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Feature

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# Rejecting Power-Purchase Agreements in Energy Cases

## Do Bankruptcy Courts Have Exclusive Jurisdiction?

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In a much-awaited and pivotal decision in the *PG&E* chapter 11 proceeding, the U.S. Bankruptcy Court for the Northern District of California held that it not only has exclusive jurisdiction over the rejection of wholesale power-purchase agreements, but that the Federal Energy Regulatory Commission (FERC) has no such jurisdiction and any determinations by FERC to the contrary would be void.[2] While the decision might not be surprising to most bankruptcy practitioners, the proposition that FERC has no jurisdiction over the breach or modification of a power-purchase agreement is not only shocking to energy practitioners, but contrary to well-established authority in the energy arena.

Further, other courts have held otherwise, and the issue is percolating its way up on appeal to the Sixth and Ninth Circuits. There is a split of authority, and the collision between the regulation of energy sales in interstate commerce and bankruptcy policy is unsettled territory. This article explores the ever-changing legal landscape on the question of whether bankruptcy courts have sole authority to approve rejection of a power agreement otherwise within FERC's province.

### Bankruptcy Basics: Rejection of Executory Contracts Is a Core Matter over Which Bankruptcy Courts Have Exclusive Jurisdiction

First, let's review some basic bankruptcy principles. Section 365(a) of the Bankruptcy Code provides that "the trustee [or debtor-in-possession], subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."[3] This section allows debtors to be relieved of burdensome agreements, and bankruptcy courts have broad discretion to authorize rejection under this provision. The U.S. Supreme Court has recognized that the authority to reject an executory contract "is vital to the basic purpose of a Chapter 11 reorganization, because rejection can release the debtor's estate from burdensome obligations that can impede a successful reorganization."[4]

Further, bankruptcy courts have "original and exclusive" jurisdiction of all cases "under" title 11.[5] There is no question that the rejection of contracts under § 365 is a core matter and a proceeding that "invokes a substantive right provided by title 11 or ... a proceeding that, by its nature, could arise only in the context of a bankruptcy case."[6] Courts have similarly held that "[t]he right of a debtor in possession to reject certain contracts is fundamental to the bankruptcy system because it provides a mechanism through which severe financial burdens [might] be lifted while the debtor attempts to reorganize."[7]

It is also clear that rejection of an executory contract under 11 U.S.C. § 365(a) constitutes a breach of the contract, not a modification or termination.[8] Rejection creates a contract "breach," and the non-

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2 *In re PG&E Corp. Pacific Gas and Electric Co. v. Fed. Energy Regulatory Comm'n*, Adv. Proc. No. 19-03003, 2019 WL 2477433 (Bankr. N.D. Cal. June 12, 2019), attaching Memorandum Decision on Action for Declaratory and Injunctive Relief (Dkt. No. 153), entered June 7, 2019.

3 11 U.S.C. § 365(a).

4 *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984).

5 28 U.S.C. § 1334(a).

6 *See* 28 U.S.C. § 157(b)(1); *In re Gruntz*, 202 F.3d 1074, 1081 (9th Cir. 2000) (quoting *In re Wood*, 825 F.2d 90, 97 (5th Cir. 1987).

7 *Westbury Real Estate Ventures Inc. v. Bradlees Stores Inc. (In re Bradlees Stores Inc.)*, 194 B.R. 555, 558 n.l (Bankr. S.D.N.Y. 1996).

8 *Mission Product Holdings Inc. v. Tempnology LLC, NKA Old Cold LLC*, 587 U.S. __ (2019); *Thompkins v. Lil'Joe Records Inc.*, 476 F.3d 1294, 1306 (11th Cir. 2007) ("Rejection has absolutely no effect upon the contract's continued existence; the contract is not cancelled, repudiated, rescinded, or in any other fashion terminated.").

breaching party to the rejected contract holds an unsecured claim against the debtor's estate. The Bankruptcy Code thus permits debtors to breach burdensome contracts and transforms a debtor's obligations to perform into a pre-petition claim for damages under § 365(g) of the Bankruptcy Code.

In reviewing a debtor's request, bankruptcy courts apply the "business judgment" standard to determine whether the rejection of an executory contract or unexpired lease should be authorized.[9] Rejection is appropriate where it would benefit the estate.[10] In other words, if a bankruptcy court finds that a debtor has exercised sound business judgment to determine that rejection of a contract is in the best interests of the debtor, its creditors and all parties-in-interest, the bankruptcy court should approve rejection.[11] Generally speaking, bankruptcy courts approve a debtor's decision to reject as a matter of course, and the business-judgment standard is fairly easily satisfied.

## FERC Has Exclusive Jurisdiction over Wholesale Energy Contracts: The "Filed Rate" Doctrine (*Mobile-Sierra*)

However, there is also a well developed body of case law upholding the proposition that FERC has exclusive authority to regulate the provision of electric energy in interstate commerce. Furthermore, it exercises this authority for the "public interest."[12] FERC is vested with exclusive authority to regulate rates for wholesale sales of electric energy, and this exclusive authority extends to the terms and conditions of wholesale power agreements (including their duration and early termination), as well as changes to those agreements.[13]

Moreover, filed rates for wholesale sales of electric energy carry the force of law.[14] Once approved by FERC, the duty to perform under a contract "springs from the Commission's authority, not from the law of private contracts."[15] If a party seeks to modify a filed rate contract, the Supreme Court has ruled that the Federal Power Act requires FERC to apply a rigorous standard, and a party may not unilaterally modify the contract without a showing that continuation of the contract would harm the public interest.[16] This fundamental principle of energy law is known as the "*Mobile-Sierra* doctrine."

Extremely important in this calculus and subsumed in its role as the agency vested with authority to oversee the sale of energy, FERC has unique expertise in ensuring the reliable provision of energy at "just and reasonable rates" that serve the public interest. Indeed, that is its primary purpose. It implements national energy policy to maintain economically efficient, safe, reliable and secure energy services at a reasonable cost for consumers. More succinctly, it safeguards the stability of the nation's electric markets on the transmission grid. Undeniably, FERC has expertise that the bankruptcy court does not concerning the provision of electricity.

## Bankruptcy Code Contains Provisions that Affirm that Debtors Remain Subject to Regulatory Supervision and Authority

There can be no doubt that Congress intended for debtors in bankruptcy to operate in compliance with regulatory oversight, and several Bankruptcy Code sections reveal this intent. Under § 362(b)(4), the automatic stay does not stay any "action or proceeding by a governmental unit…to enforce such governmental unit's ... regulatory power."[17] Certainly, FERC's regulatory authority under the Federal Power Act to safeguard energy markets is an exercise of regulatory power under § 362(b)(4). Ironically, the U.S. Bankruptcy Court for the Northern District of California affirmed this authority with respect to the California Public Utilities Commission in the prior *PG&E* bankruptcy proceeding.[18]

Further, § 1129(a)(6) requires that as a condition to confirmation of a reorganization plan, "[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." A debtor in possession must manage its estate in accordance with all applicable state and federal law regulations.[19]

## Circuits Are Split on Whether a Debtor May Be Relieved of Its Obligations Without FERC Approval

Given the two bodies of law, which authority should govern a debtor's decision to reject a power-purchase agreement? Should it be the bankruptcy court or FERC, or should they have concurrent authority and perhaps work together harmoniously?

Various courts have addressed the issue of jurisdiction over the rejection of power-purchase agreements, and the opinions are split. In the *Mirant* opinion, the Fifth Circuit Court of Appeals held that because the rejection of a FERC contract is a breach, the bankruptcy court may grant a debtor's motion to reject such a contract and give full effect to the filed rate in determining contract damages resulting from the rejection. However, it also opined that the bankruptcy court should apply a heightened standard: "Use 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."[20] On remand, the district court held that the debtor:

> must prove that [the contract] burdens the bankruptcy estate ... that after careful scrutiny and giving significant weight to comments and findings of the FERC relative to the effect such a rejection would have on the public interest inherent in the transmis-

9 *See Orion Pictures Corp. v. Showtime Networks Inc. (In re Orion Pictures Corp.)*, 4 F.3d 1095, 1098-99 (2d Cir. 1993); *see also Bildisco*, 465 U.S. at 524 (acknowledging that business judgment is "traditional" standard for rejection of executory contracts).

10 *See In re Orion Pictures Corp.*, 4 F.3d at 1098-99; *Sharon Steel Corp. v. Nat'l Fuel Gas Distrib. Corp.*, 872 F.2d 36, 40 (3d Cir. 1989); *In re HQ Glob. Holdings*, 290 B.R. 507, 511 (Bankr. D. Del. 2003).

11 *See, e.g., Summit Land Co. v. Allen (In re Summit Land Co.)*, 13 B.R. 310, 315 (Bankr. D. Utah 1981) (holding that absent extraordinary circumstances, court approval of debtor's decision to assume or reject executory contract "should be granted as a matter of course").

12 16 U.S.C. § 824; *see also Fed. Power Comm'n v. Sierra Pac. Power Co.*, 350 U.S. 348, 355 (1956).

13 *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 966-67 (1986).

14 *Bos. Edison Co. v. FERC*, 846 F.2d 361, 372 (1st Cir. 1988).

15 *Penn Water & Power Co. v. Fed. Power Comm'n*, 343 U.S. 414, 422 (1952).

16 *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956) (*Mobile*); *Sierra*, 350 U.S. 348.

17 11 U.S.C. § 362(b)(4).

18 *See, e.g., In re Pac. Gas & Elec. Co.*, 263 B.R. 306, 319 (Bankr. N.D. Cal. 2001) (finding that California Public Utilities Commission rate-setting function was excepted from automatic stay).

19 28 U.S.C. § 959(b).

20 *Mirant Corp. v. Potomac Elec. Power Co. (In re Mirant Corp.)*, 378 F.3d 511 (5th Cir. 2004) (emphasis added).

> sion and sale of electricity in interstate commerce, the equities balance in favor of rejecting the [contract], and that rejection of the [contract] would further the Chapter 11 goal of permitting the successful rehabilitation of Debtors.[21]

The district court also held that "[i]f rejection would compromise the public interest in any respect, it would not be authorized unless [the] Debtor ... show[s] that [it] cannot reorganize without the rejection."[22] However, the U.S. District Court for the Southern District of New York declined to follow *Mirant* in the *Calpine* case.[23] In *Calpine*, the court held that the only forum for a challenge to the filed rate (including terms and conditions of wholesale energy contracts) is FERC, and that once filed with FERC, wholesale power contracts become the equivalent of federal regulation. This decision was followed some years later when the same court held that in order to reject a power contract, the debtor must also obtain a ruling from FERC that abrogation of the contract does not contravene the public interest.[24]

Faced with this issue once again, the U.S. Bankruptcy Court for the Northern District of Ohio rejected these prior opinions and analyses. It held that "rejection, including the attendant cessation of performance, does not intrude on FERC's jurisdiction over filed rates."[25] The court reasoned that rejection affirms the filed rates in power-purchase agreements "by allowing damage claims pursuant to those contracts and rates."[26] This decision is on appeal to the Sixth Circuit.[27]

On June 7, 2019, the U.S. Bankruptcy Court for the Northern District of California entered a similar ruling. In an animated and somewhat rancorous opinion, the court declared that

> FERC, despite its denial, has chosen to interfere with bankruptcy courts' decisions. Without statutory or [S]upreme [C]ourt authority to support its position, it in fact "presumes to sit in judgment" and second-guess — no overrule — decisions of the bankruptcy court…. FERC must be stopped and the division and balance of power and authority of the two branches of government restored ... the court declares FERC's decision announcing its concurrent jurisdiction unenforceable in bankruptcy and of no force and effect on the parties before it. If necessary in the future, it will enjoin FERC from perpetuating its attempt to exercise power it wholly lacks.[28]

Thus, in responding to a pre-petition opinion by FERC that it had "concurrent jurisdiction" with the bankruptcy court to review and address the disposition of wholesale power contracts sought to be rejected, the court held that FERC does not have concurrent jurisdiction — or any jurisdiction — over rejection determinations. This decision is also on appeal, and the bankruptcy court certified the matter for direct appeal to the Ninth Circuit.[29]

## Conclusion

The question of whether bankruptcy courts should defer — or at least listen — to FERC in determining whether wholesale power-purchase agreements can be rejected is not only a fascinating one, but one that affects billions of dollars in damages to wholesale energy suppliers. We have not heard the last word on this thorny matter, as appeals are in the works and the circuits are split. However, we can only hope that bankruptcy courts will be sensitive to the consequences of their decisions on energy markets and investment in the provision of energy, particularly in delicate and evolving renewable energy markets. The saga continues, and we will see whether bankruptcy courts maintain sole authority to determine whether energy contracts may be rejected, and under what circumstances, or whether these contracts are so different that different laws must be applied. abi

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21 *In re Mirant Corp.*, 318 B.R. 100, 108 (N.D. Tex. 2004).
22 *Id.*
23 *Calif. Dep't of Water Res. v. Calpine Corp. (In re Calpine Corp.)*, 337 B.R. 27 (S.D.N.Y. 2006).
24 *See In re Boston Generating LLC*, No. 10 Civ. 6528 (DLC), 2010 WL 4616243 at *1, *3 (S.D.N.Y. 2010).
25 *In re FirstEnergy Sols. Corp.*, No. 18-50757, 2018 WL 2315916, at *17 (Bankr. N.D. Ohio May 18, 2018).
26 *Id.* at *19.
27 *See* Case No. 18-3788.
28 *In re PG&E Corp. v. FERC*, Adv. Proc. No. 19-03003 (June 7, 2019).
29 *See* Memorandum Regarding Certification for Direct Appeal to Court of Appeals, *In re PG& Corp. Pac. Gas and Elec. Co. v. Fed. Energy Regulatory Comm'n*, Adv. Proc. No. 19-03003, 2019 WL 2477433 (Bankr. N.D. Cal. June 12, 2019).