The $7 Billion Default Threat

By James S. Granelli
National Law Journal Staff Reporter

SEATTLE — The long-threatened default on $2.25 billion worth of municipal revenue bonds sold to build two nuclear power plants in Washington state will likely occur June 1, perhaps triggering the biggest municipal bankruptcy ever while dramatically raising the stakes in what is already a mammoth legal brawl.

The executive board of the municipal joint venture known as the Washington Public Power Supply System, unable to get 88 participating utilities to pay their bills for the now terminated plants, set its own fate May 13 when it decided not to pay the monthly $15.6 million in interest due May 31.

The default would mean that $2.25 billion in tax-exempt bonds and $4.8 billion in interest would go unpaid, making it one of the largest municipal bond defaults in U.S. history.

The likelihood of a default is shaking confidence in the usually low-risk municipal bonds and is thwarting WPPSS efforts to find money to finish three other nuclear projects in the state.

Some 40 lawsuits have been filed over the potential default and its ramifications. The suits, which contain of accusations of mistake, misrepresentation, mismanagement, incompetence, coercion, fraud, deceit, name a varied cast of

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Power System Earmarks $18M for Attorney Fees

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dants, including energy forecasters, bond counsel, outside lawyers, bond brokers, architects, engineers and, of course, WPPSS.

Bureaucratic bungling on the project became so evident three or four years ago that the supply system, which had been proud that people pronounced its initials WUPS, was tagged with a moniker it didn't like — WHOOPS.

The litigation is chock full of contracts, creditors rights and securities law issues that would make law school examiners' eyes gleam. In one related action, King County Superior Court Judge Robert Elston bemoaned a 950-page contract and an 1,100-page agreement. *WPPSS v. Exxon Nuclear,* 81-2-03850-6.

"Unlike most cases, lawyers can't turn to the contracts themselves for answers," he said. "These are not the kinds of contracts one normally sees. They are more the nightmarish stuff of which law school exams are made."

The tangled litigation also could change the way utilities band together to build large electric generating units and alter the language of the contracts they sign.

'Making Out Like Bandits'

And the lawsuits are filling law firm coffers. "The lawyers are making out like bandits," said WPPSS spokesman John Britton. (See accompanying story.)

In its May 13 meeting, for instance, the supply system's executive board decided to put $24.7 million of its remaining $28 million into a separate account for administrative and legal bills. Up to $18 million of that sequestered amount is earmarked for attorney fees over the next 18 months, Mr. Britton said.

Nearly every major law firm in the Pacific Northwest is representing some entity in the litigation, which is spread out among state and federal courts in at least five states, said Seattle lawyer William N. Appel, who resigned from all litigation April 15 to work for a political settlement.

The trouble with a political settlement, though, is that some legal issues — particularly the authority of utilities to enter into these agreements with WPPSS and the interpretation of clauses requiring payment regardless of whether any plants are completed — may have to be decided by the courts first, Mr. Appel said. And that won't occur soon enough to prevent default or, possibly, bankruptcy, he said.

Organized in 1957 by 19 Washington public utility districts and four cities in the state, WPPSS was expected to be the best vehicle for financing plant construction and marketing low-cost power in the capital-poor but energy-rich Pacific Northwest.

Based on forecasts of energy shortages starting in the 1980s, the supply system, which had built and operated only two small generating plants, embarked on an ambitious program in the early 1970s to build nuclear reactors to provide electricity to utilities, cities, farms and the aluminum and timber interests.

Problems, Problems

Construction on the first reactor — plant 2 — began in 1973, and plants 1 and 3 were started two years later. Security for the revenue bonds sold as separate projects to build the units came when 115 utilities signed up as participants to buy power and the Bonneville Power Administration, a federal agency similar to the Tennessee Valley Authority, promised to buy plants and 70 percent of plant 3's capacity.

But in 1976, the BPA, one of the primary energy forecasters, issued notices of insufficiency, telling Pacific Northwest utilities that future energy needs still wouldn't be met. It urged construction of two more reactors — plants 4 and 5 — which WPPSS started building as a single project the following year. BPA, however, didn't offer the same security to investors because Congress refused to have the agency become the buyer of last resort.

Problems cropped up almost from the start of construction. The supply system didn't have the experience to oversee such massive projects and the contractors apparently didn't have much more experience in building reactors, especially on the fast-track method where design barely kept ahead of construction and much work had to be redone.

Interest rates and inflation soared and the recession and conservation set in, halting the annual 7 percent increase in electricity consumption that

'The lawyers make out like bandits,' says one spokesman for the state's Public Power System.

BPA and other forecasters had counted on. Regulatory changes, delays and cost overruns helped to push the estimated total bill for all five plants from $4 billion in the mid-1970s to nearly $24 billion in 1981.

In short, ratepayers had as much electricity as they wanted but had to pay more for it — and power from two or, perhaps, three of the plants wouldn't be needed after all.

Cutting Back

With 23 percent of plant 4 and 17 percent of plant 5 completed, WPPSS terminated them in January 1982. Under the contracts, the system had to start paying off interest on the bonds a year later.

Plant 1, which was 63 percent completed, was put in mothballs, and plant 3 workers were put on a four-day schedule to finish the remaining 30 percent of the construction. Only plant 2 is expected to be completed and operational by next February, but the supply system still needs to find $149 million to complete the job.

When a state Senate report put most of the blame of cost overruns and delays on the supply system, ratepayers became furious. They got 58 percent of the vote on Initiative 394, a state measure requiring a public vote before any more bonds could be sold to build plants. (The state courts have invalidated the measure as applied to plants 1, 2 and 3.) The initiative also required that cost-effectiveness studies, be performed, which WPPSS had never done, to determine if the plants were still feasible.

"All we were saying is show us a cost-effective plant and we won't oppose it," said Steve Zemke, chairperson of Don't Bankrupt Washington, a grassroots group that sponsored the initiative.

Angry ratepayers also started an avalanche of lawsuits over plants 4 and 5 by claiming their utilities didn't have authority to enter into the plant 4/5 participation agreements without

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~~er approval. And~~ If the utilities did ve the authority, the ratepayers ued, the contracts they signed were reements to sell and buy power, not pay for the equivalent of a "dry e."

Chemical Bank of New York, signated under the agreements as istee for the bond fund, last year ed what has become the major suit the litigation. Its declaratory relief tion in the King County Superior Court here joins most of the parties and raises most of the issues involved in all other suits, lawyers here said. *Chemical Bank v. WPPSS*, 82-2-06840-3.

Utilities also jumped into the fray, charging in four U.S. Claims Court suits in Washington, D.C., that BPA coerced them into participating in the 4/5 project and misled them on the nature of their participation.

The latest major suits filed were more than a dozen bondholder class actions seeking to enforce the contract clause that calls for bond and interest payments even if the plants never get constructed, a clause people here interpret to mean participants must pay "come hell or high water."

"All the suits by utilities seek to relieve the participants of their obligation to pay," said Richard C. Yarmuth of Seattle's Culp, Dwyer, Guterson & Grader, which took over as chief outside counsel for WPPSS in November 1981.

Only two of the 88 utilities participating in plants 4 and 5 are paying WPPSS the share they contracted for. The Oregon participants have been blocked from paying anything under a trial court ruling that found they didn't have the authority, without a public vote, to enter into the contracts. *DeFazio v. WPPSS*, 16-81-11344 (Lane County Circuit Court). The Idaho Supreme Court has prohibited five participants there from paying anything on the contracts until the lawsuits are resolved. *Asson v. City of Burley*, 14719, 14809. Other utilities are paying their money into a Washington court-approved escrow account, which now stands at about $30 million.

State High Court Review

While the Oregon and Idaho decisions are on appeal, the Washington Supreme Court has accepted review of three issues on interlocutory appeal — the interpretation of the participation contracts, the authority of the participants to enter into the contracts and the use of a jury trial. *Chemical Bank v. WPPSS*, 49186-1.

"Our position is that there is no dry hole risk for the participants," said John D. Lowery of Seattle's Riddell, Williams, Bullitt & Walkinshaw, who represents 21 small cities and utility cooperatives that total 5½ percent of plant 4/5 participation. "Our clients contracted to buy electricity. If the system doesn't supply the goods, our clients shouldn't pay."

But King County Superior Court Judge H. Joseph Coleman ruled that the so-called "hell or high water" clause was essentially an unconditional promise to pay the bonds off no matter what happens to construction.

Many of the utilities don't have their own generating facilities and rely on WPPSS and BPA for their power. They charge that the two agencies took advantage of their situation and forced unconscionable contracts on them, even though bond brokers and underwriters routinely require such clauses in power plant construction contracts to get favorable ratings and to sell the bonds with minimum risks to investors, Mr. Lowery said.

"If it's a power sale contract, the litigation is all over," he said. "If the court finds the utilities have a dry hole risk, then it has to decide if there was authority for them to enter into the contracts."

While Lane County Circuit Court Judge George J. Woodrich in Portland ruled last December that Oregon utilities had acted beyond the scope of their authority under state law in signing the 4/5 agreements, Judge Coleman found no Washington bar to stop the utilities there from joining in the venture.

Judge Coleman also decided that since the claims against the supply system essentially called for rescission of the contracts, the nature of the action was equitable and no jury trial would be needed. The participants claim that fact issues for a jury still remain in the suit.

If the courts agree with Chemical Bank and WPPSS, which is nominally a defendant and supports the bank, the trial will center on two issues, contract formation and breach of contract by the supply system, said Culp Dwyer's Mr. Yarmuth.

The utilities claim that the formation of the contract was defective because of mistake, misrepresentation and procedural unconscionability. They claim the supply system misrepresented the cost of the project; the ability of the contractors; the ability of the system to finance, construct and manage the operation; and the authority the utilities had to sign the contracts.

"WHOOPS knew long before the contracts were signed that some utilities didn't have authority to sign," Mr. Lowery charged.

Wood & Dawson of New York, then bond counsel, and Seattle's Houghton, Cluck, Coughlin & Riley, the former chief outside counsel, are named in a number of suits alleging they failed to disclose doubts about the authority of 16 utilities to join the 4/5 project. Routine bond counsel opinions stated simply that a review of 72 utilities showed no authority problems.

Robert Amdursky of New York's Willkie, Farr & Gallagher, hired as bond counsel about a month ago, pointed out that each utility had its own outside lawyer that issued opinions saying it had authority to sign the agreements. Such opinions, he said, are standard in bond matters.

"What is being tested is an expanded consideration of bond counsel's role," said Seattle's Mr. Appel. "There's no clear national standard among lawyers about who has the duty of due diligence and disclosure."

He said underwriters, particularly in the East, have borne the responsibility for disclosure. But he indicated that the Securities and Exchange Commission, through public announcements in the past, may have the view that bond counsel has the last clear chance to disclose defects in the validity of bonds.

The other main trial issue, breach of contract, rests primarily on charges that the supply system so grossly mismanaged the projects that the utilities should be relieved of paying excessive amounts of constructions costs. If plant 2 goes into operation next February, for instance, it will be seven years behind schedule and will cost some four times the original price.

The state Senate wasn't the only official body to criticize WPPSS. The Nuclear Regulatory Commission fined the system $61,000 in June 1980 for failing to comply with regulations on 20 separate items. "The basic problem was a glaring deficiency in the quality assurance program," said James Hanchett of the NRC's regional office in San Francisco.

Host of Questions

There are other weighty issues in other suits, too. Plants 4 and 5 were built adjacent to plants 1 and 3, respectively, to save construction costs on common structures, such as access roads. But lawsuits question the allocation of costs between the terminated plants and the still solvent plants.

The bondholder suits, the likelihood of default and the possibility that WPPSS may file under Chapter 9 of the bankruptcy laws raise other issues as well. Will bondholders be able to attach assets or eventual profits from plants 1, 2 and 3? Is a supply system bond junior or senior to other bonds each participant-municipality issues? Will the role of bond counsel be scrutinized more closely? Will the SEC continue to treat municipal bonds with benign neglect?

Mr. Appel said those questions have cropped up throughout the nation, and the litigation over WPPSS may go a long way to resolving the issues.

Robert Graham of Seattle's Bogle & Gates, who is president of the Northwest Chambers on Energy and Utilities, also figured such questions will eventually be cleared up because

'Our clients contracted to buy electricity. If the system doesn't supply the goods, our clients shouldn't pay,' says a utility lawyer.

"the bondholders are going to litigate until they're paid."

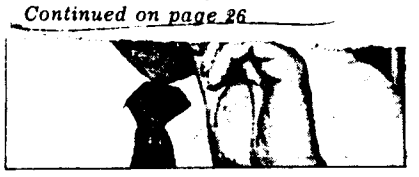
Exactly what will happen June 1 is largely a guess, though Chemical Bank has announced it plans to issue a "cure" notice, which gives WPPSS 90 days to come up with the money due or face further action, including possibly forcing the sale of WPPSS assets. No outside party, however, can put the power system into bankruptcy involuntarily because of its municipal status.

The possibility of a federal bail-out was raised for the second time last week as U.S. Rep. George V. Hansen, R-Idaho, reportedly was preparing legislation to use federal funds to buy up the bonds on plants 4 and 5 and, perhaps, on 1, 2 and 3 as well. The bonds would be purchased at bondholder cost with no interest payment.

But a federally issued bond plan to alleviate the debt couldn't gain congressional support last fall, and Seattle lawyers don't expect Congress to feel sorry for ratepayers whose electric bills would average half the typical bill nationwide if the ratepayers themselves were forced to pay off the bonds.

Meantime, the supply system has found it hard to get money to complete plants 1, 2 and 3. Moody's Investor's Service drastically downgraded its bond ratings on the three projects, and Standard & Poor's Corp. suspended its ratings on existing bonds on the three projects and on two small, non-nuclear power plants the system has been operating for the last 20 years.

Mr. Amdursky and other lawyers said the rating services would restore high ratings if litigation winds up on WPPSS' side and if the state passes a law forbidding the power system from declaring bankruptcy. That bill, however, is bottled up in committee and is unlikely to be passed, observers said.



Photos James Granelli

THE CONTENDERS: The many prominent Seattle lawyers involved in the WPPSS controversy include, from top, William N. Appel; Richard C. Yarmuth of Culp, Dwyer, Guterson & Grader; Robert Graham of Bogle & Gates; and John D. Lowery of Riddell, Williams, Bullitt & Walkinshaw.