"Rejection of Power Purchase Agreements in Bankruptcy"

Kari Moore & Thomas J. Perich
September 1, 2003

Before restructuring of the energy industry, energy law and bankruptcy law generally occupied separate spheres. But the new instability in the industry caused by unbundling set the two bodies of law on a collision course that came to a head when energy providers NRG and Mirant filed for Chapter 11 protection under the U. S. Bankruptcy Code (11 U.S.C. 1.01 *et seq*.). In the aftermath of that collision, the courts will have to issue definitive rulings addressing the rights of a debtor to reject wholesale power sale or purchase agreements in bankruptcy proceedings. At issue is which authority controls regarding the rejection of energy contracts—the Bankruptcy Code, administered by the bankruptcy courts, or the Federal Power Act (FPA), administered by the Federal Energy Regulatory Commission (FERC).[1]

Restructuring and the Destabilization of the Energy Industry

Energy restructuring was motivated by public decision makers' perception that competition would create lower prices. Federal restructuring through the Energy Policy Act of 1992 created competition in the wholesale electric energy market. State unbundling measures soon followed. Many states passed legislation allowing vertically integrated electric utilities (utilities that owned generation, transmission, and distribution facilities) to divest their generating assets. While the utilities remained regulated, the prices for generated electricity in many states became less regulated. Before unbundling, utilities had produced most of their own power from their generating facilities. After divesting those facilities, utilities had to purchase power, usually through long term power purchase agreements.[2] Under Connecticut's deregulation legislation, Connecticut Light and Power (CL&P), a regulated electric utility, divested its generating assets and bought wholesale power. One of its contracts was a 4-year fixed rate power purchase agreement with NRG Power Marketing, Inc. (NRG), a subsidiary of NRG Energy, Inc., to supply 45% of the utility's power requirements.

With restructuring came volatility in pricing that led to a wave of bankruptcies in what had previously been a somewhat stodgy industry. Restructuring changed the normal course of business in the energy industry. As companies acted to take advantage of the opportunities that restructuring and unbundling created, some overestimated the demand for electric power and were unprepared for the intense level of competition.

After unbundling in Connecticut, NRG began a program of acquisition and construction of generation assets, the financing requirements for which resulted in a continued need to access capital markets. Financing was tied to NRG's financial performance and ratings, leaving the company limited flexibility. When market volatility caused NRG's financial situation to deteriorate, Standard and Poor's downgraded its debt rating, triggering collateral calls. NRG, already leveraged due to its acquisition program, did not have the financial flexibility to meet the calls. Unable to continue, NRG filed for Chapter 11 protection in May 2003.[3] CL&P found itself in the position of having one of its major power purchase agreements subject to bankruptcy proceedings, and thus potentially to rejection by NRG.

The Conflict Between Bankruptcy and Energy Law

The conflict between the FPA and the Bankruptcy Code arises where a company in Chapter 11 attempts to reject a power contract regulated by the FPA. The heart of the conflict lies in the very different perspectives that each tribunal takes when implementing its goal of serving the public interest.

A primary goal of the FPA is to regulate energy in a manner consistent with the public interest. The FPA generally allows FERC to approve modifications or abrogations of FERC jurisdictional contracts under one of two standards. First, under the Mobile-Sierra test,[4] a company seeking modification or abrogation must show the change is required by the "public interest". Since most such changes entail rate increases not immediately palatable to the public, this usually entails proving that continuing to provide service under the contract will "impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory."[5] Under this test, FERC inquires into the interest of the company, if at all, only to the extent it affects the public interest.

The second standard of review available to FERC allows the agency to approve rates and rate changes if they are "just and reasonable" as required by the FPA. Last year, on August 1, 2002, FERC issued a proposed policy statement indicating that it would use the just and reasonable standard in regard to proposed changes to negotiated rates unless language in the contract establishing those rates indicated the parties were choosing the "public interest" standard. Either because of the fact that most parties do not sign contracts unless they are satisfied with the terms or because the "more satisfied party" at the time of signing has the leverage to require it, many recent power purchase agreements and tolling agreements do contain such language. However, the FERC announcement remains only a proposed policy at this time and no one is certain where this course will lead. Either FERC utilized test will entail an approach, and have an orientation, in favor of preserving the integrity of the rate structure.

While intent on effectuating the public interest, the bankruptcy court does so from a different perspective. It aims to allow a financially distressed company to reorganize, thereby maximizing the recovery of the bankrupt's creditors, and avoiding the need for a liquidation with its resultant loss of jobs, contribution to the tax base, and the like. In addition, a successful reorganization almost always benefits society because a viable business can emerge without its previous debt-laden structure.

Section 365 of the Bankruptcy Code allows a company in Chapter 11 to reject, with court approval, certain leases and executory contracts (virtually any contract entered into before bankruptcy that has not been fully performed by both sides). This provision advances the public interest goal of the Bankruptcy Code in that by being able to shed burdensome contracts, a company has a better chance for a successful reorganization. Additionally, the bankruptcy court can ensure that similarly situated creditors receive comparable treatment, and can gather various claims for orderly and comprehensive resolution before a single forum rather than permitting piecemeal litigation in forums across the country.

Most bankruptcy courts apply the business judgment test in determining whether to approve a motion to reject. Under the business judgment test, a court will generally approve rejection of a contract upon a showing by the debtor that rejection will benefit the estate. The bankruptcy court's perspective on how to further the public interest thus can be significantly different than that of FERC. That is, a contract with a very favorable rate from the perspective of the power purchaser would be a most likely candidate for rejection by a bankrupt. It is precisely this showing of favorable terms to the non-bankrupt party to the contract (and corresponding burden on the debtor-in-possession in Chapter 11) that the Bankruptcy Code envisioned as a basis for rejection, which rejection would, in theory, facilitate a successful reorganization and avoid the necessity for liquidation. Thus, the bankruptcy court's view of how to satisfy the public interest focuses, in the first instance, on the debtor and creditors and secondarily, on a broader constituency.

The result of these different standards is that a company trying to avoid an unfavorable power sale contract might satisfy the business judgment test required for rejection under the Bankruptcy Code, yet fail to satisfy the public interest test of the FPA. This is precisely the conflict that arose when NRG filed for bankruptcy protection. Upon filing, NRG requested court approval to reject its agreement with CL&P. The court applied the business judgment rule, and approved the motion to reject the agreement on the basis that the contract was losing money (NRG claimed to be losing $500,000 a day on the contract).

FERC responded by issuing an order on June 25, 2003 requiring NRG to continue performance until FERC determined whether termination of the contract met the Mobile-Sierra public interest test. FERC held that cessation of performance under rejection was equivalent to an abrogation of the contract. Since the agreement was regulated by the FPA, FERC held that NRG had to continue delivering power under the agreement until NRG showed the contract was contrary to the public interest.

FERC Claims Its Authority Is Undiminished by Bankruptcy

NRG argued that because the bankruptcy court had authorized rejection of its contract with CL&P, FERC lacked authority to order continued performance of the contract. FERC rejected that argument, concluding that its authority to enforce the contract was undiminished by the simultaneous bankruptcy proceedings.

The FERC majority actually relied on Section 362 of the Bankruptcy Code, the automatic stay provision, as support for its ruling. Section 362 provides that upon filing for bankruptcy, an automatic stay goes into effect that prohibits actions against the debtor.[6] Section 362 contains an exemption from the automatic stay for government units or regulatory agencies enforcing their regulatory authority.[7] The FERC majority interpreted that provision as preventing bankruptcy courts from interfering in a government agency's regulatory action. The majority cited *Eddelman v. U.S. Dep't of Labor* for the proposition that government agencies are exempt from the automatic stay if the action is regulatory in nature, even where the agency's action conflicts with the bankruptcy court.*[8]* The majority concluded that since it was acting in its regulatory capacity under the FPA, it was authorized to require NRG's performance despite the bankruptcy court's decision to allow NRG to reject the contract.

The majority also cited Section 1129 of the Code (wherein the required elements for confirmation of a plan of reorganization are contained), which requires a government regulatory commission with authority over the debtor's rates to approve any rate change in the confirmation plan before the court approves the plan.[9] They interpreted that provision to indicate that an agency retains its control over rates throughout a bankruptcy.

In her dissent to the FERC order, Commissioner Brownell objected to the majority's interpretation of Section 362 and Section 1129. She noted that the cited provision in Section 362 is a specific exemption to the automatic stay, and does not make any reference to Section 365 that would indicate it also applied to the rejection of executory contracts. She similarly argued that Section 1129 is a specific condition to plan confirmation, and is unrelated to Section 365.

The majority maintained that it was not attacking NRG's right to reject the contract under Section 365. Rather, it contended that while a debtor may be authorized by a court to reject a contract, the debtor must still satisfy its obligations under the FPA. Commissioner Brownell did not find this argument persuasive. In her dissent, she argued that "asserting the authority to enforce a contract that the bankruptcy court has already allowed NRG to reject does amount to contesting NRG's rights to reject the contract under the Bankruptcy Code."

The FERC majority cited several federal cases to further support its position that it maintains its authority during bankruptcy proceedings, including *In Re Cajun Electric Power Coop, Inc.*, where the court upheld a state agency's reduction of a debtor's rates. That court held that state laws dealing with public safety and welfare are not preempted by the bankruptcy policy of promoting the rehabilitation of debtors. The majority also relied on *In Re Nextwave Personal Comm. Inc.*, which held that where a federal agency is given exclusive jurisdiction by Congress over a matter, its jurisdiction controls over any bankruptcy rulings that would prevent the agency from fulfilling its statutory purpose.[10] FERC asserted that if NRG could simply reject its obligations under the FPA through the bankruptcy court's authorization of a contract rejection, FERC would be unable to satisfy its duties under the FPA.

Commissioner Brownell argued that the FERC holding is problematic in the face of the Supreme Court's decision in *National Labor Relations Board v. Bildisco and Bildisco.*[11] In *Bildisco*, the Court held that the NLRB could not enforce a collective bargaining agreement against a debtor, where the debtor had received permission from a bankruptcy court to reject the agreement under Section 365. She wrote, "if the NLRB could not enforce the NLRA because to do so would indirectly enforce a rejected executory contract, then I do not see how we, acting under the Federal Power Act, can directly enforce this rejected executory contract".

Current State of the Law

FERC required continued performance under the contract in an August 15 order, finding that NRG failed to meet the Mobile-Sierra test. NRG has filed an appeal of FERC's order with the 2nd Circuit Court of Appeals. Since its contract with CL&P expires December 31, 2003, the issue for NRG may become moot before the appeal is heard. However, Mirant's July 2003 filing also raises issues concerning the relationship between the FPA and the Bankruptcy Code.

When Mirant filed for bankruptcy in July 2003, it wanted to reject a power purchase agreement with Potomac Electric Power Company (PEPCO). Mirant had witnessed FERC's response to NRG's attempt to reject its contract with CL&P, and decided to pursue a different strategy. Anticipating FERC's order to continue performance, Mirant obtained a temporary injunction from the bankruptcy court. The order prevents FERC from ordering Mirant to continue performing its obligations under the contract pending a hearing to determine whether the court will allow Mirant to reject the contract with PEPCO. FERC and PEPCO have asked the District Court to remove the dispute from bankruptcy court and allow FERC to rule on the issue, claiming that FERC has authority over the matter under the FPA. Notably, Mirant was buying power under the contract it sought to reject, unlike NRG's situation, where NRG was selling power to an electric utility company in the contract NRG sought to reject. If the Commission's avowed goal is continuity of service, the Mirant circumstances may be materially different than those of NRG.

The determination of whether the Bankruptcy Code or the FPA controls the issue could become a key ingredient in determining how and whether NRG, Mirant, and other similarly situated power providers are able to reorganize. As stated, the perspective of how to implement public policy goals and the effects of those perspectives under each law are dramatically different. If the FPA controls, companies in bankruptcy will have to meet the Mobile-Sierra test to avoid unfavorable contracts or, at the very least, show that the rejection, and the resultant rate increases and service changes that follow, are all just and reasonable. While the just and reasonable standard may make approval of such rejection by FERC somewhat more likely, this is far from certain. If FERC's position prevails, failure to meet whatever test is applied means a bankrupt will have to continue to perform a contract that is burdensome and could seriously hinder its ability to reorganize. In the real world, it seems challenging to meet any FERC imposed test in a bankruptcy contract rejection environment. If the contract affects the public and burdens the company, in all likelihood it will be beneficial to that public, and therefore would be viewed favorably by FERC. This will make it more difficult for the company to successfully reorganize, not only because the company may be losing money under the contract, but also because that contractual burden may make it more difficult for the company to find post-petition financing to fuel its reorganization.

Conversely, if the Bankruptcy Code controls, companies in Chapter 11 can avoid a contract by showing it is in the company's best interest to do so. Once a debtor rejects a contract under Section 365, the other party to the contract has only a claim against the debtor for breach of contract.[12] This claim will be an unsecured claim against the bankruptcy estate,[13] which generally results in a recovery equal to only a fraction of the face amount of the claim. In the case of contracts under which a bankrupt utility is selling power to residential and small commercial consumers, abrogation under bankruptcy court authority could undermine the public policy goals of FERC and the FPA.

The competition and decreased protections brought about by restructuring and unbundling have made bankruptcy a new reality for the energy industry. NRG's and Mirant's Chapter 11 filings represent not only this new reality, but also the need to resolve the underlying public policy conflict between the FPA and the Bankruptcy Code. The importance of this conflict leads one to conclude that a properly timed and argued case may make its way to the highest level of our judicial system for determination in the near future.

[1] Somewhat similar concepts arise in respect of contracts between a utility and a Qualifying Utility (QF) under the Public Utility Regulatory Policies Act of 1978 (PURPA). However, because QF's are partly creatures of, and governed by, state law, the interplay between their regulation and the Bankruptcy Code becomes more problematic.

[2] See Gary A. Saunders, *Brave New World of Big Defaults: The Once Risk-Averse Utilities Industry is Now No Stranger to Restructurings*, National Law Journal, August 18, 2003.

[3] See Arleen Spangler and Terry A. Pratt, *Energy Peer Comparison: The Rise and Fall of NRG, NEG, and Mirant*, Standard & Poor's Report, August 28, 2003.

[4] *United Gas Pipeline v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956) and *Federal Power Commission v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956).

[5] *Federal Power Commission v. Sierra Pacific Power Co*., 350 U.S. at 355.

[6] 11 U.S.C. §362(a).

[7] 11 U.S.C. §362(b)(4).

[8] *Eddelman v. U.S. Dep't of Labor*, 923 F. 2d 782 (10th Cir. 1991), overturned in part on other grounds by *Temex Energy* 968 F. 2d 1003 (10th Cir. 1992).

[9] 11 U.S.C. §1129(a)(6).

[10] *In Re Nextwave Personal Comm. Inc*., 200 F. 3d 43, 54 (2d Cir. 1999).

[11] *National Labor Relations Board v. Bildisco and Bildisco*, 465 U.S. 513 (1984).

[12]11 U.S.C. §365(g).

[13] 11 U.S.C. §502(g).