Jared Ellias Public Testimony 3/4/2019

California State Senate

Chairman Hueso and the Honorable Members of the Committee:

Good morning. My name is Jared Ellias. I am an associate professor of law at the University of California Hastings College of the Law in San Francisco, where I teach courses in business law and bankruptcy law.

I was asked to today to provide you with some background on Chapter 11 bankruptcy as you consider your regulatory responsibilities and options when it comes to PG&E.

There is a great deal of confusion in the press and among even many lawyers about what Chapter 11 bankruptcy can do for a distressed company; my goal today is to clear up some of that confusion for you and provide a primer that will help you navigate what is shaping up to be one of the most complicated restructuring situations of all time.

In general, bankruptcy law solves the problems that financial distress creates. Imagine that somebody borrows $100 from a bank to invest in an opportunity, such as opening a store. Now let's imagine that store does not succeed and that person cannot pay back the bank. As a matter of law, we could take different approaches with this person. Should he be forced to work the rest of his life to get out from under this debt? Or should we have some sort of legal process where he can break his promise to the bank, get a fresh start and go on with his life, so long as creditors are provided with some basic level of protection?

The Federal bankruptcy code takes the position that the answer to this question should be: that he gets a fresh start. That's why I often teach my students that bankruptcy law is the law of breaking promises; promises that you made to creditors, the implicit promise you make to people who use your property that they will be made whole for any damages you cause; and promises you make to governments and courts.

Importantly, bankruptcy law provides for two basic treatments for distressed companies. When a company files for bankruptcy, they indicate what kind of bankruptcy relief they want. The first type of relief is a Chapter 11 reorganization. This is the most famous form of bankruptcy relief. At a high level, a firm files for Chapter 11 when they have an operating business that produces a profit but, perhaps, too much debt for the amount of profit that they have. So Chapter 11 provides an opportunity for the firm to reduce the amount of debt it has, as well as the ability to get rid of underperforming assets and shed bad contracts.

In some cases, firms could instead apply for a liquidation under Chapter 7. In a Chapter 7, a firm sells its assets, usually piecemeal, because there is no longer a good operating business worth saving and it may have assets, such as land, for example, that other companies can use.

PG&E filed for Chapter 11 bankruptcy on January 29, 2019, meaning that it intends to reorganize its business.

Next, I thought it would be useful to summarize why PG&E is better off because they filed for bankruptcy.

First, PG&E has about $20 billion dollars in bond and bank debt. While this sounds like a lot, it actually isn't a problem for PG&E – they are so large and produce so much revenue, they can easily service this debt. This means PG&E has a very different profile than your average corporate bankruptcy, where the problem usually is that the company borrowed too much money.

Instead, PG&E filed for bankruptcy because of the liability situation associated with various wildfires, especially the 2017 and 2018 wildfires. PG&E's CFO testified on the first day of the bankruptcy case that they face more than 5,600 plaintiffs who have filed more than 750 lawsuits related to those two fires. This litigation is incredibly complicated and will involve various subrogation lawsuits with insurers, and, of course, disputes with governmental entities.

Bankruptcy law provides for something we call an "automatic stay." The automatic stay of litigation means that all of those court cases involving PG&E – spread over 750 lawsuits – are instead channeled into the bankruptcy court's claims process. Outside of bankruptcy, a wildfire victim sues them in state court for relief. Inside bankruptcy, there is a federal statutory claims process where that same wildfire victim files a claim to be repaid.

The second benefit of Chapter 11 for PG&E is the ability to get new financing. PG&E has asked the court for permission to borrow $5.5 billion from a consortium of banks in what we call a "debtor-in-possession" (or "DIP") loan. Outside of bankruptcy, it might be hard for PG&E to borrow on attractive terms given the size of the wildfire liability claims. Inside bankruptcy, it can give a "super senior" claim to the new lenders, who are giving them cash knowing there is an almost 100% chance they will be repaid in full.

There are a couple of noteworthy things about this DIP loan that jump out at me as a bankruptcy expert.

First, the sheer size of it is unusual. This is a lot of money, and it reflects that investor community's confidence that PG&E is a strong business and also the belief that PG&E might be in bankruptcy for a long time.

Second, and relatedly, the DIP loan isn't due until December 31, 2020, and PG&E has the option to extend the loan until December 30, 2022 if it wants! That's a very long time in the bankruptcy world. The median public company that filed for bankruptcy between 2015 and 2018 needed about 160 days, or 5 months, to confirm a plan of reorganization, so a three year repayment period is an eternity.

The third reason why PG&E can benefit from bankruptcy is the opportunity to get out of unprofitable contracts and shed underperforming assets. A debtor in Chapter 11 has the power to tear up contracts when it makes business sense to do so; the counterparty to that contract might get a claim for damages, but that claims for damages might not end up worth much.

Finally, many firms use bankruptcy to improve their governance. PG&E is no exception, with the board currently in flux and various consultants on site to improve PG&E's internal controls and set them up to succeed in the future.

Before I speak specifically on how the PG&E bankruptcy process is likely to play out, I want to point out a couple of basic things about how bankruptcy law works.

First, a creditor in bankruptcy has a claim that is subject to "discharge." This means that the creditor's claim will be cancelled at the end of the bankruptcy case. The law provides that the creditors will receive the share of the debtor's assets they are entitled to. To the extent there are not enough assets to satisfy the claims of all creditors, creditors can be forced to accept a payment that does not satisfy all that they are owed.

Second, here, for the most part, wildfire victims and PG&E's bondholders have claims of equal priority. This means they will receive the same treatment in bankruptcy. This creates incentives, for example, for bondholders to try to do their best to disqualify the claims of wildfire victims. PG&E's shareholders are also likely to try to disqualify the claims of wildfire victims.

Third, bankruptcy law draws a distinction between pre-bankruptcy creditors and those who have claims that arise after a bankruptcy petition is filed. For example, a wildfire victim from 2017 is a "pre-bankruptcy creditor" or a "pre-petition creditor." These creditors have claims subject to discharge, as I mentioned.

Fourth and relatedly, post-bankruptcy creditors become "administrative claimants." This means that their debt must be paid in full before the firm is allowed to leave bankruptcy. What makes this case so remarkable is that if there are wildfire victims this summer in 2019, those victims will have claims that will become automatically senior to the 2017 and 2018 victims. Administrative claimants are always paid ahead of pre-bankruptcy creditors.

In fact, significant wildfire damage this summer could mean that PG&E has very little value for pre-bankruptcy creditors since, as a matter of law, administrative claimants get paid first.

As we consider PG&E's bankruptcy process, it's helpful to consider where we currently are to set the stage for what comes next.

As of now, Judge Montali has granted some preliminary requests of PG&E to do things like pay insurance and pay its workers. These are typical and noncontroversial. PG&E is also poised to borrow the DIP financing and have the funds for a long bankruptcy case.

The ideal of bankruptcy law is a fully negotiated resolution to the debtor's problems. While the background laws of bankruptcy provide for default treatment, the parties are supposed to bargain around them.

To lubricate negotiations, bankruptcy law appoints official committees of creditors. These official committees represent a specific interest in the case. They are also entitled to hire lawyers and consultants that will be paid for by PG&E.

Here, we have more official committees than we usually do. We currently have an official committee of unsecured creditors, that is more like an official committee of bondholders and companies that do business with PG&E as well as unions and pension creditors. There is also an official committees of tort victims, made up of 11 wildfire victims.

There are also likely several ad hoc committees of bondholders and shareholders that do not have "official status" (which means they have to pay for their own lawyers) that will also participate in the bankruptcy bargaining.

There's even a motion filed by a variety of California municipal entities impacted by the 2017 and 2018 wildfires, such as the City of Napa, Mendocino County and Sonoma County, among others, seeking court permission for their own official committee. They want to have their own seat at the bargaining table because they are not only concerned with past damages, like the wildfire victims, but what happens with PG&E in the future.

Importantly, some sort of process will be put into place to estimate the claims of the wildfire victims. There are different ways this could be done, and it could also be done while PG&E is in bankruptcy or after PG&E leaves, or some mixture of both. The bankruptcy judge will likely be in charge of it. It's also possible that there could be some sort of trust resolution process.

There's also a question of whether FERC can block PG&E from tearing up Power Purchase Agreements. This is an unsettled question of law. The Department of Justice has asked the federal district court to make this decision, but Judge Montali just signaled that he would like to do it. Whatever ends up happening, there will be an appeal by the losing side.

I want to underscore: This is a really complicated bargaining environment! Fortunately, some of the best bankruptcy lawyers in the country are working on this. Unfortunately, it will still be really hard.

Finally, just a couple of thoughts on where all of this will end up. PG&E has 18 months of "exclusivity," which means they have the exclusive right to propose a plan of reorganization. This agenda-setting power puts management in control of the case and you can expect that they will try to finish the bankruptcy process in that 18 months.

With that said, the company has yet to articulate publicly a concept for a plan of reorganization - which is not the norm in Chapter 11 practice these days, where management usually tries to tell the world where everything is going.

There are intense negotiations to come over important questions that will require days of hearings and many rulings from Judge Montali: How much past wildfire liability is there really? How does PG&E get in front of future liability? Will there be a big 2019 wildfire claim that "swamps" the existing debt? Will the legislature / CPUC provide PG&E with extra revenue or insurance? Will the CPUC support rate increases?

Two points are especially important to emphasize.

First, Judge Montali will only approve a plan of reorganization to let PG&E out of bankruptcy if PG&E can convince him that they are unlikely to file for bankruptcy again. This means that sometime in the next 18 months, PG&E will need some kind of solution to the problem of existential wildfire liability. This could take many forms – for example, improvements in safety that reduce the risks of fires, a state insurance pool, changes in inverse condemnation law or other liability reform.

Second, bankruptcy law requires a regulated entity to have the approval of its regulator for any rate increase that is part of a plan of reorganization. This means that, notwithstanding the automatic stay, the CPUC will have an important role to play in shaping the process since they will need to authorize a rate increase to the extent PG&E needs one.

In conclusion, you should think of PG&E as now being stuck in this federally created negotiating process where there are lots of players with their own agendas. There's also a federal bankruptcy judge who has the job of finding facts, making rules and prodding the sides to come to a negotiated resolution.

Given that PG&E is likely to need a rate increase, there is room for state government to shape the outcome of the bankruptcy. In fact, the state government may need to play a role, given the likelihood that PG&E will need a legislative solution to its overall liability problem for the future.

Thank you for your time.