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PG&E II: Utility's second bankruptcy to have far-reaching implications

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PG&E Corp. and its regulated utility subsidiary Pacific Gas & Electric Co. filed Chapter 11 cases Jan. 29 in the U.S. Bankruptcy Court for the Northern District of California.

The PG&E cases are among the largest and most complex bankruptcy cases of the last several years, with reported assets of $71.4 billion and liabilities of $51.7 billion.

The cases will affect 16 million customers, 24,000 employees, victims of the 2017 and 2018 California wildfires holding an estimated $30 billion in claims, holders of about $24 billion in funded debt, contract counterparties, insurers, equity holders, state regulators and government officials.

It is difficult to imagine a case with more far-reaching implications. With so many constituencies, myriad issues will arise.

This commentary will analyze two of the most significant matters: the quantification and treatment of present and future wildfire claims, and the potential rejection of power purchase agreements.

BACKGROUND

PG&E's difficulties largely stem from unprecedented wildfires in 2017 and 2018. The 2017 fires, which began Oct. 8 that year, caused 44 deaths, burned more than 245,000 acres and destroyed an estimated 8,900 structures, according to the California Department of Forestry and Fire Protection, or Cal Fire.[1]

Cal Fire indicated that the 2018 Camp Fire, which began Nov. 8, consumed 153,336 acres, caused 86 fatalities, and destroyed 13,972 residences, 528 commercial structures and 4,293 other buildings. The Camp Fire is the only 2018 fire for which PG&E has disclosed potential liability.[2]

Cal Fire has issued a determination on the cause of 18 of the 2017 wildfires (there were 21 total), saying that each involved Pacific Gas equipment.

This is significant because of the doctrine of "inverse condemnation," which imposes strict liability (including liability for attorney fees) for damages related to the design, construction and maintenance of utility facilities.[3]

Accordingly, PG&E is liable for damages caused by these fires, irrespective of whether it acted negligently or recklessly. With respect to the Camp Fire, no formal determination of cause has been made, although it has been found that the fire originated near PG&E transmission lines that show damage indicative of malfunction.

As of Jan. 11, PG&E was aware of 700 complaints filed on behalf of at least 3,600 plaintiffs related to the 2017 wildfires, five of which seek to be certified as class actions. The utility was also aware of 46 complaints filed on behalf of 2,000 plaintiffs related to the Camp Fire, six of which seek to be certified as class actions.[4] PG&E also faces claims from governmental entities and subrogation claims from insurance carriers.

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PG&E has only $840 million of insurance coverage for the 2017 fires, with an additional $1.4 billion for the Camp Fire.[5] Obviously, the potential liabilities greatly exceed these amounts.

PG&E disclosed these "extraordinary challenges" in a Jan. 14 filing with the Securities and Exchange Commission, noting that it had determined that "commencing reorganization cases under Chapter 11 of the U.S. Bankruptcy Code ... is appropriate, necessary and in the best interests of all stakeholders."[6]

This prompted a reaction from numerous parties, including counterparties to certain power purchase agreements, which have instituted actions before the Federal Energy Regulatory Commission, or FERC.

While these constituents will play a major role in the Chapter 11 cases and are discussed below, we start with the driving factor in the cases: the resolution of claims related to the 2017 and 2018 California wildfires.

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2017 AND 2018 CALIFORNIA WILDFIRE CLAIMS — AND BEYOND

PG&E has stated that the Chapter 11 cases are "not a strategy or attempt to avoid PG&E's responsibility for the heartbreaking and tragic loss of life, devastating damage and destruction to homes and businesses, and harm to communities that has been incurred because of the 2017 and 2018 Northern California wildfires."[7]

Instead, PG&E maintains that its principal objective is to establish a process to address and resolve its liabilities from the wildfires, and to pay those entitled to compensation. The debtors assert that Chapter 11 is the most efficient route to this end.

It is significant to note that the Chapter 11 cases provide the debtors with significant advantages in resolving litigation claims. First, the Bankruptcy Code provides for an "automatic stay" of the litigation, which precludes the commencement of any further litigation or the enforcement of any judgment obtained.[8]

This statutory "breathing spell" is critical. It provides PG&E time to formulate a cohesive plan to quantify and deal with the wildfire liabilities. It is also important that the claims can be adjudicated in a single forum, alleviating expense.

The debtors will have several tools at their disposal to institute a process to deal with claims. One tool that might be utilized is a channeling injunction, which directs claims to a litigation trust. Such a trust, generally funded by the debtor, would implement some protocol with respect to adjudicating, quantifying and ultimately satisfying claims, and would represent the sole avenue to recovery on specified claims.

The concept originated more than 25 years ago in the bankruptcy proceedings of Johns Manville Corp., which faced overwhelming tort liability as one of the largest producers of asbestos-containing products. It was ultimately codified in Bankruptcy Code Section 524(g).[9]

The channeling injunction/trust model has been utilized most recently in the bankruptcy of airbag manufacturer Takata Corp. to compensate claimants who suffered personal injury or wrongful death caused by the company's defective air bag inflators.[10]

Additionally, in January, auto parts manufacturer and distributor Maremont Corp., a subsidiary of Meritor Inc., filed for bankruptcy with a prepackaged reorganization plan that contemplates the establishment of a trust for the resolution of asbestos-related personal injury claims.

At the first-day hearings, the debtors suggested that they were considering the channeling injunction/trust model. If this path is chosen, the debtors would need to establish a protocol for addressing claims and determine the aggregate amount of funding for the trust, both of which would require court approval.

Each term would likely be a product of negotiation with interested constituencies, particularly wildfire claimants. It seems likely that these claimants' interests would be represented by a wildfire claimants' committee, which the U.S. Trustee has the power to appoint.[11]

In any case, setting up such a trust would take time and considerable thought. This may be a contributing factor to the debtors' expected two-year stay in bankruptcy.[12]

While bankruptcy positions the debtors well to deal with claims arising from the 2017 and 2018 California wildfires, a more important question may be how claims arising from potential future fires are addressed.

For example, if PG&E resolves the 2017 and 2018 claims, and a fire occurs in 2020, the process could simply repeat itself. The debtors assert that climate change has heightened the risk of future fires, making this issue paramount.[13]

The Chapter 11 cases will provide a platform on which all the parties in interest — ratepayers, financial creditors, litigation claimants, and state regulators and politicians — will need to resolve these issues.

It will be a fine line to walk. PG&E (as well as the state government and regulators) will have to carefully balance safety and expense.

For example, on Jan. 9, Judge William Alsup of the U.S. District Court for the Northern District of California, who is tasked with overseeing PG&E's probation stemming from a 2010 explosion, sought to modify PG&E's conditions of probation.[14]

His proposal would require that PG&E take actions to "reduce to zero the number of wildfires caused by PG&E in the 2019 wildfire season."[15] The debtors subsequently stated that complying was not feasible, and estimated that the cost to comply would be $75 billion to $150 billion. One of the debtors' unions agreed that the task was not logistically or economically feasible.

This is indicative of the difficulties the parties will encounter in seeking to substantially mitigate wildfire risk going forward at an acceptable cost. Moreover, the parties will need to consider how to allocate liability for future events.

Currently, under inverse condemnation, PG&E is subject to strict liability with respect to the operation of its equipment. California could consider changes to the doctrine (although these could be difficult to effectuate) or could implement legislative relief like Senate Bill 901, which allows PG&E to pass certain costs related to the 2017 wildfires to customers.

REJECTION OF POWER PURCHASE AGREEMENTS

Another issue that will be a focus of the PG&E bankruptcy proceedings — and energy industry participants worldwide — is the potential for the debtor to reject its power purchase agreements.

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Bankruptcy Code Section 365 gives a debtor the power to "reject," or to cease performing under, an ongoing contract. The rejection of a contract is treated as a court-authorized breach of contract as of the date the bankruptcy was filed and limits the nondebtor counterparty to asserting a claim for the breach against the debtor.

PG&E has noted that the power to reject power purchase agreements and other regulated agreements, or PPAs, is particularly important to its bankruptcy proceedings because they represent contractual commitments aggregating about $44 billion.

Anticipating the potential for PG&E to seek to reject certain of its power contracts, counterparties to wholesale PPAs with PG&E initiated proceedings before FERC, requesting an order that provides, "PG&E may not abrogate, amend, or reject in a bankruptcy proceeding any rates, terms and conditions of its wholesale power purchase agreements subject to the commission's jurisdiction without first obtaining approval from the commission."[16]

While bankruptcy positions the debtors well to deal with claims arising from the 2017 and 2018 California wildfires, a more important question may be how claims arising from potential future fires are addressed.

In response, FERC issued orders stating that "this commission and the bankruptcy courts have concurrent jurisdiction to review and address the disposition of wholesale power contracts sought to be rejected through bankruptcy."[17]

The issue of whether a debtor can reject a FERC-regulated contract in a bankruptcy proceeding relates to the Federal Power Act, or FPA, which provides that energy contracts must be filed with FERC and FERC is vested with the exclusive authority to determine the reasonableness of wholesale electricity rates.

Moreover, the "filed rate doctrine" states that a utility's right to a reasonable rate under the FPA is the right to the rate that FERC files or fixes and, except for review of FERC orders, a court cannot order a different rate or collaterally attack the reasonableness of the rate.

In the proceedings before FERC, the contract counterparties argue that the filed rate doctrine preempts a bankruptcy court's ability to approve a debtor's rejection of a FERC-regulated contract.

In response, PG&E has sought to terminate the proceedings before FERC and enjoin FERC from impeding the Bankruptcy Court's authority to approve or deny the debtor's requests to reject executory contracts.

This issue has some recent history. In 2018 the U.S. Bankruptcy Court for the Northern District of Ohio, overseeing the FirstEnergy Solutions bankruptcy, was faced with a similar request.

Ultimately, in issuing a preliminary injunction, the FirstEnergy court ruled that FirstEnergy's bankruptcy filing gave the court exclusive jurisdiction to decide motions to reject FERC-regulated PPAs.[18]

While the Bankruptcy Court noted that FERC's jurisdiction over rates charged in the wholesale power market was not preempted by the exclusive jurisdiction of the bankruptcy court, the court found that the rejection of a power purchase agreement is not a collateral attack on the filed rate.

The Bankruptcy Court reasoned that rejection is treated as a breach of contract, not a request for modification of the rate under the FPA, and thus the appropriate remedy for the nondebtor counterparty is to file a claim in the bankruptcy case for breach-of-contract damages at the filed rate. These findings are on direct appeal to the 6th U.S. Circuit Court of Appeals.

The decision from the Ohio Bankruptcy Court mostly adopts the 2004 ruling by the 5th U.S. Circuit Court of Appeals in the Mirant Corp. bankruptcy cases.

There, the 5th Circuit ruled that a debtor's motion to reject a FERC-regulated PPA in bankruptcy is not a challenge to the filed rate, and therefore the FPA does not preempt the court's ability to rule on a rejection motion.

Unlike the *FirstEnergy* ruling, however, the 5th Circuit suggested that a heightened standard should apply to the rejection of FERC-regulated contracts to account for the public interest inherent in the transmission and sale of electricity.[19]

While the 5th Circuit decision in *Mirant* is the only circuit court precedent, it has not been unanimously adopted by bankruptcy courts outside the 5th Circuit.

For example, the U.S. District Court for the Southern District of New York in the Calpine Corp. bankruptcy cases found that a bankruptcy court lacks jurisdiction to authorize the rejection of FERC-regulated power purchase agreements because doing so would constitute a collateral attack on the filed rate itself and would directly interfere with FERC's jurisdiction over the rates, terms, conditions and duration of wholesale energy contracts.[20]

There is no controlling precedent in the 9th Circuit. Thus, given the diverging case law, whether PG&E can reject its PPAs without FERC approval will be hotly contested and closely followed by major industry players.

CONCLUSION

This commentary discussed two major issues that will be addressed in the Chapter 11 cases, and that will impact millions of people.

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There are surely others — the role of equity holders, who will seek to unseat the board of directors and form an equity committee, and the treatment of billions of dollars in employee pension obligations immediately come to mind — but those are outside of the scope of this analysis.

One thing is readily apparent — the PG&E Chapter 11 cases will have significant ramifications and will bear watching for the next several years.

NOTES

[1] *PG&E Corp. Form 8-K* (Jan. 14, 2019).

[2] *Id.*

[3] Declaration of Jason P. Wells in Support of First Day Motions and Related Relief, *In re PG&E Corp.*, Case No. 1930088, at 14.

[4] *Id.*

[5] *PG&E Corp.* Form 8-K (Jan. 14, 2019).

[6] *Id.*

[7] Wells Decl., *supra* note 3, at 4.

[8] 11 U.S.C.A. § 362(a)(1)-(2).

[9] 11 U.S.C.A. § 524(g) specifically relates only to asbestos claims. However, courts have utilized channeling injunctions in other cases under the auspices of Bankruptcy Code Section 105.

[10] Third Amended Joint Chapter 11 Plan of Reorganization of TK Holdings Inc. and its Affiliated Debtors, Jan. 5, 2018, *In re TK Holdings Inc.*, Case No. 17-11375, ECF No. 1629.

[11] *See* 11 U.S.C.A. 1102(a)(1)-(2).

[12] *PG&E Corp.* Form 8-K (Jan. 21, 2019).

[13] Wells Decl., *supra* note 3, at 4-5.

[14] *United States v. Pac. Gas & Elec. Co.*, No. 14-0175 (WHA) (N.D. Cal. Jan. 9, 2019).

[15] *Id.* at 3.

[16] Order on Petition for Declaratory Order and Complaint, *NextEra Energy Inc. and NextEra Energy Partners LP v. Pacific Gas and Electric Co.*, 166 FERC ¶ 61,049, Docket No. EL 19-35-000 (Jan. 25, 2019); Order on Petition for Declaratory Order and Complaint, *Exelon Corp. v. Pacific Gas and Electric Co.*, 166 FERC ¶ 61,053, Docket No. EL 19-63-000 (Jan. 28, 2019).

[17] *Id.*

[18] *FirstEnergy Solutions Corp. v. Fed. Energy Regulatory Comm'n*, No. 18-05021, 2018 WL 2315916, *17 (Bankr. N.D. Ohio May 18, 2018).

[19] *Mirant Corp. v. Potomac Elec. Power Co.*, 378 F.3d 511 (5th Cir. 2004).

[20] *Cal. Dep't of Water Res. v. Calpine Corp. (In re Calpine Corp.)*, 337 B.R. 27 (S.D.N.Y. 2006).

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