each of the debtor's termination service providers would likely deplete all cash reserves. Under the § 366 paradigm, the debtor must rely on the bankruptcy court's significant discretion in determining what constitutes adequate assurance under § 366. *See, e.g. Virginia Elec. & Power Co. v. Caldor, Inc.*, 117 F.3d. 646, 650-51 (2nd Cir. 1997).

Unfortunately, the unsettled nature of the definition of utility under section 366 means that the telecom debtor cannot wait for a service provider to file a motion for relief from stay or adequate protection under section 362. Rather, one of the first pleadings filed should be a 366/362 motion to determine what, if any adequate protection and/or adequate assurance is required to keep the provider from terminating service. In addition, an adversary proceeding seeking a section 105 injunction in aid of the stay should be considered, particularly as the 20-day deadline of section 366 closes in.

It has become the usual practice to use the section 366 motion to reach agreement with various telecom providers or to have the court determine what is adequate protection without necessarily deciding whether the telecom providers are, in fact, utilities. It is because the question of whether telecom providers are or are not utilities has not been settled that this has become a necessary feature of the telecom case. *E.g., In re Tel-Central Communications, Inc.*, 212 B.R. 342, 345 (Telecom provider given adequate protection payments of a series of deposits and definitive payment dates for outstanding invoices as a condition of being required to continue service).

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B.R. 781 (E.D. Ark. 2001) (Bank violated stay by terminating bank card merchant agreement).

What and how the debtor's telecom service providers are due for post petition services may be the subject of some debate. Many termination agreements have minimum fees due (similar to take or pay contracts in the gas industry) that are not always enforced prepetition. In both termination agreements and colo agreements, there may be minimum notice requirements for the termination of those agreements. Colo agreements have the added complication of the debtor's equipment being stored in space that is controlled by a lessor. As a practical matter, removing valuable equipment before declaring a rejection may be prudent to avoid protracted litigation. Two relevant legal principles may be utilized to stem the tide of high administrative costs for post-petition telecom services. First, there's the "one potato, two potato" argument of whether a multi-circuit contract is really one contract or several divisible contracts. Second, termination contracts and non-real property colo agreements do not have the benefit of a section 365(d)(3) or section 365(d)(10) contract-rate presumption making it necessary to prove actual benefit under 11 U.S.C. § 503(b).

## **B. Divisible Contracts and Cross Default Provisions**

We all know that an executory contract cannot be assumed in part and rejected in part. *See, e.g., In re Nagel*, 216 B.R. 397, 398 (Bankr. W.D. Tex. 1997). One of the structures of an inter-provider contract whether a colo or termination agreement is a "master contract" that provides global terms supplemented by tens and hundreds of smaller circuit agreements setting forth place (or termination point) and price. As the telecom debtor winds its way through a profitability analysis, it is advisable to reject or not perform some of the circuit agreements while keeping others.

Once the debtor begins to terminate and/or reject certain circuits and keep others, there will invariably be minimum notice provisions and termination fees that are invoked as part of the master contract. The legal issue will be are those notice provisions and termination fees enforceable as a condition of keeping other circuits up? When negotiating an adequate protection order under the section 366 rubric, a provision that specifically



defines what charges will and will not be paid as part of the debtor's ongoing obligations should be included to avoid later confusion. The adequate protection payments should exclude cross-default provisions, multiple circuit provisions, monthly minimums and similar charges that do not otherwise qualify as a charge for actual use. As discussed below, only those charges that otherwise qualify as administrative expenses under section 503(b) should be required.

A divisible or severable contract or lease may be assumed or rejected among its divisible portions. *See, e.g., In re Stewart Title Guaranty Company*, 83 F.3d 735, 742-43 (5th Cir. 1996) (explaining that an agreement can contain severable portions which may be rejected); *In re Plitt Amusement Co. of Washington*, 233 B.R. 837, 848 (Bankr. C.D. Cal. 1999) (finding a commercial lease for different locations inherently severable and rejectable by location); *In re Bretano's Inc.*, 29 B.R. 881, 883-84 (Bankr. S.D. N.Y. 1983) (allowing assumption and assignment of a single floor under a single lease covering two floors).

In *Stewart Title*, the Fifth Circuit explained the analysis for determining whether an agreement contains severable or divisible obligations. *Stewart Title*, 83 F.3d at 739-41. A contract is severable when one party's performance consists of more than one "distinct and separate item and the price paid by the other party is apportioned to each item." *Id.* (citing *In re Ferguson*, 183 B.R. 122, 124 (Bankr. N.D. Tex. 1995) (quoting *Johnson v. Walker*, 824 S.W.2d 184, 187 (Tex. App. -- Fort Worth 1991, no writ))). Thus, a divisible contract is defined as: "one in which is in its nature and purpose susceptible of division and apportionment, having two or more parts in respect to matters and things contemplated and embraced by it, not necessarily dependent upon each other nor intended by the parties so to be." *Id.* (quoting BLACKS LAW DICTIONARY 479 (6th ed. 1990)). Additionally, "a type of conduct which is particularly telling in an inquiry [into divisibility] is the method of payment arranged by the parties. Where the subject matter of the contract is divisible and the consideration is apportioned, these are consistent with and indicative of a severable contract." *Id.* at 740 (citing *Ferguson*, 183 B.R. at 126; *Budge v. Post*,

544 F. Supp. 370, 382 (N.D. Tex. 1982); *Lake LBJ Mun. Util. Dist. v. Coulson*, 771 S.W.2d 145, 153 (Tex. App. -- Austin 1988), rev'd on other grounds).

Arguably, enforcement of termination notice provisions and penalties under a master contract are little more than cross-default provisions. Of course, cross-defaults are not enforceable in bankruptcy. *See, e.g., In re Sambo's Restaurants, Inc.*, 24 B.R. 755, 757 (Bankr. C.D. Ca. 1982). Artful drafting of the contractual documents cannot be permitted to circumvent section 365. *In re Plitt Amusement Co. of Washington, Inc.*, 233 B.R. at 848.

Depending on the language of the particular agreement, the existence of a master contract should not be automatically considered to create an indivisible contract for all of the circuits or locations at issue. Rather, careful examination of the timing of the various components of the contract as well as pricing and divisibility mechanisms in the contract itself may lead to the appropriate position that allows the debtor to reject some but not all of the individual contracts.

### C. Administrative Priority: Telecom Providers

Unless they can be otherwise characterized as an equipment or real property lease, telecom contracts will fall into the category of general executory contracts. Whether charges due under the contracts are required to be paid as part of the adequate protection/366 process or allowable as administrative claims will be largely determined by relevant authority under section 503(b). Certainly, the added complexities of what is adequate protection under section 361 will play a role in what is actually paid to the provider.

Section 503(b) of the Bankruptcy Code provides: "After notice and hearing, there shall be allowed administrative expenses, . . . including. . . the actual necessary costs and expenses of preserving the estate[.]" 11 U.S.C. § 503(b)(1)(A). In order to show that the expenses sought to be recovered are, in fact, actual and necessary, two general requirements must be satisfied: (1) the alleged administrative expense arose from a transaction with the debtor-in-

possession as opposed to the preceding entity (or, alternatively, that the claimant gave consideration to the debtor-in-possession); and (2) the alleged administrative expense directly and substantially benefitted the estate. See, e.g., *In re Sunarhauserman, Inc.*, 126 F.3d 811, 816 (6<sup>th</sup> Cir. 1997); *In re Hemingway Transport, Inc.*, 993 F.2d 915, 929 (1<sup>st</sup> Cir. 1993); *In re Santa Monica Beach Hotel, Ltd.*, 209 B.R. 722, 724 (Bankr. 9<sup>th</sup> Cir. 1997).

The costs and expenses of preserving an estate are not limited to the categories specified in Section 503 of the Bankruptcy Code but include other necessary costs and expenses incurred in running a business during the pendency of a chapter 11 case. *In re Coastal Carriers Corp.*, 128 B.R. 400, 404 (Bankr. D. Md. 1991). For example, when a debtor-in-possession elects to continue to receive benefits from the other party to an executory contract pending a decision to reject or assume the contract, the debtor-in-possession is obligated to pay for the reasonable value of those services, which, depending on the circumstances of a particular contract, may be what is specified in the contract. *Nat'l Labor Relations Board v. Bildisco & Bildisco*, 465 U.S. 513, 104 S.Ct. 1188, 1199 (1984). Thus, when third parties are induced to supply goods or services to the debtor-in-possession, the purposes of Section 503 of the Bankruptcy Code plainly require that their claims be afforded priority. *In re Jartran, Inc.*, 732 F.2d 584, 586 (7<sup>th</sup> Cir. 1984). In such circumstances, the claimant is entitled to a post-petition administrative claim to the extent that it has benefitted the debtor-in-possession in operating the business. *United States Postal Service v. Dewey Freight System, Inc.*, 31 F.3d 620, 624 (8<sup>th</sup> Cir. 1994).

In addition to circumstances where a debtor's continued receipt of benefits of an executory contract gives rise to an administrative expense, administrative priority is also afforded to creditors who enter into new contracts with the debtor-in-possession in order to advance the goal of avoiding liquidation. See *In re Merry-Go-Round Enterprises, Inc.*, 180 F.3d 149, 156 (4<sup>th</sup> Cir. 1999). The reason for such a rule is that creditors will be more likely to extend credit to a rehabilitating debtor if their post-petition agreements will, in the event of a breach, be

accorded administrative expense priority under Section 503(b) of the Bankruptcy Code. See *In re IML Freight, Inc.*, 37 B.R. 556, 559 (Bank. D. Utah 1984).

For telecom providers, the key issue will be whether the debtor has "induced" them to supply goods and services to the estate and/or whether the provider can prove benefit to the estate. This requires a certain amount of proactivity on the provider's part. Simply keeping circuits available to the debtor without any evidence that the debtor induced the continuation of service should not give rise to an administrative claim unless the provider can prove that actual minutes were put on the circuit and the estate benefitted from that use. E.g., *Cohen v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.)*, 134 B.R. 482, 489 (Bankr. S.D.N.Y. 1991) ("A creditor provides consideration to the bankrupt estate only when the debtor-in-possession induces the creditor's performance and performance is then rendered to the estate."). Advice to the telecom provider: keep good records of your communications with the debtor and its employees. Many of the circuit-level transactions are accomplished by e-mails full of technical jargon but will be critical to the issues of inducement and benefit later on.

#### **D. Administrative Priority: Equipment Leases**

Telecom companies have lots of equipment leases. In recent years, equipment leases have become more and more popular as a way of getting equipment with little taken out of cash flow. Equipment leases look and smell very much like secured transactions with the debtor paying casualty risks, insurance and reimbursing the lessor for taxes and the like. The leases have acceleration clauses and features that are similar to a security agreement. The lessor typically files a UCC-1 and otherwise acts as if it should protect its security interest in the event the lease is determined to be a financing transaction.

Section 365(d)(10) makes the management of equipment leases an issue early on in the case. If, after 60 days into the case, the debtor has not rejected the lease (or otherwise gotten a determination that the lease is not a true lease), the debtor must begin making the full rent payments

due under the lease (unless there are divisible contracts, which as explained above, can be bifurcated). If the lease is determined to be a financing transaction, the secured party may be entitled to periodic payments equivalent to the decrease in value of the equipment. *See* 11 U.S.C. § 361(1).

Several factors are relevant to determining whether a lease of personal property is a “true lease” or a lease intended as security. *See* TEX. BUS. & COM. CODE § 1.201(B).

Whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if ... the term of the lease is not subject to termination by the lessee, and ...

- [1. The lease is longer than the economic life of the goods;
2. The lessee is bound to renew for the life of the goods or to become the owner of the goods; *or*
3. The renewal option *or* purchase option is for no or nominal consideration.]

Of course, each equipment lease should be analyzed on its own terms taking into account the various factors viewed in the context of the transaction. While many of the cases interpreting this codification focus on the enumerated “objective” factors, the statute certainly leaves open the option for arguing a subjective application of the statute based on the language of the first sentence. *See, e.g. PSINet, Inc. v. Cisco Systems Capital Corp. (In re PSINet, Inc.)*, 271 B.R. 1 (Bankr. S.D.N.Y. 2001) (only subjective test based on lease terms relevant, not intent of parties). Nonetheless, true lease fights will continue to be on the rise in tech and telecom bankruptcies. An exhaustive analysis of the factors is contained in *In re Edison Bros. Stores*, 207 B.R. 801 (Bankr. D. Del. 1997) (finding equipment lease to be true lease in the absence of proof of fair market value for purposes of determining whether purchase option was “nominal”). *Edison Bros.* also puts the burden of proof squarely on the Debtor to show each of the requisite factors in its favor.

If a lease is shown to be a true lease, the post-petition rent will be bifurcated into a section 503(b) claim and a section 365(d)(10) claim which must be paid as and when due, much like a section 365(d)(3) claim. *See, Guttman v. Xtra Lease, Inc. (In re Furley’s Transport, Inc.)*, 263 B.R. 733 (Bankr. D. Md. 2001). However, there is some support for the proposition that section 365(d)(10) was intended to negate any 503(b) claim for the first 60 days of a case. *In re Kyle Trucking, Inc.*, 239 B.R. 198 (Bankr. N.D. Ind. 1998) (“Where, as in this case, an unexpired lease of personal property is ultimately rejected, the obligations coming due during the 60 days following the order for relief will be included in the lessor’s claim for damages arising from the rejection of the lease. Those obligations do not represent an administrative claim.”). *See also, In re Elder-Beerman Stores Corp.*, 201 B.R. 759 (Bankr. S.D. Ohio 1996) (explaining history and effect of section 365(d)(10)).

## E. Intellectual Property: Security Interests

An issue that has risen to prominence as a result of the tech bust is the ability to obtain a perfected security interest in a debtor’s intellectual property. This intellectual property falls into three general categories: patents, copyrights and trademarks. Each of these kinds of collateral have been the subject of several opinions finding that perfection requires filing in the U.S. Patent or Copyright Office to be effective. *In re Together Development Corp.*, 227 B.R. 439 (Bankr. D. Mass. 1998) (because Lanham Act governing trademarks requires assignments, to be valid, to be filed in the Patent and Trademark Office (“PTO”), a security interest in a trademark is not perfected by the filing of a UCC-1 alone); *In re Avalon Software, Inc.*, 209 B.R. 517 (Bankr. D. Ariz. 1997) (secured creditor, to be perfected, must file against copyrights whether or not copyright is registered, but maintenance and service agreements were ordinary accounts receivable and therefore perfected by UCC-1 filing); *In re Peregrine Entertainment, Ltd.*, 116 B.R. 194 (C.D. Cal. 1990) (To be perfected, secured party must file evidence of security agreement in U.S. Copyright Office). The only dissent has been on the issue of unregistered copyrights. While *Peregrine* and *Avalon* require filing even if the copyright remains unregistered, *Aerocon*

*Engineering, Inc. v. Silicon Valley Bank (In re World Auxiliary Power Co.)*, 244 B.R. 149 (Bankr. N.D. Cal. 1999), found that a UCC-1 sufficient to perfect security interest in unregistered copyrights as general intangibles. To be sure, there may be many cases where the question of whether intellectual property is properly perfected will turn on whether it is copyrightable or patentable in the first place.

#### **F. Intellectual Property: Assumption and Assignment of Licenses**

The pinnacle of a telecom case will likely be the sale of its assets to another telecom company in the current buy or be bought paradigm. Because a telecom company is suffused with both equipment and the software it takes to run that equipment, the sale of the deployed network will necessarily entail assigning license to run the networking equipment. And if section 365(d)(10) were not ammunition enough, this is where the equipment manufacturers/lessors have another magic bullet. Numerous cases have held that because a non-exclusive copyright license cannot be assigned under Federal copyright laws, the debtor cannot assign them to a purchaser under section 365(c). *In re Golden Books Family Entertainment, Inc.*, 269 B.R. 300 (Bankr. D. Del. 2001) (non-exclusive licenses cannot be assigned under Federal Copyright Law). A similar logic applies to non-exclusive patent licenses. *Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)*, 165 F.3d 747 (9th Cir. 1999) (determining that assignment of non-exclusive patent license was prohibited by patent law and hypothetical interpretation of section 365(d)(1)); *In re CFLC, Inc.*, 89 F.3d 673 (9th Cir. 1996) (non-exclusive patent license non-assignable under Federal Patent Law and 365(c)).

The major exceptions to this prohibition occur when the license itself contains a consent, such as a consent to assignment upon the sale of substantially all of the assets. *Murray v. Franke-Misal Technologies Group, LLC (In re Supernatural Foods, LLC)*, 268 B.R. 759 (Bankr. M.D. La. 2001) (license permitting assignment in connection with “sale of substantially all assets” amounted to requisite consent to transfer under section 365(c)). There is also a body of copyright and patent law that holds that exclusive patent and

copyright licenses are transferable, making section 365(c) inapposite. *In re Golden Books Family Entertainment, Inc.*, 269 B.R. 311 (Bankr. D. Del. 2001) (exclusive copyright license assignable under Copyright Law), citing *In re Patient Educ. Media, Inc.*, 210 B.R. 237 (Bankr. S.D.N.Y. 1997). See also, *Supernatural Foods* 268 B.R. at 800-801 (distinguishing cases regarding exclusive license in concluding that partial license with exclusive features was not assignable).

On the issue of assumption, there is a split of authority among the various circuits as to whether the meaning of section 365(c) and 365(f) can be harmonized. The cases are generally distilled into a “hypothetical” versus an “actual” test. Without delving into semantics, the wording of section 365(c) leaves much to be desired as applied to assumption without assignment. If there is assumption without assignment, the “actual” test argues, there is no reason to analyze whether the non-debtor party should accept performance from someone other than the debtor in possession. Under the “actual” test, assumption may be accomplished even in a stock sale plan without an actual assignment. *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir.), cert. denied, 117 S.Ct. 2511 (1997) (rejecting hypothetical test and allowing assumption of patent license in stock sale plan). The “hypothetical” camp contends that if assignment is prohibited by applicable law, then so is assumption under the plain meaning of section 365(c). E.g., *In re Access Beyond Technologies, Inc.*, 237 B.R. 32 (Bankr. D. Del. 1999) (on motion to sell assets, court determined that non-exclusive patent license is non-assumable and non-assignable.).

This set of decisions is making it more and more difficult to extract value from telecom networks for the simple reason that equipment lessors and manufacturers typically include non-exclusive licenses as part of their leases and sales documents. The end result is that, in a cash-strapped industry, a good amount of horse trading occurs right before the sales hearing. Hardly anyone is in a position to turn down a little extra cash when the alternative is zero cash and the return of equipment that is scattered about the country. The best strategy may be to have the

lawyers load the guns, but let the business people make the decision to shoot or not.

## **VI. CONCLUSION**

Telecom bankruptcies require a great deal of proactivity from both debtors and creditors. It is only through mutual cooperation with a dose of foresight that both can avoid the bankruptcy equivalent of a goose egg. As the industry continues its contraction and consolidation, buyers may become more of a commodity and a few debtors will not get sold or survive. The tricky part will be knowing when to liquidate and when to hold on in a murky economic outlook.