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Legal Update
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Are Power Purchase and Similar Agreements Excluded from the Automatic Stay under the Safe Harbor for Forward Contracts? Recent US Utility Bankruptcies Raise This and Other Important Questions

Both the First Energy Solutions and PG&E bankruptcies have seen proceedings regarding power purchase and similar agreements (PPAs) that raise this question.

Background

Contracts often contain provisions that enable a party to terminate or modify the contract based on the other party's bankruptcy filing, insolvency or deteriorating financial condition. In general, the Bankruptcy Code renders these types of provisions (sometimes referred to as *"ipso facto"* clauses) ineffective. Specifically, under section 365(e)(1) of the Bankruptcy Code (**emphasis added**):

1. **Notwithstanding a provision in an executory contract** or unexpired lease, or in applicable law, **an executory contract** or unexpired lease of the debtor **may not be terminated** or modified, and any right or obligation under such contract or lease may not be terminated or modified, **at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—**

A. **the insolvency or financial condition of the debtor at any time before the closing of the case**;

B. **the commencement of a case under this title**; or

C. the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

The Bankruptcy Code generally renders such provisions ineffective because "automatic termination of a debtor's contractual rights [upon bankruptcy] frequently hampers rehabilitation efforts by depriving the chapter 11 estate of valuable property interests at the very time the debtor and the estate need them most."[1]

However, the Bankruptcy Code contains a number of statutorily defined exceptions to section 365(e)(1). Among these are "safe harbor" provisions that permit the liquidation, termination or acceleration of certain types of "qualified financial contracts" (including commodity contracts, forward contracts, repurchase agreements, securities contracts and swap agreements) upon a bankruptcy or similar default. The safe harbors reflect a policy objective of minimizing potential disruption of related financial markets and allowing prompt fixing of claims under such qualified contracts rather than risking delay and uncertainty as to the amount of losses and potential contagion to other market participants. As one early court decision noted in the context of commodity contracts and forward contracts, "[t]he failure to liquidate open positions of an insolvent customer would expose a commodity broker or forward contract merchant to liability for large

losses with respect to those positions and the consequent inability of the broker or merchant to meet its obligations to make margin payments, all of which could adversely affect the other members of the clearing chain."[2]

One such safe harbor provision is section 556 of the Bankruptcy Code, which provides (**emphasis added**):

> **The contractual right of a** commodity broker, financial participant, or **forward contract merchant to cause** the liquidation, **termination, or acceleration of** a commodity contract, as defined in section 761 of this title, or **forward contract because of a condition of the kind specified in section 365(e)(1) of this title**, and the right to a variation or maintenance margin payment received from a trustee with respect to open commodity contracts or forward contracts, **shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by the order of a court in any proceeding under this title**.

By its terms, section 556 does not create any greater termination or acceleration rights for a counterparty than the "contractual rights"[3] it has from non-bankruptcy sources. Thus, a counterparty seeking to terminate a forward contract based on an *ipso facto* condition must have such a contractual right. In addition, both the contract itself, as well as the non-debtor party seeking to terminate it, must meet the relevant statutory criteria. Specifically, for purposes of section 556: (i) the contract must qualify either as a forward contract or commodity contract; and (ii) the terminating party must qualify either as a commodity broker, financial participant or forward contract merchant. The recent bankruptcies of First Energy Solutions and PG&E Corp. (along with its primary operating subsidiary, Pacific Gas and Electric Company) have led to litigation over the scope of this safe harbor in the context of terminating PPAs.

First Energy Solutions

Following First Energy's bankruptcy filing, one of its customers (an auto parts manufacturer, Meadville Forging Company) terminated a power supply agreement with First Energy, contending that the safe harbor provisions of section 556 applied to it. First Energy then moved for a finding of contempt in the bankruptcy court, contending that the customer's actions violated the automatic stay. Since the parties had stipulated that the power supply agreement was a "forward contract," the only significant legal issue in resolving First Energy's motion was whether the customer was a "forward contract merchant" within the meaning of section 101(26) of the Bankruptcy Code. That section defines a "forward contract merchant" as (**emphasis added**):

a) Federal reserve bank, **or an entity the business of which consists in whole or in part of entering into forward contracts as or with merchants in a commodity** (as defined in section 761) or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade.

On January 15, 2019, Judge Koschik found in favor of First Energy and held that the customer's attempt to terminate its power supply agreement violated the automatic stay because the customer was not a forward contract merchant.[4] In reaching his decision, Judge Koschik noted that there was a split in authority regarding the breadth of the statutory definition. At one end of the spectrum was the narrow interpretation from the bankruptcy court in *Mirant Americas Energy Marketing, L.P. v. Kern Oil & Refining Co. (In re Mirant Corp.)*, 310 B.R. 548, 567 (Bankr. N.D.Tex. 2004), which focused on the words "business" and "merchant" in the statutory text. The *Mirant* court defined a "merchant" as "one that is not acting as either an end-user or a producer ... [r]ather ... is one that buys, sells or trades in a

market," 310 B.R. at 567, and defined "business" as "something one engages in to generate a profit," 310 B.R. at 567, 568 (citations omitted). Based on this, the *Mirant* court limited forward contract merchant status only to a person "that, in order to profit, engages in the forward contract trade as a merchant or with merchants." *Id.*

At the opposite end of the spectrum, Judge Koschik noted that at least one court[5] had concluded that the inclusion of the phrase "in whole or in part" in the definition has the effect of including "essentially any person that is in need of protection with respect to a forward contract in a business setting should be covered, except in the unusual instance of a forward contract between two non-merchants who do not enter into forward contracts with merchants." *BCP Liquidating LLC v. Bridgeline Gas Marketing, LLC (In re Borden Chemicals and Plastics Operating L.P.),* 336 B.R. 214, 225 (Bankr. D. Del. 2006) (punctuation corrected from original).

In ruling in favor of First Energy, Judge Koschik adopted a narrow interpretation that is largely consistent with the *Mirant* decision. In particular, the court concluded that to qualify as a forward contract merchant, a person "**must enter into forward contracts for the purchase and sale of electricity to generate a profit. Merely entering into supply contracts as an end user of electricity is insufficient**." Based on the evidence before it, the court held that Meadville Forging Company was not a forward contract merchant, because it solely purchased electricity as an end user.[6]

That said, even applying a narrow standard, the court failed to explain why it concluded that Meadville hadn't entered into the forward contract in order to generate a profit; after all, fixing costs so that products and services can be sold or provided for a profit is basic business. While it did not state it outright, the *First Energy* court may have viewed end users as not the intended beneficiaries of the safe harbor provisions since the risk of financial contagion is likely less with such parties than with brokers or financial intermediaries.

PG&E

More recently, ENEL Green Power North America filed a motion[7] in PG&E's bankruptcy case seeking confirmation that the safe harbor protections under sections 362(b)(6) and 556 apply to ENEL's capacity storage agreements with PG&E on the basis that ENEL is a forward contract merchant and that the capacity storage agreements are forward contracts.

In its related memorandum of law, ENEL notes that "forward contract" is defined in section 101(25)(A) of the Bankruptcy Code as follows:

> a contract (other than a commodity contract, as defined in section 761) for the purchase, sale, or transfer of a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase or reverse repurchase transaction (whether or not such repurchase or reverse repurchase transaction is a "repurchase agreement", as defined in this section) consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any other similar agreement;

and that section 761(8) of the Bankruptcy Code adopts the definition of "commodity" under the Commodity Exchange Act, which is found in section 1(a)(9) thereof and which provides (**emphasis added**):

> wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil,

> and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions (as provided by section 13–1 of this title) and motion picture box office receipts (or any index, measure, value, or data related to such receipts), **and all services, rights, and interests** (except motion picture box office receipts, or any index, measure, value or data related to such receipts) **in which contracts for future delivery are presently or in the future dealt in.**

ENEL noted that among the few cases in the Ninth Circuit to have addressed the issue of whether a contract is a forward contract, the primary decision on point is *Clear Peak Energy, Inc. v. S. Cal. Edison Co. (In re Clear Peak Energy, Inc.)*, 488 B.R. 647, 661 (Bankr. D. Ariz. 2013). In *Clear Peak*, the court found that a renewable PPA for electricity produced by a solar generating facility qualified as a forward contract after applying a four factor test, namely whether: (i) the subject of the contract was a commodity, with substantially all costs of performance attributable to the costs of the underlying commodity; (ii) the contract had a maturity date more than two days after the contracting date; (iii) the quantity and time elements were fixed at the time of contracting; and (iv) the contract had a relationship to the financial markets.

Critically, in *Clear Peak*, the court found a substantial relationship to the financial markets existed where the principal purpose of the PPA was to hedge the price the counterparty had to pay over the long term, even though the PPA also served the purpose of complying with a state law requirement that 33 percent of California's energy be sourced from renewable resources by 2020. The *Clear Peak* court determined that the PPA was part of a broader price-hedging scheme, whereby the counterparty acquired 98 percent of its power through short- and long-term PPAs with both renewable and conventional resources. Based on the complex mechanism the counterparty had created to evaluate the contracts that supply power to its customers, the court concluded that the primary purpose of the PPA was to allow the counterparty to hedge the price over the long term, thereby satisfying the fourth prong of the forward contract test.

ENEL argues that its capacity resource agreements are similar and also relate to a commodity, namely resource adequacy capacity, which is the primary product of the regulated resource adequacy framework in the California electricity market. Capacity is a product traded in various capacity markets in parallel with electricity markets throughout other independent system operator and regional transmission operator areas. As a result, ENEL is seeking confirmation that it may exercise any of its contractual rights pursuant to and in accordance with section 556.

It remains to be seen whether the *PG&E* court will agree.

Conclusion

As these cases clearly demonstrate, the potential application of the safe harbors for qualified financial contracts to PPAs and similar agreements is often far from clear. The provisions are relatively complex as applied to the variety of PPAs and other agreements used by energy market participants and courts have expressed differing views of their application, meaning and scope.[8]

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[1] *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 610 (1st Cir. 1995).

[2] *Matter of R.M. Cordova Intern., Inc.*, 77 B.R. 441, 448 (Bankr. D.N.J. 1987) (citations omitted). Although the court referred to the clearing chain, the financial contract safe harbors are concerned with market interdependencies more generally. See, e.g., *In re Olympic Natural Gas Company*, 294 F.3d 737, 741 (5th Cir.2002)(forward contract safe harbor applicable to off-exchange transactions).

[3] The term "contractual right" is defined in section 556 to include a "right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice" as well as rights set forth in the rules or bylaws of certain organized markets and clearing organizations.

[4] *See In re FirstEnergy Sols. Corp.,* No. 18-50757, 2019 WL 211807 (Bankr. N.D. Ohio Jan. 15, 2019). Judge Koschik's order included a lengthy discussion at footnote 5 of the distinction between the section 556 safe harbor (allowing termination of forward contracts) and the section 546(e) safe harbor (precluding avoidance of any margin or settlement payment and certain other transfers "by or to" a forward contract merchant under certain of the avoidance provisions of the Bankruptcy Code). Notably, to invoke the latter defense, a counterparty need not itself be a forward contract merchant so long as the debtor itself is one (as was almost certainly the case with respect to First Energy).

[5] *BCP Liquidating LLC v. Bridgeline Gas Marketing, LLC (In re Borden Chemicals and Plastics Operating L.P.),* 336 B.R. 214, 225 (Bankr. D. Del. 2006).

[6] The court held also that a stipulation in the power supply agreement that the parties were forward contract merchants was an unenforceable attempt to "contract into" a preferred status under the Bankruptcy Code.

[7] *See In re PG&E Corp,,* No. 19-30088, at Dkt. 81 ("Motion and Memorandum of ENEL Green Power North America for Entry of an Order Confirming Safe Harbor Protection Under 11 U.S.C. §§362(b)(6) and 556") (Bankr. N.D. Cal. Feb. 19, 2019).

[8] While this Legal Update is focused on the safe harbor for forward contracts, some PPAs and other agreements in use in the energy markets may be eligible for one or more of the other safe harbors for qualified financial contracts (for example, the safe harbor for swap agreements). The statutory requirements for those related safe harbors are different and beyond the scope of this Update.