# FIRSTENERGY: BANKRUPTCY COURT ASSERTS PRIMACY OVER FERC; APPROVES REJECTION OF POWER PURCHASE AGREEMENTS

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**U.S. Restructuring & Insolvency Alert**

In a closely watched battle between FirstEnergy Solutions ("FirstEnergy") and the Ohio Valley Energy Corporation ("OVEC") that could have significant implications for the U.S. power sector, the U.S. Bankruptcy Court for the Northern District of Ohio asserted its primacy over the Federal Energy Regulatory Commission ("FERC") in deciding whether to allow FirstEnergy to repudiate certain FERC-regulated power purchase agreements ("PPAs"). In a decision with significant implications for all participants in rapidly evolving wholesale power markets, the bankruptcy court applied the highly deferential business judgment standard instead of the more stringent standard applied by FERC when evaluating proposed changes to PPAs featuring mutually agreed-upon filed rates. The court's decision is now the subject of a direct appeal to the U.S. Court of Appeals for the Sixth Circuit, and the outcome may inspire additional action by Congress and the president.

In a July 31 ruling from the bench, U.S. Bankruptcy Judge Alan M. Koschik handed FirstEnergy an early victory in a highly contentious dispute. At issue is whether the bankruptcy court or FERC has the right to decide whether a debtor in bankruptcy may reject a wholesale power purchase agreement that would ordinarily be overseen by FERC. In siding with FirstEnergy, Judge Koschik rejected the effort by OVEC (and other power purchase counterparties) to have the dispute resolved by FERC, stating that "[t]he economic disappointment a power contract counterparty experiences in a debtor-party's bankruptcy case cannot be avoided by invoking the Federal Power Act and the filed rate doctrine any more than can the disappointment of any other general unsecured creditor be avoided by invoking the law of contract or tort."[1] The issues to be decided in the *FirstEnergy* case underscore the tension between the Bankruptcy Code and the Federal Power Act, as well as the authority of U.S. bankruptcy judges to decide matters typically reserved to FERC outside of bankruptcy.

## BACKGROUND

FirstEnergy operates fossil-fueled and nuclear-powered generating facilities serving six million customers from Illinois to Maryland. As a result of governmental initiatives in the states it serves, FirstEnergy was required to purchase a certain amount of renewable energy (i.e., wind and solar), and to thereby obtain renewable energy credits ("RECs"),[2] commensurate with its commercial activity in retail power markets within those states. In the early 2000s, FirstEnergy entered into a series of long-term PPAs with producers of renewable energy thereby ensuring a sufficient inventory of RECs to meet the company's projected compliance needs. By 2011, FirstEnergy was a party to eight PPAs obligating the company to purchase millions of dollars worth of green electricity annually over an extended period of time.

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While meeting its state-mandated REC compliance requirements, FirstEnergy continued to invest in fossil-fuel-based energy production as one of 13 “Sponsoring Companies” of the Ohio Valley Electric Corporation. Under an Inter-Company Power Agreement (“ICPA”), FirstEnergy had agreed to cover 4.85% of the costs associated with two coal-fired generating plants owned by OVEC in Ohio and Indiana. In exchange, FirstEnergy could purchase a proportionate share of the electricity generated by these plants. Among the costs it agreed to cover under the ICPA, FirstEnergy committed to paying employee benefits, including legacy benefits to more than 600 retired workers and to contribute to the eventual decommissioning of the plants. These obligations ran to 2040.

After rising steadily for 100 years, electricity demand in the United States began to stagnate. As a result of the ensuing price decline, revenue generated by FirstEnergy's retail sales failed to hit projections, leaving it with more RECs than it needed. In addition, significant advancements in horizontal drilling and hydraulic fracturing methods massively increased the domestic supply (and lowered the price) of natural gas, prompting the further decline in electricity prices. According to FirstEnergy, by the end of 2017, it was losing $46 million a year buying renewable energy that it couldn't resell at a profit, while simultaneously committing $12 million per year to the OVEC coal-fired plants in exchange for even more electricity that it could not use.[3] By the first quarter of 2018, FirstEnergy was having serious discussions with various stakeholders about exiting from the retail energy business and shedding these burdensome agreements through bankruptcy.

## CONTRACT REJECTION UNDER THE BANKRUPTCY CODE AND FEDERAL POWER ACT

In general, a debtor in bankruptcy can reject burdensome “executory” contracts, thereby relieving it from all future performance obligations.[4] Rejection is treated as a breach, and the nondebtor counterparty's recourse is limited to asserting a claim for damages against the debtor's estate.[5] Although contract rejection requires bankruptcy court approval, the debtor need only establish that its decision to reject is the product of sound business judgment, a standard easily met in most cases.[6] When it comes to contract rejection, the bankruptcy court considers the best interests of the estate (and by extension, creditors) over the particularized interests of the contract counterparty.[7] In the bankruptcy context, it is almost a foregone conclusion that a bankruptcy court will allow a debtor to reject a money-losing contract that offers little or no benefit to the estate.

Contracts involving the wholesale supply of electricity are covered by the Federal Power Act (“FPA”) and are subject to the jurisdiction and regulation of FERC. The FPA requires public utilities to publish the rates charged for electricity under their private contracts. Outside of bankruptcy, FERC has the exclusive authority to determine the reasonableness of the rates charged for electricity.[8] In contrast to the debtor-friendly standard applied by bankruptcy courts to a decision to reject a power supply contract, FERC considers an entirely different set of criteria in determining whether to modify a previously filed rate. First, the FPA requires filed rates to be “just and reasonable.”[9] Under the so-called *Mobile-Sierra* Doctrine, electricity rates set in a freely negotiated wholesale-energy contract by private parties are presumed to be just and reasonable. The *Mobile-Sierra* Doctrine is named after two landmark Supreme Court decisions issued more than 60 years ago in *United Gas Pipeline Co. v. Mobile Gas Serv. Corp*.[10] and *Federal Power Comm'n v. Sierra Pacific Power Co*.[11] The holdings in these cases set the standard for contract modification under the FPA. Under the *Mobile-Sierra* Doctrine, FERC can only modify rates set in a freely negotiated wholesale-energy contract if the contract “seriously harms the public interest.”[12] The financial circumstances of the particular buyer or seller of the electricity are not a primary factor.

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## RACE TO FERC

In anticipation of an imminent bankruptcy filing by FirstEnergy, on March 26, 2018, OVEC filed a petition with FERC seeking a declaratory order that the rejection of the ICPA by FirstEnergy would result in a change to the filed rate and would be contrary to the public interest. If successful, FirstEnergy would be compelled to continue performing under its ICPA with OVEC. This “first to file” strategy by OVEC was based, in part, on a 2006 decision by the U.S. District Court for the Southern District of New York. In *In re Calpine*, the District Court concluded that it lacked jurisdiction to decide whether a chapter 11 debtor utility could reject PPAs under the Bankruptcy Code due to the pendency of a FERC proceeding wherein the affected counterparty sought an order from the commission requiring the debtor to continue rendering performance.[13] *Calpine* holds that only FERC may decide whether to abrogate a filed-rate agreement,[14] but the district court's decision is at odds with the only circuit-level opinion addressing the issue. In *In re Mirant*, the U.S. Court of Appeals for the Fifth Circuit held that the FPA and Bankruptcy Code do not conflict because the former deals only with rate modification, while the latter allows the debtor to breach the contract in its entirety and quantify the counterparty's damages at the prevailing filed rate.[15] In an Interim Guidance Order issued in conjunction with *Calpine*, FERC indicated that it would follow the Fifth Circuit's opinion in *Mirant* while reserving its rights to inform the bankruptcy court of its views regarding the potential rejection of a filed-rate contract.[16]

On March 31, 2018, FirstEnergy and several of its affiliates filed for relief under chapter 11 of the Bankruptcy Code in the Northern District of Ohio. FirstEnergy immediately moved to reject the PPAs and ICPA and filed an adversary proceeding seeking an injunction preventing FERC from taking any action in the proceeding commenced by OVEC a few weeks earlier. OVEC and several of the green producers under various PPAs intervened in the adversary case and objected to the relief sought by FirstEnergy.

On May 11, 2018, the bankruptcy court issued a preliminary injunction barring FERC from initiating or continuing any proceeding and from issuing any order that would require FirstEnergy to continue performing under the PPAs and ICPA.[17] The injunction was designed to afford the bankruptcy court a reasonable opportunity to conduct hearings and accept briefing from each of the many parties involved in the dispute.

## COURT HOLDS THAT FERC IS SUBJECT TO AUTOMATIC STAY

Judge Koschik's written decision on the preliminary injunction noted, as an initial matter, that an injunction was unnecessary in this case because the Bankruptcy Code's automatic stay prevented FERC from adjudicating what was essentially a dispute between private parties.[18] Although section 362(d)(4) of the Bankruptcy Code codifies a “police powers” exception to the automatic stay, the bankruptcy court ruled that FERC would not be acting within its police powers if its activities were undertaken primarily for a pecuniary purpose.[19] In this case, the bankruptcy court found that any action by FERC to force FirstEnergy to continue performing under the PPAs and ICPA would primarily protect the private rights of OVEC and the other counterparties, effectively elevating their unsecured rejection claims to priority status over other stakeholders in the bankruptcy process.[20] Finding that the “obvious and dominant purpose” of the FERC proceeding was to elevate the rights of OVEC over other similarly situated creditors, the bankruptcy court concluded that the automatic stay applied to OVEC's proceeding before FERC, and that any action taken by FERC post-petition would be void.[21]

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## BANKRUPTCY COURT FINDS EXCLUSIVE JURISDICTION TO RULE ON CONTRACT REJECTION

Having found that the Bankruptcy Code prevented FERC from acting on OVEC's requests for relief, the bankruptcy court further held that FirstEnergy's bankruptcy filing gave the court exclusive jurisdiction to decide whether the rejection of the PPAs and ICPA were appropriate. Allowing FERC to weigh in on contract rejection and possibly requiring FirstEnergy to continue performing would "create a result financially indistinguishable from mandatory assumption."[22] For good measure, the bankruptcy court found that FirstEnergy had satisfied the criteria for a preliminary injunction under section 105(a) of the Bankruptcy Code and Federal Rule of Bankruptcy Procedure 7065.[23]

The bankruptcy court also found that FERC's jurisdiction over rates charged in the wholesale power markets was not preempted by the exclusive jurisdiction conferred upon bankruptcy courts to decide motions to assume or reject power supply agreements.[24] On this point, Judge Koschik agreed with the Fifth Circuit in *Mirant* that contract rejection is not a collateral attack on a filed rate. Disagreeing with the district court in *Calpine*, Judge Koschik observed that section 365 of the Bankruptcy Code provides broad power to reject contracts, subject to specific exceptions (e.g., collective bargaining agreements, commitments to federal depository institutions regulatory agencies, and railroad and airport terminal leases). There is no exception for contracts involving filed rates, Judge Koschik observed.[25] While he acknowledged that FERC has approved and published the rates in the ICPA, Judge Koschik declined to afford the ICPA the deference of a regulation, commenting that it "reads and performs like a contract."[26]

Finally, the bankruptcy court noted that contract rejection under the Bankruptcy Code and modification under the FPA are completely different matters. If a solvent party simply stopped paying under a FERC-regulated contract, it would be absurd for the counterparty to argue that it had somehow modified or abrogated the agreement.[27] Contract rejection under section 365 is understood as a breach of the contract, and the counterparty may claim damages at the filed rate. This, Judge Koschik explained, was the appropriate remedy for the nondebtor counterparty.

## COURT HOLDS THAT BUSINESS JUDGEMENT IS THE APPROPRIATE STANDARD TO BE APPLIED WHEN EVALUATING A DECISION TO ASSUME OR REJECT POWER PURCHASE AGREEMENTS

In dicta to its *Mirant* decision, the Fifth Circuit suggested that a more rigorous standard was appropriate in the rejection of FERC-regulated contracts, given the unique nature of the interstate sale of electricity.[28] Nevertheless, during a June 26 hearing, Judge Koschik determined that he would apply the traditional "business judgment" standard to FirstEnergy's rejection motions. In his view, the public interest principles furthered by the FPA were not relevant to FirstEnergy's restructuring. Instead, Judge Koschik said he would focus on whether the PPAs and ICPA were burdensome to the bankruptcy estate and whether rejection would advance FirstEnergy's reorganization.

Prior to the July 31 hearing on contract rejection, the parties stipulated to the fact that FirstEnergy had no business need for the PPAs and ICPA.[29] This stipulation provided a sufficient basis for Judge Koschik to

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overrule the remaining objections and approve rejection of the PPAs as an appropriate exercise of the debtor's business judgment.[30]

## TO BE CONTINUED . . .

On August 14, 2018, the U.S. Court of Appeals for the Sixth Circuit agreed to hear a direct appeal of the bankruptcy court's preliminary injunction order and announced that it will consider the following questions: (1) whether a bankruptcy filing automatically stays FERC's review of a filed-rate contract, (2) whether the bankruptcy court has exclusive jurisdiction over the rejection of a FERC-regulated contract, and (3) assuming it has such jurisdiction, under what standard is a chapter 11 debtor authorized to reject such contract. On August 28, Judge Koschik certified a direct appeal of his orders approving rejection of the PPAs, allowing the Sixth Circuit to consider the rejection of the agreements in conjunction with the preliminary injunction if it is so inclined. As of this writing, the Sixth Circuit has not accepted the appeal of the rejection orders or set a date for argument with respect to the preliminary injunction order.

As the federal courts consider these issues, other parties involved in federal energy policy are considering options to intervene, directly or indirectly. The Trump administration has proposed policy measures that would compensate certain coal- and nuclear-power generators for their contributions to energy security and grid resilience.[31] Proponents of this policy argue that coal and nuclear generating units are uneconomic, in part, because their dispatch prices do not compensate them for the resiliency attributes these units provide. If the outcome of the *FirstEnergy* case encourages more coal operators to reject contracts associated with uneconomic generating units, then the Trump administration may accelerate efforts to provide economic incentives to keep those business units operating. K&L Gates will continue to monitor the developments in this case and its broader implications for U.S. energy policy.

**Notes:**

[1] *See* FirstEnergy Solutions Corp. v. Federal Energy Regulatory Commission, No. 18-05021, 2018 WL 2315916, *17 (Bankr. N.D. Ohio May 18, 2018).
[2] An REC is a tradable nontangible commodity that represents proof that 1 megawatt-hour of electricity was generated from an eligible renewable energy resource.
[3] *See Motion for Entry of An Order Authorizing FirstEnergy Solutions Corp. and FirstEnergy Generation, LLC to Reject A Certain Multi-Party Intercompany Power Purchase Agreement With the Ohio Valley Electric Corporation as of the Petition Date* (Case No. 18-50757 Bankr. N.D. Ohio) [Docket No. 44] ¶ 4; *Motion for Entry of An Order Authorizing FirstEnergy Solutions Corp. and FirstEnergy Generation, LLC to Reject Certain Energy Contracts as of the Petition Date* (Case No. 18-50757 Bankr. N.D. Ohio) [Docket No. 45] ¶ 4.
[4] *See* 11 U.S.C. § 365(a).
[5] *See* 11 U.S.C. §§ 365(g), 502(g).
[6] *See* Orion Pictures Corp. v. Showtime Networks, Inc. (In re Orion Pictures Corp.), 4 F.3d 1095, 1098–99 (2d Cir. 1993).
[7] *See id.*
[8] *See* 16 U.S.C. § 824d.
[9] *See id.* § 824d(a).

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[10] 350 U.S. 332 (1956).
[11] 350 U.S. 348 (1956).
[12] *See* Morgan Stanley Capital Group Inc. v. Public Utility Dist. No. 1 of Snohomish County, Wash., 554 U.S. 527, 530 (2008).
[13] *See* 337 B.R. 27 (2006).
[14] *See id.* at 35 ("Having determined that the Bankruptcy Code does not expressly limit FERC's jurisdiction, and that it contemplates agency action during the pendency of a reorganization, 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.").
[15] *See* 378 F.3d 511, 519 (5th Cir. 2004).
[16] *See* California Elec. Oversight Bd., People of the State of California, *ex rel.* Bill Lockyer, Attorney Gen. of the State of California, & California Dep't of Water Res., 114 FERC ¶ 61003, 61005 (Jan. 3, 2006).
[17] *See* No. 18-05021, Docket No. 114, (Bankr. N.D. Ohio May 11, 2018).
[18] *See FirstEnergy*, 2018 WL 2315916 at *11.
[19] *See id.* at * 9 (following Chao v. Hospital Staffing Servs., 270 F.3d 374 (6th Cir. 2001)).
[20] *See id.* at *10.
[21] *See id.* at * 11. The Bankruptcy Court additionally questioned whether reducing the credit risk of filed rate contracts by preventing a bankruptcy court from considering rejection was even an appropriate exercise of FERC's regulatory power when, "outside of bankruptcy court, FERC itself has the ability to completely abrogate such contacts (not only excusing performance but excusing liability for breach) for completely solvent entities." *See id.*
[22] *See id.*
[23] *See id.* at *11–14.
[24] *See id.* at *16.
[25] *See id.* at *15.
[26] *See id.*
[27] *See id.* at *17.
[28] *See* 378 F.3d at 525.
[29] *See Stipulation* [Docket No. 1047], ¶ 13 (Specifically, OVEC and the other objecting parties did not contest that FirstEnergy would incur "material, cumulative losses from its obligation under the [ICPA] and the resulting sale of capacity and energy in the PJM market in the near term.").
[30] Prior to the July 31 hearing, FirstEnergy also entered into settlements with several of the PPA counterparties, allowing for the rejection of their agreements in exchange for allowed claims in the bankruptcy.
[31] Jeff Brady, *President Trump Orders Help for Coal and Nuclear Plants*, NPR, June 1, 2018, https://www.npr.org/2018/06/01/616245180/president-trump-orders-help-for-coal-and-nuclear-plants

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