The Treatment of the Master Service Agreement and its Associated Service Orders in a Telecommunications Bankruptcy

Written by: James H. Lister
Birch Horton Bittner and Cherot, PC; Washington D.C.
jlister@dc.bhb.com

Telecommunications carriers generally assemble much of their network by leasing large numbers of point-to-point circuits from a handful of other providers (vendors). These arrangements generate recurring issues involving the rules for rejecting and assuming executory contracts and unexpired leases under §365 of the Bankruptcy Code.

Because so many point-to-point circuits are typically needed to assemble a network, the industry practice is for each purchasing carrier to enter into an umbrella master service agreement (MSA) with each of their vendors covering multiple-circuit leases with that vendor. Each circuit lease is usually called a service order.

The MSA contains all the contract boilerplate and some of the business terms, including a formula for calculating the "early termination liability" if the purchaser elects to terminate a particular circuit lease before the agreed upon termination date. Sometimes the MSA establishes a monthly pricing menu. Each service order establishes the circuit bandwidth (DS-3, OC-12, etc.), end points, lease expiration date (key to calculating the early termination liability) and sometimes the monthly rate. The MSA looks like a traditional contract. By contrast, the services orders are informal. They may be fax cover sheets or short emails replete with the technical jargon needed to specify circuit end points and bandwidth.

One unsettled issue is whether the purchaser who files for chapter 11 bankruptcy reorganization may elect to assume or reject the contractual relationship with the vendor under §365 of the Bankruptcy Code on a circuit-by-circuit basis, or must instead assume or reject the entire MSA as a whole.

The well-advised debtor will file motions to assume or reject on a circuit-by-circuit basis. Vendors may object to this practice by arguing that contracts must be assumed or rejected as a whole, and may try to negotiate extra compensation as the price for acquiescence.

The advantages to the debtor in assuming and rejecting on a circuit-by-circuit basis are immense. An example illustrates how expensive it can be for a debtor to assume at the MSA level. Say there are only two circuits (and so two service orders) under a MSA. Circuit 1 is attractively priced and essential to the debtor's network. Circuit 2 is now six months into a three-year commitment at a monthly rate that seemed fair at the time of the order but is now well above the going market rate. Although the debtor could terminate circuit 2 early and obtain a substitute circuit from another vendor at market rate, the MSA might impose an early termination liability equal to one year's charges or more. Under §365(b)(1) of the Bankruptcy Code, the debtor, in order to assume the MSA, would have to pay in full the pre-bankruptcy and post-bankruptcy arrearages under both circuits and, unless the debtor is willing to reaffirm the three-year commitment on circuit 2, the substantial early termination liability for circuit 2.

By contrast, if the debtor is allowed to assume just circuit 1, it needs to pay in full (*i.e.* "cure") only the arrearages accumulated on that circuit, which are likely small because the debtor was probably diligent in its payments on that essential circuit. If the debtor is similarly allowed to reject just circuit 2, the pre-bankruptcy arrearages under that circuit plus the early termination liability are treated as general unsecured pre-bankruptcy claims, which need not be paid in full on a current basis. This general unsecured claim will receive whatever distribution (maybe pennies on the dollar) the unsecured creditors in the bankruptcy case get. The vendor will lose the revenue stream generated by the circuit, and will shut the circuit down.

The law of severing master contracts into component contract that can be separately rejected or assumed is complex.[i] In many instances, the debtor may have a plausible claim that severance of the MSA into separate contracts (the service orders) is appropriate. That debtor will likely argue that the service orders are unrelated independent contracts that happen to draw on one common document (the MSA) as a convenient source for standard boilerplate contract terms. In response, the vendor may try to point to some deeper relationship among the various circuits under a MSA, for instance, a volume discount that the vendor granted only because the debtor had agreed to lease several circuits at one time. A vendor that anticipates that the purchaser may later file for bankruptcy should describe in the MSA any such relationship among circuits.

The debtor will likely move to reject circuit 2 as soon as possible in order to reduce its current operating expenses and convert the early termination liability into a general unsecured claim. A cautious vendor that files an objection to the debtor's attempt to independently reject circuit 2 should consider trying to find some way to postpone a final decision by the court on the objection. A busy debtor may agree to allow the vendor to reserve its right to litigate the appropriate compensation in exchange for confirmation that the debtor may immediately terminate the circuit and so stop paying for post-bankruptcy service. Should the vendor instead try to fight a pitched battle at this time, the debtor may well reject circuit 1 and thus the entire MSA – an action that the vendor cannot stop.

The vendor's position improves if and when the debtor finally commits to assuming circuit 1, perhaps at the time the plan of reorganization is confirmed. At that point, the debtor loses the power to reject circuit 1 and thus the whole relationship. By assuming circuit 1, the debtor also becomes obligated under §365(b)(1) of the Bankruptcy Code to cure "any default" in the contract being assumed. The MSA will supply much of the contract terms that make up the circuit 1 service order and will probably provide that failure to pay an amount due with respect to any circuit is a default under the MSA justifying termination of service as to all circuits. While a bankruptcy court that finds the MSA to be severable may ignore this "cross-default" provision, the provision at the very least gives the vendor a plausible argument that the debtor must now cure defaults under circuit 2 in order to assume circuit 1. The vendor's position is enhanced if it entered into a reservation of rights agreement when the debtor rejected circuit 2.

Having gained better leverage, the vendor that pushes the issue at this point may well be able to negotiate additional compensation for circuit 2. These issues generally settle.

To avoid exposing itself to these types of claims, a debtor thinking of assuming any circuit under a MSA should first check to see if it is has rejected other circuits relating to the same MSA. If it has, it should address the issues raised in this article in a comprehensive settlement with the vendor, before committing to any circuit assumptions.

---

[i] The root case to begin researching these issues is *Stewart Title Guar. Co. v. Old Republic Nat. Title Ins. Co.,* 83 F.3d 735, 741 (5th Cir. 1996).