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Fifth Circuit Affirms A Bankruptcy Court's Power to Authorize Rejection of Executory Contracts - Even if They Are Subject to Regulatory Oversight - But Requires A More Stringent Standard for Rejecting Contracts Implicating the Public Interest

In a decision containing both good and bad news for debtors interested in rejecting unwanted contracts in bankruptcy, the Fifth Circuit Court of Appeals in Mirant Corp. et al. v. Potomac Electric Power Co. et al. (In re Mirant Corp.), -- F.3d --, 2004 WL 1620794 (5th Cir. Aug. 4, 2004), recently held that a bankruptcy court may authorize a chapter 11 debtor to reject an executory power contract even if the contract is subject to regulatory oversight. At issue was whether the debtor's rejection of a power contract was an impermissible collateral attack on the Federal Energy Regulatory Commission's ("FERC's") exclusive jurisdiction to determine the reasonableness of wholesale electricity rates. The Fifth Circuit Court of Appeals held that a bankruptcy court has jurisdiction to authorize rejection of an executory contract even if FERC has regulatory oversight of the contract. The decision is good news for debtors to the extent that the Fifth Circuit reaffirmed the bankruptcy court's comprehensive jurisdiction over matters connected with the bankruptcy estate, and the central role that a debtor's power to reject executory contracts plays in reorganization cases. It may make a debtor's ability to reject contracts more difficult, however, to the extent that the Fifth Circuit held courts should apply a more rigorous standard than the debtor's business judgment to a debtor's rejection decision when the executory contract implicates the public interest.

Facts

The debtor, Mirant Corp. ("Mirant"), one of the largest regulated public utility companies in the United States, sought to reject power contracts pursuant to section 365 of the Bankruptcy Code. Mirant had entered into the power contracts in connection with Mirant's purchase and sale agreement with Potomac Electric Power Company ("PEPCO"). Pursuant to the purchase and sale agreement, PEPCO sold Mirant its electric generation facilities and assigned to Mirant most of its long-term, fixed rate contracts to purchase electricity from outside suppliers (each, a "PPA"). Because PEPCO could not assign some of the PPAs without the PPA supplier's consent, Mirant and PEPCO agreed that, among other things, if PEPCO could not obtain a supplier's consent, then Mirant and PEPCO would enter into an aneillary agreement, a so-called "back-to-back agreement," pursuant to which PEPCO would continue to comply with the terms of the unassigned PPAs and Mirant would agree to purchase from PEPCO an amount of electricity equal to PEPCO's obligation to purchase power under the unassigned PPAs at the rates set in those contracts. PEPCO did not receive consent to assign two

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of its PPA's and Mirant accordingly entered into a back-to-back agreement under which it became liable to PEPCO in an amount equal to PEPCO's obligations under the two PPAs. In July 2003, Mirant filed a chapter 11 case. As part of its reorganization, Mirant sought to reject the back-to-back agreement as an executory contract.

Procedural History

The Bankruptcy Court granted Mirant's motion to reject the back-to-back agreement. It also granted Mirant injunctive relief against the Federal Energy Regulatory Commission ("FERC") prohibiting FERC from taking any actions to require Mirant to abide by the terms of the back-to-back agreement or other wholesale energy contracts. The district court then withdrew the reference to the bankruptcy court and held new hearings. It concluded that FERC has exclusive authority to determine the reasonableness of the wholesale rates charged for electric energy sold in interstate commerce, and that Mirant could only challenge those rates in a FERC proceeding, not through a collateral attack in state or federal court. The district court found that Mirant's rejection motion was a prohibited attempt to avoid its electric energy purchase payment obligations under FERC-approved rates. The district court also vacated the bankruptcy court's injunctive relief on grounds that it interfered with FERC's performance of its regulatory oversight functions.

The Fifth Circuit's Decision

On appeal, the Fifth Circuit concluded that the Federal Power Act, 16 U.S.C. § 792 *et seq*. (the "FPA"), does not preempt a bankruptcy court's jurisdiction to authorize the rejection of an executory contract that is subject to FERC regulations. It held that the debtor's motion to reject an executory power contract was not a collateral attack upon that contract's filed rate because the bankruptcy court gives that rate full effect when determining the breach of contract damages resulting from the rejection. It further held that nothing in the Bankruptcy Code itself limits a public utility's ability to choose to reject an executory contract subject to FERC regulations as part of its reorganization process, whereas the Code elsewhere prohibits the rejection of certain regulatory imposed obligations.

In rejecting FERC's argument that Mirant's efforts to reject the back-to-back agreement were a collateral attack upon a filed rate (over which FERC claimed exclusive jurisdiction under the FPA), the Fifth Circuit noted that rejection of an executory contract under the Bankruptcy Code results in a breach of the contract, not in its abrogation. Consequently, whether the FPA preempts the district court's jurisdiction over a bankruptcy rejection depends on whether the FPA generally preempts the district court's jurisdiction over claims of breach related to executory power contracts. The Fifth Circuit found that district courts have authority to grant relief in situations where a party bases its breach of contract claim on a rationale other than a challenge to a filed rate. Consequently, because Mirant had argued that the filed rate of the back-to-back agreement exceeded the market rate for electricity and that Mirant did not need the electricity purchased under the agreement to fulfill its obligations to supply electricity, the Fifth Circuit concluded that Mirant's rejection of the back-to-back agreement was not a prohibited collateral attack on the filed rate.

The Fifth Circuit also held that the bankruptcy court's injunctive relief against FERC exceeded the bankruptcy court's authority. Although the Fifth Circuit agreed that the bankruptcy court had authority to enjoin FERC from negating Mirant's rejection of the contracts by requiring continued performance at the pre-rejection filed rate, the Fifth Circuit found that the bankruptcy court's injunction prohibiting FERC from taking *any* action to require Mirant to abide by the terms of its wholesale power contracts was broader than necessary to further the purpose of the Bankruptcy Code's rejection provision.

A More Rigorous Standard for Rejecting Contracts

In Mirant, the Court developed a more stringent standard for evaluating a debtor's contract rejection decision if the contract implicates the public interest. Courts normally apply a business judgment test to a debtor's contract rejection decision. In Mirant, however, the Fifth Circuit found that the business judgment standard did not account for the public interest inherent in the transmission and sale of electricity, and accordingly, was not the correct standard by which the district court should decide the merits of Mirant's motion to reject the back-to-back agreement. The Fifth Circuit directed the district court on remand to consider a more rigorous standard under which Mirant could only reject the contract if Mirant could show (a) that the contract burdens the estate, (b) that, after careful scrutiny, the equities balance in favor of rejecting the contract, and (c) that rejection of the contract would further the chapter 11 goal of permitting the successful rehabilitation of the debtors. The Fifth Circuit further directed the courts, when considering these issues, to scrutinize carefully the impact of rejection upon the public interest and to ensure, among other things, that rejection does not cause any disruption in the supply of electricity to other public utilities or consumers.

Implications

The Mirant decision reaffirms a bankruptcy court's jurisdiction to authorize a debtor to reject executory contracts in a chapter 11 case, even if a federal agency has regulatory oversight of the contract. The decision also develops a "public interest" exception to the business judgment standard normally applicable to a debtor's contract rejection decision. Ironically, notwithstanding the Court's affirmation of the broad authority to reject executory contracts, the Mirant decision actually makes it more difficult for a debtor to do so if the contract involves the public interest. Although subsequent cases may limit Mirant's more rigorous standard to executory power contracts, the Court's general reference to the public interest, amorphous articulation of its more rigorous standard, and its emphasis on the rehabilitative goals of chapter 11, may make this opinion fertile ground for subjecting a debtor's contract rejection decisions to heightened scrutiny where the contract involves the public interest and the debtor is not reorganizing.

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