NCRA CONFERENCE RECEIVERSHIP SESSION OUTLINE

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I. OVERVIEW

Purpose of this Presentation is to provide an overview of Receiverships and Liquidations within the utility area.

II. INTRODUCTION

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III. IDENTIFY SITUATIONS WHERE A RECEIVERSHIP OR LIQUIDATION ACTIONS SHOULD BE CONSIDERED WHEN IT INVOLVES A UTILITY

A. The Utility Has <u>Critical Operational Failing(s) or Financial Failing(s)</u>

1. **Example Red Boiling Springs -stopped billing customers**
2. **Example Laurel Hills – turned off water/ no license or CCN**

B. A <u>Corrective Action Plan</u> has been initiated by the Regulatory Body.

1. **Example – ordered to obtain necessary regulatory license**
2. **Example – make certain financial reporting**
3. **Example – ordered to make certain operating changes or improvements**

C. Utility is <u>not complying or unable to comply with Corrective Action Plan</u>

IV. RECEIVERSHIPS

A. <u>What is a Receivership</u>?

1. **Statutes vary by state**
2. **General authority across the states to take over and operate the utility**

B. Factors to Consider when Determining if you should consider a Receivership:

1. **Is the Customer Base Stable?**

2. **Is Utility system's plant and equipment sufficiently stable and reliable to deliver service to customer base;**

3. **Are there other market services not being operated (i.e. are there other sources of revenue available?)**

4. **Is there capacity for rate increases?**

5. **Is there the possibility to expand customer base because system has more capacity?**

6. **Are the existing staff able to operate the utility (in whole or in part) consistent with regulatory requirements to have the license or right to offer utility service;**

7. **Do you anticipate existing utility will cooperate with the regulatory body's proposed action?**

8. **Are there any existing employees who are reliable and possess the necessary expertise to operate the utility or assist in operating the utility?**

9. **Do you plan to take the asset away as part of your regulatory action? If this action is planned – you must be able to provide your case to get permanent action.**

10. **Are there other persons who could operate and would want to operate the utility in the area?**

11. **Is it an essential utility service – required for health and safety?**

If any of these result in negative responses, rehabilitation of business is probably not an option.

C. Positive Attributes of Using a Receivership

1. **Power of the Court to Require Action;**

2. **Immediate Control of Operations;**

3. **Immediate Control of Finances;**

4. **Potential discharge of certain debts or other obligations;**

5. **Ability to direct, conduct and immediately implement efficient and safe operations;**

6. **Ability to Select Responsible Operators (i.e. qualified to provide utility service).**

D. <u>Negative Attributes of a Receiverships</u>

1. **Expensive (costs paid by State/Regulatory Body);**

2. **May involve a lot of Litigation – complex process;**

3. **May Strain Existing Regulatory Resources Needed for other matters;**

4. **Judge's orders may not be what the regulator or fiduciary operator wanted to take place;**

5. **Rate Increases (hefty); and**

6. **Cannot Operate the Utility in Perpetuity.**

E. <u>How is a Receivership Designed to be Concluded?</u>

1. **Adoption of a Receiver Plan;**

2. **Return of Business to Previous Owners;**

3. **Auction of the Business; or**

4. **Transfer to New Operators.**

V. LIQUIDATION

A. <u>What is a Liquidation</u>?

1. **Statutes vary by state**

B. <u>Why Is Liquation Not usually an Option for Utility Situation?</u>

1. **General goal is to cease and not re-continue the operation of the business/utility.**

2. **It is not an option because of the necessity of continued service for the customers – must have water and sewer service.**

VI. QUESTIONS

NCRA CONFERENCE
BANKRUPTCY PROVISIONS AFFECTING UTILITIES AS A DEBTOR

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A. Summary of Pacific Gas & Electric Chapter 11 Case

On January 29, 2019, Pacific Gas & Electric (PG&E) filed for relief under Chapter 11 of the U.S. Bankruptcy Code in the Northern District of California. This filing was prompted by its potential liability resulting from wildfires occurring in California in 2017 and 2018. The potential liability from the wild fires was estimated to be $30 billion. In addition PG&E has $24 billion in debt obligations consisting of trade debt, term loans, senior notes, pollution bonds and revolver facility and will incur debtor-in-possession financing in its Chapter 11 case in the amount of at least $5.5 billion. Its total assets are estimated to be approximately $71.4 billion at book value and it has 24,000 employees involving three labor unions. Affected by the bankruptcy are 17 million customers and the following regulatory entities: CPUC, Federal Energy Regulatory Commission (FERC) and Nuclear Regulatory Commission (NRC).

B. Chapter 11 Cases

1. <u>Summary of Chapter 11.</u>

Any corporation or individual that is not a municipality is eligible to file for Chapter 11. Immediately upon the filing of such a case there is an automatic stay that enjoins any legal proceedings that could be commenced against the debtor. Thus in the case of PG&E, this stopped all of the litigation initiated regarding the 2017 and 2018 wildfires. Procedurally upon the filing of a Chapter 11 case, no trustee is appointed, but instead a committee of creditors is appointed by the U.S. Trustee, who monitors the Chapter 11 case. The U.S. Trustee has no other operational duties regarding the debtor's assets. In a large case such as PG&E there may be multiple committees because of the diverging interests among interested parties. For example, the personal and property injury claimants will have different interests than normal trade creditors. In most instances, however, specific creditors such as secured creditors or regulatory authorities will not be members of a committee but will need to represent their own interest.

A meeting of creditors is scheduled at the end of the first month of the case in order to provide an opportunity for creditors to ask questions of the debtor under oath. Following that meeting, the debtor has the exclusive right over four months to file a plan. No other creditor can propose a bankruptcy plan during this period. This exclusive period may be extended up to 18 months, and is often extended in large Chapter 11 cases.

Operationally, the debtor is authorized to continue dealings in the ordinary course of business without court approval or interference. The sale of assets or new loan agreements incurred outside the ordinary course of business, however, will require court approval.

The debtor will continue to be obligated to perform under contractual agreements, provided no payments will be necessary until a plan is approved regarding any obligations under such contracts that existed before the filing of the bankruptcy. As it relates to unexpired leases and executory contracts, the debtor will be entitled to reject or assume such contracts. If it assumes the contract, it must promptly cure any prepetition defaults. If it rejects a contract, all obligations owing under that contract will become prepetition obligations, including obligations in the future that may be required of the debtor under that contract. This provision provides the debtor an opportunity to rid itself of burdensome contracts, but the obligations will still exist and will have to be paid pursuant to the plan. Effectively by rejecting the contract, the debtor avoids having to make immediate payment obligations under that contract.

2. Regulatory Authority in Bankruptcy Cases

There are two provisions in Chapter 11 that relate to regulatory authority in a Chapter 11 case. As a general matter, 11 U.S.C. § 1142(a) states as follows:

> Notwithstanding any other applicable non-bankruptcy law, rule, or regulation relating to financial condition, the debtor and any entity to be organized for the purpose of carrying out the plan shall carry out the plan and shall comply with any orders of the court.

This seems to give the Bankruptcy Court authority to confirm a plan "notwithstanding any otherwise applicable non-bankruptcy law, rule or regulation relating to financial condition of a debtor." Nevertheless, the forerunner of the Bankruptcy Code enacted in 1978 was the Chandler Act of 1938. It had a Chapter X that specifically required a reorganized public utility debtor and any corporation organized or to be organized to procure authorization, approval, or consent of the appropriate regulatory commission prior to its plan being approved. This also required plan approval by the state regulatory commission if the debtor was an interstate public utility. In addition, the Public Utility Holding Company Act of 1935 stated that a plan of a registered utility had to be approved by the Securities and Exchange Commission. (49 Stat. 838, § 11(f); 15 U.S.C. § 79(f). There is no reason to believe the Bankruptcy Code was intended to usurp the jurisdiction of a regulatory agency, particularly if the plan provides for changes in tariffs, service, or other regulated terms, but the Code provisions are less general in what is subject to regulatory approval.

Bankruptcy Code 11 U.S.C. § 1129(a)(6) is a provision that specifically requires regulatory approval of rate changes before a plan is approved:

> Any governmental regulatory commission with jurisdiction, after confirmation of the plan, over the rates of the debtor has approved any rate change provided for in the plan, or such rate change as expressly conditioned on such approval.

A federal court provision in title 28 gives further support for regulatory authority. 28 U.S.C. § 959(b) states as follows:

> (b) Except as provided in section 1166 of title 11, a trustee, receiver or manager appointed in any ca0se pending in any court of the United State, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

Nevertheless, courts have found it difficult in some cases to deal with regulations in the context of a Chapter 11 case. In *Public Service Co. of New Hampshire*, the court stated as follows:

> It has become abundantly clear to this court in the five months that have transpired in this proceeding that the deceptively simple and discreet words "rates", "rate base", "tariffs" and "prudency" that govern the utility regulation world are clearly overlapping and conflicting with the words "valuation", "claims determination", "sale of assets" and "fair and equitable" that largely govern the bankruptcy reorganization world."

In re Public Service of New Hampshire, 88 B.R. 521 (Bankr. D. N.H. 1988); *see also* 114 B.R. 820 (Bankr. D. N.H. 1990) and *In re Auto-Train Corp*., 6 BR 510 (Bankr. D. D.C. 1980).

Also, the Fifth Circuit concluded that there was no intention by Congress in enacting the Bankruptcy Code in 1978 to limit the debtor's ability to reject utility contracts as authorized under Code § 365. *See In re Mirant Corp.*, 378 F.3d, 511, 521 (5th Cir. 2004). This decision was not followed by a U.S. District Court in the Southern District of New York, however, which held that the bankruptcy court did not have authority to approve the rejection of a filed rate "Power Agreement" because such a rejection would directly interfere with the jurisdiction of the Federal Energy Regularory Commission (FERC). *See In re Calpine Corp.*, 337 B.R. 27 (S.D.N.Y. 2006).

3. The Automatic Stay Exceptions Under the Bankruptcy Code

The Bankruptcy Code provides exceptions to the automatic stay that is imposed upon the filing of a Chapter 11 case for governmental units to enforce police and regulatory powers. In analyzing whether an action is under the police and regulatory powers, the courts have to consider whether the government is actually seeking to recover a claim, such as reclamation for environmental problem, or seeking an injunction to stop the harm that is taking place. Claims for collection of money are typically not excepted from the automatic stay, whereas injunctions to stop unlawful actions would be excepted from the stay. In the healthcare area, this has become litigated because many times the penalties are monetary in effect and not centered around injunctive relief.

4. Treatment of Executory Contracts in Bankruptcy Cases

Bankruptcy Code § 365 permits the debtor in a bankruptcy case to assume or reject executory contracts. Executory contracts are not defined in the Code but have been held to apply to contracts where both sides have material requirements yet to be performed. For example, an unexpired lease of real property or an employment contract fall within this category. Utilities will certainly have contracts both in providing the source of the utility and in providing that utility to its customers. In order to assume a contract, the debtor must promptly cure any default that existed prior to the filing of the bankruptcy and show that it has the ability to continue satisfying all post-petition obligations under the contract.

As it relates to a utility dealing with its customers, when a customer files bankruptcy, the utility must still continue to provide the services as long as the customer provides an assurance of future performance within 30 days after the filing of a Chapter 11 case (20 days for Chapter 7 and 13 cases). If this is not provided within this required timeframe, the utility may terminate the service. This assurance of payment may be in the form of a cash deposit, letter of credit, certificate of deposit, surety bond, pre-payment of utility consumption, or another form of security that is mutually agreed on between the utility and the debtor. The Code specifically states that an administrative expense priority shall not constitute an assurance of payment. Thus, the debtor cannot rely on the fact that the post-petition obligation would be an administrative expense priority in providing adequate assurance.

If the debtor decides to reject the contract, then the other party to the contract will have a claim against the bankruptcy estate for all amounts owed prior to the filing of the bankruptcy and for which the creditor would have been paid after the filing of the bankruptcy under the terms of the agreement that was rejected. This may be subject to a discount for present value purposes and the principal of mitigation may reduce the amount that parties may recover upon a breach of the agreement.

5. First Day Motions in Chapter 11 Cases

In the beginning of a case there are certain initial important motions that are typically filed.

a. Joint Administration.

In many large Chapter 11 cases, there are multiple affiliates that have to file as well. The courts generally permit the debtor to jointly administer all of these cases under one case number so that separate pleadings will not have to be filed in each individual case. This joint administration, however, does not subsequently consolidate the assets of these debtors unless a separate determination is made by the Court.

b. DIP Financing.

In most cases the debtor needs some additional financing in order to pay payroll and cover post-petition operating expenses that must be paid. If the debtor has sufficient cash flow it may be able to avoid any new loans and just use its own cash flow for the payment of these obligations. Most lenders, however, prefer a DIP Financing Order before advancing any new funds.

c. Cash Management System.

In most large Chapter 11 cases the debtor and its affiliates operate under a single cash management system. Chapter 11 contemplates that each debtor will have its own bank account, but courts often permit a preexisting consolidated cash management system to continue in order to avoid disruption in the issuance of checks and the deposit of electronic funds.

d. Prepetition Wages.

Inevitably when a debtor files Chapter 11 there will be certain prepetition wages that have not been paid as of the date of the filing of the bankruptcy since most payrolls have at least one or two weeks in arrears. Thus court approval is necessary in order to make even the most routine payroll that typically will be scheduled in a week or so after the filing of the bankruptcy. Most courts permit the payment of prepetition wages since those wages have priority under the Bankruptcy Code and thus would likely be paid in full anyway. Allowing uninterrupted payroll at the beginning of the case avoids uncertainty among the employees and enables the debtor to continue operations smoothly. These orders also include the payment of benefits, continuation of employee withholding, the payment of supplemental workforce on a temporary basis. In the PG&E case, these employee obligations totaled approximately $220 million.

e. Customer Programs.

In large Chapter 11 cases, there are often programs that are contractual in nature with customers. For example, in a utility case, there may be security deposits that are being held for the utility's customers, and, these deposits are returned to the customer in the ordinary course of business as accounts are closed. The refund of these funds would need to be approved by the Bankruptcy Court in the beginning of a case.

f. Prepetition Obligations to Critical Vendors, Shippers, and Warehouses.

In any large case, there will often be vendors who are critical to the operation of the debtor's business, and these vendors may refuse to continue operations after the filing of the bankruptcy. In order to entice them to continue their business relationship, debtors often get approval from the court to allow the payment of certain prepetition obligations, as long as the vendor continues to provide the services that are required. Shippers and warehouses may also assert liens on property in their possession, and payment of prepetition obligations may be necessary to continue operations. In the PG&E case, these critical vendors totaled $65 million for shippers and warehouses and $116 million for suppliers, which constituted 5.5% of the total trade debt.

g. Insurance Policies.

Any business will require the continuation of certain insurance policies which may require the payment of premiums that were owed prior to the filing of the bankruptcy. These prepetition obligations are typically approved for payment in order to maintain these important policies.

h. Prepetition Taxes.

Many of these obligations are priority claims and would receive payment ahead of unsecured creditors in a Chapter 11 case. Often the debtor will get approval from the Bankruptcy Court to allow the continued payment of these prepetition taxes, similar to the approval received for the payment of payroll. In the PG&E case, these obligations totaled $139 million.

i. Adequate Assurance.

Utilities are required to continue to provide services to a debtor pursuant to Code § 366 for a period of twenty days. This obligation may be extended by the debtor upon providing adequate assurance that it will continue to provide the payment of charges incurred to the utility. Typically an individual debtor will agree to provide a one month security deposit if it has not already been provided a security deposit. Courts generally approve this deposit as sufficient adequate assurance. In the PG&E, case there were 150 providers of which $8.6 million was over thirty days past due. PG&E proposed to deposit in an interest bearing account two weeks of utility service subject to an objection to be filed by the utility provider that more was needed. None of this would have been applicable if there existed a security deposit. The estimated obligation for adequate assurance in the PG&E case was $4.8 million.

j. 503(b)(9) Claims.

Another priority obligation that a debtor has in a Chapter 11 case is to pay for goods received within twenty days of the filing of the bankruptcy. These obligations have priority over other unsecured creditors. Most large cases will have procedures for how creditors may assert these 503(b)(9) claims.

k. Prepetition Obligations to Natural Gas and Electric Exchange Operators.

In the PG&E case, the debtor had certain prepetition obligations to ICE NGX Canada and the California Independent System Operator Corp. (CAISO). A court order was entered to permit setoffs for the exchanges being made between these entities in the ordinary course of business.

6. Approval of a Chapter 11 Plan

For a debtor to receive approval of a Chapter 11 plan, it must pay the priority claims on the effective date of the plan, which typically is a month or so after the court approves the plan, and must also show to the Court that the treatment is fair and equitable as to the secured and unsecured claims. For it to be fair and equitable to the secured creditors, the Code states that the secured creditors should receive the present value of the value of its collateral to be paid over the useful life of that collateral. As it relates to unsecured creditors, however, the absolute priority rule applies. This rule states that senior classes of creditors must consent to a plan or be paid in full before any payments can be made to junior interests. This means that the equity interests in the debtor will be terminated unless the creditors consent to the plan or are paid in full. In the case of a for-profit entity in which the equity seeks to remain in control, this is an important limitation and insures that creditors get 100% payment for the plan to be approved.

As discussed above, section 1129(a)(6), specifically requires a plan to be approved by any "governmental regulatory commission with jurisdiction . . . over the rates of the debtor."

C. Chapter 7 Cases

The Chapter 7 bankruptcy option is a complete liquidation of the debtor. A trustee is immediately appointed upon the filing and the debtor loses control of its operations. It is assumed that the operations will cease, although a trustee can get court approval to continue operations if that is necessary to wind up the business. In most instances, it would be very unusual for a utility to file a Chapter 7 since its operations would need to continue. An exception would exist if the debtor sold its assets and no longer had any operations. In that case, it would only have non-operating assets to be liquidated and distributed to creditors. A liquidation could also occur in a situation when the debtor plan is not successful and the utility ends up being shut down for liquidation purposes.

Chapter 7 trustees are often motivated to sue creditors to recover payments made by the debtor to the creditor prior to the filing of the bankruptcy case. These payments are generally known as preference payments and may be avoided pursuant to section 547 of the Bankruptcy Code. The elements of such an action are as follows: (1) transfer of asset or payment in satisfaction of an antecedent claim, (2) made within 90 days of the filing of the bankruptcy, (3) made while the debtor was insolvent (presumed to be satisfied within 90 days of the filings), and (4) provides the creditor more than the creditor would receive in a liquidation. The most common exceptions to protect the creditor from such avoidance actions are (1) the ordinary course of business defense (§ 547(c)(2)), and (2) the new value defense (§ 547(c)(3)).

D. Chapter 9 Cases

Chapter 9 may be available for a debtor who qualifies as a "municipality" under Code § 101(40). This definition states that a municipality includes a political subdivision, public agency or instrumentality of a State.

For a municipality to file, there are several preliminary requirements that must be met. First, the municipality must be specifically authorized by the State to seek bankruptcy relief. This was a requirement imposed by the states when the Bankruptcy Code was originally enacted by Congress. Although Congress had the right to enact bankruptcy laws, states still wanted to retain control over whether one of its entities were subject to the federal law.

Additionally the municipality must be insolvent (i.e. generally not paying undisputed debts as they become due or unable to pay debts as they come become due). Prior to filing for bankruptcy, a municipality must have either (a) reached an agreement with creditors regarding treatment in a plan; (b) negotiated in good faith with creditors and failed to obtain an agreement regarding treatment in a plan; (c) is unable to negotiate with creditors because negotiations are impracticable; or (d) reasonably believes that a creditor will attempt to obtain a preferential transfer.

Assuming that no agreement is reached in creditor negotiations, the municipality may file for bankruptcy, but creditors can still contest eligibility. The Chapter 9 case of an eligible municipality will have many differences from the normal Chapter 11 case, including:

1. No trustee can be appointed in a Chapter 9 case.

2. The U.S. Trustee may appoint committees, however, at least one court has held that there is no statutory authority to appoint an unsecured creditor's committee since § 1102 appears to limit this authority to Chapter 11 cases.

3. The bankruptcy court has little oversight authority over the municipal debtor's operation or management of property. These limitations are necessary to comply with the Tenth Amendment to the United States Constitution, which requires that a municipality control its political and governmental affairs, even in bankruptcy. Among other things, there is no "property of the estate" in a Chapter 9 case. This is a major distinction from Chapter 11 because municipal debtors may pay pre-petition expenses and claims in the ordinary course of business without limitation. The municipal debtor in a Chapter 9 case is free to obtain credit without court approval, other than secured credit or credit to be provided a super priority administrative status.

4. Bondholders' interests in "pledged special revenues" (ie, revenues from operation of utilities, among other things, pledged to secure debt) have special protections in Chapter 9 to ensure that such revenues remain subject to a prepetition pledge. However, such pledges of special revenues are still subject to payment of necessary operating expenses for the utility.

5. A municipality's plan of adjustment does not have to meet the liquidation test (since there is no liquidation of a municipality in Chapter 9) which requires the debtor to pay at least as much as the creditors would have received in a Chapter 7 liquidation.

6. There is no deadline for filing a plan of adjustment until the court sets a deadline.

7. Generally the confirmation requirements for a plan of adjustment are similar to a Chapter 11 case. One major distinction is that since there is no equity in a municipal debtor, the absolute priority rule would not apply except to the extent that junior debt claims may not receive payments until a superior claim is paid in full.

8. The debtor must pay all administrative claims on the effective date of the plan, much like a Chapter 11 plan.

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9. The Code provisions applying to the employment of professionals and approval of professional fees do not apply in Chapter 9 cases. Professional fees only have to be disclosed and shown to be reasonable upon the confirmation of the plan.

10. The regulatory approval for plan confirmation required in Chapter 9 is broader than in Chapter 11. It is not limited to "rates" and states as follows:

> Any regulatory or electoral approval necessary under applicable non-bankruptcy law in order to carry out any provision of the plan has been obtained, or such provision is expressly conditioned on such approval.
> 11 U.S.C. § 943(b)(6).