

BANKRUPTCY IN THE ADMINISTRATIVE STATE

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I

INTRODUCTION

Bankruptcy and regulation have grown together. Railroad regulation, one of the earliest manifestations of the modern regulatory state,¹ was the product of the growth and power of the railroad industry. When the railroad industry fell upon hard times, it provided the first important test of the relationship between insolvency proceedings and regulation. The modern corporate reorganization originated in equity receiverships spawned by failing railroads.² These receiverships were later formalized under bankruptcy

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After completion of this article, the author, at the request of a public interest group, testified before the New Orleans City Council in rate proceedings covering New Orleans Public Service Inc. The testimony, which consisted of this article and a supplementary statement, was to the effect that a regulatory body otherwise inclined to deny a rate increase ought not grant the increase merely because it fears denial would push the utility into bankruptcy.

1. Congress established what has been called the first modern regulatory agency, the Interstate Commerce Commission, to regulate railroads. Interstate Commerce Act of 1887, 24 Stat. 379 (1887) (current version at 49 U.S.C. § 1 et seq. (1982)). See S. BREYER, *REGULATION AND ITS REFORM* 1 (1982); *PROPHETS OF REGULATION* 1-79 (T. McCraw ed. 1984) (biographical perspective on the history of railroad regulation).

2. See Report of the Commission on the Bankruptcy Laws of the United States, H.R. DOC. NO. 137, 93d Cong., 1st Sess., pt. 1, at 256-83 (1973); G. GLENN, *LIQUIDATION* § 430, at 606-07 (1935). An 1845 Georgia state court case may have been the first railroad equity receivership. The court ordered the sale of properties of a Georgia railroad with 100 miles of line, free of debts incurred prior to the sale, and "distribution of the proceeds among the creditors, according to the priority of their claims." Lasdon, *The Evolution of Railroad Reorganization*, 88 *BANKING L.J.* 3, 6 (1971). In *Davis v. Gray*, 83 U.S. (16 Wall.) 447, 453 (1872), a case in which a railroad receiver was a party, Justice Swayne's opinion for the Court states,

It is not unusual for courts of equity to put [receivers] in charge of the railroads of companies which have fallen into financial embarrassment, and to require them to operate such roads, until the difficulties are removed, or such arrangements are made that the roads can be sold with the least sacrifice of the interests of those concerned.

The Wabash, St. Louis & Pacific Railway is reported to have been, in 1884, the first American railway to ask a federal court to appoint receivers to avoid the fragmentation of the line that would result from foreclosures under its mortgages, Lasdon, *supra*, at 7, a report seemingly at odds with Justice Swayne's statement. The Supreme Court approved the practice of appointing receivers for a

reorganization statutes.³ Since the first financial failure of a regulated railroad, there has been a need to coordinate bankruptcy and regulation.

Recent developments in the utility industry highlight that need. Expensive nuclear power plant construction projects⁴ have brought several regulated utilities to the brink of bankruptcy.⁵ But questions about bankruptcy-regulatory interaction reach beyond nuclear power's cost and safety problems. A utility that constructs a coal plant at excessive cost or misreads demand for its product may be a candidate for chapter 11 reorganization.⁶ An inner city gas company with a declining rate base, a water company in need of expensive equipment, and a telephone company faced with competing technologies each faces problems that could trigger a consideration of bankruptcy as an alternative to large rate increases.

Questions about the role of regulation in bankruptcy also arise in less regulated industries. In 1984, a furor accompanied the Supreme Court's effort to reconcile the needs of a reorganizing debtor with the rights of the debtor's workers under the National Labor Relations Act.⁷ Longstanding tension divides the needs of a bankruptcy reorganization and the securities laws.⁸ Some debtors' rehabilitation efforts may be jeopardized by pension law regulation or by environmental law restrictions.⁹

The legal system focuses on these issues as isolated, unusual phenomena. Bankruptcy itself is regarded as an exception to the norm. It is simply bad

regulated toll bridge. *Covington Drawbridge Co. v. Shepherd*, 62 U.S. (21 How.) 38 (1858). See G. GILMORE, *THE AGES OF AMERICAN LAW* 129 n.28 (1977).

3. See W. BLUM & S. KAPLAN, *CORPORATE ADJUSTMENTS AND REORGANIZATIONS* 221-22 (1976). For problems with the equity receivership, see Lasdon, *supra* note 2, at 9-10.

4. Between 1972 and 1982, 100 nuclear power plant cancellations resulted in losses of about \$10 billion. See U.S. DEP'T OF ENERGY, ENERGY INFORM. ADMIN., *NUCLEAR PLANT CANCELLATIONS: CAUSES, COSTS, AND CONSEQUENCES* x (1983); Pierce, *The Regulatory Treatment of Mistakes in Retrospect: Canceled Plants and Excess Capacity*, 132 U. PA. L. REV. 497 (1984). Fifteen cancellations in 1983 and 1984 resulted in further losses of \$11 billion. Cavanagh, *Least-Cost Planning Imperatives for Electric Utilities and Their Regulators*, 10 HARV. ENVTL. L. REV. 299, 302 n.11 (1986).

5. See, e.g., *Generators of Bankruptcy: Some Utilities Are Approaching the Brink*, TIME, July 23, 1984, at 81; Flaschen & Reilly, *Bankruptcy Analysis of a Financially-Troubled Electric Utility*, 59 AM. BANKR. L.J. 135, 136 (1985); Pierce, *supra* note 4, at 498.

6. From 1976 to 1984, 75 coal-fired power plants were cancelled. L. BROWN, *STATE OF THE WORLD—1986*, at 100 (Table 6-1). In 1983, there were 21 coal plant cancellations and 6 nuclear plant cancellations. In 1984, there were 18 coal plant cancellations and 8 nuclear plant cancellations. The cancelled megawatt capacity for the two years was 14,477 for coal plants and 15,078 for nuclear plants. *Id.*

Kentucky's Big Rivers Electric Cooperative is in financial difficulty as the result of its construction of a large coal-burning generating plant "for which there's no market." *Public Power Broker*, BARRON'S, Jan. 28, 1985, at 9. See also *In re Montana Power Co.*, 61 Pub. Util. Rep. 4th (PUR) 177 (Mont. Pub. Dep't Serv. Reg. 1984) (denying rate increase to recover costs associated with Colstrip Unit 3 coal plant), *reconsideration ordered*, 68 Pub. Util. Rep. 4th (PUR) 521 (Mont. Dist. Ct. 1985).

7. *In re Bildisco*, 465 U.S. 513 (1984).

8. H.R. REP. NO. 595, 95th Cong., 1st Sess. 370-73, 403-07 (1977). The nature of the Securities and Exchange Commission's right to participate in a bankruptcy reorganization has been particularly important. See, e.g., Wall St. J., Dec. 10, 1985, at 8, col. 1 (SEC trying to force Manville to hold annual meeting while in bankruptcy).

9. See *Midlantic Nat'l Bank v. N.J. Dep't of Env'tl. Protection*, 106 S. Ct. 755 (1986); Novikoff & Polebaum, *Pension-Related Claims in Bankruptcy Code Cases*, 40 BUS. LAW. 373 (1985). See generally *In re White Farm Equip. Co.*, 42 Bankr. 1005 (Bankr. N.D. Ohio 1984).

luck for the system when a bankrupt debtor is subject to a detailed regulatory scheme. But bankruptcy is a common event¹⁰ and regulation is everywhere.¹¹ Bankruptcy of any substantial entity may require considering how nonbankruptcy regulation should apply. Bankruptcy's role in dealing with the debtor's crisis ought to be played out against an informed view of bankruptcy law and its relationship to a theory of regulation.

This article discusses the relationship between bankruptcy and regulated industries. One important aspect of that relationship stems from the distinctive nature of each of the two fields. Administrative agencies and bankruptcy courts would not have arisen unless specialized knowledge was believed desirable. But expertise begets isolation. Knowledge of these exclusive fields is not fully disseminated to the general bar and the public. In the best of times this is a regrettable necessity. In times of financial stress, the dual isolation hinders full analysis of available alternatives.

Part II of this article examines misconceptions concerning the effect of bankruptcy on regulated entities. For example, many regard a utility bankruptcy as unthinkable and a potential disaster.¹² This view has it backwards. The bankruptcy of a monopolistic utility is among the more thinkable bankruptcies. The questionable nature of past analyses of utility bankruptcy illustrates the need to incorporate bankruptcy considerations more fully into the mainstream of economic life.

Part III turns from debunking myths about bankruptcy to investigating whether bankruptcy might make a positive contribution in the utility area. For the utility that is denied rate increases and is on the brink of financial collapse, bankruptcy has its usual benefits—providing breathing space and preserving going concern value. But bankruptcy may offer more advantages by furthering regulatory goals. Detecting the additional benefits requires settling on a basis for regulating utilities. The principal focus of Part III is on the concept of representation, a central theme of the administrative state.¹³ Bankruptcy offers a framework in which to address several representational imperfections. This part also assesses bankruptcy's possible enhancement of representation in light of modern economic rationales for regulation.

After surveying myths about utility bankruptcy and assessing bankruptcy's effect on representation of regulated industries, Part IV probes expected problems in a utility bankruptcy. These problems are largely matters of uncertainty, coordination, and delay. In bankruptcy, for example, enhanced representation is viewed as competing with speed. Allowing broad or even altered participation may slow the proceedings, a result regarded as

10. See, e.g., Countryman, *Scrambling to Define Bankruptcy Jurisdiction: The Chief Justice, The Judicial Conference, and the Legislative Process*, 22 HARV. J. ON LEGIS. 1 (1985).

11. Bankruptcy itself could be regarded as a form of regulation and there are occasional proposals to have the bankruptcy system run by an administrative agency. See *infra* text accompanying notes 110-11.

12. See *infra* text accompanying notes 24-25.

13. See generally Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1667 (1975).

undesirable. Part IV discusses questions of uncertainty and coordination and then inquires whether speed is as important as it is usually believed to be in bankruptcy reorganizations. The occasional benefits of delay will also be suggested.

The observations on isolating expertise, altered representation, and bankruptcy-regulatory coordination are of general applicability to many debtor industries. It is not feasible to discuss the relationships of these issues to all possible interactions between bankruptcy and regulation. Therefore, this article is limited to some examples of such interaction. It emphasizes bankruptcy's possible role for the electric utility industry because a nontrivial portion of that industry is or has been near bankruptcy and because the industry's possible fate in bankruptcy has become a matter of public debate.

Given this emphasis on the electric utility industry, it is useful to supplement pure bankruptcy-administrative law considerations with an exploration of the relationship between bankruptcy and the circumstances underlying the current nuclear power plant crisis. In particular, bankruptcy's role is shaped by regulators' views of how the current losses of the electric utility industry should be allocated between ratepayers and investors. Part V explores these matters and suggests that utility bankruptcies will not occur unless regulatory authorities more fully understand bankruptcy and thereby become less fearful of it. Yet, utility regulators often state the need to avoid bankruptcy as a reason for granting rate increases,¹⁴ a line of reasoning that extends beyond the nuclear industry.¹⁵ Perceptions about bankruptcy will shape the rate struggles that attend technological developments in the regulatory future as well as those rate struggles that attend the fading away of industries once so central that they commanded regulation in the public interest.

An independent reason supports emphasizing the interaction between bankruptcy and electric utilities. Many regard regulation as most warranted in the industries that cannot efficiently support more than one firm, such as

14. *In re Pub. Serv. Co. of Ind.*, 72 Pub. Util. Rep. 4th (PUR) 659, 678 (Pub. Serv. Comm'n of Ind. 1986) (delays, costs, added layer of bankruptcy regulation, and uncertainties inherent in the bankruptcy of an electric utility support raising rates to avoid bankruptcy); *In re Maine Pub. Serv. Co.*, 67 Pub. Util. Rep. 4th (PUR) 101-19 (Maine Pub. Util. Comm'n 1985) (costs of bankruptcy too large); *In re Pub. Serv. Co. of N.H.*, 66 Pub. Util. Rep. 4th (PUR) 349, 426 (N.H. Pub. Util. Comm'n 1985) ("a denial of the proposed financing which results in a PSCNH bankruptcy would be inconsistent with the public good"); *In re Consumers Power Co.*, 66 Pub. Util. Rep. 4th (PUR) 1, 20 (Mich. Pub. Serv. Comm'n 1985); *In re Long Island Lighting Co.*, 63 Pub. Util. Rep. 4th (PUR) 165, 186 (N.Y. Pub. Serv. Comm'n 1984) (asking, in the future, for more thorough exploration of bankruptcy alternative); *In re Nantahala Power and Light Co.*, 57 Pub. Util. Rep. 4th (PUR) 324, 336 (N.C. Util. Comm'n 1983) ("the roll-in methodology proposed [of applicant] . . . by the intervenors . . . will ultimately result in insolvency or bankruptcy . . . and an inability . . . to meet . . . customers' needs for electric power. . .").

15. *In re Investigation into Effects of Competition Upon Local and Toll Exch. Serv.*, 54 Pub. Util. Rep. 4th (PUR) 175 (Calif. Pub. Util. Comm'n 1983) (officers of companies predicting bankruptcy if certain policies implemented); *In re HVL Utilities, Inc.*, 53 Pub. Util. Rep. 4th (PUR) 508, 515 n.5 (Ind. Pub. Serv. Comm'n 1983) (mentioning, in passing, possible bankruptcy of water utility); *In re Gas Co. of Vt.*, 49 Pub. Util. Rep. 4th (PUR) 460 (Vt. Pub. Serv. Bd. 1982) (mentioning possibility of bankruptcy of bottled gas company).

some aspects of furnishing electricity.¹⁶ Under traditional views, these areas of natural monopoly present the strongest case for economic regulation.¹⁷ Studying their relationship to bankruptcy law presents the purest case of interaction. Therefore, there is little concern about accounting for effects caused by a mistaken decision to regulate such areas, as seems to be the new conventional view about regulating much of the transportation industry.¹⁸

One important caveat is in order. Even for insolvent entities, bankruptcy is not usually the forum of choice in which to address financial difficulties. Bankruptcy has real costs, and all parties must concede some measure of control to the bankruptcy court. Whether regulated or not, most debtors and their creditors would and should prefer to work out their problems in a nonbankruptcy setting. Given this preference, bankruptcy rules are often more important outside bankruptcy than in a bankruptcy proceeding. Bankruptcy law, like other law, plays an important role whether or not it is formally applicable. During negotiations outside bankruptcy, perceptions about bankruptcy substantially influence the parties' positions and bargaining strengths.¹⁹

For example, the utility management or investment banker that convinces a public utility commission that bankruptcy would be disastrous has gone a long way toward obtaining a rate increase. No public authority wants to have a disaster on its regulatory conscience. If the disaster forecast is inaccurate, the commission may grant a rate increase that it would otherwise deny or reduce, thereby allocating a loss to ratepayers instead of investors. A mistaken view of bankruptcy's effect on the amount of the debtor's worth available to all parties may distort a regulatory body's view on the allocational question of who should bear a loss. The shadow of bankruptcy thus reaches well beyond proceedings in which bankruptcy law formally governs. Even if

16. It may be necessary to distinguish between electricity production, which may no longer be viewed as a natural monopoly, and electricity transmission, which is still so regarded. *See infra* note 17.

17. S. BREYER, *supra* note 1, at 16; P. SAMUELSON & W. NORDHAUS, *ECONOMICS* 522-25 (12th ed. 1985); Dowd & Burton, *Deregulation Is Not an Answer for Electric Utilities*, 110 *PUB. UTIL. FORT.* 21, Sept. 16, 1982; Goldberg, *Regulation and Administered Contracts*, 7 *BELL J. ECON.* 426 (1976); Stewart, *supra* note 13; Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 *J.L. ECON.* 233 (1979) [hereinafter cited as Williamson I]; Williamson, *Franchise Bidding for Natural Monopolies—In General and with Respect to CATV*, 7 *BELL J. ECON.* 73 (1976). *But see* P. JOSKOW & R. SCHMALENSEE, *DEREGULATION OF ELECTRIC POWER: A FRAMEWORK FOR ANALYSIS* (1982); Betty, *The Case for Competition in the Electric Utility Industry*, 110 *PUB. UTIL. FORT.* 13, Sept. 16, 1982; Golub & Hyman, *The Financial Difficulties and Consequences of Deregulation Through Divestiture*, 111 *PUB. UTIL. FORT.* 19, Feb. 17, 1983; Loeb & Magat, *A Decentralized Method for Utility Regulation*, 22 *J.L. ECON.* 399 (1979); Sharkey, *A Decentralized Method for Utility Regulation: A Comment*, 22 *J.L. ECON.* 405 (1979); Meyer, *A Modest Proposal for the Partial Deregulation of Electric Utilities*, 111 *PUB. UTIL. FORT.* 23, April 14, 1983; Plummer, *A Different Approach to Electricity Deregulation*, 112 *PUB. UTIL. FORT.* 16, July 7, 1983.

18. S. BREYER, *supra* note 1, at 197-239 (airlines and trucking); P. SAMUELSON & W. NORDHAUS, *supra* note 17, at 526-27 (airlines and oil industry); Stewart, *supra* note 13, at 1689-90 (transportation sector); Williamson I, *supra* note 17, at 258 (trucking).

19. *See* Eisenberg, *The Undersecured Creditor in Reorganizations and the Nature of Security*, 38 *VAND. L. REV.* 931, 965-66 (1985) (effect of § 1111(b) on negotiations); *cf.* Mnookin & Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 *YALE L.J.* 950 (1979) (impact of divorce rules and procedure on out-of-court bargaining).

no major utility files for a chapter 11 reorganization, bankruptcy rules will play an important role in determining the outcome of the current struggles over the costs of today's nuclear power plants and in justifying proposed future large rate increases.²⁰

II

BANKRUPTCY, REGULATED INDUSTRIES, AND CONFIDENCE

A dual problem of isolation attends most bankruptcy-regulatory interaction. Bankruptcy and any particular regulatory scheme are each isolated from the rest of the legal world. When two remote areas require coordination, surprising results can occur. For example, the deregulation of the economic aspects of airline transportation²¹ left no justification for the special treatment in bankruptcy law of security interests in aircraft. If airlines need not have their rates regulated, the case for special treatment of their secured investors also disappears. Yet, Congress failed to repeal the favorable treatment in bankruptcy of security interests in aircraft.²²

Some people caught up in the current electric utility crisis know little about the bankruptcy alternative.²³ Those knowledgeable about bankruptcy know little about the electric utility industry. Bankruptcy for an electric utility

20. There is a "split-the-loss" atmosphere in several recent rate decisions. See Bussey, *Consumers Sets Big Write-Off on Midland*, Wall St. J., Dec. 10, 1985, at 10, col. 1 (referring to grant of \$94 million rate increase out of \$205 million emergency rate increase request); Richards, *Spending Limit Asked on Illinois Power Project*, Wall St. J., July 30, 1985, at 3, col. 4 (recommending \$2.69 billion spending ceiling on Clinton plant with additional costs to be absorbed by shareholders); Richards, *Utilities Seek to Skirt State Rulings*, Wall St. J., June 17, 1985, at 8, col. 2; Russell, *Two Ohio Utilities to Take Charges Related to Zimmer*, Wall St. J., Dec. 20, 1985, at 8, col. 3 (disallowance of \$861 million from customer rates out of plant costs of \$1.7 billion); *Kansas City P&L, Kansas Gas Appeals in Rate Case Rejected*, Wall St. J., Nov. 14, 1985, at 43, col. 2; *Lilco Can't Charge Users For a Third of Shoreham*, Wall St. J., June 27, 1985, at 6, col. 1; *Limit to Funding of Seabrook Unit is Upheld by Court*, Wall St. J., Sept. 13, 1985, at 16, col. 4; *Fitchburg G&E Says It Agreed to Absorb Some Seabrook Costs*, Wall St. J., Oct. 4, 1985, at 11, col. 2; *Philadelphia Electric Accepts State Terms on Plant Completion*, Wall St. J., Dec. 24, 1985, at 18, col. 2 (utility accepts cap on amount of Limerick Unit No. 2 costs that will be absorbed by ratepayers); *Pacific G&E Receives Interim Rate Increase Totaling \$53.8 Million*, Wall St. J., Dec. 16, 1985, at 18, col. 4 (Pacific Gas & Elec. receives about 26%, or \$53.8 million, of a rate increase requested for costs of the Diablo Canyon nuclear power plant); Wall St. J., Jan. 9, 1986, at 26, col. 3 (unit of Middle South Utilities Inc. accepts settlement under which it will receive partial rate increase to pay for its share of Grand Gulf nuclear plant). Perhaps this is as it should be. See *infra* text accompanying notes 201-02; cf. Stutz, *Risk Sharing in a Regulated Industry*, 117 PUB. UTIL. FORT. 29, 32, April 3, 1986 ("Recent Department of Energy studies, as well as a survey of plant cancellation . . . show that risk sharing, often without any claim of imprudence, has been the norm recently."). But see Paul, *Electricity Pricing Policy That Switches Risks to Investors Planned in California*, Wall St. J., Oct. 11, 1985, at 49, col. 1; *Northern Indiana PS Will Seek Rehearing on Rate-Rise Request*, Wall St. J., Nov. 21, 1985, at 26, col. 3 (court ruling could preclude utility from recovering any of its \$2.8 billion investment in cancelled Marble Hill nuclear plant).

21. See, e.g., PROPHETS OF REGULATION, *supra* note 1, at 222-99 (discussing Alfred Kahn and the deregulation of airline transportation).

22. 11 U.S.C. § 1110 (1982).

23. "We think it's in the ratepayer's and state's best interest not to allow [the utility] to go into bankruptcy We don't have a very scientific basis for the decision." Winslow, *Utility Chapter 11 Filing May Mean Problems for Consumers, Investors*, Wall St. J., April 17, 1984, at 37, col. 3 (quoting Indiana official).

is said by some to be unthinkable,²⁴ and it is regarded by others merely as a negotiating ploy.²⁵

This part first discusses the reasons for keeping some regulated industries beyond the reach of bankruptcy law. The discussion provides a background against which to assess the reasons offered for keeping regulated utilities out of bankruptcy. The usual bankruptcy concerns about consumer confidence, investor confidence, and related matters need to be rethought in the case of a monopolistic utility.

A. The Treatment of Regulated Industries in Bankruptcy

For purposes of this article, "regulated industries" refers to industries in which basic industry functions are subject to detailed governmental regulation and for which specialized regulatory bodies exist. The term thus embraces much of the financial and utilities industries and excludes manufacturing enterprises that may be subject to other forms of regulation, such as automobile manufacturing. Industries with their own regulatory bodies raise special questions because a governmental entity has been charged with important aspects of management or control of the industry. That entity's role in bankruptcy is likely to be especially interesting and important.

In these industries, such as transportation, electricity, gas, and water utilities, regulation is intertwined with the business itself. Rates, plant construction, service expansion or contraction, mailings to consumers, rates of return, and other aspects of the business may be subject to administrative regulation. The business cannot be viewed independently from the regulatory structure to which it is subject. If one of these entities initiates a bankruptcy proceeding, the proceeding will have to take account of the special regulatory structure applicable to the debtor.

Bankruptcy law deals with these regulation-dominated industries through a mixture of express exclusion from coverage by bankruptcy law, of highly specific interaction, and of nearly complete silence. Financial institutions illustrate the express exclusion theme. The railroads illustrate specific interaction. Other utilities illustrate the theme of silence.

1. *Industries Unsuitable for Regular Bankruptcy.* The bankruptcy system relies on federal and state regulators to detect and heal those financial institutions in fiscal ill health. Historically, bankruptcy law seems to have deferred to some regulatory schemes because those schemes were in place before an

24. Public Serv. Co. of Oklahoma, Cause No. 27068, Order No. 206560, at 58 (Okla. Corp. Comm'n, Jan. 15, 1982) ("Bankruptcy is not a viable option."); Hayes, *Bankruptcy is Too Dangerous—For Everyone*, ELEC. WORLD, June 1984, at 3.

25. *Generators of Bankruptcy: Some Utilities Are Approaching the Brink*, TIME, July 23, 1984, at 81 (quoting Michael Totten, Director of the Critical Mass Energy Project). Some of the adverse reaction to utility bankruptcy stems from the association of bankruptcy with termination of the debtor's business. No one proposes utility bankruptcies in which service to customers simply ends. Threats of bankruptcy and termination of service therefore may appropriately be branded a negotiating ploy. See *infra* note 48.

extensive federal bankruptcy law was available to corporations.²⁶ For whatever historical reasons, federal regulators bail out Continental Illinois,²⁷ and most troubled banks are merged out of existence. Such institutions are not even allowed to become the subject of traditional bankruptcy proceedings.²⁸

In an era when prior state regulation of financial institutions can hardly continue to explain federal inaction, there is little pressure to have bankruptcy law embrace these institutions. Three reasons support their continued special treatment. The first is the common association of bankruptcy with liquidation of the financially troubled entity.²⁹ The economic system regards unregulated liquidation of a financial institution with alarm. Visions of depression era "runs on the banks" have not vanished. Fear of extreme reactions underlies reluctance to allow the straightforward liquidation of a bank or savings and loan association.

The second and related reason pertains to user confidence. In the banking system, the cost of loss of confidence is high. Allowing a bank to commence a traditional chapter 11 bankruptcy runs the risk of a long period of uncertainty, during which low user confidence may erode even further. The announcement of a bankruptcy may ensure the failure of a financial institution's rehabilitation effort.³⁰ In addition, commencement of chapter 11 proceedings runs the risk of failure. Most reorganization proceedings wind up as liquidations. This scenario is not acceptable for reasons of economic and banking policy having little to do with bankruptcy.

The third reason for excluding financial institutions from bankruptcy is that our system has a substantial investment in the notion that financial institutions require expert regulation. The more necessary such regulation, the less useful a routine bankruptcy proceeding is likely to be. If special expertise is needed to assist troubled financial institutions, the bankruptcy court, the traditional bankruptcy forum, may be at a relative disadvantage vis-a-vis federal or state regulatory authorities.³¹

26. Sovern, *Section 4 of the Bankruptcy Act: The Excluded Corporations*, 42 MINN. L. REV. 171 (1957). Professor (now President) Sovern cogently suggests that there may be a greater need for federal bankruptcy proceedings being open to insurance companies than there is for such proceedings being open to banks. *Id.* at 207-31.

27. See *The Nationalization of Continental Illinois*, FORTUNE, Aug. 20, 1984, at 135.

28. 11 U.S.C. § 109(b)(2), (b)(3), (d) (1982).

29. Congress's early vision of bankruptcy as primarily a liquidation device undoubtedly influenced early exclusion of banking and insurance corporations from bankruptcy coverage. Sovern, *supra* note 26, at 207-08.

30. Even in a less regulated environment, loss of consumer confidence is cited as a prime reason for avoiding bankruptcy or even talk of bankruptcy. See R. REICH & J. DONAHUE, *NEW DEALS: THE CHRYSLER REVIVAL AND THE AMERICAN SYSTEM* 106, 120-21 (1985).

31. Other businesses technically qualify for treatment under chapter 7 or chapter 11 but have characteristics, such as a high need for consumer confidence, political leverage, or simple size, that deflect treatment of them as traditional bankrupts. Chrysler underwent one of the most substantial corporate reorganizations in economic history, but it did so outside the auspices of the bankruptcy

2. *Industries Treated Specially in Bankruptcy.* Unlike financial institutions, railroads, at least in the short term, are not so dependent on consumer confidence. A railroad may be placed in chapter 11 without fear of immediately losing customers. There will not be a "run to the buses." Several railroads have operated under the protection of bankruptcy laws for many years. Historically, the problem with railroads has been whether to allow owners to close them down.

Because the consequences of reorganizing a railroad are regarded as less cataclysmic than those of reorganizing a financial institution, bankruptcy law does not prevent railroads from using chapter 11 and even provides a subchapter dedicated to railroad reorganization.³² Unlike regular chapter 11 proceedings, however, railroad reorganization cases require appointment of a trustee who must be one of five disinterested persons whose names have been submitted to the bankruptcy court by the Secretary of Transportation.³³ Railroad unions receive express protection against rejection of collective bargaining agreements,³⁴ protection not afforded to other unions.³⁵ Furthermore, the automatic stay in bankruptcy law and the trustee's right to use property of the bankruptcy estate do not affect secured loans to railroads.³⁶

Perhaps most important, the Bankruptcy Code specifies the effect of the Interstate Commerce Act and other railroad regulation on bankruptcy proceedings. Under section 1166 of the Code,³⁷ the trustee is generally subject to orders of any federal, state, or local regulatory body to the same extent the debtor would be subject to such orders outside bankruptcy.³⁸ In addition, the reorganization plan may provide for transfer or abandonment of some of the debtor's railroad lines.³⁹

law. R. REICH & J. DONAHUE, *supra* note 30. Had it ever filed for bankruptcy, some believe liquidation would have been inevitable. *See supra* note 30.

For a company like Chrysler, consumer confidence is an important factor, one that might evaporate almost overnight given the publicity that would accompany a bankruptcy filing. *See Altman, A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 1067, 1071-72 (1984) (reporting loss of confidence in companies in or near bankruptcy). A company that deals less with the public, such as Manville, might be expected to survive more readily despite the adverse publicity of a bankruptcy filing.

32. The special railroad bankruptcy statute dates from 1933. 47 Stat. 1474. *See also* 62 Stat. 163 (1948) (amendments to Interstate Commerce Act). The modern provision is codified at 11 U.S.C. §§ 1161-1174 (1982).

33. 11 U.S.C. § 1163 (1982).

34. *Id.* § 1167.

35. *Id.* § 365.

36. *Id.* § 1168. The Code grants the Interstate Commerce Commission, the Department of Transportation, and state regulators the right to be heard. *Id.* § 1164. The bankruptcy court is required to consider the public interest. *Id.* § 1165. The Code specifies the effect of rejection of a lease of a railroad line, *id.* § 1169, and the conditions for abandonment of a railroad line, *id.* § 1170. Claims based on personal injury or death arising out of operation of the railroad are given priority status. *Id.* § 1171.

37. *Id.* § 1166.

38. Exceptions to this rule apply in the case of proposed abandonment of a railroad, alterations of financial structure, and issuance or sale of securities; and regulatory orders requiring the expenditure of funds must be approved by the court. *Id.* § 1166.

39. *Id.* § 1172.

3. *The Rest of the Regulated Industries.* Putting aside the special cases of financial institutions and railroads, bankruptcy law provides little guidance on how to conduct a reorganization in other industries affected by rate hearings and similar administrative requirements. The Bankruptcy Code does not completely displace federal and state regulatory authority with the regulatory judgment of bankruptcy judges. Section 1129(a)(6) of the Code conditions bankruptcy court approval of a reorganization plan on satisfaction of the following condition:

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.⁴⁰

Section 362(b) of the Code states that the filing of a bankruptcy petition does not operate as a stay "of the commencement or continuation of an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power"⁴¹ The Judicial Code further requires a trustee, receiver, or manager to manage and operate property in accordance with the law of the state where the property is located.⁴²

This is all scant guidance as to how regulated industries should be treated in bankruptcy. The provision excepting regulatory authorities from the automatic stay on actions against the debtor⁴³ is a slender foundation on which to construct a legal relationship between bankruptcy and regulation. On its face, the provision merely suspends the automatic stay. Nothing is said about who the first or primary actor should be when the bankruptcy court is considering a plan. At most, the provision indicates that regulatory authorities may proceed without seeking permission from the bankruptcy court if they wish to do so. It does not indicate what role the results of the state regulatory proceedings will have in the bankruptcy proceedings. The Judicial Code's general instruction that trustees and others obey the law⁴⁴ is too general a prescription to warrant the assumption that Congress meant the provision to furnish guidance for the situations under discussion.

The plan confirmation provision also falls short of articulating a relationship between the bankruptcy court and regulatory authority. Indeed, the provision seems to leave to the bankruptcy court's discretion whether to

40. *Id.* § 1129(a)(6) (1982 & Supp. II 1984).

41. *Id.* § 362(b)(4).

42. 28 U.S.C. § 959(b) (1982).

43. The relationship between the automatic stay and regulatory authority has been the subject of substantial litigation. See, e.g., *In re Mansfield Tire & Rubber Co.*, 660 F.2d 1108 (6th Cir. 1983); *In re Continental Airlines*, 40 Bankr. 299 (Bankr. S.D. Texas 1984); *In re La Porta*, 26 Bankr. 687 (Bankr. N.D. Ill. 1982).

44. 28 U.S.C. § 959(b) (1982). Interestingly, a few regulatory authorities have dealt with financially troubled utilities partly by conditioning aspects of rate awards on the nonfiling of a bankruptcy petition. See, e.g., *In re Maine Pub. Serv. Co.*, 67 Pub. Util. Rep. 4th (PUR) 101 (Maine Pub. Util. Comm'n 1985); *In re Long Island Lighting Co.*, 63 Pub. Util. Rep. 4th (PUR) 165 (N.Y. Pub. Serv. Comm'n 1984). If such conditions were imposed by contract or by state statute, they would likely be unenforceable under the Bankruptcy Code. 11 U.S.C. §§ 365(b), (e), (f), 541, 545 (1982). Congress's failure to expressly undermine such conditional rate awards probably should be viewed as part of the larger statutory void in the area of bankruptcy-regulated industry relations.

condition plan approval upon subsequent regulatory approval or to require that regulatory approval be obtained prior to bankruptcy court approval.

Those who claim federal bankruptcy statutes mandate regulatory dominance⁴⁵ also must take account of section 105. Section 105 authorizes a bankruptcy court to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”⁴⁶ This section provides as much *prima facie* statutory support for bankruptcy court dominance as do other provisions for regulatory dominance. This is not a matter upon which federal statutes make a firm pronouncement.⁴⁷

B. The Roles of Consumer and Investor Confidence in the Case of Monopolistic Utilities

The need for consumer confidence helps explain the exclusion of financial institutions and other entities from traditional bankruptcy. This factor is less significant in the case of monopolistic regulated utilities. Such utilities have a source of funds and a set of dependent customers that will not disappear quickly. Erosion of consumer confidence during reorganization does not threaten the existence of a utility the way it threatens the existence of a financial institution. There is no equivalent to a run on the bank when an electric company incurs financial difficulty. The prospect of a failed

45. The Johnson Act, 28 U.S.C. § 1342 (1982), should also be noted. It limits federal court authority to interfere with a state order affecting utility rates, but it has broad enough exceptions to render it inapplicable in any likely bankruptcy proceeding.

46. 11 U.S.C. § 105(a) (1982).

47. Despite the sparse statutory guidance, some debating the utility bankruptcy issue have staked out both extreme positions. Arthur Young, echoed by Morgan Stanley, states that “[i]n cases of conflict between authority of the bankruptcy court and the authority of a regulatory agency, the court’s authority is paramount.” ARTHUR YOUNG & COMPANY, REPORT ON ANALYSIS OF THE POTENTIAL EFFECTS OF BANKRUPTCY, October 1980, at II-33 [hereinafter cited as ARTHUR YOUNG & Co.]; A. RODGERS RATLIFF & P. TOMASETTI, THE EFFECTS OF BANKRUPTCY: AN ANALYSIS OF THE IMPACT ON THREE INVESTOR-OWNED UTILITIES, May 1984, at 8 [hereinafter cited as Morgan Stanley Report]. And bankruptcy courts have enjoined regulatory agencies where the courts found that agency action threatened the debtor. *In re National Hosp. and Institutional Builders*, 658 F.2d 39 (2d Cir. 1981), *cert. denied*, 454 U.S. 1149 (1982) (bankruptcy court may enjoin regulatory board from revoking debtor’s certificate of occupancy if proposed action was in bad faith); *In re Otis & Co.*, 104 F. Supp. 201 (D. Ohio 1952) (enjoining administrative actions against debtor pending before the SEC); *In re Portland Electric Power Co.*, 97 F. Supp. 877 (D. Ore. 1943) (court temporarily restrained state utility regulatory body from entering an emergency order granting a rate reduction); *In re King Memorial Hosp.*, 4 Bankr. 704 (Bankr. S.D. Fla. 1980) (restraining state agency from forfeiting debtor’s “exemption from a certificate of need review” with respect to construction of new hospital). Others suggest that the bankruptcy court would not or could not interfere with ratemakers’ authority. ELEC. UTIL. WEEK, June 11, 1984, at 11 (quoting Jacob Worenklein) (available on NEXIS); Stewart, *A Bankrupt Electric Utility—What If?*, 112 PUB. UTIL. FORT. 15, 17, Sept. 15, 1983 (quoting Aaron Levy of the SEC). See also *Palmer v. Massachusetts*, 308 U.S. 79 (1939) (bankruptcy trustee required to seek local regulatory approval before discontinuing unprofitable transportation services); *Jordan v. Randolph Mills, Inc.*, 716 F.2d 1053 (4th Cir. 1983) (“bankruptcy judge has no power to control [Federal Energy Regulatory Commission’s] interpretation and application of its own rules and practices”); *In re Gary Aircraft*, 698 F.2d 775 (5th Cir. 1983) (bankruptcy court should defer to agency with respect to liquidation of claims arising from a government contract dispute); *In re Larocque*, 47 Bankr. 83 (Bankr. D. Vt. 1985) (deferring to Agricultural Stabilization Conservation Service County Committee where prior agency determination found to be fair); authorities discussed in Flaschen & Reilly, *supra* note 5, at 145-46.

reorganization does not haunt a utility bankruptcy.⁴⁸ So long as ratepayers pay their bills and use the utility's product, prospects for ultimate failure are small.⁴⁹

Two aspects of investor confidence are worth separating. The first pertains to investor confidence in the troubled utility and the returns that investors will demand if they are to lend to that utility shortly after bankruptcy. Low investor confidence may lead to a demand for an unusually high return on investment, thereby causing increased costs for the utility's next construction project. The other aspect pertains to the future cost of funds to the industry as a whole and, in the long term, to the bankrupt utility and to society. A bankruptcy may affect future institutional arrangements for utility financing.

The response to both concerns depends in part on actions that are taken by the bankruptcy court and the regulatory authority. As will be discussed below, if prepetition investments are scaled down in bankruptcy, the financing costs of the troubled utility should decrease after bankruptcy.⁵⁰ But future investors would then know that their package of risks includes the circumstances triggering the bankruptcy. To the extent that the risk is perceived as one that exists throughout the utility community, the costs of future capital to the industry (and rates to customers) may increase.⁵¹

If the bankruptcy court and regulatory authority fully honor prepetition investments, however, the package of risks should not be viewed as increasing, and costs of capital to the industry would be largely unaffected. But the favorable treatment of prepetition investments would make it riskier to lend to the utility after bankruptcy. As a result, the immediate financing costs of the particular utility would not decrease.

Thus, the effect of bankruptcy on future access to capital depends, not surprisingly, on how existing investments are treated in the bankruptcy proceeding. It seems obvious that the effect is uncertain. Yet, most industry reports on utility bankruptcy, though appropriately hedged, emphasize only the "worst case" bankruptcy scenarios. The reports deemphasize the options available to bankruptcy courts and to utilities for reducing financing costs.⁵²

48. This has not stopped the electric utility industry from trying to exploit the fear of turning out the lights. Consider the following:

In an unlikely display of heavy-handedness, the court could begin to order the liquidation of major utility assets so creditors can be paid

. . . No one is sure if a state can require a utility not to interrupt its service despite liquidation actions taken by the bankruptcy court.

ELEC. UTILITY WEEK, June 11, 1984 (remarks of Jacob Worenklein) (available on NEXIS).

49. Although a majority of consumers in a utility's service area will, for a while, regard themselves as locked in, consumers of utility services will ultimately be sensitive to large rate increases. To the extent people leave or decline to move to a utility's service area, one effect of massively increased rates will be to reduce the utility's rate base, thereby requiring even further rate increases. *See generally* A. LOVINS, *SOFT ENERGY PATHS: TOWARD A DURABLE PEACE* 30-31 (1977).

50. *See infra* text accompanying notes 59-68.

51. *See infra* text accompanying notes 186, 195-203.

52. One report notes that a bankruptcy petition would be accompanied by an emergency request for higher rates from the state, thus raising the specter of bankruptcy leading to an

These options are discussed here. The possible industry-wide and long-range economic effects are addressed in Part V in the context of discussing the allocation of losses between investors and ratepayers.⁵³

An Arthur Young & Company report on the Jersey Central Power & Light Company, principal owner of Three Mile Island, identifies frequently cited financing-related costs of a utility bankruptcy.⁵⁴ One important cost identified is the increased cost of funds to the bankrupt utility.⁵⁵ The other factors noted in the report and frequently relied upon are (1) the loss of low embedded cost of fixed income securities on recapitalization, and (2) increased risk premium on newly issued common stock.⁵⁶ These themes are repeated in a report by Morgan Stanley covering Consumers Power, a Michigan utility, the Long Island Lighting Company, and the Public Service Company of New Hampshire (PSCNH).⁵⁷ A report prepared for the State of New Hampshire on PSCNH states that “[i]t is anticipated that a Debtor-in-Possession would have limited access to capital markets and then only at terms unfavorable to the Debtor, its current creditors and ratepayers.”⁵⁸

1. *Future Borrowing Costs for Troubled Utility.* Financing in bankruptcy is more flexible and favorable to postpetition lenders than most reports to date suggest. Under current bankruptcy law, routine borrowings by a troubled utility probably would cost less after bankruptcy than they would cost the same utility before bankruptcy. This is so despite the increased risk premium usually associated with lending to an entity in bankruptcy. Indeed, the postpetition cost of borrowing should be significantly smaller for an electric utility. To defend these assertions, it is necessary to explore some details of bankruptcy law in view of the nature of the entity under consideration.

Under section 364(a), a trustee or debtor-in-possession may obtain unsecured credit and incur unsecured debt in the ordinary course of business.⁵⁹ These obligations are administrative expenses of the bankruptcy estate entitled to priority over prepetition claims against the debtor.⁶⁰ If

immediate increase in rates. ELEC. UTIL. WEEK, June 11, 1984 (remarks of Jacob Worenklein) (available on NEXIS). A utility will file for bankruptcy, however, only if substantial rate increases have been denied and if cost reduction measures fail.

53. See *infra* text accompanying notes 195-203.

54. ARTHUR YOUNG & Co., *supra* note 47, at III-12.

55. The report phrases increased cost in terms of funds for future capital requirements, but the point could be generalized to other borrowings by the bankrupt utility. *Id.*

56. *Id.* The report also notes the cost of litigation and other administrative aspects of the bankruptcy process. *Id.* at III-2.

57. Morgan Stanley Report, *supra* note 47, at 13.

58. Devine, Millimet, Stahl & Branch, The State of New Hampshire and Public Service Company of New Hampshire, Sept. 18, 1984, at 22. See also Stewart, *A Bankrupt Electric Public Utility—What If?*, 54 ORLA. BAR J. 1131, 1133 (1983).

59. 11 U.S.C. § 364(a) (1982).

60. *Id.* §§ 364(a), 503(b)(1). It may be a close question whether capital borrowing by a utility is in the ordinary course of business and, therefore, subject to section 364(a). Ordinary course borrowing may be reserved for borrowings to pay more current expenses. But the point need not detain us. A bankruptcy trustee or debtor-in-possession may seek long-term unsecured financing under section 364(b) and again confer administrative priority on the lender's claim. *Id.* § 364(b).

necessary, a debtor-in-possession or trustee may issue secured debt, and that debt can be given priority over preexisting secured claims.⁶¹

Examined from the point of view of a potential lender, the possibility of postpetition priority borrowing suggests that the cost of funds to the debtor could decrease in bankruptcy. Consider a debtor with \$100 million unsecured debt, in need of an additional \$100 million in capital. An unsecured lender outside bankruptcy who lends the additional \$100 million will share equal priority with the prior lenders of \$100 million. If there is less than \$200 million to be distributed to creditors, the new lender (as well as the earlier lenders) will not be repaid in full. Unless expressly subordinated, all unsecured debt ranks equally under state law.

Consider the same situation in bankruptcy. There the postpetition lender of the additional \$100 million finds itself, under section 364, with priority over the earlier \$100 million. If there is less than \$200 million but more than \$100 million to distribute, the postpetition lender will be paid in full and the prepetition lender will not. Although other costs of the bankruptcy, such as attorneys' fees, must be taken into account, these will reduce the amount available to all lenders. Only if bankruptcy costs were enormously high would the postpetition lender be worse off than if it were lending before bankruptcy. The available evidence indicates that direct bankruptcy costs are not of such magnitude.⁶²

In comparing prepetition and postpetition lending, the important consideration is not the absolute cost of funds in bankruptcy, but rather their cost relative to a similar loan to the same debtor outside bankruptcy. If there will be a pool of assets sufficient to pay off administrative claims, the position of a postpetition lender to a utility appears safer than the position of a prepetition unsecured lender. It is misleading to state the issue in a way that suggests that the fact of bankruptcy imposes an enormous added burden on access to capital. For one could equally well ask whether a utility in financial trouble that does not file for bankruptcy could raise capital at a nonexorbitant cost. The PSCNH Seabrook experience, in which financing proposals involved rates of return to investors in excess of twenty percent, suggests that it could not.⁶³

61. *Id.* § 364(c), (d). The trustee or debtor-in-possession must provide prepetition secured creditors with "adequate protection" of their interest before subordinating their liens on the property to a postpetition lender and must not be able to obtain secured credit otherwise. *Id.* § 364(d)(1)(A), (B). For discussion of the controversy surrounding the concept of adequate protection, see *In re Briggs Transp. Co.*, 780 F.2d 1339 (8th Cir. 1986); *In re American Mariner Inds., Inc.*, 734 F.2d 426, 432-35 (9th Cir. 1984).

For an illustration of a postpetition secured lender being granted a superpriority over all claims, including administrative expenses, see *In re Flagstaff Foodservice Corp.*, 739 F.2d 73 (2d Cir. 1984). In such cases, there may be disputes over the authority to award interim fees to attorneys and others at the possible expense of the priority lender. Compare *Flagstaff Foodservice Corp.*, *supra*, with *In re Callister*, 15 Bankr. 521 (Bankr. D. Utah 1981), *aff'd*, 13 Bankr. Ct. Dec. 21 (10th Cir. 1984).

62. See *infra* text accompanying notes 170-78.

63. See CAMPAIGN FOR RATEPAYERS' RIGHTS, REPORT TO DONORS AND FRIENDS, No. 7 (Dec. 1985) (22% financing cost); *Municipal Utilities with Seabrook Stake Plan Issue of Notes*, Wall St. J., Oct. 14, 1985, at 21, col. 1 (tax-exempt notes to yield about 16.4%). See also *Flaschen & Reilly*, *supra* note 5, at 138-

Given these facts, why is greater use not made of bankruptcy to exploit postpetition lending opportunities at the expense of prepetition financiers? For a debtor with a doubtful cash flow and financial future, the administrative priority is not a panacea to postpetition unsecured lenders. There is no assurance in the Bankruptcy Code that all administrative expenses will be paid. There is little assurance that the business will survive. Most reorganization efforts fail. A nontrivial risk premium makes sense.

For a debtor likely to survive, however, and one, like a utility, with thousands of locked-in customers, immediate postpetition cash flow is unlikely to be a serious problem. Unsecured administrative priority for short-term debt is a safe lending position. The risk premium normally associated with lending to bankrupt entities should not prevail.

Further comfort may be drawn from the usually limited scope of a utility's problem. Today's troubled electric utilities are not yet entities that face massively declining demand for their product.⁶⁴ Many of their troubles stem from a single isolated matter such as a burdensome plant or investment. Prospects for financial rehabilitation of such an entity are brighter than are prospects for saving a business in general decline or a utility in a declining industry. Thus, Penn Central's difficulty in attracting postpetition financing⁶⁵ does not provide guidance for utility bankruptcies. That bankruptcy involved a declining industry subject to important new competition from trucking and air transportation.⁶⁶ There was no single source of financial difficulty the removal of which would have allowed a return to financial health.

39 (hypothesizing utility unable to obtain funds outside of bankruptcy). There is one wrinkle in this analysis worth noting. A judicially developed "six months" rule treats as expenses of bankruptcy administration, and thus entitled to administrative priority on a par with expenses treated under section 364, the costs of labor, supplies, repairs, and some capital provided to a debtor within six months before the appointment of a trustee. The rule was developed in railroad reorganizations, see *Fosdick v. Schall*, 99 U.S. 339 (1878), and was extended to other public service corporations, see *In re Hallmark Medical Servs., Inc.*, 475 F.2d 801, *reh'g denied*, 478 F.2d 1402 (5th Cir. 1973); *Dudley v. Mealey*, 147 F.2d 268 (2d Cir. 1945); *Louisville and Nashville R.R. Co. v. Memphis Gaslight Co.*, 125 F. 97 (6th Cir. 1903). The rule provides unsecured creditors with additional motivation to risk lending to a failing enterprise. It thus marginally decreases the differences between prepetition lending and postpetition lending without eliminating those differences. The status of the six months rule under the new Bankruptcy Code is not settled.

64. Electricity's share of U.S. energy consumption has almost doubled since 1960. Cavanagh, *supra* note 4, at 301 (citing to ENERGY INFORMATION ADMIN., U.S. DEP'T OF ENERGY, ANNUAL ENERGY REVIEW 1984, at 11 (1985)). Generation of electricity in the United States has showed a slow but steady increase since 1970. D. CHAPMAN, ENERGY RESOURCES AND ENERGY CORPORATIONS 69 (1983) (Figure 4-3). *But see* R. SANT, D. BAKKE & R. NAILL, CREATING ABUNDANCE: AMERICA'S LEAST-COST ENERGY STRATEGY 134 (1984) ("centrally generated electricity at current prices is already uncompetitive in several energy service markets . . . [and] is in many cases losing to conservation technologies[,] . . . cogeneration, and other decentralized sources of electric generation").

65. "[W]ithin six months of Penn Central's bankruptcy petition it was apparent that no entity would lend money to the debtor on any terms absent a sweeping federal guaranty of loan obligations." Flaschen & Reilly, *supra* note 5, at 161 n.86, citing H.R. REP. NO. 1770, 91st Cong., 2d Sess. 1 (1970). Congress enacted legislation authorizing federal guarantees of priming loans made to reorganizing railroads. Emergency Rail Services Act of 1970, Pub. L. No. 91-663, 84 Stat. 1975 (codified as amended at 45 U.S.C. §§ 661-68 (1982)). The matter is discussed in Perritt, *Ask and Ye Shall Receive: The Legislative Response to the Northeast Rail Crisis*, 28 VILL. L. REV. 271 (1983).

66. This is not to deny the existence of some competition affecting electric utilities. See R. SANT, D. BAKKE & R. NAILL, *supra* note 64; Habicht, *Competition Can Power Utilities Into the Black*, Wall St. J.,

In short, a rational lender may well charge a utility in bankruptcy less for funds than it would charge the same utility outside bankruptcy.⁶⁷ In other settings, even after the bankruptcy case is closed and the administrative priority lost, many debtors are still able to borrow.⁶⁸ Whether this is true for a particular debtor must depend on whether the financial community perceives the causes of the bankruptcy to have been eradicated by the proceeding. But a sound reorganization plan should make it easier rather than more difficult for a financially troubled utility to gain reasonable access to capital markets.

These considerations address the general concern of increased funding costs to bankrupt utilities. They do not specifically address the concerns about losing the benefits of low embedded cost debt and the premium needed to attract future stockholders, tasks to which we now turn.

2. *Costs of Attracting Equity Investment.* Considerations similar to those bearing on the cost of attracting new debt financing also apply to the cost of attracting equity investment in a bankrupt utility. The precise position of the new equity investor, however, depends more heavily on the reorganization plan than did the lender's position. Again, it may be less costly to attract new equity in bankruptcy than it would be outside bankruptcy.

Consider the debtor with \$100 million in prepetition debt and prepetition equity investors whose investment of \$50 million is currently worth \$10 million. Such a debtor will likely need to promise to pay dividends at a substantial premium to attract additional equity outside bankruptcy. The new investors, assuming they receive stock of equal rank with the prior investors, will find their equity investment immediately diluted by the full weight of the prior shareholders' interests and will rank behind the preexisting debt interests. Information about troubled utilities supports the notion that a dividend premium is necessary under such circumstances.⁶⁹

In bankruptcy, however, the prior debt can be scaled down to help attract new equity, and the old equity must be scaled down to its actual value of \$10 million. A new equity investor need not worry about the diluting effect of prior equity. On initial examination the cost of new equity might also be expected to decrease in bankruptcy. Like a postpetition lender, a postpetition

Oct. 14, 1985, at 14, col. 3; Paul, *Easing of Electric Rate Increases Benefits Industry and Consumers*, Wall St. J., Sept. 12, 1985, at 6, col. 1 (noting competition from oil and natural gas); Richards, *Cogenerated Power Irritates Utilities*, Wall St. J., Oct. 23, 1985, at 6, col. 1; Richards, *Power Users Seek Relief from Nuclear Costs*, Wall St. J., Sept. 12, 1985, at 6, col. 1 (shift in utility used by town after 32% rate increase); Sawhill, *Your Local Utility Will Never Be the Same*, Wall St. J., Jan. 2, 1986, at 14, col. 3 (competition driving the restructuring of electric utility industry).

67. See also Warner, *Bankruptcy, Absolute Priority, and the Pricing of Risky Debt Claims*, 4 J. FIN. ECON., May 1977, 239, 260-62 (in study of railroad bankruptcies, investors purchasing a portfolio of bonds on the date of bankruptcy appear to earn abnormal returns).

68. Cf. D. STANLEY & M. GIRTH, *BANKRUPTCY: PROBLEM, PROCESS, REFORM* 62-64 (1971) (only one-third of consumer debtors found credit harder to obtain after bankruptcy).

69. Examine, for example, the stock market report in a recent issue of the *Wall Street Journal*. Find those utilities that are paying the highest dividends and you will have constructed a list of utilities in serious financial difficulty.

equity investor may regard the utility in bankruptcy as a safer investment than the troubled utility outside bankruptcy. If the reorganization plan actually reduces the debtor's debt burden and if prepetition shareholders lose a portion of their interest, as would be likely in any reorganization, the postpetition equity investor should be better off when the financially troubled utility is in bankruptcy than it would be investing at the same time in the same company in a nonbankruptcy setting.⁷⁰

3. *Loss of Low Embedded Fixed Costs.* Some believe that bankruptcy would cause loss of low embedded cost debt.⁷¹ This seems to mean that, in any recapitalization accompanying a reorganization, old debt issued at favorable rates might be replaced with new debt issued at higher rates. The Oklahoma Corporation Commission relied on loss of low embedded fixed costs in bankruptcy as a reason for granting rate increases to help avoid bankruptcy.⁷² The importance of this factor for any particular utility depends on that utility's debt structure. For some utilities, current interest costs may be lower than historical costs, in which case the loss of low embedded cost factor disappears. But for others, it is a factor worthy of consideration.

Building on this theme, the Morgan Stanley Report observed that the embedded cost of debt for Consumers Power in Michigan is 10.1%, for Lilco 10.4%, and for PSCNH 14.0%. These costs were all said to be "well below current market rates for below investment grade securities."⁷³ Would the benefits of these low rate borrowings be lost in bankruptcy?

To the extent the costs referred to are costs of *past* borrowing, the argument that bankruptcy will adversely affect them is seriously oversimplified.⁷⁴ Those funds have already been borrowed. The question in bankruptcy is as much one of whether they will be repaid at all as it is one of at what interest rate they will be repaid. One way to deal with past borrowings in bankruptcy is not to repay them. If the debts are not repaid, the loss of their low interest rate becomes an insignificant detail.

Nevertheless, circumstances might dictate repayment of prepetition low interest debts. If the value of the firm exceeds the amount of debt, then the reorganization plan probably must provide for payment of the debt in full.⁷⁵ The fact that debt is to be repaid under the plan, however, does not mean it

70. The postpetition stock investor, however, does not automatically find itself in a position of administrative priority. Such an investor must be concerned about ranking behind both portions of prepetition debt that are not scaled down in bankruptcy and all postpetition debt.

71. ARTHUR YOUNG & Co., *supra* note 47, at III-15.

72. Public Service Co. of Oklahoma, Cause No. 27068, Order No. 206560, at 57-58 (Okla. Corp. Comm'n, Jan. 15, 1982).

73. Morgan Stanley Report, *supra* note 47, at 13.

74. Lenders locked in by a contract to lend to a utility at low rates in the future would be relieved of that obligation in the event of bankruptcy. A trustee or debtor-in-possession may not assume an executory contract to lend money. 11 U.S.C. § 365(c)(2) (1982). Of course, some lenders may have seen fit to protect themselves with financial covenants that relieve them of the obligation to make future advances (even to a nonbankrupt entity) in the event of the debtor's financial difficulty.

75. *Id.* § 1129(b)(2) (1982 & Supp. II 1984). One would have to repay the debt in full if the firm's value exceeded its outstanding liabilities. See *id.* § 1129(1). The Arthur Young Report

will carry a higher interest rate. The debtor may leave low cost, prepetition debt in place in accordance with its original terms.⁷⁶ In bankruptcy parlance, this treatment does not "impair" the creditor's claim. A creditor with an unimpaired claim is not even entitled to vote on the debtor's reorganization plan.⁷⁷ Furthermore, debt may be deemed unimpaired notwithstanding a prepetition default if the default is cured, the original maturity of the debt instrument is reinstated, and the lender is compensated for damages resulting from the default.⁷⁸ Analyses that project the loss of low embedded costs are assuming that prepetition debts will be repaid in full under a plan that impairs these debt interests.⁷⁹

Even if prepetition debts are repaid in full, bankruptcy may reduce the cost of borrowed funds. This is possible because bankruptcy suspends the accrual of interest as of the date of the filing of the petition.⁸⁰ Any unsecured funds borrowed before bankruptcy are, in effect, used by the bankrupt on an interest-free basis during the pendency of the proceedings. Unsecured lenders subject to the suspension of interest on prepetition loans are not entitled to protection of their interest through interim payments. Since a major utility reorganization is unlikely to be a brief affair, the effective cost of prepetition funds to a debtor should be substantially reduced during the proceedings. Indeed, this interest-free use of funds provides shareholders with an incentive to prolong the proceedings in the hope that the stock will increase in value.

III

BANKRUPTCY LAW AND REGULATORY THEORY

Dire projections about the effects of a utility bankruptcy are largely unfounded. Once one discards initial fearful reactions, bankruptcy may supply benefits other than the obvious benefit of avoiding piecemeal dismantling of the debtor.⁸¹ Some problems faced by financially troubled utilities are not purely matters of dollars and cents. There are also questions of representation, participation, and regulatory theory. Bankruptcy may make its most important contributions to a troubled utility in these areas. If representation and participation are flawed and bankruptcy can help correct

assumes that the utility it studied has assets worth more than liabilities. ARTHUR YOUNG & Co., *supra* note 47, at III-3 to III-10.

76. Under 11 U.S.C. § 1124(1) (1982), a class of claims or interests is not impaired if a reorganization plan "leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest." Under 11 U.S.C. § 1129(a)(8) (1982 & Supp. II 1984), a class that is not impaired under the plan within the meaning of section 1124 does not even have to approve the plan.

77. *Id.* § 1129(a)(8)(B).

78. *Id.* § 1124(2)(A), (B), (C).

79. For one of the rare analyses from the investment or utility community that emphasizes some of the most important benefits of bankruptcy, see Whitman, *Virtues of Bankruptcy*, BARRON'S, May 6, 1985, at 16.

80. *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156 (1946).

81. In the utility area, piecemeal dismantling of the debtor can be avoided or at least deferred by rate increases.

the flaws, going concern value may be enhanced. But benefits are only part of the story. This part and Part IV attempt to set forth both the benefits and burdens of a utility bankruptcy. Improved representation may be the prime benefit of bankruptcy and administrative costs may be its prime burden.

A. The Role of Bankruptcy Law Under the Traditional Model of Administrative Law

One tack for exploring the less obvious benefits of bankruptcy in the utility area is to build upon the foundations of administrative law. Identifying what regulatory schemes seek to accomplish permits a consideration of whether bankruptcy law is likely to further those goals.

Under one view of administrative law, there would be little for the bankruptcy process to contribute. In what Professor Stewart terms the "traditional model," administrators' decisions are regarded as implementing a plainly discernable legislative will.

The traditional model of administrative law . . . conceives of the agency as a mere transmission belt for implementing legislative directives in particular cases. It legitimates intrusions into private liberties by agency officials not subject to electoral control by ensuring that such intrusions are commanded by a legitimate source of authority—the legislature.⁸²

Interference with legislatively supported administrative decisions could subject the bankruptcy process to criticism on two counts. On the substantive level, bankruptcy law would be tinkering with decisions of experts presumably better qualified to deal with an area. On the process level, bankruptcy courts would be changing the substance of legislatively mandated action without the political accountability attributed to regulators.

Bankruptcy law's special treatment of railroads reflects both the traditional model of administrative law—what could be more traditional than railroad regulation?²—and a predictable response to the problems perceived in bankruptcy court interference with such a regulatory structure. A nonbankruptcy statutory scheme for regulating railroads is supplemented in bankruptcy by another specialized set of provisions for railroads.⁸³ Under the traditional model of administrative law, such provisions may be the only acceptable response to the bankruptcy of a regulated entity. Specific bankruptcy legislation covering railroads reduces the problem of inexpert bankruptcy courts dealing with matters with respect to which the regulatory agency is better qualified. Such legislation requires bankruptcy courts to defer to the body charged with railroad regulation, the ICC. The bankruptcy court's actions are endorsed by a detailed statutory scheme, thereby maintaining perceived political accountability.

82. Stewart, *supra* note 13, at 1675.

83. See *supra* text accompanying notes 32-39.

B. The Role of Bankruptcy Law Under the Modern Emphasis on Representation

The demise of the traditional model of administrative law is ably traced elsewhere.⁸⁴ The importance of its demise for the present inquiry is the resulting need for another standard by which to assess the role of bankruptcy in the administrative state. Without suggesting that it is the only possible standard, one interesting candidate is the concept of representation. Representation is both an important theme of modern administrative law and an idea of growing importance in bankruptcy. Much of the modern concern about agency decisions focuses on adequate representation of diverse interests.⁸⁵ The expansion of due process rights, standing, and rights of participation before administrative agencies may all be viewed as efforts to broaden representation.⁸⁶ Whether such broadened representation is normatively desirable, adequacy and breadth of representation have become standards by which to evaluate the administrative process.⁸⁷

Even those critical of the modern emphasis on representation may find the representational adjustments in bankruptcy law to be acceptable, for much of the effect of bankruptcy law on representation goes not to the breadth of the basis of representation of all possible interests, but rather to flaws in the nonbankruptcy representational scheme.

On the bankruptcy side, questions concerning representation in the bankruptcy process are emerging. For example, the problem of participation by the SEC in the reorganization process was an issue debated before the enactment of the new Bankruptcy Code,⁸⁸ and the question of representation in bankruptcy of future tort claimants is a matter occupying several courts.⁸⁹ Less in the headlines, but perhaps more fundamental to bankruptcy, is the way the Code allocates representation to those with claims against the debtor. Much of the complexity in the Code's confirmation standards stems from an effort to allocate the right to vote on a proposed plan of reorganization.⁹⁰

In light of the representation's possible bearing on a debtor's problems, several questions arise: Can bankruptcy improve upon the nonbankruptcy representational structure? Is there reasonable hope that the bankruptcy court can provide fuller, fairer, or in any way better representation of interests? The next four subparts address these questions.

84. Stewart, *supra* note 13.

85. "Increasingly, the function of administrative law is not the protection of private autonomy but the provision of a surrogate political process to ensure the fair representation of a wide range of affected interests in the process of administrative decision." *Id.* at 1670. See also Reich, *Public Administration and Public Deliberation: An Interpretive Essay*, 94 YALE L.J. 1617 (1985).

86. Stewart, *supra* note 13, at 1711-60.

87. For criticisms of the interest group representation view of administrative law, see Reich, *supra* note 85, at 1619-27; Stewart, *supra* note 13, at 1760-89.

88. *E.g.*, H.R. REP. NO. 595, *supra* note 8.

89. See, *e.g.*, *In re Amatex Corp.*, 755 F.2d 1034 (3d Cir. 1985).

90. 11 U.S.C. §§ 1124, 1126, 1129 (1982).

1. *Replacing Management.* The bankruptcy court's first opportunity to rearrange representation arises shortly after the filing of the bankruptcy petition. The bankruptcy court may be asked to exercise its authority to replace the debtor's management with a trustee.⁹¹ It is common for a reorganizing debtor's management to remain in place and for a trustee not to be appointed to run the debtor's business. The costs, in terms of time and continuity, of finding new competent management can be high.

Because of the high cost of replacement, corrupt managers are the prime candidates for replacement by a bankruptcy trustee. The bankruptcy court's authority to replace management is not limited to replacing thieves; it may also replace inefficient managers.⁹² In doing so, the court may shift the interests represented by management in a way that is not likely to occur outside the bankruptcy forum. If the source of financial difficulty can be traced to a single position stubbornly adhered to by management, such a shift may be all that is needed to begin the recovery of a troubled debtor.

Consider the case of a bankrupt electric utility with a management determined to complete an uneconomical nuclear power plant. The plant construction and debt service costs burden the utility. Failure to complete the plant would reflect poorly on management, which has continually backed the plant. It is politically impossible for existing management to reverse course. Politicians in the state may also have become boxed in. In such a situation, a bankruptcy court can break the management-generated political logjam merely by replacing management.

The court should be confident that it has properly identified the source of the utility's problem and its connection to current management. Reported allegations of utility mismanagement are so numerous that serious investigation is warranted.⁹³ Once it is determined that management is part of the problem, the bankruptcy court would likely find it easier to displace management than would shareholders outside bankruptcy. Shareholders are not known for their revolts against management, and it might not be in the

91. *Id.* § 1104(a). The court may take the less drastic step of appointing an examiner to investigate the debtor while management remains in place. *Id.* § 1104(b). Appointment of a trustee or examiner must be on request of a party in interest. For a utility-flavored case indicating that appointment of auditors, investigators, and examiners is within the equity power of the bankruptcy court, see *In re Utilities Power & Light*, 90 F.2d 798 (7th Cir. 1937).

92. The statutory standard for replacing management is:

for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case

11 U.S.C. § 1104(a)(1) (1982).

93. For findings of mismanagement (without replacement), see *In re Wolf Creek Nuclear Generating Facility*, 70 PUB. UTIL. REP. 4th (PUR) 475 (Kansas St. Corp. Comm'n 1985); *Kansas City Power Gets 33.4% Boost in Missouri Rates*, Wall St. J., Apr. 24, 1986, at 22, col. 1 (rate request cut 58% owing to inefficient or imprudent management). For allegations of mismanagement, see Cook, *Nuclear Follies*, FORBES, Feb. 11, 1985, at 82; Flaschen & Reilly, *supra* note 5, at 150 n.49. See also ELEC. UTIL. WEEK, May 28, 1984, at 7 ("street wisdom" holds that an impending bankruptcy is needed to shock utility managers into operating more efficiently) (available on NEXIS); Letter from Peter A. Bradford, Chairman, Maine Pub. Util. Comm'n, to Theodore Eisenberg, Apr. 3, 1986 (suggesting that Central Maine Power Company's return to relative financial health may be connected to a clean sweep of management by the Board of Directors).

shareholders' interest to stage a coup. If a plant is abandoned before its costs can be incorporated into a utility's rate base, much of the shareholders' equity in a company is likely to be eliminated. Their best hope is for completion and for the costs to be passed on to ratepayers. Bankruptcy gives a voice in management to those otherwise without one or with one that can be exercised only through a highly attenuated political process.⁹⁴ Even without replacing management, a bankruptcy court can take the less drastic step of authorizing an investigation by an examiner⁹⁵ who reports to the court on the management and affairs of the debtor.

2. *Scaling Down Prepetition Interests.* Management is not the only group with a position that can be modified in a bankruptcy proceeding. As pointed out above, the interests of shareholders and creditors may be best served by pursuing to completion an economically questionable project. Under state law, shareholders and creditors may be required to bear the cost of an uncompleted project, while completion of the project would allow costs to be passed on to ratepayers. Outside bankruptcy, the shareholders' voice in the enterprise is often tied to historical investment rather than to current values, giving them relatively more influence than is warranted by the true current value of their interest in the debtor.

To illustrate the point, consider a debtor on the brink of bankruptcy. Its net worth is near zero or perhaps below zero, depending on whose valuation is used. Outside bankruptcy, the shareholders continue to have full formal control of the enterprise, control manifested through a management reluctant to take positions that directly damage shareholder interests. Although creditor interest in and influence on the debtor might be expected to be growing,⁹⁶ formal decisionmaking control remains with the shareholders and management. Yet the value of what shareholders own may well be zero. To leave the shareholders in formal control at this point may be disastrous since they may require the debtor to take extraordinary risks in the hope of achieving a positive net worth and recovering their investment. The shareholders have nothing to lose.

In bankruptcy, the court can scale down the representation of shareholder interests to render their formal representational rights proportional to the true economic value of their interests. Representation in bankruptcy, in the form of voting rights to accept or reject a plan, is a function of the value of a claimant's interest in the debtor, not a function of paper claims in debt or stock against the debtor.

3. *Regulators as an Interest Group.* Outside bankruptcy, a regulatory authority must be viewed as a neutral adjudicator. An agency may be subject

94. See generally Stewart, *supra* note 13, at 1790-1802.

95. A bankruptcy court must appoint an examiner upon request of a party in interest if the debtor has debts in excess of \$5 million. 11 U.S.C. § 1104(b)(2) (1982).

96. Creditor influence could formally increase if lenders' debt instruments included financial covenants that increased creditor control in times of financial difficulty.

to judicial review, but it is regarded as the formal embodiment of the public interest. A regulatory authority that has approved all the steps that lead to the brink of bankruptcy, however, is not necessarily a detached observer parceling out representational rights among others. Such an authority may adopt an advocate's role to justify past decisions. A bankruptcy court may consider that the regulatory authority is itself an interest capable of advocate-like behavior. The court can provide a check on this vital interest group. Outside bankruptcy, such a check can be obtained only after substantial delay and expense, subject to standards of judicial review of administrative action, and on the basis of a record constructed by the agency itself.⁹⁷

4. *Broadening the Base of Representation.* A bankruptcy court may broaden representation in two ways. First, it can expand the number of groups given a voice in proceedings affecting the debtor. In the asbestos bankruptcies, a crucial question has become whether asbestos workers with future claims, claims that would not be actionable under state law at the time of the filing of the bankruptcy petition, may or must be represented in the companies' reorganization proceedings.⁹⁸ In a nonbankruptcy setting, there is no formal mechanism through which to give such an inchoate interest a current voice.

The role of interested but underrepresented parties is likely to become an important question in a utility bankruptcy. For example, ratepayers are the prime source of funds for a regulated utility, and a utility in trouble will be looking to rate increases to bail itself out. Outside bankruptcy, the ratepayers' point of view⁹⁹ may be presented to the regulatory authority. But the case for allowing only the authority to speak for the public diminishes once the authority has approved actions leading to the bankruptcy.¹⁰⁰ The question that arises is whether ratepayers are entitled to independent representation in the bankruptcy proceedings.

In bankruptcy, however, ratepayers lack the formal status of creditor or shareholder and are not likely to be viewed as holders of claims (debts) or

97. Bankruptcy courts will be in a position to provide a check only on ratemaking authorities that provide rates too favorable to ratepayers. Authorities that render rate decisions too favorable to investors will grant sufficient rate increases to keep a utility out of dire financial difficulty. Even regulators wishing to grant increases may see a benefit to a bankruptcy proceeding. Regulators who favor rate increases may feel political pressure not to follow their best regulatory judgment. If a bankruptcy court is likely to grant the desired rate increase or is unlikely to prevent the regulatory authority from granting an increase, the bankruptcy court may absorb some of the political heat that would otherwise focus solely on the regulators.

98. *See, e.g., In re Amatex Corp.*, 755 F.2d 1034, 1037-39 (3d Cir. 1985) (appointment of a guardian ad litem to represent the interests of prospective unknown asbestos claimants).

99. I realize the difficulty in referring to a single ratepayer's point of view. Aside from the regulatory authority, there is no obvious candidate to present the official "public interest" view with respect to a rate increase request. This problem exists both inside and outside of bankruptcy and has been addressed by many states by providing for public counsel or citizen utility boards, *see, e.g.,* MO. STAT. ANN. §§ 386.700, .710 (Supp. 1987); N.J. STAT. ANN. §§ 52:27E-16 to 20 (1986); OHIO REV. CODE ANN. §§ 4911.01-.19 et seq. (1977); WISC. STAT. ANN. §§ 199.01-.09 (Supp. 1986), or by allowing recovery of fees, *see* 16 U.S.C. § 2632 (1985) (allowing compensation for costs of consumer participation in proceedings affecting electric utilities where state does not provide a compensation mechanism).

100. *But see* Flaschen & Reilly, *supra* note 5, at 140.

interests (equity), the groups normally entitled to representation in bankruptcy. The Bankruptcy Code does provide for representation of a "party in interest," a concept seemingly broader than that of claim or interest, who may be heard on any issue in a bankruptcy case.¹⁰¹ Ratepayers of a regulated utility are strong candidates for "party in interest" status. Much of the debate in the utility industry focuses on how to allocate the cost of burdensome facilities between investors and ratepayers. Ratepayers will be involuntarily funding the plan, directly or indirectly, and should be granted a fresh, formal voice in the proceedings.

The second way in which representation may be broadened in the bankruptcy setting is by expanding the range of decisions with respect to which nonmanagement interests are entitled to representation. For example, the decision to construct or complete a power plant is not always within the jurisdiction of the regulatory agency.¹⁰² If excluded from agency consideration, these decisions become, in practice, exclusively those of management. Yet the decisions may substantially influence regulators. Once presented with a completed plant, regulators may be tempted to allow it to be brought on line and included in the rate base. In bankruptcy, such construction or completion decisions can be reviewed by nonmanagement interests even if the regulatory authority would lack jurisdiction. Such decisions would have to be incorporated into a reorganization plan, where they could be voted upon, and comments upon the decisions could be solicited from all interested parties, including ratepayers.

C. Bankruptcy and the New Economic Rationales for Regulation

Another approach to regulation also suggests that bankruptcy might validly address representational defects. Economists draw on Professor Ian Macneil's theory of relational contracts in addressing the theoretical justification for regulation. Macneil argues that the world of contract is best regarded not as "a world of discrete transactions" but rather as "a world of relation, an ongoing dynamic state, no segment of which—past, present or future—can sensibly be viewed independently from other segments."¹⁰³ Whether this relational view, standing alone, captures all of Contract is not

101. 11 U.S.C. § 1104 (1982).

102. See Public Serv. Co. of Okla., Cause No. 27068, Order No. 206560, at 54 (Okla. Corp. Comm'n, Jan. 15, 1982) ("We recognize that the decision to construct or to continue to construct an electric generating station is a decision which under Oklahoma law rests exclusively with management of our electric utilities"), quoted in Note, *Public Utilities: The Black Fox Nuclear Project Cancellation Dilemma: Of Judicial Review and Reform of Oklahoma's Administrative Process*, 36 OKLA. L. REV. 190, 197 (1983). New Hampshire law appears only to require that a utility report the commencement of construction of a plant to the regulatory authority. Permission to commence construction from the authority does not appear to be necessary. N.H. REV. STAT. ANN. § 374:5 (1984).

103. Macneil, *The Many Futures of Contracts*, 47 S. CAL. L. REV. 691, 694 (1974) (footnote omitted); Macneil, *Restatement (Second) of Contracts and Presentation*, 60 VA. L. REV. 589 (1974). See also Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963). Professor William Klein makes an analogous point but does so from the perspective of the firm rather than from the perspective of the individual contract. Klein, *The Modern Business Organization: Bargaining*

important, for surely it captures much that is significant. Most successful ventures do not triumph on the basis of a single isolated contract. Long-term relationships are a foundation of commerce.

Building upon Macneil's work, Professor Oliver Williamson describes the situations in which economic activity will be more efficiently organized if the relational character of the contractual situation is acknowledged and endorses a governance structure most suitable for relational bargains.¹⁰⁴ Williamson identifies uncertainty, frequency of exchange, and the degree to which investments are transaction-specific¹⁰⁵ as important characteristics that separate relational situations from traditional contractual arrangements.¹⁰⁶ Most importantly, Williamson and Professor Victor Goldberg identify some regulated industries to which Macneil's relational theory applies and attempt to build a justification for regulation based on that insight.¹⁰⁷ Goldberg, for example, argues:

The paradigmatic contract of economic theory (and of law) is a discrete transaction conveying a well-defined object . . . in exchange for cash. This characterization is adequate for many purposes but it diverts attention from some aspects of contract that will be of particular significance in a regulatory context. This discrete transactional mold is apt to be singularly inappropriate for representing relations which are to take place over a long period of time and in which the parties will have to deal with each other regularly over a wide range of issues (many of them unknown in advance)

By attempting to analyze regulation within a discrete transaction framework, economists have suppressed the most significant aspects of the regulatory arrangement and this has led to an overstatement of the case against regulation.¹⁰⁸

It is interesting and fruitful to apply the relational contractual approach to regulation in a potential bankruptcy setting.

In developing his justification for regulation, Goldberg notes another feature of relational contracts that the discrete transactional mode of traditional contract theory suppresses. "A second suppressed problem concerns the reliance of individuals on agents (for gathering information, making decisions, negotiating contracts, adjusting the terms of ongoing relationships, and so on.)"¹⁰⁹ He regards the suppression of ongoing relationships and reliance on agents as distinctive characteristics of properly regulated areas and uses this insight to defend regulation against recent attacks. Although not concerned with the implications of his theory for bankruptcy, Goldberg's emphasis on the role of agency in regulated

Under Constraints, 91 YALE L.J. 1521 (1982). See also McDonnell, *The Bank-Customer Relationship*, in 3 DEBTOR-CREDITOR LAW (T. Eisenberg ed. 1985).

104. Williamson I, *supra* note 17.

105. Williamson describes his notion of transaction-specific costs in *id.* at 239-45. Examples of physical capital that are transaction specific are "(1) the purchase of a specialized component from an outside supplier or (2) the location of a specialized plant in a unique, proximate relation to a downstream processing stage to which it supplies vital input." *Id.* at 242. He notes that transaction-specific investments in human capital include craftsmanship. *Id.* at 243.

106. *Id.* at 261.

107. See Goldberg, *supra* note 17; Williamson I, *supra* note 17.

108. Goldberg, *supra* note 17, at 426-27 (footnote omitted).

109. *Id.* at 427.

industries suggests that flaws in the performance of the agent might warrant further regulation.

For convenience, Goldberg makes the "wildly unrealistic assumption" that "the agent is a faithful representative of his principals' interests."¹¹⁰ The utility commissioner or public advocate is thus assumed to be a perfect, faithful representative of ratepayer interests. If that assumption is relaxed, what can be done about the commission that is "captured" by a utility industry or is otherwise imperfectly representing ratepayers? If improper decisions by the commission-agent lead to misallocations of resources through unwarranted rate increases, a case for further regulation may exist. Bankruptcy can again be thought of as extended regulation patching a representational flaw in the basic regulatory framework. Indeed, all of bankruptcy law can be thought of as a kind of catch-as-catch-can patch to financial ventures that did not work.¹¹¹

IV

THE LIMITS OF BANKRUPTCY

Part II suggests discounting the more pessimistic projections about the fiscal effect of bankruptcy on a utility. Bankruptcy may yield positive fiscal effects for a utility already in trouble. Part III suggests that bankruptcy may provide a useful mechanism for enhancing the goals of administrative law. Specifically, bankruptcy may provide an enhanced scheme of representation. Neither set of benefits, however, is without costs. This part explores some of the costs associated with providing fiscal relief and enhanced representation. It then takes up bankruptcy-related variations on valuation problems that exist outside of bankruptcy. Finally, it turns to some problems unique to bankruptcy. Initially, however, it is appropriate to explore whether bankruptcy is a proper mechanism for securing whatever gains may be obtained through additional regulation.

110. *Id.* at 430.

111. Another economic view of regulation justifies it on the ground that it lowers systematic risk, that is, lowers the risks of extreme profit or price fluctuations for producers and consumers, thereby reducing the effects of exogenous shocks. See Joskow, *Inflation and Environmental Concern: Structural Change in the Process of Public Utility Price Regulation*, 17 J.L. ECON. 291 (1974); B. OWEN & R. BRAEUTIGAM, *THE REGULATION GAME: STRATEGIC USE OF THE ADMINISTRATIVE PROCESS* (1978); Shaffer, *Regulation and Risk Preferences*, 32 J. INDUS. ECON. 349 (1984). But see Keran, *Inflation, Regulation and Utility Stock Prices*, 7 BELL J. ECON. 268 (1976); Chandrasekaran & Dukes, *Risk Variables Affecting Rate of Return of Public Utilities*, 107 PUB. UTIL. FORT. 32, Feb. 26, 1981. For an empirical study supporting the risk-reduction hypothesis, see Norton, *Regulation and Systematic Risk: The Case of Electric Utilities*, 28 J.L. ECON. 671 (1985).

If regulation is to be supported on the risk-reduction basis, then extreme increases in financing costs and consumer prices are powerful evidence of regulatory failure. Thus, where New Hampshire's Seabrook plant results in 22% financing costs and expected rate increases of 100% and 200% over the next several years, see CAMPAIGN FOR RATEPAYERS' RIGHTS, *supra* note 63, normal regulation may be said to have failed, and some supplementary regulation, perhaps in the form of bankruptcy, may be in order. In the economists' parlance, one might call this a new "governance structure." See Goldberg, *supra* note 17; Williamson I, *supra* note 17.

A. Why Bankruptcy as the Supplementary Regulatory Mechanism?

If one accepts “flawed agency” as a basis for further utility regulation or accepts the earlier discussion of representation as supporting further public action, the additional regulation must be by an entity other than utility commissioners. Bankruptcy, however, is not the only possible additional regulatory mechanism. Additional state regulation may be achieved through more active judicial review of agency decisions, or through the utilization of public advocates, existing federal agencies, new state agencies, or some new federal agency.

Each alternative supplementary mechanism nonetheless will likely raise problems of its own. State rules of judicial review may be too narrow and may not regard the agency as part of the problem. Public advocates may be imperfect agents for want of adequate resources or sufficient independence. New federal or state agencies may be subject to the same pressures that affected the concededly imperfect utility commissioners. In addition, new agencies may require a substantial new infrastructure solely for what may turn out to be a narrow class of problems. Hence, new agencies may not be cost effective. All of these mechanisms, to the extent they are new, also take time to establish. Utilities and ratepayers face an immediate problem.

Bankruptcy’s infrastructure, by contrast, is already in place. Bankruptcy thus provides a politically independent, immediately available, supplementary regulatory mechanism without large and new overhead costs. Bankruptcy is not the only plausible supplementary regulatory system. Nevertheless, some further regulation may be warranted and bankruptcy is available now. Any other supplementary system that realistically might be in place in time to affect the instant problem should also receive serious consideration. Any such system likely would share some of the costs and benefits discussed here under bankruptcy’s banner.

Among the benefits bankruptcy may bring to the regulatory arena is a federal court system providing uniform treatment of a nationwide problem. Resolving the current crisis in the nonbankruptcy setting promises results ranging from full absorption of costs by ratepayers to full absorption by investors.¹¹² The stakes are so large that the variety of results that must attend solutions by local regulatory authorities may not be welcome. The ratepayer in New Hampshire whose utility rates increase by 100 percent from bringing Seabrook on-line will not appreciate learning that elsewhere a similarly situated ratepayer bore none of that cost.¹¹³ Bankruptcy courts, subject to appellate review in a single court system, offer some hope of a uniform solution without providing a federal bailout of the industry.¹¹⁴

112. See *supra* note 20.

113. This is based on the assumption that the terms of regulation are the same in both states. There are important interstate differences in the makeup of utility rates. See *infra* text accompanying notes 188-93.

114. Use of the term “uniform solution” is not intended to suggest that the results with respect to each troubled utility must be the same. The regulatory environment for each utility varies from state

A regional or national approach to regulation is particularly attractive in the case of failed nuclear power plants.¹¹⁵ Federal regulation, through the Nuclear Regulatory Commission (NRC), affects the costs of construction, the timing, the licensing, and the operation of such plants.¹¹⁶ Much of the plants' costs stem from safety measures for which the NRC is primarily responsible. Transfers of control of nuclear plants are subject to NRC approval.¹¹⁷ The NRC shares responsibility for controlling utilities with other regulatory agencies. The Federal Energy Regulation Commission (FERC) is responsible for setting rates for the interstate sale of electric power, usually sales by one utility to another.¹¹⁸ The SEC has authority over many of the financial activities of registered utility holding companies.¹¹⁹ In addition to being subject to this complex scheme of federal regulation, nuclear plants may be owned by utilities in several jurisdictions.¹²⁰ The regulatory authorities in those jurisdictions may allocate the costs of the same failed plant differently.¹²¹ Abandonment of such plants thus seems to call for a regional or national perspective to regulation. Bankruptcy provides such a perspective.

As the foregoing suggests, bankruptcy may function as an effective regulatory mechanism. Bankruptcy promises a uniform approach to the

to state. Ideally, use of the federal court system would promote similar results for ratepayers and investors in similar regulatory environments.

115. See generally Zitser, *The Nuclear Plant Problem Needs A Federal Solution*, 113 PUB. UTIL. FORT. 22, Mar. 29, 1984.

116. 42 U.S.C. §§ 2011-2296 (1982 & Supp. III 1985).

117. *Id.* § 2131 (1982).

118. *Id.* §§ 7171, 7191-93. Consider the following description of FERC proceedings:

Proceedings before the FERC are less frequently adversarial in nature than those before state regulatory commissions inasmuch as the purchasers of the electricity are usually retail electric utilities which may flow the costs through to their own retail customers without question by the state regulatory authorities. The proceedings are generally far removed geographically from the ultimate ratepayers and are, therefore, less political and time consuming. FERC has also shown itself to be less stringent than many state commissions in the allowance of construction work in progress (CWIP) into a rate base and the treatment of cancelled investment for ratemaking purposes. As a result, an increasing number of utilities are creating subsidiaries or affiliated corporations for the generation and transmission of electricity so that all of their power supply costs would be regulated by FERC rather than at the state level.

MASS. CONT. LEGAL EDUC., INC., BANKRUPTCY CODE AMENDMENTS—A UTILITY IN CHAPTER 11, at 134 (1984). But see P. NAVARRO, *THE DIMMING OF AMERICA* 114 (1985) ("Wall Street considers the FERC to be at least as rate-suppressive as a majority of the state PUC's."). See generally *Mid-Tex Elec. Coop. v. FERC*, 773 F.2d 327 (D.C. Cir. 1985) (reviewing and remanding FERC's proposed rule allowing wholesale sellers of electricity to include in their rate base 50% of their investment in construction work in progress). For FERC's interim response to *Mid-Tex*, see *FERC Acts to Facilitate Transition to Order 436 and Modifies CWIP with Interim Rule*, 117 PUB. UTIL. FORT. 41, 43-44, Apr. 17, 1986.

119. Public Utility Holding Company Act of 1935, ch. 687, title I, 49 Stat. 803, 15 U.S.C. §§ 79a to 79z-6 (1982) (PUHCA). The PUHCA has its own reorganization provisions. In 1976, it was reported that only one-third of the utility industry was subject to the PUHCA. Katzin, *Electric Utility Financing Today*, 55 OR. L. REV. 479, 486 (1976).

120. Flaschen & Reilly, *supra* note 5, at 138 n.9.

121. Compare *South Dakota Pub. Util. Comm'n v. FERC*, 690 F.2d 674 (8th Cir. 1982) (sustaining FERC allocation of costs of cancelled nuclear plant built by a utility with multijurisdictional plants), with *In re Northern States Power Co.*, 42 Pub. Util. Rep. 4th (PUR) 339 (Minn. Pub. Util. Comm'n 1981) (limiting recovery of costs of abandoned nuclear power plant despite the existence of an interstate coordinating agreement allocating costs between multijurisdictional plants).

problems currently faced by troubled utilities. The utilization of bankruptcy as such a mechanism, however, is not without costs. An examination of these costs is critical to an evaluation of bankruptcy as a supplementary regulatory mechanism.

B. The Costs of Enhanced Representation

Outside bankruptcy, "the problems in assuring representation of all affected interests . . . are determining which interests are to be represented and the means by which such representation is to be provided."¹²² In proceedings before an agency, a choice must be made among the groups claiming an interest in the proceedings. Those who purport to speak for the "public interest" represent at most an important subset of that interest, a subset often of the attorney's choosing.¹²³ The dollar costs of enhanced representation are also important. Much discussion of public interest representation concerns whether the agency itself or the government should fund public interest participation and whether litigation expenses should be awarded to the public interest representatives by the agencies.¹²⁴ Perhaps most importantly, delay is a cost of broad representation. In nonbankruptcy regulatory settings, delay is a recognized price paid for widespread participation.¹²⁵

Enhanced or modified representation through bankruptcy is neither a guarantee of "correct" substantive results nor a goal achievable without costs. One cost is the shift of some decisionmaking responsibility from a politically accountable body, the regulatory agency, to the courts.¹²⁶ Other costs attend the determination of who is entitled to representation¹²⁷ and who is to pay for representation. In addition, wider representation imposes costly delay.¹²⁸

1. *The Shift in Accountability.* The control of unelected agency officials over much of modern life has traditionally been justified by their conduit-like function: Politically accountable legislators make the rules; administrators merely enforce them.¹²⁹ If modern administrative agencies in fact operate within the traditional model and merely implement legislative directives, a

122. Stewart, *supra* note 13, at 1762.

123. See Cahn & Cahn, *Power to the People or the Profession?—The Public Interest in Public Interest Law*, 79 YALE L.J. 1005 (1970); Stewart, *supra* note 13, at 1765.

124. See Bonfield, *Representation for the Poor in Federal Rulemaking*, 67 MICH. L. REV. 511 (1969); Gellhorn, *Public Participation in Administrative Proceedings*, 81 YALE L.J. 359 (1972); Lazarus & Onek, *The Regulators and the People*, 57 VA. L. REV. 1609 (1971).

125. See, e.g., Stewart, *supra* note 13, at 1770-76.

126. In the loosest sense, bankruptcy judges, who are not appointed for life, 28 U.S.C.A. § 152(a)(1) (West Supp. 1986), might be viewed as more politically accountable than other federal judges. But bankruptcy judges' terms are lengthy enough, *id.* (14 years), and their decisions are subject to review by district and circuit court judges, *id.* § 158. Hence, their decisions are perhaps as politically accountable as those of other federal judges.

127. See Stewart, *supra* note 13, at 1762-70.

128. See *id.* at 1770-76.

129. *Id.* at 1672-73.

loss in accountability will result from sharing decisionmaking with a bankruptcy court.

With the growth of agency discretion, however, administrators are more like legislators and less like technocrats who merely implement legislative policy.¹³⁰ Even in their capacity as ratemakers, modern regulators pass implicit judgment on the desirability of such politically charged programs as nuclear power and conservation. Today, unelected agency officials are perhaps no more politically accountable than judges.¹³¹ Sharing traditional agency decisions with a bankruptcy court, therefore, does not substantially decrease political accountability.

2. *Reassessing Other Costs in Bankruptcy.* Although bankruptcy does not substantially decrease political accountability, the other costs of enhanced representation do not disappear in bankruptcy. Indeed, conventional wisdom dictates that concern about one cost—delay—should increase in bankruptcy. But the costs must be considered in the bankruptcy context, in which they take on a different flavor and are on the whole of no greater concern than they are outside of bankruptcy. In the bankruptcy context, delay may even be a positive factor.

Much of the representational enhancement that bankruptcy offers differs from the free-floating selection of interests to be represented in nonbankruptcy regulatory proceedings. That enhancement does not come so much from selecting groups for representation as from reassessing the importance of the interests of groups already represented. In most situations, the players in the bankruptcy game are determined in advance by prebankruptcy occurrences. The muting of management interests and the scaling down of old, wounded investor interests are more concessions to economic reality than they are power plays to provide others with a voice.

The costs of the representational scheme may be allocated differently in bankruptcy than they are outside of bankruptcy. Outside bankruptcy, each group usually bears its own costs, absent some fee shifting mechanism. Even a state such as California, which allows those representing consumer interests to be reimbursed, may limit reimbursement to situations in which the consumer makes a "substantial contribution" to the adoption of the regulatory authority's order.¹³² This limitation assures that groups seeking participation have a significant interest in the proceedings.¹³³

130. *See id.* at 1683.

131. *Id.* at 1790. Utility regulators are elected in nine states. P. NAVARRO, *supra* note 118, at 98.

132. CAL. PUB. UTIL. CODE § 1803(a) (West Supp. 1986). As a prerequisite to reimbursements, California law also requires a showing that participation without an award of fees or costs imposes a significant financial hardship. *Id.* § 1803(b).

133. But much of the public interest participation is funded by lawyers working at below market rates, by private firms supporting pro bono work, and by foundations. *See, e.g.,* Heineman, Book Review, 84 YALE L.J. 182, 185-87 (1974) (reviewing S. LAZARUS, *THE GENTEEL POPULISTS* (1974)); Stewart, *supra* note 13, at 1763.

In bankruptcy, the participation costs of those with officially recognized interests are borne by the bankruptcy estate,¹³⁴ thereby reducing the amount available for distribution to creditors and investors and increasing the debtor's funding needs. Those possessing well-established claims against a debtor who is able to pay administrative expenses are assured of reimbursement. Those with marginal claims that may be disallowed or those fighting for novel theories of participation are less certain of reimbursement. This possibility provides some incentive for those with marginal claims to representation to keep costs under control.

3. *Increased Concern in Bankruptcy About Delay.* A final cost associated with enhanced representation is the cost of delay. For the financially healthy business, the delay attending broader or rearranged representation may be a cost of securing the public benefits of regulation. For the financially distressed business, the extra burdens imposed by delay may signal the dividing line between regulation that provides a net gain and that which provides a net loss. Much of the concern about regulation and representation in bankruptcy is thus concern about time.

Modification of "normal" regulation in bankruptcy often seeks to prevent delay. The SEC, with limited rights of participation, plays a muted role under the 1978 Bankruptcy Code.¹³⁵ Reorganization plans need not be submitted to state regulators in advance. Ex parte modifications of labor agreements permit action before it is too late to save the distressed business.¹³⁶ The need for speed is perceived as a dominant factor.

Why does this heightened sensitivity to delay exist in bankruptcy? Financially, the debtor is unlikely to be worse off the day after the petition is filed than the day before; however, the psychology of commercial situations is important. Bankruptcy sends a signal to everyone dealing with a bankrupt debtor: "Get out now with as much as you can as fast as you can." With respect to the bankrupt debtor, bankruptcy suggests that there is no long-term worth worrying about. Suppliers are less likely to ship for fear of not being paid. Customers are less likely to order for fear of not being able to rely on the debtor's existence, much less the debtor's timely performance. Employees and managers become nervous and less faithful and may leave.¹³⁷

134. 11 U.S.C. §§ 328, 330-31 (1982 & Supp. II 1984).

135. *Id.* § 1109(a) (1982) (SEC has no right of appeal); H.R. REP. NO. 595, *supra* note 10.

136. 11 U.S.C. § 1113 (Supp. II 1984).

137. Consider the case of a business on the brink of bankruptcy that sells its accounts receivable to a factor. The price, it has been stated, will be heavily discounted.

[O]nce a manufacturer begins to go under, even his best customers begin refusing payment for merchandise, claiming defects in quality, failure to meet specifications, tardy delivery, or what-have-you. The great enforcer of morality in commerce is the continuing relationship, the belief that one will have to do business again with this customer, or this supplier, and when a failing company loses this automatic enforcer, not even a strong-arm factor is likely to find a substitute.

R. AXELROD, *THE EVOLUTION OF COOPERATION* 60 (1984) (quoting M. MAYER, *THE BANKERS* 280 (1974)). To counter this reaction, according to conventional thinking, a reorganization must be as speedy as possible. One must convince suppliers, customers, employees, and managers that the business will emerge quickly from the bankruptcy law umbrella.

To counter these reactions, conventional thinking dictates that reorganization be as speedy as possible. Suppliers, customers, employees, and managers must be convinced that the business will emerge quickly from the bankruptcy law umbrella.

4. *Rethinking Delay in a Utility Bankruptcy.* Recent interesting work in both contract theory and cooperation theory casts doubt upon the dominant notion that reorganizations must be completed quickly to maximize the chance of success. It is important to note, however, that the benefits of delay should not be overemphasized. Obviously, at some point delay will become too excessive and costly to all involved. Nevertheless, there is room for some delay in bankruptcy—delay that may benefit all parties in the long run.¹³⁸

Contract theorists such as Macneil, Williamson, and Goldberg have supplied a description of the long-term relational foundations of much of contract.¹³⁹ Both Williamson and Goldberg suggest that regulated utilities are often prime examples of relational contractual situations.¹⁴⁰ Some of the features suggesting the presence of relational situations also suggest that delay should be less of a problem in a utility bankruptcy than perhaps otherwise expected.

Williamson and Goldberg emphasize the recurrence of exchange or ongoing relationships as important aspects of relational contracting. Both also suggest that these relational characteristics attend naturally monopolistic industries. Ratepayers, like it or not, are in a long-term relationship with their electric utility. The utility is likely involved in a long-term relationship with its supplier. If the utility is constructing a plant, the construction is likely to take long enough to foster other ongoing relationships.

For a debtor involved in long-term relationships, the risks of delay are perhaps less drastic than they are for the debtor engaged in traditional "one-shot," single transaction exchanges. A utility's customers are not likely to abandon it in the short term. Some of its important suppliers likely can be kept on-line during the remainder of a long-term contract. Suppliers may have an "investment" in the debtor that is not easily transferred.¹⁴¹ As indicated in Part II above, a debtor's new financial suppliers may be better off lending to the debtor in bankruptcy than before bankruptcy.¹⁴² On the other hand, some minor suppliers may be repelled by a bankruptcy filing. Furthermore, a debtor whose major supply contracts are about to expire may

138. Bankruptcy recognizes the benefits of some delays. The automatic stay of section 362, 11 U.S.C. § 362 (Supp. II 1984), slows down creditors so that the debtor has time to plan its rehabilitation without being financially dismembered in the process.

For a discussion of possible benefits of delay in another unexpected context, judicial administration, see Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEG. STUD. 399, 445-48 (1973).

139. See *supra* text accompanying notes 103-110.

140. See Goldberg, *supra* note 17; Williamson I, *supra* note 17.

141. In Williamson's terminology, parties dealing with a utility may have both an ongoing relation with the utility and transaction-specific costs. See *supra* note 104 and accompanying text.

142. See *supra* text accompanying notes 59-68.

find it difficult while in bankruptcy to enter into new long-term arrangements without offering some security or assurance to the nonbankrupt party.

These considerations suggest that marginally increased delay in bankruptcy is unlikely to be disastrous or even severely threatening to most utilities in chapter 11. Although increased delay may be a significant concern for utilities with important supply contracts about to expire, this is not a basis for shunning bankruptcy across the board.

Cooperation theory takes analysis of delay one step further. The relational contract theorists use their insights to select appropriate governance structures. They do not address the question whether long-term relations are normatively more desirable than single-shot transactions. Contract theorists reveal merely that ongoing relations are a characteristic of relational contracts. They view the parties to contracts as able to determine the most efficient relationship. Under this contractual analysis, the presence of ongoing relations reduces concern about delay for relational debtors. Contractual analysis, however, does not suggest that delay can be a positive force.

In contrast, cooperation theorists supply a normative analysis suggesting that the long-term view may be desirable because it helps achieve the benefits of cooperative behavior. Consider, for example, Robert Axelrod's summary:

The foundation of cooperation is not really trust, but the durability of the relationship. When the conditions are right, the players can come to cooperate with each other through trial-and-error learning about possibilities for mutual rewards, through imitation of other successful players, or even through a blind process of selection of the more successful strategies with a weeding out of the less successful ones. Whether the players trust each other or not is less important in the long run than whether the conditions are ripe for them to build a stable pattern of cooperation with each other.¹⁴³

If people must get along for a minute, they may do so, but they have little incentive to probe for mutually beneficial transactions. If they must get along for a year, they have dramatically different incentives. If long-term relationships generate cooperative behavior, and cooperative behavior yields economic payoffs, then long-term relationships may be normatively desirable. Perhaps a government normally willing to let the private market function on its own should consider fostering long-term relations when a debtor needs help.

Thus, one important task of a bankruptcy law may be to convince the debtors' relations that there is a long term worth worrying about or at least to raise the cost to the debtor' relations of disentangling themselves from the debtor. Various means of implementing these objectives exist. The debtor's relations may be assured that the bankrupt entity will be supported by the government so as to insure its survival for a period long enough to count as "long-term." Chrysler's experience attests to the success of such a venture in

143. R. AXELROD, *supra* note 137, at 182.

a nonbankruptcy setting.¹⁴⁴ This survival by governmental fiat, however, is not something any particular debtor can rely upon,¹⁴⁵ is subject to abuse, and is politically incapable of exploitation on a broad basis.

Alternatively, incentives may be supplied to creditors to encourage continued dealings with the bankrupt debtor. Bankruptcy law provides such incentives in various ways. Those who deal with the debtor after the filing of a bankruptcy petition are entitled to an administrative priority and thus rank ahead of prepetition unsecured claims.¹⁴⁶ Banks are subtly encouraged not to exercise their state law rights of setoff,¹⁴⁷ and postpetition lenders receive special priority treatment.¹⁴⁸

Government can accomplish some of the same results by imposing delays, such as those accompanying a bankruptcy law, on interactions with a debtor. The inability of the debtor's relations immediately to extricate themselves from involvement with the debtor becomes a reality unto itself. The debtor's relations must think in terms of long-term interactions because they find themselves in a long-term relation. The "get-out-now" mentality is cushioned by planning in light of the new, longer relationship with the debtor. All parties have increased incentives to discover mutually beneficial transactions. The payoff is a larger pie for all of the relations to share.

These possible benefits should reduce concern about enhancing representation or permitting normal regulation, such as SEC participation, to function in bankruptcy. And again, the nonbankruptcy reality must be acknowledged: If a business is going to deteriorate, it will likely do so whether or not representation is broadened or whether the SEC is entitled to full participation in bankruptcy. The deterioration curve for a business may be steep shortly before and shortly after bankruptcy. The marginal delay added by enhanced representation or regulatory participation is not likely to be the factor causing a failed reorganization.

C. New Twists on Old Valuation Problems

1. *The Value of the Firm.* Valuing the firm, always a difficult problem, might seem exacerbated in the case of a utility bankruptcy. The authority to scale down debt and equity in any reorganizing firm depends on the liquidation value and the going concern value the bankruptcy court assigns to the firm. At the extreme, if a bankruptcy court finds that the debtor has a

144. See Chrysler Corporation Loan Guarantee Act of 1979, Pub. L. No. 96-185, 93 Stat. 1325 (1980) (codified at 15 U.S.C. §§ 1861-1875 (1982)) (authorizing federal loan guarantees of up to \$1.5 billion).

145. Nevertheless, it is common to hear that an industry or entity near bankruptcy is counting upon government assistance. See Morgan Stanley Report, *supra* note 47 (possible federal aid for nuclear utilities); Kempton, *Outrageously Normal*, N.Y. REV. BOOKS, Jan. 30, 1986, at 31 (referring to proposed 1980 legislation to bail out Manville).

146. 11 U.S.C. §§ 503, 507 (1982 & Supp. II 1984).

147. *Id.* § 553. The encouragement is through the enhanced postpetition setoff rights embodied in this section. These rights come at the cost of having to request court permission to engage in postpetition setoff.

148. See *supra* text accompanying notes 59-61.

liquidation value equal to the sum of its liabilities and shareholder interests, then a reorganization plan must pay every creditor in full and cannot reduce any shareholder interest. A reorganization plan must provide that holders of claims or interests will receive at least as much as they would receive if the firm were liquidated.¹⁴⁹

Putting aside the unusual case of a healthy bankrupt entity, the degree to which claims or interests participate in the reorganization is governed by the bankruptcy court's determination of the firm's going concern value. Every class of creditors or claims that is senior to another class must be paid in full before the subordinate class may participate.¹⁵⁰ A bankruptcy court will thus likely be required to determine both the liquidation value and the going concern value of a financially troubled utility.

But how does one determine the value of a firm whose discounted stream of earnings, the usual measure of going concern value,¹⁵¹ depends on the rates established by a state regulatory authority? In the short term, the value of a regulated utility is determined by the rates set by the regulatory authority.

The valuation problem faced by the bankruptcy court is not, however, different in kind from the state authority's determination outside of bankruptcy. In deciding the proper rate of return for investors and the appropriate burden on ratepayers, the state authority is, *de facto*, determining the value of the firm. The bankruptcy court may engage in a similar endeavor, but for a different purpose: to determine who participates in the bankruptcy.

Again, what actually happens to a utility in bankruptcy is not the central concern. Rather, it is the utility regulators' perception of what happens. If regulators regard bankruptcy as an unmitigated disaster for the utility and the community, near unlimited rate increases will likely be invoked to maintain the utility's solvency. If the regulators have a more informed, less apocalyptic view of bankruptcy, however, they may decide that a scaling down of existing obligations is appropriate and that bankruptcy provides a reasonable forum in which the scaling down can occur.

2. *Allocating Appreciated Assets.* A related difficult valuation question arises in deciding how to account for appreciation in a utility's assets. Consider a utility with excess capacity that owns a plant carried on the utility's books at \$200 million and included in the rate base at that figure. The plant has become worth \$500 million owing to inflation and appreciation. Sale of the plant will generate a large gain. Unless the selling utility is required to dedicate some or all of the gain to ratepayers, selling appreciated plants or

149. Each holder of an impaired claim or interest must accept a reorganization plan or "receive or retain under the plan . . . property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date . . ." 11 U.S.C. § 1129(a)(7) (1982 & Supp. II 1984).

150. *Id.* § 1129(b).

151. See, e.g., J. BONBRIGHT, *THE VALUATION OF PROPERTY* 233-66 (1937). *But see* Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983).

assets or pledging them as collateral for new loans may become the means of financing economically questionable plants.

The implications of such a practice are troubling.

If utilities have the right to charge ratepayers for expensive new generating plants, at cost, in the early years, when the power may not be economically competitive, and then sell off the asset to another entity once inflation makes the power cost-effective, and keep the profit for the stockholders, ratepayers are in an untenable bind. Every coal plant in the country built more than 5 years ago will change hands, as will all of the nuclear plants placed in operation prior to 1980, so that utilities can revise their rate base up to "replacement cost" or fair value.¹⁵²

The question of how to allocate such appreciation is likely to be critical in a utility bankruptcy. Is this a special bankruptcy-related problem?

In one perspective, the allocation of appreciation does not present a novel issue. The question of how to account for such a sale may arise outside of bankruptcy in the context of an application for regulatory approval of transfer of the plant. Pursuant to its grant of approval, the regulatory authority may extract a share of the profits from the transfer for ratepayers. Hence, regulatory commissions and the courts reviewing their decisions frequently encounter the question of how to allocate gains between ratepayers and investors.

If there is a "rule" for allocating gains, it seems to be that gains on the sale of depreciable property go to ratepayers,¹⁵³ who are viewed as having "bought" the wasting assets through rate payments. On the other hand, gains on the sale of nondepreciable property (land) belong to investors.¹⁵⁴ No single rule, however, is universally followed, and support exists for a rule that

152. Lazar, *Do or Die: The Seabrook Nuclear Generating Station and the Public Service Company of New Hampshire*, at 8 (on file with author).

153. See *Bebchick v. Washington Metropolitan Area Transit Comm'n*, 485 F.2d 858, 873 (D.C. Cir. 1973); *Washington Gas Light Co. v. Public Serv. Comm'n*, 450 A.2d 1187, 1237 (D.C. 1982) (gain on sale of propane reserves to ratepayers); *Boise Water Corp. v. Idaho Pub. Util. Comm'n*, 99 Idaho 158, 162, 578 P.2d 1089, 1092-93 (1978); *Maine Water Co. v. Public Util. Comm'n*, 482 A.2d 443, 448 (Me. 1984); *Casco Bay Lines v. Pub. Util. Comm'n*, 390 A.2d 483, 489 (Me. 1978); *In re Revision in Rates Filed by Plainfield-Union Water Co.*, 57 N.J. Super. 158, 176-77, 154 A.2d 201, 211 (1959); *In re Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services* (second computer inquiry), 94 F.C.C.2d 76, 78 (1983) (notice of proposed rulemaking). *But see Board of Pub. Util. Comm'rs v. New York Tel. Co.*, 271 U.S. 23, 32 (1926) ("By paying bills for service [customers] do not acquire any interest, legal or equitable, in the property used for their convenience or in the funds of the company."); *In re Associated Natural Gas Co.*, 55 Pub. Util. Rep. 4th (PUR) 702, 707 (Mo. Pub. Serv. Comm'n 1983) (but decision is "not indicative of a general policy to treat gain on sale of utility property in this manner . . . in future cases"); *Gas Co. of N.M. v. New Mexico Pub. Serv. Comm'n*, 100 N.M. 740, 676 P.2d 817 (1984) (following *New York Telephone*); *Accounting Treatment to Account for Gains and Losses on the Disposition of Utility Property that Had Been Classified in Utility Service and Consolidation of Certain Depreciation Accounts*, 49 F.P.C. 390, 391 (1973) (implementing rulemaking).

154. *Boise Water Corp. v. Idaho Pub. Util. Comm'n*, 99 Idaho 158, 162, 578 P.2d 1089, 1093 (1978); *City of Lexington v. Lexington Water Co.*, 458 S.W.2d 778, 779 (Ky. 1970); *Maine Water Co. v. Pub. Util. Comm'n*, 482 A.2d 443, 448 (Me. 1984); *Pennsylvania Gas and Water Co. v. Pennsylvania Pub. Util. Comm'n*, 72 Pa. Commw. 331, 355-56, 456 A.2d 1126, 1137-38 (1983), *rev'd sub nom. Barasch v. Pennsylvania Pub. Util. Comm'n*, 482 A.2d 1274 (1984); *Philadelphia Suburban Water Co. v. Pennsylvania Pub. Util. Comm'n*, 58 Pa. Commw. 272, 280, 427 A.2d 1244, 1248 (1981); *Washington Pub. Interest Org. v. Pub. Serv. Comm'n*, STATE UTIL. L. REP. ¶ 23,668 (D.C. 1982). *But see Democratic Central Comm. v. Washington Metropolitan Area Transit Comm'n*, 485 F.2d 786, 822 (D.C. Cir. 1973), *cert. denied*, 415 U.S. 935 (1974).

the gain on an investment should go to the group that bore the risk of loss, with a determination of the appropriate group left to the facts of each case.¹⁵⁵

In the bankruptcy of a utility with appreciated assets, a court will have to address the question of allocating unrealized appreciation. The accounting question presents two interesting added twists in the bankruptcy setting. On the practical level, the question is more difficult because it arises in the context of valuing the firm, with no actual transfer contemplated. This adds another valuation matter to a bankruptcy court's long list of likely valuations. During the proceedings, however, the bankruptcy court will already be valuing many assets as well as the firm. Therefore, this subclass of valuations involving appreciated assets need not be viewed as a major separate problem. The marginal burden or complexity added by the need to value appreciated assets may be de minimis.

More serious, however, is the problem of allocating the appreciation among the bankruptcy participants. An instinctive reaction of the bankruptcy court might be to regard such value as being dedicated first to creditors, traditionally the highest ranking group in a bankruptcy, and then to shareholders. Ratepayers, being neither classic lenders nor classic creditors, do not fit comfortably within traditional bankruptcy categories. Perhaps the plant should be valued for bankruptcy purposes in the same manner it is valued for rate-base purposes. Historical cost might then be substituted for current value. Alternatively, the bankruptcy court could take account of any foreseeable nonbankruptcy regulatory requirement that the ratepayers share in the profit. The value of the plant or other assets would then reflect any likely regulatory restrictions on the transfer of assets outside of bankruptcy.

Lenders, particularly secured lenders, may extend credit in reliance on the fair market value of the utility's assets as well as on the basis of the utility's historical cost and rate base. Nevertheless, given lenders' experience with railroads, they should be aware that utility plants cannot simply be sold to outsiders who may discontinue service or increase rates. A bankruptcy valuation scheme that is premised on liquidating sales is not a realistic alternative, and this is known to lenders at the time they extend credit. At the very least, secured lenders who extend credit to utilities should be subject to the same unreimbursed delay in selling off operating assets that was imposed upon lenders to railroads.¹⁵⁶

155. See *Kansas Power & Light Co. v. State Corp. Comm'n*, 5 Kan. App. 2d 514, 529, 620 P.2d 329, 341 (1980) (stockholders and ratepayers should both benefit from profit on sale of utility's office building); *Committee Servs. v. Public Serv. Comm'n*, 595 P.2d 871, 874 (Utah 1979); *In re El Paso Natural Gas Co.*, 23 Pub. Util. Rep. 4th (PUR) 66, 92 (FERC 1977) (balancing ratepayer and stockholder interests in the case of an abandonment); minority authority cited *supra* notes 153-54. See also *In re Florida Power & Light Co.*, STATE UTIL. L. REP. ¶ 23,457 (Fla. Pub. Serv. Comm'n 1981); Note, *Awarding In-Service Appreciation to Public Utility Ratepayers—Windfall or Perdition?*, 11 CALIF. W. L. REV. 160 (1974).

156. See generally Graybeal, *Reflections on the Golden Spike: A Look at the Bankruptcy Reform Act and Railroad Reorganization*, 6 HASTINGS CONST. L.Q. 1107 (1979); Note, *Conrail and Liquidation Value: Creditors' and Stockholders' Entitlement in the Regional Rail Reorganization*, 85 YALE L.J. 371 (1976); cf. *Clearwater County State Bank v. Bagley-Ogema Tel. Co.*, 116 Minn 4, 133 N.W. 91 (1911)

These allocation problems also exist outside of bankruptcy, for the regulatory authority must itself determine a proper rate of return for equity and debt in a utility. In doing so, the authority faces questions resembling those that attend the valuation of a firm.¹⁵⁷ This suggests that the allocation-of-appreciation question is less a problem peculiar to bankruptcy than it is a problem of the ultimate allocation of risk between shareholders and ratepayers. Discussion of that question is deferred to Part V.

D. New Problems in Bankruptcy

1. *Uncertainty.* Because there have been no major utility bankruptcies in recent years, uncertainty attends the course of a utility reorganization.¹⁵⁸ The postpetition cost of capital, attitudes towards methods of valuation, allocation of unrealized appreciation, and the role of regulators are all issues with respect to which our system lacks much actual experience. This uncertainty has been offered as a prime reason for keeping utilities outside bankruptcy. Costs of this uncertainty must be balanced against bankruptcy's potential benefits as outlined in Parts II and III.

In considering the role of uncertainty, the burden of uncertainty in bankruptcy should be compared to the burden of uncertainty outside of bankruptcy. A troubled utility outside bankruptcy is not a model of stability and long-term planning opportunity. One constantly reads of utilities being on the brink of bankruptcy,¹⁵⁹ petitioning for an "absolutely necessary" rate increase,¹⁶⁰ engaging in creative financing,¹⁶¹ commencing extraordinary court actions,¹⁶² considering whether to withdraw as a partner from a major project,¹⁶³ considering and studying bankruptcy,¹⁶⁴ being considered for takeover by the state,¹⁶⁵ defaulting on obligations,¹⁶⁶ deferring or canceling

(modifying statutory redemption rights where mortgage covers property of quasi public corporation).

157. 1 A. KAHN, *THE ECONOMICS OF REGULATION* 42-54 (1970).

158. Of course it is doubtful that a single utility chapter 11 proceeding would have resolved all or even most uncertainties for later proceedings.

159. See *supra* note 5; *In re Public Serv. Co. of N.H.*, 66 Pub. Util. Rep. 4th (PUR) 349 (N.H. Pub. Util. Comm'n 1985); Dahl, *Kansas G&E Calls Rate Increase Crucial to Prevent Crippling Firm*, Wall St. J., Aug. 29, 1985, at 6, col. 3; Burrough, *Middle South Seen Near Filing for Chapter 11*, Wall St. J., Aug. 16, 1985, at 3, col. 1.

160. See *PS of Indiana Gets Extension on Loans Totaling \$200 Million*, Wall St. J., Nov. 26, 1985, at 20, col. 4 (Pub. Serv. Co. of Indiana receives \$200 million credit extension and needs to recover its investment in a nuclear plant to preserve its existence).

161. See *In re Seabrook Unit No. 1*, 63 Pub. Util. Rep. 4th (PUR) 401 (Conn. Dept. Pub. Util. Control 1984) (describing extraordinary financing vehicle and noting that absent extraordinary financing PSCNH would be in bankruptcy).

162. See, e.g., *Louisiana Power & Light Co. v. Ackel*, 616 F. Supp. 445 (M.D. La. 1985) (dismissal of action seeking injunction to require Louisiana Pub. Serv. Comm'n to grant increase in intrastate electric utility rates); *Middle South Units' Suits for Rate Rises Dismissed*, Wall St. J., Aug. 13, 1985, at 12, col. 2 (same).

163. See Wessel, *Investor Group Seeks to Buy 9.7% of Seabrook Plant*, Wall St. J., Feb. 13, 1985, at 20, col. 2; Wessel, *Vermont Utilities Are Told to Sell Stake in Seabrook Unit 1*, Wall St. J., May 6, 1985, at 28, col. 3; *Vermont Utilities Order to Sell Seabrook Shares*, Boston Globe, May 4, 1985, at 8, col. 1.

164. See *supra* authorities cited note 159.

165. See *Public Electric Power on Long Island—Study and Report*, 1986 N.Y. Laws ch. 2, § 2 (\$500,000 appropriated "in support of an investigation and evaluation of the economic, legal,

dividends,¹⁶⁷ or being subjected to extraordinary regulatory divestment orders.¹⁶⁸ In general, bankruptcy will not dramatically increase uncertainty. Most of the uncertainty that attends troubled nuclear utilities exists because they face difficult problems—problems that are about as intractable outside bankruptcy as inside bankruptcy. The forum in which those problems are addressed is a secondary matter.

One measure of the cost of uncertainty is the return a debtor must offer its investors. As noted above, a considerable price is being paid for economic uncertainty in the current nonbankruptcy setting in which most utilities operate. High, sometimes extraordinarily high, financing costs are paid by financially troubled utilities.¹⁶⁹ These costs stem from the utilities' uncertain financial future associated with the fact that current debt generally does not rank ahead of previously incurred debt. Again, the nonbankruptcy setting is no panacea.

2. *Costs of Bankruptcy and Coordination.* Two classes of bankruptcy costs have no direct analog in a nonbankruptcy setting. First, bankruptcy generates its own administrative costs. A trustee, if appointed, must be paid. When creditors' and shareholders' committees are formed, they will likely retain counsel and other expensive experts. Jurisdictional disputes may arise over whether a bankruptcy court or a district court should hear a matter. In addition, unforeseeable issues may arise that prompt the parties to seek a court ruling where none would be sought outside bankruptcy.

Empirical evidence about the administrative costs of bankruptcy is sketchy. Professor Warner's study of eleven railroad bankruptcies occurring between 1933 and 1955 reports that bankruptcy administrative costs, measured as a fraction of the firm's value on the date of bankruptcy, consumed a mean of 5.3% of the firms' assets, with a range of 1.7% to 9.3%.¹⁷⁰ Warner also found a significant scaling effect. Bankruptcy administrative costs are a lower percentage of the firm's prebankruptcy value for larger firms than they are for smaller firms. Professors Ang, Chua, and McConnell studied a random sample of eighty-six bankruptcy liquidation cases filed in the Western District of Oklahoma. They found the ratio of administrative costs to total liquidating

financial and structural feasibility of the transition to or implementation of public power on Long Island"). See also Paul, *Lilco Banks to Refinance \$1 Billion Debt as Pressure Grows for State Takeover*, Wall St. J., Jan. 8, 1986, at 4, col. 2; Paul, *Cuomo Backs Idea of Power Authority to Replace Lilco*, Wall St. J., Oct. 25, 1985, at 6, col. 2.

166. *Fitchburg Defaults on Seabrook*, Boston Globe, May 16, 1985, at 51.

167. Wall St. J., Jan. 9, 1986, at 26, col. 3 (noting omission by Louisiana Power & Light Co. of preferred dividends); *PS of New Hampshire Says Dividends Hinge on Seabrook's Finish*, Wall St. J., Mar. 22, 1985, at 11, col. 5; *Kansas G&E Seeks Re-Hearing of Order on Annual Rate Rise*, Wall St. J., Oct. 8, 1985, at 12, col. 3 (noting reduction of common dividends); *Burrough, Middle South Unit Defers Decision on Two Dividends*, Wall St. J., Sept. 24, 1985, at 47, col. 1.

168. *Wessel, Vermont Utilities Are Told to Sell Stake in Seabrook Unit 1*, Wall St. J., May 6, 1985, at 28, col. 3.

169. See *supra* note 63.

170. Warner, *Bankruptcy Costs: Some Evidence*, 32 J. FIN. 337, 343 (1977). Warner defines direct bankruptcy costs to include "lawyers' and accountants' fees, other professional fees, and the value of the managerial time spent in administering the bankruptcy." *Id.* at 338.

value of the firm to have a mean of 7.5% and a median of 1.7%.¹⁷¹ They also found a scaling effect. They concluded, "If we were to extrapolate the results of our . . . equation to firms with liquidating values in excess of \$1.0 million, the estimated bankruptcy costs would amount to less than 2.0 percent of the firm's value."¹⁷² Professor Altman studied the bankruptcies of twelve retailers and seven industrial firms.¹⁷³ In the retail group, he found the ratio of bankruptcy administrative expenses to the value of the firm to have a mean of 4.0% and a median of 1.7%;¹⁷⁴ in the industrial group, the mean was 9.8% and the median was 6.4%.¹⁷⁵

These studies do not provide a firm basis for forecasting the administrative costs of a utility bankruptcy. They can all be distinguished, as they do not focus on electric utilities.¹⁷⁶ The studies, however, are the only available data. Given the observed scaling effect and the size of electric utilities, the studies suggest expected bankruptcy administrative costs of less than two percent of a utility's value.¹⁷⁷

One might compare this figure with the percentage of a utility's value reflected in ongoing nuclear construction. A study of thirty-eight utilities reveals the average current investment in ongoing nuclear construction to be thirty-seven percent of their total net plant.¹⁷⁸ If, for any one of these utilities, bankruptcy would help avoid construction or completion of a

171. Ang, Chua & McConnell, *The Administrative Costs of Corporate Bankruptcy: A Note*, 37 J. FIN. 219, 223 (1982).

172. *Id.* at 224.

173. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 1067 (1984). Altman uses a different measure of firm value than Warner. *Id.* at 1076. It should be noted that the finance theorists are less interested in the cost of administering bankruptcy than they are in the effect of bankruptcy costs on the theory of the firm. Their main goal seems to be to ascertain the costs of a failed business, a concept that they equate with bankruptcy, rather than the costs of what a lawyer would term a bankruptcy proceeding.

174. *Id.* at 1074 (Table I).

175. *Id.* at 1075 (Table II). The mean results for the retail group were heavily and perhaps unduly influenced by a single bankruptcy in which the firm had a value of \$38.6 million and incurred bankruptcy costs of over \$9 million! Altman does not discuss a scaling effect, and analysis of his data suggests that it does not show a statistically significant scaling effect. Neither linear regression nor a quadratic equation of the form used by Ang, Chua, and McConnell, *see* Ang, Chua & McConnell, *supra* note 171, at 223-24, yielded a statistically significant result on Altman's data.

176. The railroads' special problems perhaps undermine the predictive value of Warner's study. The Ang, Chua, & McConnell study involved relatively small firms and dealt only with liquidations. The Altman study was not a random sample, and demonstrates the potential influence of the industry involved on the magnitude of administrative costs. Furthermore, the finance theorists' primary interest is in the cost of business failure as it pertains to corporate finance policy, rather than in the actual costs of bankruptcy. Compare Modigliani & Miller, *Corporate Income Taxes and the Cost of Capital: A Correction*, in AM. ECON. REV., June 1963, at 433, with Ang, Chua & McConnell, *supra* note 171, at 219. This concern undoubtedly influences the nature of these studies.

177. This figure is based on the bankruptcy costs of firms with values, as measured by the authors of the empirical studies, in excess of \$100 million on the date of bankruptcy. In the Warner study and the Ang, Chua, & McConnell study, there were a total of four such firms. Their bankruptcy costs were .6%, .3%, 4.7%, and 1.7% of the value of the firm on the date of bankruptcy, respectively. The figure is also within the range forecast by Ang, Chua & McConnell, *supra* at text accompanying note 171.

178. Nucleonics Week, at 4 (Mar. 27, 1986) (Donaldson, Lufkin & Jenerette study) (available on NEXIS).

questionable nuclear plant, even the straight dollar comparisons favor bankruptcy.

Bankruptcy's administrative costs must be adjusted to reflect similar costs being incurred outside bankruptcy. Bankruptcy experts already testify in rate proceedings of some nonbankrupt utilities.¹⁷⁹ State regulators' opinions treat bankruptcy as a major contingency, even if one to be avoided.¹⁸⁰ Troubled utilities engage in elaborate and costly planning in efforts to obtain rate increases.¹⁸¹ Thus, some bankruptcy costs replace costs currently being incurred in speculating about the effects of bankruptcy. So long as bankruptcy is regarded as a possible alternative, it is destined to generate nontrivial costs whether or not utilities are formally in bankruptcy.

A second cost unique to a utility bankruptcy is the cost of coordinating bankruptcy regulation with nonbankruptcy regulation. The question of whether the bankruptcy court or a regulatory authority will resolve an issue does not arise outside bankruptcy. The bankruptcy court and regulatory authority do not interact outside bankruptcy. The ability of litigants to pit court against agency, to protest the scope of authority of one vis-a-vis the other, and to seek duplicate resolution of the same issues does not exist in a nonbankruptcy setting.

V

PRELUDE TO BANKRUPTCY: ALLOCATING LOSSES BETWEEN RATEPAYERS AND INVESTORS

In a utility's financial crisis, regulatory authorities face the threshold question whether to deny rate increases. They must decide the extent to which ratepayers and investors should bear the cost of a failed excessively expensive power plant. If they decide that ratepayers should bear the loss through higher rates, there will be no immediate utility bankruptcies. If they decide that investors should bear the loss, rate increases will be denied in whole or in part, intense postdenial negotiations will ensue, and some bankruptcies will perhaps be initiated.¹⁸²

179. *In re* Maine Pub. Serv. Co., 67 Pub. Util. Rep. 4th (PUR) 101 (Me. Pub. Util. Comm'n 1985); *In re* Public Serv. Co., 66 Pub. Util. Rep. 4th (PUR) 349 (N.H. Pub. Util. Comm'n 1985).

180. *See supra* notes 14-15.

181. *Id.*

182. Denying rate increases does not automatically result in bankruptcy. The parties usually remain better off negotiating a nonbankruptcy settlement. Unregulated entities in dire financial condition often achieve satisfactory nonbankruptcy workouts. Denying rate increases would, however, remove one of the barriers to bankruptcy. It would increase the likelihood of self-interested creditor collection behavior threatening the going-concern value of a firm. Denial of rate increases is thus a necessary but not sufficient condition for triggering a utility bankruptcy. This fact simplifies the relationship between the bankruptcy court and the regulatory authority. One is unlikely to see cases in which the authority wants to raise rates and the bankruptcy court wishes to keep them lower. An authority with that attitude will have kept the utility out of bankruptcy in the first place by granting rate increases. A bankruptcy court willing to fiddle with rates will grant rate increases, not rate decreases, over an authority's objection.

Given regulators' authority to increase rates, the bankruptcy system's participation depends on the allocational decision of how to spread a loss between ratepayers and investors. The allocational decision should not be distorted by erroneous views of bankruptcy consequences—that is, by illusions about the effect of bankruptcy on the size of the pie. Because the role of bankruptcy is so dependent on the allocational decision, it is appropriate to discuss that decision.

In allocating large unforeseen costs, one approach is to begin with the analogous problem in an unregulated industry. Answers in that less complex setting may be used as a starting point for analysis of similar problems in a regulated environment. Analogous problems, however, provide only a starting point. In a regulated setting, the competitive forces that shape the bargain among the parties are lacking.

A. The Nonregulatory Model and the Nature of the Regulatory Bargain

Assume that a major manufacturer begins building an expensive manufacturing plant that triples in cost before completion. To recover its costs, the business must raise prices to its customers. In a competitive environment, customers will substitute other purchases. The forced sale of the product to customers at the increased price will *not* occur. Absent a government granted monopoly to supply the product, the debtor will either cease doing business or scale down old obligations, including those attending the building of the plant, to reduce costs to a competitive level. No effective mechanism is available to pass mistaken past costs on to customers.

When the government sets the rates at which customers purchase a commodity and the customers cannot immediately stop using the commodity, a different situation is presented. Given the obvious result in the nonregulated industry—that the cost of past mistakes will be borne by past investors, both creditors and shareholders—should the outcome differ when a regulated utility cancels an expensive plant or fails to complete it?¹⁸³

183. For utility regulatory decisions dealing with abandoned power plants, see *In re Pacific Power & Light Co.*, 53 Pub. Util. Rep. 4th (PUR) 24, 27-29 (Mont. Pub. Serv. Comm'n 1983) (ratepayers not required to compensate utility for investment in terminated generating plants); *In re Pacific Power & Light Co.*, 49 Pub. Util. Rep. 4th (PUR) 82, 90-92 (Or. Pub. Util. Comm'n 1982) (limited recovery of costs from abandonment of plants); *In re Virginia Elec. & Power Co.*, 48 Pub. Util. Rep. 4th (PUR) 327, 346-47 (N.C. Util. Comm'n 1982) (recovery through rates of costs associated with servicing senior capital but not common equity); *In re Bangor Hydro-electric Co.*, 46 Pub. Util. Rep. 4th (PUR) 503, 556-58 (Me. Pub. Util. Comm'n 1982) (costs of cancelled plant projects allocated between shareholders and ratepayers); *In re Rochester Gas & Elec. Corp.*, 45 Pub. Util. Rep. 4th (PUR) 386, 396-99 (N.Y. Pub. Serv. Comm'n 1982) (recovery through rates of engineering and related charges of abandoned fossil fuel plant); *In re Jersey Cent. Power & Light Co.*, 44 Pub. Util. Rep. 4th (PUR) 54, 57 (N.J. Bd. Pub. Util. 1981) (disallowing recovery of funds used during construction subsequent to decision to suspend construction); *In re Arizona Pub. Serv. Co.*, 38 Pub. Util. Rep. 4th (PUR) 547, 555-56 (Ariz. Corp. Comm'n 1980) (disallowing costs incurred due to cancellation of construction in calculating test-year operating expenses used to calculate rates). For court decisions approving nonrecovery of costs of abandoned plants, see *Central Maine Power Co. v. Public Util. Comm'n*, 433 A.2d 331 (Me. 1981); *Office of Consumers' Counsel v. Pub. Util. Comm'n*, 67 Ohio St.2d 153, 423 N.E.2d 820 (1981).

There are two principal arguments for a different result. First, fairness commands a different result because the implicit bargain between investors and ratepayers differs from the bargain between an unregulated entity and its customers. The heart of the fairness argument rests on an appeal to symmetry. Ratepayers, the argument runs, reap the benefit of windfall increases in utility profits. They therefore should bear the burden of unexpected losses. This situation differs from the unregulated sector, where investors receive windfall gains and losses. Second, prudence commands a different result because of the disastrous long-term effects on the utility and ultimately on the ratepayers and the society that is spared short-term burdens.

One way to evaluate these arguments is to imagine a bargain between ratepayers and investors. There are, of course, limits to the extent to which a contract model can provide answers to difficult regulatory problems, whether those problems pertain to drafting a comprehensive regulatory statute¹⁸⁴ or to an agency's deciding specific cases under a regulatory scheme. Even in the case of classical express contracts, where one has a clearer sense of who the players are and what interests they represent, the legal system relies on supplementary judicial principles to resolve unanticipated disputes. Nevertheless, the pseudocontractual approach to regulation has been employed as a model by economists to support regulation itself¹⁸⁵ and has been invoked in the utility crisis.

Professor Alfred Kahn and others rely on a bargaining model that generates a result largely favorable to investors. An implicit bargain between consumers and investors, they argue, requires assuring investors a return on their investment even if the investment fails.

The essential basis of public-utility regulation is an implicit bargain between consumers and investors that, in exchange for a monopoly franchise, the company accepts the strict legal obligation to serve all customers on reasonable terms. This means that shareholders accept a return on investment equivalent only to something like the market cost of capital—the minimum that investors must see a reasonable prospect of earning if they are to put up the necessary funds—along with the duty conscientiously to anticipate the future needs of the public and to make whatever investments may be necessary in order to meet them efficiently.

This means that if the company makes a particularly successful investment—and there have been many such—the lion's share of the benefit goes to the consumer. . . .

The other side of the bargain is, and has to be, that investors are permitted to earn that same minimum return also on the dollars that they put into investments that turn out sour. If they can earn the cost of capital only on the successes and not on the failures, it follows that they will earn less than the cost of capital on all their dollars, taken together. And investors won't play that game once they understand that those are going to be the rules.¹⁸⁶

184. See generally Stewart, *Regulation in a Liberal State: The Role of Non-Commodity Values*, 92 YALE L.J. 1537, 1547-56 (1983) (criticizing the "deals" approach to regulation as unable to supply normative principles but noting its continuing symbolic relevance, and sketching other approaches to regulation).

185. See *supra* text accompanying notes 103-111.

186. Kahn, *Who Should pay for Power-Plant Duds?*, Wall St. J., Aug. 15, 1985, at 26, col. 3. Accord Smart, *Holding to the Bargain in Utility Regulation*, 117 PUB. UTIL. FORT. 4, 4-6, Feb. 6, 1986; Butler, *A Social Compact to be Restored*, 116 PUB. UTIL. FORT. 17, 17-21, Dec. 26, 1985.

Accepting a bargain theory of utility investment, however, does not necessarily support Professor Kahn's conclusions. As noted above, the arguments in favor of departing from the nonregulatory result can be subdivided into (1) an argument from fairness based on symmetry, and (2) an argument based on long-term economic effects.

B. The Implicit Bargain: Fairness and Symmetry

The argument based on fairness exerts emotional and intellectual pull. If ratepayers benefit from unforeseen gains, an implicit bargain model commands that they bear unforeseen losses.

Accepting this argument at face value has important implications for the current utility crisis, not all of which support allocating the losses to ratepayers. The core of the case for allocating losses to ratepayers rests on the unforeseeability of the losses attributable to failed or excessively expensive power plants. In a contractual model, foreseeable risks are usually viewed as having been allocated. Yet the unforeseeability assumption is open to question.

Investors sometimes advance funds after it becomes clear that there are risks of noncompletion of power plants. Many recent investors in troubled utilities are receiving premiums directly attributable to the financial risks of a troubled nuclear power plant.¹⁸⁷ These investors cannot have it both ways. They cannot receive a nuclear risk premium until payments on their investments cease and then claim the shelter of a bargain premised on a near riskless rate of return. The existence of premiums is also persuasive evidence that investors do not command the near risk-free investment that Professor Kahn hypothesizes. The implicit bargain model therefore disqualifies some investors from the protection the bargain affords against loss attributable to noncompletion of a nuclear power plant.

There is evidence that the most important risk factor affecting utility investors, while once ignored, is now expressly considered and allocated by states. Much of the electric utilities' difficulty stems from deciding who is to pay the costs of an uncompleted plant. Fifteen or twenty years ago, plants were routinely completed and brought on-line without major financial dislocations.¹⁸⁸ The question of whether to pass on to customers the cost of construction work in progress (CWIP) never arose. Texts of the time do not mention the concept of including such costs in a utility's rate base.¹⁸⁹

187. *Id.* (20 to 60%); CAMPAIGN FOR RATEPAYERS' RIGHTS, *supra* note 63 (rates may double). See generally Christy & Christy, *Who Says Utilities Are Less Risky?*, 105 PUB. UTIL. FORT. 11, May 8, 1980 (investors treat utilities as riskier than industrials); Beedles, *Are Utilities Less Risky? A Reexamination*, 112 PUB. UTIL. FORT. 28, Aug. 4, 1983.

188. C. PHILLIPS, *THE REGULATION OF PUBLIC UTILITIES* 322-29 (1984) (in the late 1960's, construction and capital costs began to increase dramatically, and construction periods were greatly extended; cost of new plants may now represent a large fraction of firms' assets); Phillips, *The Changing Structure of the Public Utility Sector*, 117 PUB. UTIL. FORT. 13, Jan. 9, 1986.

189. See, e.g., I A. KAHN, *supra* note 157. For an alternative treatment of nuclear construction costs, allegedly resulting in less rate shock, see Nellis, *Allocating Nuclear Power Plant Costs Over Time*, 112 PUB. UTIL. FORT. 22, Sept. 29, 1983 (taking account of inflation).

Recently, however, state legislators and regulators have been expressly considering the CWIP risk. The issue debated is whether to include costs of uncompleted plants in a utility's rate base.¹⁹⁰ Inclusion of CWIP in the rate base was a major issue in the 1978 gubernatorial race in New Hampshire,¹⁹¹ and states reach varied results on the issue.¹⁹² Because of this widespread express consideration, exclusion of the cost of CWIP from the rate base is no longer accidental.¹⁹³ In jurisdictions that follow the practice of exclusion, recent investors cannot claim that noncompletion of a plant was an unallocated risk. No party in a true contractual situation can claim noncompletion to be an unforeseen risk.

Problems with using the implicit bargain model to allocate losses to ratepayers run more deeply than questioning the unforeseeability assumption for recent investors. In hypothesizing a bargain between ratepayers and investors, it is unlikely that an appeal to simple symmetry will produce anything like what an actual bargain should look like.

The symmetry argument is most appealing when stated in its simplest form: Those who stand to gain from a set of events should stand to lose from them. In any real bargaining setting, however, at least two other factors are taken into account. They are (1) the probability of a gain or loss, and (2) the magnitude of the gain or loss.

To illustrate, consider ratepayers who are about to strike their implicit bargain with investors. The ratepayers calculate that, over the life of the bargain, taking into account all unforeseeable events, they have a ten percent chance of a five percent rate reduction and a five percent chance of a fifty percent rate increase. The symmetry argument in its simplest form might support allocating gains and losses to ratepayers.

But no reasonable ratepayer, knowing of the probability and magnitude figures, would voluntarily buy into such a bargain. The expected return on the up side is .5%. The expected return on the down side is 2.5%. In predicting what a voluntary bargain might look like, the symmetry argument is oversimplified unless it takes account of magnitudes and probabilities. In

190. Grieves & Weaver, *A Resolution of the Rate Base Construction Work in Progress Controversy*, 109 PUB. UTIL. FORT. 28, Apr. 15, 1982; Comtois, *Construction Work in Progress in the Rate Base: A Benefit to the Consumer*, 105 PUB. UTIL. FORT. 19, May 8, 1980; Mattutat, *A Pragmatic Approach to Construction Work in Progress*, 99 PUB. UTIL. FORT. 31, Mar. 3, 1977; Tiemann, *When Should Construction Work in Progress Be in the Rate Base?*, 112 PUB. UTIL. FORT. 43, Nov. 24, 1983.

191. C. PHILLIPS, *supra* note 188, at 17 n.36. See also Salomon Brothers, Inc., *The Elections, the Electrics—and Recent Rate Cases*, Nov. 5, 1982.

192. E. GELLHORN & R. PIERCE, JR., REGULATED INDUSTRIES IN A NUTSHELL 121 (1982) (35 states allow inclusion of some portion of CWIP in the rate base); Flaschen & Reilly, *supra* note 5, at 139 n.12. On the federal level, see *Mid-Tex Elec. Coop. v. FERC*, 773 F.2d 327 (D.C. Cir. 1985) (reviewing and remanding FERC proposed rule allowing 50% of CWIP in rate base).

193. See Note, *supra* note 102, at 224. The flip side of including CWIP in the rate base is a utility accounting practice known as "allowance for funds used during construction" (AFUDC). This allows utilities to report phantom income based on uncompleted construction work. See Chandy & Davidson, *AFUDC and Its Impact on the Profitability of Electric Utilities*, 112 PUB. UTIL. FORT. 34, Aug. 4, 1983. Eliminating AFUDC income has a profound effect on the stated profitability of many utilities. *Id.* See also Drennan, *What's Right—or Not So Wrong—about AFUDC*, 113 PUB. UTIL. FORT. 40, Mar. 15, 1984.

reality, the expected decreases in rates due to unforeseen improvements are probably substantially less than the expected increases in rates due to unforeseen adverse events. The ratepayers are being offered a *limited* potential gain and an *unlimited* potential loss. This may be symmetry, but it bears little relation to fairness.

Even if one believes that a bargain will lead ratepayers to assume all downside risk, circumstances exist where losses might be allocated to investors. Even Professor Kahn would not saddle ratepayers with the cost of "grossly imprudent" investments. "No investors can legitimately expect that."¹⁹⁴ If it is determined that investment in a plant crosses the line between a reasonable effort to provide good service in the future and an effort to recoup the costs of what turns out to be an economic mistake, the investors' claim to the benefit of the implicit bargain ceases.

The implicit bargain, like its explicit contractual cousins, does not dictate how to account for risks that are unknown to and unforeseen by the parties. It is a useful model, but it does not necessarily generate answers. Those investors who have received relatively low returns, presumably those who invested before the risks of uncompleted plants became known, cannot be said to have foreseen the future. But neither can their hypothetical bargaining partners—the ratepayers. In a true bargaining situation, if the ratepayers had been told that they would bear *all* the costs of the unknown without upper limit, they would have rejected the deal.

C. Long-Term Effects on Utilities, Ratepayers, and Society

Predicting adverse long-term effects of allocating risks to investors is premised upon an argument that long-run societal welfare will be diminished. If allocating risks to investors results in long-term harm to investors but greater long-term benefits to society, however, the long-term effects argument collapses. No one is forced to invest in utilities. How are the effects of rates and investment losses on long-term societal welfare to be determined? The imperfect tools at hand include Posnerian economic analysis and traditional economic pricing theory. Both are founded on efforts to maximize long-term societal welfare, and both suggest that welfare will be maximized by allocating risks to investors.

Judge Richard Posner and others argue that efficient allocation of resources and maximization of societal welfare command that the contracting party who is more able to protect itself against loss should bear the risk of that loss.¹⁹⁵ It is difficult to argue that consumers of electricity are better situated to protect themselves than investors. Investors may diversify their portfolios to guard against risk at less expense and effort than consumers seeking to diversify their portfolios of energy supply. Investments in funds are more quickly and cheaply shifted than are investments in residences and plant. In

194. Kahn, *supra* note 186.

195. *E.g.*, R. POSNER, *ECONOMIC ANALYSIS OF LAW* § 4.5, at 94 (3d ed. 1986); Posner & Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83, 90 (1977).

addition, when viewed as groups, investors are more sophisticated than ratepayers. Both economic efficiency and down-to-earth planning ability thus suggest that investors are better able to absorb the loss than ratepayers.

Textbook economics suggests that, assuming that dollar values reflect social utility and social costs, welfare is maximized when the price charged for goods equals the marginal cost of producing those goods.¹⁹⁶ If electricity rates are higher than the marginal costs of producing electricity (because ratepayers must pay for sunk costs such as overly expensive power plants or because new power is cheaper than the power it replaces), users will purchase less electricity than they ideally should. The lower output associated with decreased demand now has greater marginal utility to consumers than marginal cost. The demand for electricity will be artificially depressed, with negative welfare effects on the state. "The reduced amount of electricity consumed comes from consumers using less than would make them most comfortable, consumers and businesses over conserving, and businesses moving out of the state."¹⁹⁷

To some extent, regulated industries may require regulated prices that are above marginal costs, and this is the regulatory tradition.¹⁹⁸ But the economic efficiency price paid for this imbalance ought to be minimized. When faced with losses or sunk costs attributable to isolable events, such as canceled or overly expensive power plants, economic theory suggests no additional departure from the ideal of price equaling marginal cost. A one-time loss will be visited on the investors, but society's utility will be maximized by not further increasing prices above the marginal cost of producing electricity. Imprudent or excessive costs should play no role in determining that marginal cost.¹⁹⁹ If investors are to be reimbursed, a subsidy, rather than a pricing mechanism that distorts demand, is appropriate.²⁰⁰

Against these arguments, what is to be made of the claim that, given a result favorable to ratepayers, future investors "won't play the game," with the implication that this is an adverse consequence? Future investors will, of course, play the game. They will insist on greater returns, however, if they are to lend to utilities or to some risky subset of utilities. From the ratepayers'

196. I A. KAHN, *supra* note 157, at 63-158; P. SAMUELSON & W. NORDHAUS, *supra* note 17, at 525-26.

197. Testimony of M. Bidwell, Chief of Regulatory Research, Office of Research, N.Y. Pub. Serv. Comm'n, in *In re Niagara Mohawk Power Corp.*, Case 29069-29070 (Aug. 1985), at 9.

Professor Kahn once put it this way: "[C]onsumers who would willingly have had society allocate to . . . production the incremental resources required, willingly sacrificing the alternative goods and services that those resources could have produced, will refrain from making those additional purchases because the price to them exaggerates the sacrifices." I A. KAHN, *supra* note 157, at 66-67.

198. I A. KAHN, *supra* note 157, at 124-37. Samuelson & Nordhaus explain this as a need to avoid chronic losses to firms with decreasing costs. P. SAMUELSON & W. NORDHAUS, *supra* note 17, at 526; see M. Bidwell, *supra* note 197, at 10. The decreasing cost trend means that marginal cost will always be below average cost.

199. Professor Kahn states: "[T]o the extent that maintenance, depreciation, cost of capital, and various other overhead expenses are *not* a function of use, they do not belong in short-run marginal cost or, *as such*, in the ideal price." I A. KAHN, *supra* note 157, at 72 (emphasis in original).

200. *Id.* at 130.

point of view, the trade-off is between current electric rate increases estimated to be between twenty to two hundred percent²⁰¹ and future increases based on the future increase in the cost of capital.

In an idealized economic model, ratepayers' increased future costs precisely reflect the increased risk to investors attributable to avoiding current large rate increases. Ratepayers have fewer risks, investors have more, and ratepayers pay the cost of their safety in the future. It is as if over time ratepayers purchase an insurance policy against massive immediate rate increases. The long-run costs to ratepayers balance out in relief from short-term rate increases, less a small premium for the "insurance." But ratepayers avoid the likely substantial social costs of massive rate increases, such as industries being forced out of business by rate shock and consumers foregoing necessary utility services.

The long-run costs to investors also balance out. Investors learn of the increased risks but adjust future investment rates upwards. Some risk-averse investors are driven from utility investments, but the effects on the system are probably no greater than those that would attend allocating greater risk to ratepayers. The investors who will not play the game provide no reason for allocating the loss to the ratepayers.

The bargain model, Posnerian law and economics, and traditional economics may all point to visiting power plant losses on investors. They certainly do not point firmly toward substantial rate increases. Despite the theories, however, competitive markets often do not allocate the costs of unforeseen risks according to an ironclad economic principle. Private parties often decide that in the long run, both are better off if the costs of unforeseen risks are shared.²⁰² Contracts are regularly renegotiated without legal compulsion. Courts sometimes require adjustment of long-term contracts when circumstances change. Whether because of a Macneilian long-term view of contractual relations or because of the costs of litigation, compromises are common.

Thus, a fully developed bargaining model probably will not generate one-sided results. A complete analysis of the hypothetical bargain, which would be heavily dependent on the reasonable expectations applicable to a particular utility, its investors, and its ratepayers, might support compromise solutions under which ratepayers and investors share the costs of failed plants.²⁰³ The matter need not be resolved here, however. If it is accepted

201. Kahn, *supra* note 186 (20% to 60%); CAMPAIGN FOR RATEPAYERS' RIGHTS, *supra* note 63 (rates may double); Letter from Jim Lazar to Theodore Eisenberg (Feb. 5, 1986) (rates in the Northwest have increased 200% since 1979 owing to dead Washington Public Power Supply System plants and another 200% owing to live WPPSS plants and other cost increases associated with actual utility service).

202. E.g., Macaulay, *supra* note 103, at 58-59; Mueller, *Contract Remedies: Business Fact and Legal Fantasy*, 1967 WIS. L. REV. 833, 837; Trakman, *Winner Take Some: Loss Sharing and Commercial Impracticability*, 69 MINN. L. REV. 471, 489-96, 556-57 (1985). But see Gillette, *Commercial Rationality and the Duty to Adjust Long-Term Contracts*, 69 MINN. L. REV. 521 (1985).

203. See Samuels, *A Consumer View on Financing Nuclear Plant Abandonments*, 115 PUB. UTIL. FORT. 24, Jan. 10, 1985 (suggesting that consumers pay higher rates in exchange for equity interest in the

that losses should not, as the implicit bargain advocates argue, automatically be imposed on ratepayers, then there is a more modest bankruptcy-related point to be made. If some substantial rate increases should otherwise be denied, they should not be granted out of fear of possible bankruptcy consequences. Ratemakers who believe they have a sound economic or social basis for denying rate increases should not be duped into granting them by fear of an unknown dark corner of the law.

V

CONCLUSION: OTHER BANKRUPTCY-REGULATORY INTERACTIONS

This article has emphasized the relationship between bankruptcy law and one regulated industry—the utility industry. Other possible relationships between regulation and bankruptcy reorganization may be shaped by questionable assumptions similar to those affecting the utility industry.

First, there is an interesting relationship between bankruptcy law and “general” regulation that protects a financially burdensome relationship. Regulation protecting a financially burdensome status quo differs from the regulatory structures emphasized here because of the general applicability of the regulatory scheme. Public service commissions and financial regulators regulate specific industries. Their regulatory authority is not generally applicable. Nearly all industries, however, are subject to federal labor legislation, federal securities laws, federal tax laws, and other provisions administered by the regulatory bureaucracy. One or more of these regulatory provisions may be a source of the debtor’s financial difficulty and could in some sense lead to bankruptcy.

For example, federal labor laws make the collective bargaining agreement between management and workers a kind of “law of the case.” The agreement becomes the legal blueprint for union-management relations. The regulation afforded by the National Labor Relations Act protects whatever deal the parties have hammered out. In doing so, federal regulation supports one aspect of the status quo—that embodied in the collective bargaining agreement. If the agreement contains a financially burdensome wage package, then regulation may be said to have become part of the financially troubled company’s problem.²⁰⁴

utility); Urban, *Allocating the Costs of Failed or Abandoned Projects of Regulated Public Utilities*, 113 PUB. UTIL. FORT. 33, May 24, 1984, (put burden only on equity in existence during earlier time to avoid affecting future costs of capital to the utility).

If the preferred substantive solution to a particular utility’s crisis is to share the burden of an abandoned nuclear plant, it may be fairer to spread the ratepayers’ part of the cost among a group larger than that served by the particular troubled utility. Independent of nuclear power plants, the utility business itself has become regional in orientation. Parts of every state except New York participate in at least one multistate power pool. ENERGY INFORMATION ADMINISTRATION, DEP’T OF ENERGY, INTERUTILITY BULK POWER TRANSACTIONS 80 (1983) (chart of DOE electric regions in U.S. as of June 1, 1982). If costs are allocated on a regional basis, the social cost of any rate shock will be diminished.

204. The labor-management battleground supplied the most celebrated instance of the pressure to modify nonindustry-specific regulation that protects the status quo—in this case a collective

Second is the relationship between bankruptcy law and regulatory requirements that are not a cause of a debtor's financial difficulty, but that may hinder successful reorganization if not relaxed. Here, the problem is not that a labor or tax law will lead to bankruptcy. Instead, it is that applying the law to the debtor who is attempting to reorganize will hinder the reorganization. The first category leads a debtor to bankruptcy; the second prevents the debtor from successfully emerging from bankruptcy. The process of reorganization triggers the regulatory scheme, and the question arises whether to suspend the normal regulatory rules of the game.

Several regulatory mechanisms illustrate this theme. In the absence of special rules, the fact of reorganization may generate income tax consequences that impede reorganization. A reorganization often requires the issuance of new securities that would normally be subject to federal securities law regulation.²⁰⁵ Many reorganizations trigger the need to deal with a debtor's pension plan. The problems of coordinating bankruptcy law with ERISA have proven to be substantial. This phenomenon is not limited to tax, securities, and pension laws. Any change in the debtor's operations might trigger the operation of some regulatory mechanisms. Reorganizing airlines, for example, might need new airport or safety permits.²⁰⁶

Regardless of the specific relationship at issue, claims made under the bankruptcy banner should be viewed skeptically. The nuclear utilities have used the fear of bankruptcy in part as a scare tactic to shape the political environment in which they operate. Once in bankruptcy, significant debtors will not hesitate to claim the need for relief from traditional securities, tax, labor, and environmental requirements. Because they will have shifted the debate into a remote, complex corner of the law, their chances to persuade when they should not be persuasive may increase. In each case, it is necessary to analyze in detail the benefits and burdens of bankruptcy and the need to undermine important regulatory requirements in the name of avoiding bankruptcy or achieving a successful reorganization.

bargaining agreement. Managements claiming the existence of burdensome labor contracts have seen bankruptcy law as a possible means of eliminating high labor costs. They have filed under chapter 11, rejected their collective bargaining agreements, and secured lower wage scales to restore the company's financial health. Unions have responded by litigating over the standard to be satisfied before the bankruptcy court can authorize rejection of a collective bargaining agreement. The resulting case, *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984), led to congressional enactment of section 1113 of the Bankruptcy Code. The net result is that management may reject collective bargaining agreements but usually not without judicial scrutiny. Similar use of bankruptcy may be envisioned to escape the burden of environmental regulation that imposes substantial cleanup costs on businesses. See generally Hennigan, *Accommodating Regulatory Enforcement and Bankruptcy Protection*, 59 *AM. BANKR. L.J.* 1 (1985).

205. See generally Morgan, *Application of the Securities Laws in Chapter 11 Reorganizations Under the Bankruptcy Reform Act of 1978*, 1983 *U. ILL. L. REV.* 861.

206. *In re American Central Airlines, Inc.*, 52 B.R. 567 (Bankr. N.D. Iowa 1985) (enjoining O'Hare Airport from depriving debtor of 20 of its 36 air landing slots); *In re Air Illinois*, 13 Bankr. Ct. Dec. (CRR) 606 (Bankr. S.D. Ill. 1985) (allowing FAA to revoke debtor's landing and take-off privileges at O'Hare Airport after filing of bankruptcy petition).