When the Federal Power Act and the Bankruptcy Code Collide: Restricting the Bankruptcy Court's Power to Authorize Rejection of FERC-Regulated Contracts

March/April 2006

Mark G. Douglas

Conflicts arising from the seeming incongruity between the Bankruptcy Code and other federal statutes governing the way that companies in various industry sectors are regulated have figured prominently in recent headlines involving companies such as PG&E, Enron, and any number of telecoms. Bankruptcy and appellate courts are increasingly called upon to resolve these conflicts in a way that harmonizes as nearly as possible the competing policy concerns involved. One such dispute — the ability of a bankruptcy court to modify or terminate contracts regulated by the Federal Energy Regulatory Commission ("FERC") — was the subject of highly controversial rulings handed down during the last 18 months by the United States Court of Appeals for the Fifth Circuit and a New York district court. These decisions have added more fuel to a controversy that may ultimately have to be resolved by the U.S. Supreme Court.

Bankruptcy Jurisdiction and Rejection of Executory Contracts

By statute, U.S. district courts are given original and exclusive jurisdiction over every bankruptcy "case." In addition, they are conferred with non-exclusive jurisdiction over all "proceedings arising under" the Bankruptcy Code as well as those "arising in or related to cases under" the Code. Finally, district courts are granted exclusive jurisdiction over all the property of a debtor's estate, including, as relevant here, contracts, leases, and other agreements that are still in force when a debtor files for bankruptcy protection. That jurisdiction typically devolves automatically upon the bankruptcy courts, each of which is a unit of a district court, by standing court order.

A bankruptcy court's exclusive jurisdiction over unexpired — or "executory" — contracts and leases empowers it to authorize a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to either "assume" (reaffirm) or "reject" (breach) almost any executory contract during the course of a bankruptcy case in accordance with the strictures of Bankruptcy Code section 365. Assumption generally allows the DIP to continue performing under the agreement, after curing outstanding defaults, or to assign the agreement to a third party as a means of generating value for the bankruptcy estate. Rejection frees the DIP from rendering performance under unfavorable contracts. Rejection constitutes a breach of the contract, and the resulting claim for damages is deemed to be a pre-petition claim against the estate on a par with other general unsecured claims.

Accordingly, the power granted by Congress under section 365 is viewed as vital to the reorganization process because it can relieve the debtor's estate from burdensome obligations that can impede a successful reorganization. The court will authorize assumption or rejection if it is demonstrated that either course of action represents an exercise of sound business judgment. This is a highly deferential standard akin in many respects to the business judgment rule applied to corporate fiduciaries.

The Federal Power Act and the Filed-Rate Doctrine

Public and privately operated utilities providing interstate utility service within the U.S. are regulated by the Federal Power Act ("FPA") under the supervision of FERC. Although contract rates for electricity are privately negotiated, those rates must be filed with FERC and certified as "just and reasonable" to be lawful. FERC has "exclusive authority" to determine the reasonableness of the rates.

Based on this statutory mandate, courts have developed the "filed-rate doctrine," which provides that a utility's "right to a reasonable rate [under the FPA] is the right to the rate which the Commission files or fixes, and, . . . except for review of the Commission's orders, [a] court can assume no right to a different one on the ground that, in its opinion, it is the only or the more reasonable one." Under the filed-rate doctrine, the reasonableness of rates and agreements regulated by FERC "may not be collaterally attacked in state or federal courts. The only appropriate forum for such a challenge is before the Commission or a court reviewing the Commission's order."

Although FERC has exclusive authority to modify a filed rate, its discretion is not unfettered. FERC may not change a filed rate solely because the rate affords the utility "less than a fair return" because "the purpose of the power given to the Commission . . . is the protection of the public interest, as distinguished from the private interests of the utilities." FERC can change a filed rate only when "the rate is so low as to adversely affect the public interest — as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory."

If a utility files for bankruptcy, FERC's exclusive discretion in this realm could be interpreted to run afoul of the bankruptcy court's exclusive jurisdiction to authorize the rejection of an electricity supply agreement based on the debtor's business judgment that the rates charged under the agreement are unreasonable. This was the thorny issue addressed by both the Fifth Circuit Court of Appeals in August of 2004 in connection with the Mirant Corporation chapter 11 cases and, most recently, a New York district court's January 2006 decision rendered in connection with the Calpine Corporation chapter 11 cases.

The Fifth Circuit's Ruling in Mirant

Mirant Corporation and 82 of its subsidiaries (collectively, "Mirant") filed voluntary chapter 11 petitions in 2003. Prior to filing for bankruptcy, Mirant, one of the largest regulated public utilities in the U.S., agreed to purchase certain electric generation facilities from Potomac Electric Power Company ("PEPCO"). In connection with the sale, PEPCO was to assign to Mirant several purchase power agreements (each, a "PPA"), which are long-term fixed-rate contracts pursuant to which PEPCO agreed to purchase electricity from outside suppliers. Because certain of the PPAs required PEPCO to obtain the PPA supplier's consent to assignment, the purchase agreement provided that, if PEPCO could not obtain such consent, the unassigned PPAs would be subject to a "back-to-back" agreement.

Under a back-to-back agreement, PEPCO would continue to comply with the terms of any unassigned PPAs, and Mirant would agree to purchase an amount of electricity from PEPCO equal to PEPCO's obligations under the unassigned PPAs at the rate set forth in the applicable PPA. After PEPCO was unable to obtain the required consent to assign two of the PPAs, Mirant and PEPCO entered into such an agreement, which the parties filed with FERC. FERC subsequently approved the wholesale electricity rates set forth in the agreement.

Because of the significant financial losses experienced by Mirant under the back-to-back agreement, Mirant sought court authorization to reject the agreement after it filed for bankruptcy. It also sought an injunction preventing FERC or PEPCO from taking any actions to require Mirant to abide by the terms of the agreement. The bankruptcy court granted Mirant's request for injunctive relief, but did not rule on Mirant's motion to reject the back-to-back agreement.

Instead, the litigation continued in the district court, which withdrew the reference of the proceeding to resolve the potential conflict between the FPA and the Bankruptcy Code. The court ultimately ruled that FERC has exclusive authority under the FPA to determine the reasonableness of wholesale rates charged for electric energy sold in interstate commerce, and those rates can be challenged only in a FERC proceeding, not through a collateral attack in state or federal court. According to the district court, the Bankruptcy Code does not provide an exception to FERC's authority under the FPA, and therefore, Mirant had to seek relief from the filed rate in the back-to-back agreement in a FERC proceeding. The court accordingly denied Mirant's motion to reject the agreement and vacated the injunction issued below. Mirant appealed to the Fifth Circuit.

The Court of Appeals reversed. Initially, it determined that although the filed-rate doctrine prevents a district court from hearing breach of contract claims that challenge a filed rate, a court is permitted to grant relief in situations where the claim is based upon another rationale. Thus, the Fifth Circuit explained, the FPA does not prevent a court from ruling on a motion to reject a FERC-approved rate-setting agreement so long as the proposed rejection does not represent a challenge to the agreement's filed rate. PEPCO's claim arising from rejection of the agreement, the Court of Appeals emphasized, would be calculated based on the filed rate. Moreover, the Fifth Circuit emphasized, even though Mirant's desire to reject the agreement was motivated in part by the lower prevailing market rate, its business justification was also premised on the existence of excess supply and the consequent lack of any need for the energy covered by the contract. The Court of Appeals accordingly concluded that rejection of the agreement was not a challenge to the filed rate, and that the FPA did not preempt a ruling on Mirant's motion.

The Fifth Circuit rejected FERC's argument that anything less than full payment would constitute a challenge to the filed rate, observing that "any effect on the filed rates from a motion to reject would result not from the rejection itself, but from the application of the terms of a confirmed reorganization plan to the unsecured breach of contract claims." It went on to note that, although the Bankruptcy Code contains numerous limitations on a debtor's right to reject contracts, "including exceptions prohibiting rejection of certain obligations imposed by regulatory authorities," there is no exception that prohibits a debtor's rejection of wholesale electricity contracts that are subject to FERC's jurisdiction. Concluding that "Congress intended § 365(a) to apply to contracts subject to FERC regulation," the Fifth Circuit held that the court's power to authorize rejection of the back-to-back agreement does not conflict with the authority conferred upon FERC to regulate rates for the interstate sale of electricity. It accordingly reversed the decision below.

The New York District Court's Ruling in Calpine

In the aftermath of California's energy crisis of 2000-2001, power provider and federally regulated public utility Calpine Corporation entered into long-term wholesale electric power agreements with several entities, including Pacific Gas and Electric and Southern California Edison (referred to collectively as the "counter-parties"). The agreements were duly submitted to FERC and complied with the applicable filing rules and regulations.

Calpine sought chapter 11 protection in December 2005, a victim of overleveraging and a steep rise in the price of natural gas, which it relied on heavily to fuel its power plants. Anticipating Calpine's bankruptcy filing, certain of the counter-parties commenced a proceeding before FERC to compel Calpine to continue performing under the power agreements. Calpine responded by suing FERC in the bankruptcy court to enjoin FERC from requiring Calpine's continued performance. Calpine contemporaneously sought bankruptcy court authority to reject the power agreements because they were the "most financially burdensome" of its many energy contracts.

Shortly thereafter, FERC issued an order in which, based upon the Fifth Circuit's ruling in *Mirant*, FERC acknowledged that the FPA does not preempt section 365 of the Bankruptcy Code, but stated that any standard governing Calpine's attempt to reject the power agreements should take the public interest into account. Calpine's rejection motion was ultimately withdrawn from the bankruptcy court to the district court, based upon the latter's determination that the dispute required material consideration of conflicting federal statutes and neither *Mirant* nor the FERC order definitively resolved the issues.

After discussing the background of the FPA and the filed-rate doctrine, the district court emphasized that the power agreements were filed with FERC and, "under normal conditions, altering the rates, terms, conditions, or duration of the contracts would require FERC involvement and approval." According to the court, these requirements are not eliminated merely because Calpine filed for bankruptcy:

> There are no provisions in the FPA that specifically limit FERC jurisdiction in the bankruptcy context. Quite the contrary, FERC, in its charge to maintain reasonable rates and uphold the public interest, must also consider the financial ability of a utility to continue service under a filed rate, a responsibility that would include similar considerations to those in the bankruptcy court. . . . Conversely, FERC's lack of authority to modify a filed contract solely because it is in the interest of a private utility, suggests Congress thought no forum ought to have such authority.

The district court found "little evidence" in the Bankruptcy Code of congressional intent to limit FERC's regulatory authority, remarking that "[a]bsent overriding language, the Bankruptcy Code should not be read to interfere with FERC jurisdiction."

The court acknowledged that the scope of a bankruptcy court's power and jurisdiction is broad. Even so, it explained, if a bankruptcy court's power, including the power to authorize the rejection of a contract, conflicts with a federal regulatory regime, "the power of the bankruptcy court must yield to that of the federal agency." According to the court, the Bankruptcy Code itself supports this conclusion by exempting agency action from the scope of the automatic stay. As a consequence, the court reasoned, "it is clear that the bankruptcy court's authority cannot be exercised so as to interfere with the jurisdiction of a federal agency acting in its regulatory capacity."

As framed by the district court, the dispositive issue is whether rejection of the power agreements would directly interfere with FERC's exclusive jurisdiction over wholesale power contracts "or otherwise constitutes a collateral attack on the filed rate." The court concluded that it would — rejection of the agreements, which even Calpine admitted was motivated by its dissatisfaction with the below-market rates, would infringe upon FERC's exclusive province to regulate the rates, terms, conditions, and duration of wholesale energy contracts. The court gave short shrift to Calpine's contention that because rejection would result in breach of the agreements, it was thereby removed from FERC's exclusive jurisdiction, which extends to approval, modification or termination of energy contracts, but not breaches. According to the district court, "the 'breach' here does not create a typical dispute over the terms of a contract, but the unilateral termination of a regulatory obligation."

Cases in which courts have exercised jurisdiction over breach of wholesale energy contracts, or where FERC has declined jurisdiction, the district court emphasized, involved alleged breaches that could be resolved by application of simple contract principles that were well within the jurisdiction of the courts involved. Regulatory approval of the power agreements by FERC, the court reasoned, transformed the agreements into something more than simple contracts:

> [J]ust as regulatory action was required to transform the terms and conditions of the Power Agreements from mere contracts into regulated duties, . . . so also is regulatory action from FERC required to eliminate those duties. . . . . With rejection, a bankruptcy court eliminates those duties. But what FERC giveth, only FERC may taketh away.

Acknowledging that its ruling was ostensibly at odds with the Fifth Circuit's *Mirant* decision, the district court explained that, in fact, the *Mirant* rationale is entirely consistent with its own conclusions. In *Mirant*, the court explained, the Fifth Circuit held that although the FPA preempts a breach of contract claim challenging a filed rate, courts are permitted "to grant relief in situations where the breach of contract claim is based upon another rationale." The stated justification for rejection in *Mirant* was not the disparity between contract and market rates, but the fact that Mirant did not need the energy at all. By contrast, Calpine was seeking nothing more than rate relief — its rejection motion clearly stated that it needed relief from the power agreements because it was being forced to sell energy at far below-market rates.

Finally, the district court observed, its conclusion is consistent with general policy considerations. According to the court, by holding that FERC has exclusive jurisdiction to modify or terminate the power agreements under the circumstances of this case, "an issue of great public interest will be heard in a branch accountable to the electorate in a forum that specializes in considering the public interest."

Based upon its determination that FERC has exclusive jurisdiction over modification or termination of the power agreements, the district court vacated the injunction issued by the bankruptcy court and dismissed Calpine's motion to reject the agreements.

Outlook

Although they reach different conclusions, *Mirant* and *Calpine* are similar in many respects. Both decisions are emblematic of the way that most courts approach a potentially irreconcilable conflict between two federal statutes. Wherever possible, courts attempt to resolve such conflicts in a way that gives due consideration to the important policy considerations associated with both statutes. In *Mirant*, that resolution was reached by means of a determination that the rejection of an executory agreement establishing presumptively reasonable utility rates is not tantamount to a collateral attack on the reasonableness of the rates — provided rejection is not motivated solely by a desire to take advantage of lower market rates. Stated differently, the Fifth Circuit found that there was no conflict between the statutes.

Calpine picks up where *Mirant* left off, but only to a point. Unlike in *Mirant*, the debtor's rationale for rejecting the wholesale power agreements in *Calpine* was addressed squarely to the reasonableness of the rates under the contracts, which were below market value. Given FERC's exclusive jurisdiction under the FPA to determine whether rates are reasonable, the district court in *Calpine* had little difficulty resolving the resulting conflict in favor of FERC. This conclusion appears to have been based in large part upon the court's perception that the specific policy considerations entrusting wholesale power rate regulation authority to FERC should outweigh the more general policy considerations empowering a bankruptcy court to authorize the rejection of any contract that burdens the estate.

Such preemption is not without support in the Bankruptcy Code. Section 1129(a)(6) provides that a chapter 11 plan may not be confirmed unless "[a]ny 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." As noted, the Bankruptcy Court also exempts regulatory agency action from the scope of the automatic stay. Thus, Congress expressly anticipated situations in which other federal regulatory schemes would establish limitations on a bankruptcy court's otherwise exclusive jurisdiction to deal with a debtor's executory contracts.

Unfortunately, Congress expressly limited these circumstances to chapter 11 plans and actions to enforce a federal agency's regulatory powers during the course of a bankruptcy case. Both the *Mirant* and *Calpine* courts readily acknowledged that the Bankruptcy Code does not on its face contain any special restrictions on the ability of a trustee or DIP to reject a FERC-regulated rate agreement under section 365(a) of the Bankruptcy Code. Still, both the Fifth Circuit and the New York district court have created limitations on that power where they perceive it directly conflicts with FERC's regulatory powers.

Moreover, even where there is no intrusion, the Fifth Circuit postulated that a different standard should apply for rejection, remarking that the "[u]se of the business judgment standard would be inappropriate in this case because it would not account for the public interest inherent in the transmission and sale of electricity." Instead, the Court of Appeals suggested, rejection of an executory power contract should be permitted only upon a showing that: (a) the contract is burdensome to the estate; (b) the equities favor rejection; and (c) the rejection "would further the Chapter 11 goal of permitting the successful rehabilitation of debtors." In applying this test, courts should give particular consideration to the public interest and should ensure that the rejection will not disrupt power delivered "to other public utilities or to consumers."

In *Calpine*, the district court was even less generous with a bankruptcy court's retained prerogative to modify FERC-regulated contracts. Given the "business judgment" standard traditionally applied to executory contract rejection and its concerns regarding the important policy implications of allowing "a bankruptcy court to sit in judgment of FERC's determination of the public interest," the district court expressed the (purely advisory) view that FERC's jurisdiction should necessarily preempt a bankruptcy court's discretion to authorize rejection in all instances.

The problem is that neither exclusion of FERC contracts from the scope of section 365 altogether nor a heightened standard for the rejection of FERC-regulated rate agreements is found anywhere in the Bankruptcy Code. Congress has clearly delineated restrictions on the ability to reject other kinds of agreements (*e.g.*, collective bargaining agreements or retiree benefit contracts) where it saw fit to provide special consideration to the non-debtor parties to the agreement. The absence of any such express limitations with respect to FERC-regulated rate agreements suggests that *Mirant* and *Calpine* may be open to challenge — so much so, that the U.S. Supreme Court may be asked to resolve the issue definitively.

The practical ramifications of the rulings for potential debtors seeking to disavow onerous FERC-regulated contracts are fairly clear. At best, unless a convincing case can be made that the regulated rates themselves are not the primary impetus for terminating the contracts, rejection under section 365(a) of the Bankruptcy Code would not appear to be a viable option.

In re Mirant Corp., 378 F.3d 511 (5th Cir. 2004).

In re Calpine Corp., 337 B.R. 27 (S.D.N.Y. 2006).