Agenda (a newsletter circulated to business leaders by Financial Times)

Bonuses Slapped Down at Bankrupt PG&E

By Tony Chapelle September 23, 2019

Top executives at embattled **PG&E** had their request for $11 million in performance bonuses quashed last month by the federal bankruptcy court in charge of the company's restructuring.

Creditors and others affected by the company cheered the Aug. 30 decision. The judge overseeing the case ruled that he wouldn't allow the utility company's managers to receive any incentive pay without them showing a clearer link to safety improvements. He also questioned whether the company could afford to pay added compensation. PG&E went into bankruptcy last January after claiming it faces $30 billion in potential liability because of its role in causing a rash of California wildfires.

"The judge made a common-sense judgment," writes activist investor **Jing Zhao** in an e-mail. "In fact, it is not enough to deny new million-dollar compensation to the new executives. [The judge] should claw back the millions already paid to the old executives."

Zhao's proposal to eliminate the subsidiary layer at PG&E went to a proxy vote this year. Thirteen percent of shareholders supported his resolution to streamline the corporate makeup, which he claimed would save on management compensation.

"This is very supportive [of] my request to dramatically reduce executive pay [by] at least half," Zhao concluded.

Yet bankruptcy judges and trustees frequently allow boards to pay executive bonuses while they're reorganizing under Chapter 11. So even though survivors of the catastrophic wildfires consider it unthinkable that some of the same managers who were around when the firm ran into insolvency are seeking incentives, governance and bankruptcy experts predict that it's not a matter of if but how much they'll ultimately be awarded.

Last April, Judge **Dennis Montali**, who is presiding over the case at the federal bankruptcy court for the Northern District of California, approved a $235 million annual bonus plan for 10,000 mid-level PG&E employees. The top 12 executives, who did not include new CEO **William Johnson**, didn't participate in that pool. But on Aug. 9, attorneys for PG&E argued that the executives should be awarded bonuses to "appropriately incentivize" them. To that, Montali quipped, "If they're not incentivized enough, they ought to find another job, frankly."

That misses the mark from a legal standpoint, says **Howard Brod Brownstein**, who has been a chief restructuring officer in bankruptcies. "One has to focus on the overall recovery of the company."

Brownstein is a director at **P&F Industries** as well as a certified turnaround professional who operates **Brownstein Corporation**, a turnaround management firm. He and other directors maintain that, since bankruptcy is the process by which creditors (and shareholders, if there's anything left to pay them) receive money or assets from the crippled company, it's vital that the enterprise that emerges from bankruptcy be strong enough to operate. For that, says Brownstein, "you need a knowledgeable and capable management team, who understandably will require more pay … for taking the risk of being at a company that may not survive."

The Ghost of AIG

Dennis Chookaszian, who has served on 13 public company boards and who teaches corporate governance at the **University of Chicago**, says the PG&E case reminds him of the infamous bonus controversy that occurred at **AIG Group** in the wake of the global financial crisis.

Although AIG was the company that most directly wrecked the financial system due to its enormous market in subprime-mortgage credit default swaps, the federal government still assured the company it would be bailed out. In 2008, Treasury Secretary **Hank Paulson** appointed **Ed Liddy** as CEO of the troubled company. Liddy requested to be paid only $1 a year. Yet just months after AIG accepted a $37 billion loan from Uncle Sam, other managers at the insurer feasted on $165 million in retention bonuses.

Contractually, Liddy was obligated to pay the bonuses. But he appealed to the executives' consciences and asked them to return the extra pay so the company could climb back into the black quicker. Many likely declined his request, although the response to the giveback request was not revealed. His only other recourse would have been to bring a lawsuit, which Chookaszian thinks Liddy would have lost. "So he had to pay them so as to keep those executives working for AIG and keep the company going," Chookaszian says.

The situation is similar with PG&E, Chookaszian says. "The judge probably has to pay some bonuses to keep the people."

The Haggle

Chookaszian predicts there will be continuing negotiations between the judge and the utility's attorneys. He says the judge probably will attempt to help the company hold on to the maximum amount of money it can to pay as much of the $30 billion in legal liabilities as possible. "He's probably going to have to blink to keep from diminishing the value of the company. But there are no rules on this. It's whatever the judge can work out to keep the people. He starts out by saying he's not going pay anything. They come back and put pressure on him. It goes back and forth."

Chookaszian says once PG&E emerges, it will likely be sold to one or more investors who'll probably create a new public company.

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"One thing you know for sure: there's going to be a new PG&E." Chookaszian explains that the only mystery is whether the new company will keep all of the assets or if the judge will spin off multiple companies to different parts of the state.

Until then, however, Chookaszian says, the judge will have to approve bonuses to appease the managers. "If not, the power shuts down in California."

Montali acknowledged that the executive bonus plan had been vetted by independent compensation consultants to bring it comparatively close to what the market would bear. But in bankruptcy cases, outright retention bonuses are verboten. Executives at bankrupt companies must prove they're being incentivized based on performance.

Retention vs. Performance

Up until 2005, companies that filed voluntary Chapter 11 petitions routinely asked the court for bonuses through so-called key employee retention plans, or KERPs, explains **Shepherd Pryor IV.** He's a former deputy head of corporate banking at **Wells Fargo** and former director at **Taylor Capital Group**. "The KERP would coax key employees to stay through resolution of the bankruptcy, and things would work out … better for both employees and the company," writes Pryor in an e-mail.

But in 2005, when the bankruptcy code was overhauled, KERPs for senior executives suddenly were viewed as a way for failed managers to remain ensconced in their positions. What are called key employee incentive plans, or KEIPs, took the place of KERPs.

Pryor states that the difference is that KEIPs don't aim to save the company from losing value through key departures but, instead, incentivize and require managers to perform better before they earn additional money. "Still, in a litigious atmosphere, KEIPs are often criticized in litigation for being disguised KERPs," he says.

Indeed, the ***San Francisco Chronicle* reported** that Montali ruled that PG&E's bonus plan failed to show an "ascertainable connection between the officers' performance and the metrics." He did, however, leave open a door for bonuses after the company brushed up its act. The newspaper reported that Montali said he'd let PG&E propose a new plan that did not include cash payments but that was "solely motivated by safety metrics."

An outside counsel representing PG&E in the bankruptcy case, **Stephen Karotkin** at the law firm **Weil Gotschal**, did not return calls for comment.

Stephen H. Case, a retired senior partner at law firm **Davis Polk & Wardwell** and a specialist in bankruptcy and restructurings, applauds the position that Montali took. He claims the PG&E board needs to tighten up and address performance issues the way the court does.

Indeed, Case, who was chairman of Motors Liquidation Co., which had been **General Motors** until its assets were unwound after the financial crisis, isn't completely sure PG&E has to pay the bonuses at all.

"Running a utility, in my limited experience, basically requires competent engineering skills, and in America there are a lot of competent engineers. Couldn't the board hire a headhunter and in short order replace the top 20 people at PG&E? Do you really need to pay a large bonus to keep people? So it makes sense to me that Judge Montali says, 'Come on, guys. You can do better than paying bonuses just to keep them here. Show me that they're doing their job and doing it well.'"

On Sept. 13, PG&E announced a **preliminary court settlement** with insurance companies and hedge funds that had invested in insurance claims that will repay the bulk of fire victims from Northern California wildfires in 2017 and the Camp Fire in 2018. The company says the agreement covers 85% of these so-called subrogation claims. In addition, PG&E asked the court to cap its direct payments to fire victims at $8.4 billion. The requests are subject to approval by the bankruptcy court.

But on Sept. 19, bondholders – including hedge fund Elliott Management Corp. – and a court-authorized committee that represents the fires victims asked the bankruptcy court's **permission** to file a competing chapter 11 plan that would pay $24 billion to victims.

PG&E issued a statement complaining that the bondholders already were to be paid in full for their bonds under its proposed plan, and therefore should not have voting rights on the bankruptcy terms. PG&E claims Elliott and its allies are trying to "get more than they are entitled to under the law," which ultimately will cost the utility's customers extra billions of dollars.

The bondholders dispute that. According to the ***Wall Street Journal***, they said they were "cheated [out] of their contract rate of interest as well as premiums they say are due on the debt." Meanwhile, they've offered to give PG&E an infusion of $28.4 billion in exchange for 59% of the equity in the new company that emerges from bankruptcy.

Editor's Note: This story was updated to include information about the settlement announced today.