The Constellation Experience

Ring-fencing after the subprime meltdown.

By Scott Strauss and Peter Hopkins

History teaches that the combination and affiliation of regulated and unregulated corporations, particularly under the common ownership of a holding company, poses difficulties for regulatory commissions and, if unaddressed, significant and adverse consequences for utility companies and their customers. "In 1924, 74.6 percent of all electricity generated in the United States was produced by operating companies which were parts of holding companies; by 1930, 90 percent of all operating companies were controlled by 19 holding companies."[1] The collapse during the Great Depression of the highly leveraged Insull empire and numerous other utility holding companies precipitated the creation of the *Public Utility Holding Company Act* of 1935 (1935 Act). The utility holding company structure was criticized for pyramiding[2] and an attendant highly-leveraged corporate structure, a write-up of securities and capital assets, the abuse of affiliated transactions, and spending sprees to limit or eliminate competition.[3] Among other things, the 1935 Act served to limit utility holding companies from engaging in regulated and unregulated businesses.

The 1935 Act did not preclude all public utility holding companies. In 1997, Enron Corporation took advantage of an exemption to the 1935 Act limitations for intrastate holding companies and acquired Oregon's Portland General Electric (PGE). Acting with a caution out of step with the free-market spirit of the 1990s, the Oregon Public Utility Commission conditioned Enron's acquisition of PGE on the imposition of significant ring-fencing measures, which were intended to insulate PGE from potential financial calamities involving other parts of Enron's operations. PGE subsequently was spared consolidation into the Enron bankruptcy, an outcome that numerous commentators, including Standard & Poor's, stated was the result of the commission-imposed ring-fencing measures.[4] Among the important restrictions were the maintenance of a 48-percent equity level at PGE and advance notification of special or large dividends to Enron.

In more recent times, Congressional ardor for unregulated markets largely has supplanted concerns about the potential abuses of holding company structures. In 1992, Congress amended the 1935 Act to permit holding company ownership of independent power producers and regulated utilities.[5] The 1992 amendments paved the way for numerous new utility holding companies including Constellation Energy Group's (Constellation) ownership of Baltimore Gas and Electric. (BGE).

Congress repealed the 1935 Act and replaced it with the takeover-friendly provisions of the P*ublic Utility Holding Company Act* of 2005.[6] That same year, Wall Street began to issue enormous sums of highly risky subprime mortgage-related securities, many of which nevertheless had AAA ratings from the major credit rating agencies.[7] These practices culminated in the financial crisis that enveloped Wall Street in the Fall of 2008. Lehman Brothers Holdings filed a voluntary bankruptcy petition on Sept. 15, 2008. Within days following the Lehman bankruptcy, Federal Reserve Chairman Ben Bernanke warned Congress that the economy of the world would collapse unless Congress provided $700 billion in discretionary funds.[8]

Ring-fencing can help prevent a bankruptcy court from forcing a subsidiary into a parent bankruptcy.

On the morning of Sept. 16, 2008, Constellation faced its own crisis arising, at least in part, from rumors concerning the company's alleged exposure to the Lehman bankruptcy. While owning BGE, a regulated utility, much of Constellation's revenues were in fact a result of energy trading and related contracting. These trading activities, combined with threatened, and ultimately implemented, credit-rating downgrades, exposed Constellation to potential collateral needs that—in light of the credit crisis—the company simply could not meet. The Constellation "management team was concerned that a further erosion of confidence in Constellation Energy's ability to support its business… could lead to demand for additional collateral that would require more liquidity than Constellation Energy had or could access in a short time."[9] In short, Constellation faced bankruptcy:[10]

Based on statements made by the ratings agencies to Constellation Energy, absent a significant, immediate equity investment, one or more of the ratings agencies were likely to downgrade Constellation Energy's credit rating (*i.e.*, possibly

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by two notches to below investment grade), which would trigger an obligation for Constellation Energy to post additional collateral under existing counterparty contracts and further exacerbate the crisis of confidence with its business counterparties, thereby seriously impairing Constellation Energy's ability to operate its business and likely forcing the company to file for bankruptcy protection.

Constellation avoided bankruptcy by agreeing to an offer from Warren Buffet's MidAmerican Energy Holdings Co. to acquire the entire company for $4.7 billion. Electricité de France (EDF) subsequently displaced Buffet's takeover bid by making an offer adjudged by the Constellation board of directors to be superior: the acquisition of a 49.99-percent share of Constellation's nuclear generating subsidiary for roughly $4.5 billion.

One year later, testifying in support of the EDF acquisition before the Maryland Public Service Commission (MDPSC), Constellation executives acknowledged that what was true in September 2008 was still the case in September 2009. Constellation had insufficient ring-fencing measures surrounding BGE to mitigate against the likelihood that a court would involuntarily consolidate BGE into a Constellation bankruptcy.[11] In addition, Constellation controlled a majority of the seats on the board of directors of BGE, as noted, a wholly-owned subsidiary, and could direct BGE to file a voluntary petition for bankruptcy together with a Constellation filing.[12]

The MDPSC responded to this state of affairs by conditioning its approval of the EDF acquisition upon Constellation's implementation of significant ring-fencing measures. In an order issued in October 2009,[13] the commission imposed specific conditions, including: 1) creation of a special purpose entity (SPE) intermediate holding company that would hold all shares of BGE stock, and have two separate "golden votes" that must be voted in favor of any voluntary petition of bankruptcy;[14] 2) Constellation, BGE and the SPE obtain a non-consolidation opinion that a bankruptcy court would not consolidate the assets of BGE with Constellation in the event of a Constellation bankruptcy;[15] 3) the SPE and BGE implement sundry specific measures to maintain requisite legal separateness between and among themselves and Constellation; and 4) BGE's charter and by-laws be amended to require the unanimous vote of the board of directors, including the BGE independent directors, in order for BGE to file a voluntary petition of bankruptcy. The MDPSC also conditioned its approval of the acquisition on BGE's not paying dividends to Constellation if, after the dividend payment, BGE's equity level would fall below 48 percent.

With the repeal of the 1935 Act, state regulators looking to safeguard regulated utilities and protect consumer interests face the significant challenge of insulating utilities in holding companies from the risks flowing from unregulated enterprises. The credit, collateral and market risk associated with derivatives and trading activities is only one example—albeit a compelling one—of the risks associated with unregulated entities.[16]

Given the difficulty of policing and monitoring the riskiness in public utility holding company structures and dealings, ring-fencing measures offer a potential structural safeguard. However, ring-fencing does not offer fool-proof protection and can give rise to its own regulatory trade-offs.

Bankruptcy Remoteness, Not Prevention

Courts have found that it might be "sound business practice for [the parent] to seek Chapter 11 protection for its wholly-owned subsidiaries when those subsidiaries [are] crucial to its own reorganization plan."[17] A parent holding company typically can order a wholly-owned utility subsidiary to file a voluntary petition for bankruptcy together with the parent's own filing. While the utility articles of incorporation or by-laws likely would require board of director approval for such action, the parent company likely would control the board of directors of a utility subsidiary. Consistent with the concept of owner-control, the utility vote to file is thus a foregone conclusion.

The creation of a golden vote and/or golden share is a measure for addressing this issue, and was one of the MDPSC's required ring-fencing measures for BGE. The utility's governing documents are modified to provide for at least one independent board member, and the arrangements are such that the decision to file for bankruptcy must be by unanimous vote of the board.[18] Alternatively, or additionally, the decision to file can be conditioned upon the vote of a special voting share that resides in the hands of an independent entity. In the case of Enron and PGE, the suite of ring-fencing protections included a golden share requirement.

With the repeal of the 1935 PUHCA, regulators face the challenge of insulating utilities from the risks of unregulated enterprises.

The golden vote mechanism is not a guarantee that the subsidiary utility will choose to forego filing a petition for bankruptcy. There does not appear to be a recognized requirement that an independent director or golden shareholder must vote against the utility's filing a voluntary petition for bankruptcy. The Bankruptcy Court for the Southern District of New York was very clear on this point in the recent *General Growth Properties* proceeding. The "belie[f] that an 'independent' manager can serve on a board solely for the purpose of voting 'no' to a bankruptcy filing because of the desires of a secured creditor[is] mistaken."[19]

The *General Growth Properties* court rejected an argument that the subsidiary had filed for bankruptcy in bad faith because an independent manager had voted in favor of the filing notwithstanding that the governing subsidiary operating agreement required the independent manager to consider only the interests of the subsidiary, including its creditors, in casting his vote. The court found that the independent director also had fiduciary obligations of loyalty under Delaware law to shareholders and those shareholder interests extended to concerns relating to the corporate group as a whole. In short, golden share ring-fencing measures give rise to an entity that is bankruptcy remote,[20] but not bankruptcy removed.

General Growth Properties shows that the independent director might have multiple fiduciary obligations to different entities. The testimony of Charles Atkins, Constellation's ring-fencing expert in the BGE case, was to like effect: "independent directors have a combination of fiduciary duties, they have a set of fiduciary duties to their particular entity. [There] is a set of fiduciary duties to the creditors and a set of fiduciary duties to the shareholders."[21] How this can or should play out in a given circumstance is unclear. But arguably these conflicting obligations and the associated uncertainty of any dictated outcome give the golden vote its power of promoting bankruptcy remoteness. Just as the secured creditors were unsuccessful in arguing that the independent director had to vote "no," it is entirely possible that shareholders would be unsuccessful in a given case in arguing for the specific relief that an independent director must vote "yes."

Ring-fencing also can help protect against a bankruptcy court involuntarily consolidating a subsidiary into a parent bankruptcy. Consolidation is a judicially created remedy, it is not expressly provided for under the bankruptcy code. Where consolidation is ordered, the assets and liabilities of the consolidated entities are treated as combined assets and liabilities of the single, bankrupt entity. There are two different generally recognized tests for consolidation. Under the more creditor-protective approach, consolidation can be had where:[22]

A proponent proves corporate disregard creating contractual expectations of creditors that they were dealing with debtors as one indistinguishable entity… Proponents who are creditors must also show that, in their prepetition course of dealing, they actually and reasonably relied on debtors' supposed unity… Creditor opponents of consolidation can nonetheless defeat a *prima facie* showing under the first rationale if they can prove they are adversely affected and actually relied on debtors' separate existence.

The second, more consolidation-friendly approach entails a multi-factor analysis of whether "'the economic prejudice of continued debtor separateness' outweighs 'the economic prejudice of consolidation.'"[23] A central consideration under the balancing approach is the extent to which creditors have relied upon the separate credit of one of the entities and the extent to which they will be prejudiced by consolidation.

A single, substantial linkage between the parent and subsidiary could prove problematic, such as cross-default provisions in parent and subsidiary financings (*i.e*, a default on one parent borrowing is deemed a default of all of the parent and/or subsidiary lender agreements reflecting a recognition that the lender is essentially lending to one combined entity). The cross-default issue can be remedied by requiring the elimination of all cross-default provisions from such financing arrangements. More broadly, however, another routine ring-fencing requirement, and one ordered by the MDPSC in the Constellation-EDF case, is that the utility obtain a non-consolidation opinion from independent bankruptcy counsel that the required ring-fencing measures will achieve and maintain the necessary separation of subsidiary and parent such that a bankruptcy court will not apply the doctrine of consolidation to consolidate the assets and liabilities of the subsidiary with the assets and liabilities of a bankrupt parent or affiliate.[24]

Absent ring-fencing measures sufficient to establish bankruptcy remoteness, rating agencies will perceive a strong linkage between parent and subsidiary.

More extreme measures of protection are, perhaps, conceivable. A utility commission could condition regulatory approval (*i.e*, relating to some acquisition or merger) on the provision of a parent holding company and subsidiary guarantee that the subsidiary not voluntarily file a petition for bankruptcy in the event of a parent filing. However, serious questions of public policy would surround the legality and enforceability of such a provision.

Credit Rating Separation

Absent ring-fencing measures, the rating agencies fear that the parent corporation will draw the subsidiary into a parent bankruptcy or otherwise adversely affect its financial health when the parent is experiencing financial crisis.[25] "[R]ating agencies, particularly Standard & Poor's, typically accord a subsidiary the same credit rating as its parent, even if the subsidiary's financial condition on a stand-alone basis appears to be stronger."[26] However, where strong ring-fencing measures are in place, the rating agencies may accord substantial credit rating differentials between the parent and subsidiary.

This outcome is not assured. On occasion, rating agencies

have downplayed the likelihood of such benefits. In 2002, Standard & Poor's stated that "[i]n general, ring-fencing will only create a marginal rating differential between subsidiary and its parent entity."[27] Based upon his experience and the rating agencies' published criteria, witness Atkins testified in the *BGE* case that his proposed ring-fencing measures (which, with certain significant modifications and strengthening served as the core of the MDPSC's ring-fencing of BGE) would result in a three-notch credit rating separation between Constellation and BGE.[28] His prediction turned out to be partially correct. Following the MDPSC's Phase II order, on Nov. 2, 2009, Standard & Poor's revised its credit ratings for Constellation and BGE and rated BGE two notches higher than Constellation (*i.e*, a rating of BBB+ for BGE and BBB- for Constellation).

The subject of ratings separation, similar to the issue of bankruptcy remoteness, is replete with uncertainty and each case might well turn on its own particular facts. Consistent with the Delphic pronouncements of the rating agencies, in general, Standard and Poor's offers the vague caution that "each ring-fencing exercise must be viewed on its own merits."[29] However, there is a clear distinction between circumstances where robust ring-fencing measures are in place and where they are absent. In the absence of ring-fencing measures sufficient to establish bankruptcy remoteness, rating agencies will perceive a strong linkage between parent and subsidiary and there will be little or no credit-rating separation.

The potential downside to ratings separation is that the utility loses the benefit of a financially stronger parent and the ability it might otherwise have had to access capital on better terms on a consolidated basis. Regulators who require strong ring-fencing measures cannot have it both ways. For example, to the extent a utility is encouraged or directed to maintain a relatively high level of equity to debt, the utility in all likelihood will seek a commensurate rate of return reflecting the higher equity level.

Corporate Governance Structure

The separation of parent and subsidiary also can be addressed through corporate governance conditions. The Texas Public Utility Commission approved ring-fencing measures concerning Oncor Electric Delivery Co., a Dallas-area electric distribution utility, which included requiring the 80-percent parent-owned electric distribution subsidiary to have a majority independent board.[30] Based upon the Oncor ring-fencing measures, the attorney general for the State of Maryland argued that BGE should be required to have a majority independent board of directors. Constellation objected to this proposal as a deal-breaker, and the MDPSC did not impose it. The MDPSC did, however, conclude its *Phase II* order with the observation: "Nothing in this Order should be read as a decision not to exercise our general supervisory authority over BGE in the future, or a decision that we will not initiate further supervisory proceedings if and when we find them appropriate."[31] Regulators seeking to maximize the ring-fencing separation between parent and subsidiary utility can look to the Oncor example.

State Safeguards

The repeal of PUHCA has created substantial challenges for regulators. Investment-grade holding companies such as Constellation might face unknown risks or exposures to rapidly-changing market conditions. If realized, these risks can place a regulated affiliate utility in financial jeopardy. There is little that regulators can do after-the-fact to protect even a financially-healthy utility subsidiary from credit downgrades or being drawn into a parent's bankruptcy. In order to be effective, ring-fencing measures must already be in place. When things are going well, however, there might be a regulatory disinclination to take measures seemingly intrusive of management's freedom of action over its holding company activities. Moreover, by imposing greater separation between the affiliated utility and the rest of the holding company, ring-fencing arguably comes at some efficiency cost. Nonetheless, a significant argument can be made that regulators should err on the side of ratepayer protection. The Enron-Portland General Electric situation is a good example of proactive ring-fencing that paid off. Following the near-bankruptcy of Constellation, the Maryland PSC decided that it was unwilling to let EDF immerse itself in Constellation's nuclear business without ring-fencing protections for BGE going forward.

Ring-fencing can give rise to regulatory trade-offs.

In the wake of the economic crisis of 2008, President Roosevelt's observation made in 1935 rings eerily familiar: "[f]undamentally the holding company problem always has been, and still is, as much a problem of regulating investment bankers as a problem of regulating the power industry."[32] State utility regulators cannot discipline Wall Street, but they might well have the ability to better safeguard utilities and ratepayers by requiring strong ring-fencing.

Endnotes:

1. Energy Information Administration, Public Utility Holding Company Act of 1935: 1935-1992, ch. 2, at 6 (Jan. 2003), available at *http://tonto.eia.doe.gov/ftproot/electricity/0563.pdf.*
2. In a pyramid structure, one holding company owns another holding company and so on, so that ownership of the underlying operating company may be several levels removed and each additional layer of ownership gives rise to further leveraging. Each of the holding companies was able to issue its own stock and debt, typically outside the control of utility regulators.
3. *Id.* ch. 3, at 2-5.
4. Standard & Poor's, Jan. 16, 2003, "RatingsDirect," entitled, "An Enron Subsidiary is 'Ring-Fenced,'" states that these ring-fencing measures "served to

largely insulate PGE from Enron's subsequent woes."

5. *Energy Policy Act of 1992*, § 711, 15 U.S.C. § 79z-5a (repealed).
6. *Energy Policy Act of 2005*, §§ 1261-1277 (codified in scattered sections of 15 and 42 U.S.C.).
7. Michael Lewis, The Big Short 23-24, 30-31, 50-51 (W.W. Norton & Co. 2010).
8. The $700 billion in Troubled Asset Relief Program (TARP) funds was only one piece, and indeed, the smaller piece of the financial bailout. Separate and independent from TARP, the Federal Reserve purchased subprime mortgage bonds directly from the banks. "By early 2009 the risks and losses associated with more than a trillion dollars' worth of bad investments were transferred from big Wall Street firms to the U.S. taxpayer." Lewis, supra note 8, at 261.
9. Constellation Energy Group, Inc., SEC Schedule 14A, at 32 (Oct. 17, 2008) (Preliminary Proxy Statement).
10. *Id.* at 42.
11. "Constellation won't make a specific commitment [to implement robust ring-fencing] until we know what the outcome of [the EDF] transaction is." Transcript of Hearing at 439 (Michael Wallace, Vice Chairman and Chief Operating Officer, Constellation Energy), *In re Balt. Gas & Elec. Co.*, Case No. 9173, Phase II (Md. Pub. Serv. Comm'n., Sept. 15, 2009) ("Case 9173 Transcript").
12. While Constellation's finances were on the mend in September 2009, there was concern that EDF's acquisition of nearly one-half of Constellation's nuclear subsidiary could lead to the pursuit by Constellation of a the construction of a financially-challenging third nuclear reactor at Calvert Cliffs.
13. *In re Balt. Gas & Elec. Co.*, Order No. 82986, Case No. 9173, Phase II (Md. Pub. Serv. Comm'n., Oct. 30, 2009), available at *http://webapp.psc.state.md.us/Intranet/Casenum/NewIndex3_VOpenFile.cfm?ServerFilePath=C:\ Casenum\9100-9199\9173\\218.pdf.* The full particulars of the MDPSC's conditioning requirements are worth reading and appear at pages 46 through 53 of Order No. 82986.
14. The SPE is required to have an independent director as well as an SPE golden share held by an SPE administration company and the vote of both is essential to the SPE's filing of a voluntary petition for bankruptcy.
15. If the measures set forth in the Order were not sufficient to obtain a non-consolidation opinion, Constellation, BGE and the SPE were directed to take any and all further steps necessary to secure such an opinion.
16. Enron was built on fraud, and in particular accounting fraud.
17. *In re Heisley v. U.I.P. Engineered Prods. Corp.*, 831 F.2d 54, 56 (4th Cir. 1987). The *Heisley* court found that the subsidiaries' filing was proper even though the subsidiaries were solvent. *See also, In re Mirant Corp.*, 2005 WL 2148362 (Bankr. N.D. Tex. Jan 26, 2005) (noting that adverse impact of parent and affiliate filings could warrant need for subsidiary to file for bankruptcy protection). This is not to presume or prejudge the outcome in any particular case where creditors of the solvent subsidiary oppose such a filing.
18. Other major acts of corporate reorganization are also typically made subject to the golden vote requirement.
19. *In re Gen. Growth Props., Inc.*, No. 09-11977, slip op. at 33 (Bankr. S.D.N.Y. Aug. 11, 2009).
20. *Id.* at 28.
21. Case 9173 Transcript at 1120. Mr. Atkins was at that time an executive director in the Securitization and Asset Monetization Group of Morgan Stanley & Co., Inc.
22. *In re Owens Corning*, 419 F.3d 195, 212 (3d Cir. 2005) (footnote and citations omitted).
23. *Eastgroup Properties v. S. Motel Assoc., Ltd.*, 935 F.2d 245, 249 (11th Cir. 1991) (internal citation omitted).
24. Again, the particulars of the MDPSC order provide a worthwhile laundry list of relevant factors bearing on the issue of separateness. Order No. 82986, at 46-53.
25. Standard & Poor's, *Ringfencing Subsidiaries from Parent Bankruptcies in California* (Oct. 2001).
26. Rebuttal Testimony of Charles N. Atkins II at 7, *In re Balt. Gas & Elec. Co.*, Case No. 9173, Phase II (Md. Pub. Serv. Comm'n., Sept. 8, 2009).
27. Charles E. Peterson & Elizabeth M. Brereton, Utah Dep't of Commerce, Report on Ring-Fencing 18 (Sept. 2005) ("Peterson Report") (quoting Peter N. Rigby, Standard & Poor's, "Ring-Fencing" Subsidiaries to Protect from Parent Bankruptcies During the California Power Crisis, 9 The Financier 30, 32-33 (2009)), available at *http://www.psc.state.ut.us/utilities/telecom/05docs/05053301/Dirpercent20Testpercent20Cpercent20Petersonpercent20DPUpercent20Exhibitpercent2010.1.doc.*
28. Case 9173, Transcript at 1113-14.
29. Peterson Report at 18 (quoting Peter Rigby, supra note 29).
30. *Joint Report & Application of Oncor Elec. Delivery Co. & Tex. Energy Future Holdings Ltd. P'ship*. Pursuant to PURA § 14.101, Docket No. 34077, Order at 9 (Tex. Pub. Util. Comm'n., Feb. 22, 2008), available at *http://interchange.puc.state.tx.us/WebApp/Interchange/Documents/34077_735_576619.PDF* ("A majority of Oncor Electric Delivery Holdings' board members and Oncor's board members will qualify as 'independent' in all material respects in accordance with the rules and regulations of the New York Stock Exchange.")
31. Order No. 82986, at 53 (footnote omitted).
32. *In re H.M. Byllesby & Co.*, 6 S.E.C. 639, 1940 WL 36326, at *13 (Jan. 15, 1940) (quoting President Roosevelt's note to Congress accompanying 1935 Act).