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Who's the Boss? FERC and the Bankruptcy Courts' Continuing Battle for Power

Patricia Williams Prewitt

Author contact information:
Patricia Williams Prewitt
Locke Liddell & Sapp LLP
Houston, TX

pprewitt@lockeliddell.com
713-226-1200

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CONTINUING BATTLE FOR POWER

Uncertainty regarding the treatment of energy related contracts in bankruptcy is on the rise. If bankruptcy issues relating to forward contracts, tri-party setoffs and cross-commodity netting weren't enough to cause those in the energy industry unease, additional uncertainty and unpredictability relating to the treatment of energy contracts in bankruptcy is on the rise due to conflicts between bankruptcy court jurisdiction and FERC jurisdiction. Recent cases have reached different results regarding whether FERC or a bankruptcy court has the power to determine whether a debtor may reject an executory contract. FERC and the bankruptcy courts are likely to go head to head on jurisdictional issues related to other provisions of the Bankruptcy Code in the future. The recent decisions discussed below are likely only round one in what may be a long fight with no clear victor.

FERC Jurisdiction. FERC's jurisdictional muscle originates from the Federal Power Act ("FPA") and the Natural Gas Act ("NGA"). The FPA vests FERC with the authority to determine whether rates terms and conditions of service for any wholesale of electric energy and any transmission of electricity in interstate commerce are "just and reasonable" and to determine "just and reasonable" rates, terms and conditions to replace any found to be "unjust and unreasonable, unduly discriminatory or preferential." 16 U.S.C. §§824(d)(a), 824(e)(a). FERC has exclusive authority over these specific issues. *See, e.g., Mississippi Power & Light Co. v. Mississippi*, 487 U.S. 354, 371, 108 S.Ct. 2428, 101 L.Ed. 2d 322 (1988); *See also*, 16 U.S.C. §824(b). This authority has led to the "filed rate doctrine" which provides that the reasonableness of rates and agreements regulated by FERC cannot be collaterally attacked in state or federal courts. The only forum for challenging the reasonableness of rates is before FERC or a court reviewing FERC's order. *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 487 U.S.354, 371, 108 S.Ct. 2428, 101 L.Ed.2d 322 (1988). Under the filed rate doctrine, FERC can only approve a change to a filed rate if "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." *Fed. Power Comm'n v. Sierra Pac. Power Co.*, 350 U.S. 348, 355, 76 S.Ct. 368, 100 L.Ed. 388 (1956).

FERC likewise has exclusive jurisdiction under the NGA over transportation of natural gas in interstate commerce of natural gas, for resale for ultimate public consumption for domestic, commercial, industrial or any other use, and to natural gas companies engaged in such transportation or sale. 15 U.S.C. §717(b). It is well settled that only FERC and not courts, must approve changes in rates, terms and conditions of a "FERC-jurisdictional" contract. *See, e.g., Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 57, 577-79, 101 S.Ct. 2925, 69 L.Ed.2d 856 (1981). The issue then becomes what is a "FERC jurisdictional contract," who makes that initial determination and who should decide whether rates, terms and conditions of a "FERC-jurisdictional contract" are at stake.

Bankruptcy court jurisdiction.

Federal district courts have original and exclusive jurisdiction over all cases arising under title 11 (all bankruptcy cases). 28 U.S.C. §1334(a) 2004. District courts have original but not exclusive jurisdiction over all civil proceedings “arising in or related to cases under title 11. *Id.* §1334(b). District courts normally refer bankruptcy cases (and those cases arising in or related to a bankruptcy case) to bankruptcy courts by standing order. This reference may be withdrawn, in whole or in part, sending a bankruptcy case or any part thereof, back to the district court. 28 U.S.C. §157(d).

Conflicts between FERC and bankruptcy court jurisdiction.

When a contract regulated by FERC is at issue in a bankruptcy proceeding, a decision must be made as to whether the regulator agency or the court trumps the other. The most notorious recent example of such a conflict has arisen in the bankruptcy context when a debtor has sought to reject an executory contract and the rates under that contract are subject to regulation by FERC. The general basis for both FERC jurisdiction and bankruptcy court jurisdiction set forth above, law, are simple enough in a vacuum, but have been shown to be capable of multiple interpretations in two recent cases involving a Debtor’s attempt to reject executory contracts in bankruptcy, as discussed below. In those two recent case, *Blumenthal v. NRG Power Marketing Inc.*, 103 FERC, P61, 344, p.48 (2003) and *In re Mirant*, 378 F.3d 511 (5th Cir. 2004), the debtor sought to reject executory contracts which were financially burdensome to their respective estates.

Neither the Mirant or NRG disputes with FERC addressed the reasonableness of rates. Rather, in each case the issue was whether the Debtor could reject an executory contract. The executory contracts at issue happened to be subject to a tariff by which FERC governed the rates of the contract; however, the rate was otherwise irrelevant in each case. It is well settled that a court is bound to defer to FERC’s primary jurisdiction if the issue is the reasonableness of rates. *See, e.g., Maine Public Service Co. v. Federal Power Commission*, 579 F.2d 659 (1st Cir. 1978). FERC insinuated itself in the NRG and Mirant cases in an attempt to become the final arbiter of whether a contract of a bankruptcy debtor should be rejected in furtherance of a Chapter 11 plan of reorganization. To better understand the nature of the turf war, an understanding of the significance of rejection rights in bankruptcy is necessary. Section 365 of the Bankruptcy Code affords a debtor one of the most important rights contained in the Bankruptcy Code. Pursuant to this section, a debtor may reject unfavorable contracts, leaving the counterparty with a claim for rejection damages. The rejection claim is treated as a pre-petition unsecured claim. 11 U.S.C. Section 365 does not carve out any exceptions to Debtor’s right to reject executory contracts if the contract rate is a governmental regulated contract, whether governed by FERC or another governmental agency. In fact, there are no exceptions for this integral right of Debtor’s to escape onerous or unprofitable contracts even for commodity contract, forward contracts and swaps, which are subject to other safe harbor protections under the Code in order to further an express desire to protect the stability of the energy industry.

The two leading cases on the battle for jurisdiction between FERC and the bankruptcy courts, NRG and Mirant, both arose in 2003. As often happens, two cases with similar facts and legal issues resulted in two very different conclusions. For Mirant, the battle is far from over.

In the NRG case, NRG Power Marketing (“NRG”) filed a motion to reject a market-based contract with Connecticut Light and Power Company on May 14, 2003. In response to that motion, an emergency complaint was filed with FERC which resulted in FERC issuing an interim order requiring the debtor to continue performing until FERC considered the matter further (which in itself is troubling because the bankruptcy estate has an interest in obtaining expeditious rulings on motions to reject to lessen claims against the estate and consequently increase potential payouts to creditors). The NRG bankruptcy court granted debtor’s motion to reject the contract, conditioned upon the debtor obtaining an order from FERC vacating its prior order. *In re NRG Energy, Inc., et al*, 2003 WL 22509390 (Bankr. S.D.N.Y. 2003). NRG unsuccessfully attempted to obtain a district court order staying the interim FERC order and allowing the debtor to cease performance under the contract and setting a hearing to determine whether FERC should be enjoined from interference with the rejection (a procedural play which did not go unnoticed by another debtor about to file its bankruptcy petition, Mirant). The District Court denied NRG’s request for an injunction, holding that it did not have jurisdiction over the matter. *NRG Power Marketing, Inc. v. Blumenthal*, 2003 WL 21507685 (S.D.N.Y. 2003). FERC ultimately decided it had jurisdiction over the rejection issue pursuant to the FPA and FERC required the debtor to continue performance under the contract. *Blumenthal v. NRG Power Marketing, Inc.*, 103 FERC P 61,344 (2003). FERC decided it was in the best position to determine whether it should decide the rejection issue and concluded that NRG could not reject the burdensome contract. The District Court essentially agreed with FERC. The debtor in NRG appealed the District Court’s decisions but withdrew the appeal after it reached a settlement with CL & P, which FERC approved.

Mirant filed a Chapter 11 petition in the Northern District of Texas in July, 2003, while the highly publicized jurisdictional battle in the *NRG* case was being played out. Nearly two years later, the final resolution of FERC’s authority in the *Mirant* case and the appropriate standard to use in determining whether a regulated contract can be rejected are far from over.

The debtor in Mirant had, prior to its bankruptcy filing, entered into an Asset Purchase and Sale Agreement (“APSA”) with Potomac Electric Power Company (“PEPCO”) for generating plants and related assets. Under the APSA, PEPCO agree to sell its electric generation facilities and assign most of its power purchase agreements to Mirant for approximately \$2.65 billion. *In re Mirant*, 378 F.3d 511, 515 (5th Cir. 2004). The debtor in *Mirant* attempted to reject the “Back-to-Back Agreement for its purchase of electricity from PEPCO pursuant to section 365 of the Bankruptcy Code. In light of the recent *NRG* case, Mirant anticipated interference from FERC in the rejection of the PEPCO contracts. Mirant sought and obtained an injunction from the bankruptcy court prohibiting FERC from preventing the rejection of the Back to Back contracts. On September 12, 2003, the bankruptcy court issued a temporary restraining order enjoining FERC “from taking any action, directly or indirectly, to require or coerce the Debtors to abide by the terms of any wholesale contract which Debtors are substantially performing or which Debtors were not performing pursuant to the order of this court unless FERC shall have provided the Debtors with ten (10 days) written notice setting forth in detail the action which

FERC seeks to take with respect to an Wholesale Contract which is the subject of this paragraph.” FERC responded by charging that the TRO usurped its “congressionally–mandate responsibilities to assure that the Debtors are providing just and reasonable rates, conditions and terms of service under the Wholesale Contracts, all of which are subject to FERC’s exclusive jurisdiction under the FPA or the NGA.” See, *FERC’s Memorandum of Law In Support of Motion to Withdraw the Reference*, p.4.

The District Court in Mirant withdrew the reference from the bankruptcy court bringing the rejection issues to the District Court. Mirant’s motion to reject was denied by the District Court because it concluded that the filed rate doctrine required Mirant to seek relief from the filed rate from FERC and thus, it lacked jurisdiction to rule on the motion to reject. Mirant appealed this decision to the Fifth Circuit.

On appeal, the Fifth Circuit held that federal district courts, sitting in bankruptcy jurisdiction, may authorize the rejection of regulated power contracts in a bankruptcy case. *Mirant*, 378 F.3d at 515, 521-22. In reaching its decision, the Fifth Circuit made at least eight important points.

First, the Fifth Circuit noted that “Congress intended to grant comprehensive jurisdiction to the bankruptcy courts so that they might deal efficiently with all matters connected with the bankruptcy estate.” *In re Mirant*, 378 F.3d 511 (5th Cir. 2004), citing *Celotex Corp v. Edwards*, 514 U.S. 300, 308, 115 S.Ct. 1493, 131 L.Ed. 2d 403 (1995).

Second, the Court noted that the filed rate doctrine is relatively narrow, since FERC can only file a changed rate when the rate is so low as to adversely affect the public interest by impairing the financial ability of a public utility to continue its service, create an excessive burden to other consumers or be unduly discriminatory. *Id.*

Third, the Court stated “the power of the district court to authorize rejection of the Back-to-Back Agreement does not conflict with the authority given to FERC to regulate rates for the interstate sale of electricity at wholesale.” 378 F.3d at 511.

Fourth, the Court concluded that the FPA does not preempt Mirant’s rejection of the Back-to-Back Agreement because it would only have an indirect effect upon the filed rate. A rejection claim in bankruptcy is analogous to a breach of contract damage claim, which courts can award. *Id.*, citing *Gulf States Util. Co. v. Ala. Power Co.* 824 F.2d 1465, 1471-73 (5th Cir. 1987).

Fifth, the Court found that rejection under section 365 does not constitute a collateral attack on the filed rate when the electricity purchased there under is not necessary to fulfill a debtor’s supply obligations. *Id.* at 511.

Sixth, the Fifth Circuit rejected FERC's analysis that the filed rate doctrine applied because any damages based upon the breach of the contract might result in a partial payout under a confirmed plan, stating that and any effect from a reorganization is far removed from the contract breach.

Seventh (and most importantly), FERC must rely upon the provisions of the Bankruptcy Code to limit Mirant's ability to reject the Back-to-Back Agreement.

Eighth, the Fifth Circuit noted that Congress clearly knew how to exempt regulated contract from the application of section 365 of the Bankruptcy Code (the example of collective bargaining agreements being exempted was used). The absence of any exceptions makes it clear that Congress intended for section 365(a) of the Code to apply to allow debtors to reject FERC regulated contracts. 378 F.3d at 511.

The Fifth Circuit remanded Mirant's Motion to Reject the Back to Back Agreement to the District Court, to allow it to exercise its jurisdiction to determine the rejection issue. *Id* at 525-526.

On remand, the District Court, without a hearing, denied the Motion to Reject the Back to Back Agreements on December 10, 2004 (18 months after the Motion to Reject was originally filed). The rationale for the denial was based upon the District Court's conclusion that the Back to Back Agreement was not severable from the purchase of the generating facilities entered into simultaneously by the parties under the APSA. In its opinion denying the Motion to Reject, the District Court stated "The Court is satisfied that the furthest thing from the mind of the parties when they entered into the APSA and agreed to a contract price of \$2.65 billion, was that the set of rights and obligations that constituted the Back to Back Agreements would be treated as contractual commitments separate from and independent of PEPCO's sale to Debtors of its electric generation facilities." *In re Mirant Corp.*, 318 B.R. 100 (N.D. Tex. 2004). No mention is made as to whether it was Debtor's expectation at the time the contract was entered into that it would be able to reject burdensome contracts in a subsequent bankruptcy, as is often a major factor in acquiring executory contracts prior to a bankruptcy filing or whether an evidentiary hearing was held to determine the issue of the parties' intent regarding the severability of the Back-to-Back Agreement. Applying the laws of the District of Columbia, pursuant to the contract, the District Court noted that the divisibility of a contract is primarily a question of the parties' intent. P.4. It is worth noting that if FERC were allowed to determine this issue, it could make this factual determination regarding the parties' intent without hearing any testimony, hardly an ideal fact finding situation.

An executory contract which contains several agreements, must be rejected or assumed in its entirety; the debtor may not "cherry pick" only those parts of a contract which are favorable to it. *See, e.g., Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735, 741 (5th Cir.1996). The District Court in *Mirant* found that the Back to Back Agreement was not divisible from the Purchase Agreement and accordingly the Debtor could not reject only the Back-to-Back Agreement.

The District Court could have just denied the motion to reject based upon the divisibility issue, but it went on to enunciate a standard for determining whether a FERC regulated contract could be rejected pursuant to Section 365 of the Bankruptcy Code as follows: "To be entitled to an order authorizing rejection of the Back-to-Back Agreement, Debtors must prove that it burdens the bankrupt 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 transmission and sale of electricity in interstate commerce, the equities balance in favor of rejecting the Back-to-Back Agreement, and that rejection of the Back-to-Back Agreement would further the Chapter 11 goal of permitting the successful rehabilitation of the Debtors.....Before authorizing a rejection, the court would give the FERC an opportunity to participate as a party in interest for all purposes in this case under 11 U.S.C. 1109(b) and FED. R. BANKR. P. 2018(a), and would afford the FERC an opportunity to engage in appropriate inquiry to enable it to evaluate the effect that such a rejection would have on the public interest.” *Id.* at 12. The District Court did not focus on the eight factors the Fifth Circuit emphasized which are set forth above, but rather, apparently focused on just one portion of the Fifth Circuit’s opinion suggesting that when deciding these issues, the district court should carefully scrutinize the impact of rejection upon the public interest to ensure that rejection will not cause a disruption in the supply of electricity to other public utilities or to consumers or lead to unjust or excessive rates.

In summary, the District Court in *Mirant* would not allow rejection of a regulated contract if the public interest would be compromised, unless the Debtor couldn’t otherwise reorganize in which case FERC would be allowed a second bite at performing the balancing of public interest versus the debtor’s reorganization. A bit circular at best. The debtors in *Mirant* have filed an expedited appeal of the District Court’s order which is now pending before the Fifth Circuit.

There has been much discussion in the past few years, following *In re Olympic*, 294 F.3d 737(5th Cir. 2002) regarding the safe harbor protections given to forward contracts and commodity contracts. Despite a legislative history replete with a clear intent to protect the energy industry as a whole, for the good of the public, these contracts may still be considered executory contracts which Debtor may either assume or reject. While Section 365 of the Bankruptcy Code allows debtors to reject executory contracts, Section 556 and 365(e) of the Bankruptcy Code allow non-debtor counterparties to reject forward contracts if the contract provides for termination in the event of bankruptcy or that is how such contracts are generally treated in the industry. In the PG&E bankruptcy case, filed in July 2003 (only one month after the NRG decision), Vermont Public Power Supply Authority (Vt. Power) filed a complaint with FERC seeking to compel the continued performance of a market-based power sales contract by Chapter 11 debtor, PG&E Energy Trading Power, L.P. (“PG&E”). After the complaint was filed PG & E filed a bankruptcy petition and claimed that the contract at issue was terminated pursuant to a provision of the contract which provided that it would automatically terminate in the event of a bankruptcy. This automatic termination provision was made valid only by application of a bankruptcy provision recognizing the automatic termination provision (absent the specific bankruptcy provision this would have been an invalid “ipso facto” provision). FERC rejected the complaint and found that the contract was terminated upon the bankruptcy filing. *Vt. Pub. Power Supply Auth. v. PG&E Energy Trading Power, L.P.*, 104 FERC ¶¶ 61, 185 (2003). FERC recognized the power of the Bankruptcy Code, Section 556 of the Code, to terminate a power contract in that case. In both the NRG and *Mirant* cases, FERC argued that it was not bound by a specific Bankruptcy Code provision (section 365(a) that allows rejection of a regulated contract. This appears to be in direct conflict with the *Vt. Power* case wherein FERC recognizes termination of a regulated contract pursuant to a Bankruptcy Code provision (the

contractual termination provision would be ineffective absent the application of Bankruptcy Code provisions specifically authorizing rejection). FERC rejected Vt. Power's argument that it's holding was inconsistent with its decision in the *NRG* case "because the contract in *NRG* did not provide that it would automatically terminate upon one of the parties to the contract becoming the subject of a bankruptcy proceeding." There appears to have been a lack of understanding as to the interplay between various Bankruptcy Code sections and the automatic termination provisions of the Vt. Power contract. The effect was that FERC recognized the validity of certain Bankruptcy Code provisions allowing the termination of a regulated contract, but it does not give the same deference to Section 365 of the Code allowing a Debtor to reject and discontinue performance under the same contract. These seemingly incongruous stands by FERC creates questions as to FERC's future position on its role in the bankruptcy process.

The battle between the FERC and bankruptcy court's jurisdiction will likely become more convoluted before the turf war is resolved. Section 365 of the Bankruptcy Code is the source for most of the current friction, but it does not take a great deal of imagination to think that this jurisdictional tug of war will expand to other issues in bankruptcy. Aside from a Debtor's ability to reject contracts under Section 365, the FERC could ostensibly claim an interest in claims resolution (rejection damages must be determined once it is determined by either FERC or the Bankruptcy Court that rejection of a regulated contract can occur. The FERC could determine the appropriate rejection damages. Compromises of any nature filed under Bankruptcy Code 9019 could be decided by FERC if the counterparty to a regulated contract receives less than 100% on its claim as a result of the compromise which would alter the regulated rate. Taken to the extreme, FERC would have to rule on Chapter 11 plan confirmations and determine if the rights of counterparties to regulated contracts have been altered.

Who cares who's the boss? Does it really matter significantly whether the FERC or a bankruptcy court rules on issues that touch in any way on regulated entities? Bankruptcy law, like other specialized areas of the law, has a language all of its own with landmines for the unwary. The most common reaction to well-established bankruptcy principals, such as the ability to reject contracts and discharge undisputed obligations, is "that can't be right – it's not fair." In bankruptcy, the "public interest" in enforcing established contractual provisions often yields to a statutory scheme designed to allow a debtor a fresh start and a pro rata distribution to similar creditors. In instances where there is a true public interest that competes with the Bankruptcy Code, there have been legislative amendments to the Bankruptcy Code to protect that interest. For example, safe harbor provisions relating to forward and commodity contracts were added to the Code to protect the energy trading industry and prevent a domino effect. Specific provisions have been enacted to protect collective bargaining agreements as another example. Since there have been no amendments precluding rejection of FERC regulated contracts, it should be presumed that a debtor may reject such contracts in a bankruptcy case, consistent with the provisions of the Bankruptcy Code.

Real differences exist between FERC determining an issue arising in a bankruptcy proceeding and a bankruptcy court's resolution of that same issue. FERC, an administrative agency, is not required to hold an evidentiary hearing. *See, e.g., Granite State Transmission, Inc.*, 41 FERC P 61,269 (1987); *Louisiana Power & Light Co.*, 24 FERC P 61,301 (1983).

Bankruptcy courts afford an opportunity for witnesses and evidence to be presented. A bankruptcy court order becomes final the eleventh day after entry. FERC may supplement its order from time to time by imposing new terms and conditions or revising existing one “for good cause shown” as FERC ‘may find necessary or appropriate.’ *Enron Power Marketing v. El Paso Electric Co.*, 83 F.E.R.C. P 61,213 (1998). FERC undoubtedly has specialized expertise over rate regulatory issues. The bankruptcy courts have very specialized expertise over the bankruptcy statutes and the reorganization process as a whole. Following *Mirant*, it appears that resolution of bankruptcy issues touching on regulatory contracts (or regulated contracts affecting a bankruptcy case, depending on your perspective) will be decided by neither. District courts lacking specific expertise in either bankruptcy or regulatory matters will be vested with determining matters dependent on both.

Conclusion.

The final order in *Mirant* may be less important than the procedural quagmire created by the battle over jurisdiction between FERC and the courts. The Debtor in *Mirant* stated in its most recent appeal that “the mere delay of rejection of the Back to Back Agreement in these proceedings has already cost Mirant approximately \$166 million in out of market post-position payments made to PEPCO in excess of the prevailing market rates – Appeal, P.S. It would have been more correct for the Debtors to have stated that delays in the rejection damage issue cost the creditors of Debtor’s estate \$166 million. The District Court’s opinion is void of any reference to the effect of allowing rejection on Debtor’s estate and more specifically, its creditors and the “public interest” in not preferring one creditor, PEPCO, above Debtor’s other creditors.

In *Mirant*, the Debtors had hundreds of executory contracts potentially subject to FERC’s jurisdiction. According to papers Debtors filed in that case, just one non-PEPCO contract, if rejected, could save the Debtors’ estates in excess of \$100 million. If FERC is ultimately found to have jurisdiction over pure bankruptcy issues, such as whether an executory contract may be rejected, corporate reorganization will be functionally meaningless for would be Debtors who are parties to contracts. Where the rates of those contracts are governed by FERC, FERC will have de facto amended the Bankruptcy Code. The statutory purpose of FERC is to determine just and reasonable rates for certain regulated energy contracts and prevent preferential or discrimination rates. 16 U.S.C. §§824(d)(a), 824(e)(a). However, as one commentator has pointed out, FERC’s interloping into bankruptcy courts will have the effect of preferring certain creditors, contrary to the Bankruptcy Code’s scheme and contrary to FERC’s stated purpose of preventing preferential rates.