BellSouth Telecommunications, Inc.
Suite 2101
333 Commerce Street
Nashville, Tennessee 37201-3300

615 214-6301
Fax 615 214-7406

Guy M. Hicks
General Counsel

'99 NOV 23 PM 12 07

November 23, 1999

VIA HAND DELIVERY

David Waddell, Executive Secretary
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37238

Re: *Petition for Arbitration of ITC^DeltaCom Communications, Inc. with BellSouth Telecommunications, Inc. pursuant to the Telecommunications Act of 1996*
Docket No. 99-00430

Dear Mr. Waddell:

Enclosed are the original and thirteen copies of BellSouth Telecommunications, Inc.'s Brief on "Performance Guarantees" and "Penalties". Copies of the enclosed are being provided to counsel of record for all parties.

Very truly yours,

Guy M. Hicks

GMH:ch
Enclosure

FILE

178243

BEFORE THE TENNESSEE REGULATORY AUTHORITY
Nashville, Tennessee

In Re: ***Petition for Arbitration of ITC^DeltaCom Communications, Inc. with BellSouth Telecommunications, Inc. pursuant to the Telecommunications Act of 1996***

Docket No. 99-00430

BELLSOUTH TELECOMMUNICATIONS, INC.'S BRIEF ON "PERFORMANCE GUARANTEES" AND "PENALTIES"

I. INTRODUCTION

Pursuant to the request of the Tennessee Regulatory Authority ("Authority"), BellSouth Telecommunications, Inc. ("BellSouth") respectfully submits this brief addressing the Authority's power as arbitrators under the Telecommunications Act of 1996 to order that "performance guarantees" or "penalties" be included in an interconnection agreement as requested by ITC^DeltaCom Communications, Inc. ("DeltaCom"). The Authority does not have such power, and accordingly DeltaCom's request should be denied.[1]

II. DISCUSSION

A. DeltaCom's Proposed "Performance Guarantees" Constitute Penalties That Are Unenforceable Under Federal Or State Law.

DeltaCom has proposed a "three-tiered system" of so-called "performance guarantees." (Rozycki Direct at (31-10)). As explained by DeltaCom witness Rozycki, tier one requires BellSouth to refund nonrecurring charges when it does not meet specified single measurements; tier two requires BellSouth to pay the State of Tennessee $25,000 for each single measurement

[1] In addition to the legal issues concerning the Authority's power to require "performance guarantees" or "penalties," there are also policy considerations that should be taken into account in determining whether to grant DeltaCom the relief it seeks. Consistent with the Authority's instructions, this Brief will only address the legal issues, while BellSouth's Post-Hearing Brief will address the policy considerations.

that it does not meet for two consecutive months or twice during a quarter; and tier three requires BellSouth to pay the State of Tennessee $100,000 per day for each single measurement that it does not meet five times during a six-month period. *Id.* Although DeltaCom prefers to call these payments "performance guarantees," they actually constitute unenforceable penalties.[2]

When a contractual provision "entitles one party to a stipulated recovery following an event that constitutes a breach of contract," courts must look to "the substance of the provision and the intentions of the parties" to determine whether the provision is one for liquidated damages or penalties. *Guiliano v. Cleo*, 995 S.W.2d 88, 97 (Tenn. 1999). A provision is for liquidated damages only if: (1) the actual damages that would occur upon breach of the contract are indeterminable or difficult to measure as of the time the parties enter the contract; (2) the provision reflects the parties' intentions to compensate in the event of a breach; and (3) as of the time the parties enter the contract, the amount set forth in the provision is a reasonable estimate of potential damages the would occur upon breach of the contract. *Id.* at 100-101. Provisions that satisfy each of these factors generally are enforceable.

By contrast, a penalty is "a sum inserted in a contract, not as the measure of compensation for its breach, but rather as a punishment for default, or by way of security for actual damages which may be sustained by reason of nonperformance, and it involves the idea of punishment." *Cleo*, 995 S.W.2d at 98 n.9. Tennessee law disfavors the enforcement of provisions which serve to "penalize the defaulting party for a breach of contract." *Id.* at 98. Accordingly, "if the provision and circumstances indicate that the parties intended merely to

---

[2] With respect to remedies under tier one, BellSouth and DeltaCom have reached agreement on the circumstances under which BellSouth will waive nonrecurring charges for its failure to perform. Consequently, the issues concerning the waiver of nonrecurring charges have been removed from this arbitration. *See* Revised Joint Issues Matrix filed November 19, 1999.

penalize for a breach of contract, then the provision is unenforceable as against public policy." *Id.* at 101.[3]

Recognizing that the dollar amounts in question "appear high," (Rozycki Direct at (31-11 - 31-12)), DeltaCom witness Rozycki attempted to justify these high dollar amounts throughout his testimony on direct, rebuttal, and cross examination. In the process, Mr. Rozycki acknowledged that these amounts are intended to punish BellSouth:

(1) Mr. Rozycki testified that these high dollar amounts are designed to "discourage poor performance by BellSouth," (Rozycki Direct at (31-12)), and to serve as "consequences for poor performance" by BellSouth. (Rozycki Direct at (31-13)); *See also* Rozycki Rebuttal, Tr. IA at (31-131) ("It is our intent for performance guarantees to prompt performance, not to generate a revenue stream."); (Tr. IA at 62) ("The objective here is to get BellSouth performing the way [DeltaCom contends] they should be . . . .); (Tr. IA at 63) ("We want to drive performance on BellSouth's part . . . .");

(2) Mr. Rozycki acknowledged that these high dollar amounts are in the nature of fines, stating "I hope BellSouth never has to pay a nickel of money to the state as a *fine* for not achieving the performance that's specified in either ours or in BellSouth's SQMs" (Tr. IA at 62). *See also* Tr. IA at 64 ("The issue is an adequate level that will cause BellSouth to perform; an adequate level of *fine*, if you will, that will cause BellSouth to perform adequately . . . .");

(3) Mr. Rozycki acknowledged that these high dollar amounts are in the nature of penalties by stating "It's a *penalty* only if BellSouth fails to achieve performance," (Tr. IA at 65), and "*[p]enalties* are appropriate for breach of contract.") (Tr. IA at 66). *See also* Rozycki Rebuttal at (31-127) (erroneously opining that "the Authority can require specific contract language imposing State p*enalties or fines* . . . .).

---

[3] Federal law and state law are generally consistent on this point. Liquidated damages provisions are enforceable under federal common law only if the harm that will be caused by a breach is "very difficult or impossible to estimate" and if the amount fixed is "a reasonable forecast of just compensation for the harm caused. *Idaho Plumbers and Pipefitters Health and Welfare Fund v. United Mechanical Contractors*, 875 F.2d 212, 217 (9th Cir. 1989); *Robins Motor Transp. v. Associated Riggings & Hauling Corp.*, 944 F. Supp. 409, 411 (E.D. Pa. 1996). Conversely, liquidated damage provisions that are not reasonably related to the anticipated amount of damages upon a breach are void and unenforceable penalties. *Id.*

Mr. Rozycki could not have been more clear that DeltaCom intends for its proposed "performance guarantees" to fine or penalize BellSouth for its failure to perform.

It is equally clear that DeltaCom's proposed "performance guarantees" are *not* intended to compensate DeltaCom for any damages that it reasonably anticipates would arise from an alleged breach. Mr. Rozycki candidly admitted that DeltaCom is "not seeking damages," (Tr. IA at 63), and that it "wants performance, not damages." (Rozycki Direct at (31-12)). In fact, DeltaCom offered no evidence that the tier-three penalty of $100,000 is even remotely related to any damages DeltaCom reasonably anticipates would arise from BellSouth's failure to perform.

The best DeltaCom could do to relate the tier two penalty of $25,000 to any anticipated damages was to rely on a "very rudimentary cost study, if you will, back of the envelope, almost" that was never entered into the record. *See* Tr. IA at 63. This "back of the envelope" calculation (which is not a cost study at all) assumed that a deviation from any tier two standard necessarily would result in DeltaCom's loss of a "typical" customer who, had it remained with DeltaCom for a period of three years, might have generated "about $27,000 in revenue." Tr. IA at 63. DeltaCom offered no evidence to show the amount of monthly revenue it expects to receive from a "typical" Tennessee customer, no evidence that its Tennessee customers will sign three-year term contracts with DeltaCom, and no evidence that a deviation from a tier two standard likely would result in a customer's leaving DeltaCom.[4]

[4] When a customer terminates a term contract for services, it necessarily follows that the company will not receive the revenue it expected to receive (and which the customer contractually agreed to provide) over the remaining term of the contract. If BellSouth misses a proposed performance measure, however, it does not necessarily follow that a DeltaCom customer who has a three-year term contract valued at $750 per month will terminate that contract with Deltacom. DeltaCom had to pile an assumption and a supposition on top of a possibility to create a hypothetical scenario in which it might suffer $27,000 in damages upon BellSouth's failure to meet a proposed performance standard.

Mr. Rozycki explained that these evidentiary gaps are inconsequential because "remember, we did not -- we're not seeking damages." Tr. IA at 63. According to Mr. Rozycki:

> So the idea is to drive that performance. Because of that, I don't think you need to do extensive financial analyses of what damage would occur to ITC DeltaCom or statistical analyses of how frequently we would lose customers as a result of that.

Tr. IA at 64. Clearly, DeltaCom's proposed performance guarantees are not related to anticipated damages. Instead, DeltaCom candidly acknowledges that these performance guarantees are "fines" or "penalties" designed to punish BellSouth for deviations from performance standards.

The fact that the $25,000 and $100,000 fines would be paid to the State of Tennessee is the final nail in the coffin of any argument that DeltaCom's proposed performance guarantees are intended to compensate DeltaCom for anticipated damages. Payments to the State of Tennessee do not compensate DeltaCom for anything. Instead, payments to the State of Tennessee upon a deviation from performance standards are nothing more than a fine or penalty. *See, e.g.*, T.C.A. §65-3-119 (providing a "penalty" for violations of certain statutes and requiring that all such "penalties and fines" be paid to the state treasury); §65-4-120 (providing a "penalty" for violations of TRA rulings to be "placed to the credit of the public utility account"); §65-4-125 (providing a "civil penalty" payable to the TRA for slamming or cramming violations); §65-4-308 (providing a "penalty" payable to the state treasury for failure to pay regulatory fees).

B. The Authority Does Not Have The Power To Impose Penalties In The Context Of An Arbitration Under Federal Or State Law.

The actions of the Authority in this arbitration are governed by the 1996 Act and the provisions of Title 65 of the Tennessee Code Annotated. Neither the 1996 Act nor Title 65 empowers the Arbitrators or the Authority to impose penalties whenever a party to an interconnection agreement misses a "performance measure."

Section 251 sets forth a specific series of topics regarding which incumbent local exchange carriers such as BellSouth must negotiate. In particular, Section 251(c)(1) obligates incumbents to "negotiate in good faith in accordance with section 252 of this title the particular terms and conditions of agreements to fulfill the duties described in paragraphs (1) through (5) of subsection (b) of this section." If those negotiations do not result in an agreement, the State commission that arbitrates the matter must ensure that its resolution of the remaining "open issues" "meet[s] the requirements of section 251" – that is, that the incumbent has fulfilled the duties enumerated in sections 251(b) and (c). 47 U.S.C. § 252(c)(1). None of the requirements of Section 251 involves a duty to agree to penalties. Thus, the 1996 Act does not require an arbitrated agreement to contain such provisions. *See, e.g., MCI Telecommunications Corp. v. BellSouth Telecommunications, Inc.*, 40 F. Supp. 2d 416, 428 (E.D. Ky. 1999) (argument that 1996 Act requires that state commission establish "penalty provisions" "must fail"); *MCI Telecommunications Corp. v. U.S. West Communications, Inc.*, 31 F. Supp. 2d 859, 861 (D. Oregon 1998) (commission decision to reject proposed standards and remedies "was not arbitrary and capricious and does not violate the Act").[5]

As an administrative agency, the Authority has only the powers conferred upon it by statute, "and any action which is not authorized by the statutes is a nullity." *Madison Loan &*

[5] The court in *MCI Telecommunications* indicated that a state commission's decision to adopt "performance standards and specific remedies" is discretionary. 41 F. Supp.2d at 1182. In *US West Communications, Inc. v. Hix*, 57 F. Supp. 2d 1112, 1121 (D. Colo. 1999), the federal court suggested in dicta that requiring "liquidated damages and penalties provisions" was within a state commission's authority, although it was not clear to the court that the issue was "ripe for full consideration, as the agreements state only that the parties 'remain subject to any applicable liquidated damages provision that may be adopted by this Commission.'" *Id.* at 1122. However, there is a significant difference between the "penalties" at issue here and the "specific remedies" and "liquidated damages" at issue in *MCI Telecommunications* and *Hix*. BellSouth is not aware of a case that upholds the imposition of penalties such as proposed by DeltaCom.

Thrift Co. v. Neff, 648 S.W.2d 655, 657 (Tenn. Ct. App. 1982); *General Portland v. Chattanooga-Hamilton County Air Pollution Control Board,* 560 S.W.2d at 910, 913 (Tenn. Ct. App. 1976). Although statutes from which agencies derive their authority often "should be construed liberally because they are remedial, the authority they vest in an administrative agency must have its source in the language of the statutes themselves." *Wayne County v. Solid Waste Disposal Control Bd.,* 756 S.W.2d 274, 282 (Tenn. App. 1988). Applying these principles to the former Public Service Commission, the Court of Appeals has noted that "the powers of the Commission must be found in the statutes. If they are not there, they are non-existent." *Deaderick Paging v. Public Service Com'n*, 867 S.W.2d 729 (Tenn. App. 1993).[6]

Here, DeltaCom's proposed "performance guarantees" constitute penalties that are unenforceable under federal or state law. Because neither the Authority nor a court could enforce such penalties even if they were voluntarily agreed to by the parties, the Authority necessarily lacks the power to require that the parties incorporate such penalties in their interconnection agreement.

The Authority is not vested with such power simply because the penalties proposed by DeltaCom may be good "public policy" in the minds of some by encouraging "better" performance by BellSouth (a position with which BellSouth does not agree). In the *Wayne County* case, for example, an agency found that a landfill had contaminated a family's well,

---

[6] Even when it is acting in a quasi-legislative rulemaking capacity, "it is a well-established principle of administrative law and procedure that an agency cannot promulgate rules and regulations arrogating power greater than that authorized in the enabling legislation." *Sanifill v. Solid Waste Disposal*, 907 S.W.2d 807, 811 (Tenn. 1995). *Accord* T.C.A. §65-2-102 (permitting the TRA to "adopt rules implementing, interpreting, or making specific the various laws which it enforces or administers; provided, that the authority shall have no power to vary or deviate from those laws, nor to extend its power or jurisdiction to matters not provided for in those laws.").

causing the family to haul water from a nearby school for all their cooking, drinking, and bathing. *See* 756 S.W.2d at 278. The agency ordered the operator of the landfill to: (1) close the landfill in a satisfactory manner; and (2) to provide the family with a permanent, uncontaminated supply of water. In support of the second aspect of its order, the agency claimed that it had the authority "to fashion remedies for essentially private wrongs even though the Act does not give it explicit authority to do so" because such authority, according to the agency "is implicit in its authority to abate public nuisances and to issue orders of correction ...." *Id.* at 283.

While acknowledging the appeal of the agency's argument in light of the facts before it, the Court of Appeals held that the agency had no authority to order the operator of the landfill to provide the family with an uncontaminated supply of water. The Court explained that

> notwithstanding the logic and appeal of the [agency's] position, it provides an insufficient basis for this Court to engraft remedies onto the Act that were not put there by the General Assembly. It is not our role to determine whether a party's suggested interpretation of a statute is reasonable or good public policy or whether it is consistent with the General Assembly's purpose. We must limit our consideration to whether the power exercised by the [agency] is authorized by the express words of the statute or by necessary implication therefrom.

Id. at 283. The Court concluded that the family could pursue relief "in courts where the full range of legal and equitable remedies will be available to them ...." *Id.* at 284.

Just as the agency in the *Wayne County* case had no statutory authority to grant the relief set out in its order, the Authority has no statutory power to impose a penalty upon a party for its failure to perform a contract. Although some statutes permit the Authority to impose penalties in specific instances, a past or future breach of contract simply is not one of them. *See, e.g.,* T.C.A. § 65-4-123(d) ($500 - $2000 fine for extortion); § 65-4-125(f) ($100 per day penalty for slamming or cramming); § 65-21-109 ($500 penalty for certain discriminations in messages).

Moreover, no statute empowers the Authority to impose fines that even approach the magnitude of $25,000 per incident, much less $100,000 per day. *Cf.* T.C.A. §65-4-120 (Authority may impose a $50 per day penalty for failure to comply with "any lawful order, judgment, finding, rule, or requirement of the authority"). Therefore, the Authority lacks the power to impose the penalties DeltaCom proposes under the guise of "performance guarantees."

This conclusion is apparent from the Court of Appeals' decision in *General Portland v. Chattanooga-Hamilton County Air Pollution Control Board*, 560 S.W.2d 910 (Tenn. Ct. App. 1976). In that case, an agency found that a company had failed to meet an air pollution emission standard. In an attempt to discourage the company's poor performance in the future, the agency ordered the company to post a $10,000 bond, which the company would forfeit in the event of a future failure to meet the standard. The company subsequently failed to meet the standard, and the agency sued for forfeiture of the bond.

In considering the agency's claim that it had the statutory authority to effectively fine the company $10,000 for a violation of the emission standard, the Court stated that

> an administrative agency such as this board has no inherent or common law powers. Being a creature of statute, it can exercise only those powers conferred expressly or impliedly upon it by statute. In this absence of statutory authority, administrative agencies may not enforce their own determinations. Administrative determinations are enforceable only by the method and manner conferred by statute and by no other means. The exercise of any authority outside the provisions of the statute is of no consequence.

Id., 560 S.W.2d at 914. In light of these principles, the Court held that the agency had no statutory authority to either require the company to post the bond or to seek forfeiture of the bond:

> A reading of the [Tennessee Air Quality Act] clearly shows the only enforcements for violations applicable to this case are: a fine,[7] an action to abate a nuisance, or an action for an injunction. These methods being the only ones allowed by the Act, all others must be considered as being illegal. By no stretch of the imagination can these provisions of the Act be logically construed to authorize the exacting of bond as was done in this case or the forfeiture of the bond.

Id. at 913. Similarly, the Authority has no statutory power to order BellSouth to subject itself to the penalties DeltaCom seeks to impose in this arbitration proceeding.

The result would not change even had DeltaCom proposed a liquidated damages provision rather than penalties (which is not the case). The General Assembly knows how to enact statutes that prescribe liquidated damages or that allow certain persons or entities to prescribe liquidated damages, and it has done so on several occasions. *See, e.g.,* T.C.A. § 43-16-134 (authorizing cooperative marketing associates to fix liquidated damages for breach of marketing contracts); § 46-2-406 (prescribing liquidated damages upon default of certain cemetery contracts); § 47-11-107 (prescribing liquidated damages for retail installment sales contracts); § 50-2-204 (prescribing liquidated damages for violations of wage statutes); § 66-24-120 (prescribing liquidated damages for failure to record boundary survey). None of these statutes appear in Title 65 or empower the Authority to prescribe liquidated damages.

Furthermore, it would be difficult if not impossible to craft a lawful "liquidated damages" provision in the context of performance measures. After all, this is not a situation in which one party agrees to pay the remainder of its contractual commitment if it decides to terminate the contract without cause. Here, if DeltaCom had its way, any deviation by BellSouth from any performance measure would trigger "damages" even if BellSouth's non-performance is not likely to cause "damage." For example, as DeltaCom's witness acknowledged, its tier two penalty of

[7] The Act provided that violations were punishable by "a fine of not less than $50.00 nor more than $1,000.00, with each day of violations being a separate offense." *Id.* at 913.

$25,000 would apply whether BellSouth misses a collocation commitment by two months, two weeks, two days, or two hours. (Tr. IA at 65). This is tantamount to requiring a customer to pay an amount equal to the remainder of its contractual commitment if it pays its bill one day late or if it misses a minimum revenue commitment by $1.

As such, DeltaCom's proposal is similar to the bond the Court addressed in *City of Nashville v. Nashville Traction Co.*, 220 S.W. 1087 (Tenn. 1920). In that case, the city awarded a construction contract to the plaintiff, and the contract required the plaintiff to post a $200,000 bond. In determining that the bond provision of the contract was an unenforceable penalty, the Court stated that

> The single lump sum of $200,000 is made payable for any breach of the contract, regardless of the importance of the particular stipulation that may be breached. For instance, if the company spent a few dollars less than $500,000 on the work within the time prescribed, $200,000 might be recovered on the bond. If a few days more than the prescribed time were occupied in expending the $500,000, $200,000 might be recovered on the bond. Likewise for any failure of the defendant traction company to secure the city against any claim for damages occasioned by the use of electricity in the streets, in the operation of the road, or in the construction thereof, $200,000 might be recovered, regardless of the amount of the claim and the city's damage. Under circumstances like these the bond must be treated as one for a penalty. It cannot be supposed that the parties intended to liquidate or stipulate the sum of $200,000 as the amount of damage recoverable upon every such breach, regardless of its importance.

Id., 220 S.W. at 1088. Regardless of the impact of *Cleo* on the Supreme Court's legal conclusion in *City of Nashville*, the case only underscores the difficulty inherent in tying "liquidated damages" to a broad range of performance measures.

BellSouth is not seeking to prevent DeltaCom from obtaining appropriate relief in the event BellSouth deviates from acceptable levels of performance, including damages. However, DeltaCom may seek relief from this Authority or "the courts where the full range of legal and

equitable remedies will be available" to it. *See Wayne County*, 756 S.W.2d at 284. Neither DeltaCom nor the Authority, however, may force BellSouth to agree to pay $10,000 or $100,000 for any performance measurement deviation and to waive its right to determine the actual amount of damages, if any, resulting from such a deviation.

III. CONCLUSION

For the foregoing reasons, the Authority should find that it lacks the authority to order the "performance guarantees" proposed by DeltaCom.

This 23 day of November, 1999.

Respectfully submitted,

BELLSOUTH TELECOMMUNICATIONS, INC.

By: _____

Guy M. Hicks
333 Commerce Street., Suite 2101
Nashville, Tennessee 37201-3300
(615) 214-6301

R. Douglas Lackey
Thomas B. Alexander
Bennett L. Ross
675 West Peachtree Street, N.E.
Suite 4300, BellSouth Center
Atlanta, GA 30375-0001
(404) 335-0750

186398

CERTIFICATE OF SERVICE

I hereby certify that on November 23, 1999, a copy of the foregoing document was served on the parties of record, via the method indicated:

[✓] Hand
[ ] Mail
[ ] Facsimile
[ ] Overnight

Gary Hotvedt, Esquire
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37243-0500

[ ] Hand
[✓] Mail
[ ] Facsimile
[ ] Overnight

H. LaDon Baltimore, Esquire
Farrar & Bates
211 Seventh Ave. N, # 320
Nashville, TN 37219-1823