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UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA, SAN FRANCISCO DIVISION

In re PACIFIC GAS AND ELECTRIC COMPANY, a California corporation, Debtor. Tax Id # 94-0742640	CASE NO. 01-30923 DM Chapter 11 DATE: June 18, 2001 TIME: 9:30 a.m. PLACE: 232 Pine St., 22nd Floor San Francisco, CA JUDGE: Honorable Dennis Montali

OPPOSITION OF THE CITY AND COUNTY OF SAN FRANCISCO TO MOTION OF THE DEBTOR AND DEBTOR IN POSSESSION FOR ORDER AUTHORIZING ESTABLISHMENT OF MANAGEMENT RETENTION PROGRAM; MEMORANDUM OF POINTS AND AUTHORITIES

[SUPPORTING DECLARATION OF IRVING SULMEYER FILED SEPARATELY]

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The City and County of San Francisco ("San Francisco"), a creditor in this case, opposes the motion (the "Motion") filed by the Debtor and Debtor in Possession (the "Debtor") for an order authorizing (1) continuation of pre-petition employee severance and displacement programs, (2) establishment of Management Retention Program, and (3) honoring of certain pre-petition employee compensation, insofar as said motion seeks to establish a so called Management Retention Program (the "Management Retention Program"). That part of the Motion requesting the establishment of the Management Retention Program should be denied on the following grounds:

1. The Debtor has failed to provide competent evidence showing the need for the Management Retention Program.

2. The Debtor has failed to establish by a preponderance of competent evidence the fairness and reasonableness of the proposed Management Retention Program.

On its merits, the Management Retention Program should be disallowed because it rewards over $17 million to executive and senior management without any relation to merit. In sum, the highest level executives would receive the highest level of bonuses, and bonuses are guaranteed, upfront payments, regardless of an executive's contribution to the Debtor's reorganization.

I.

THE EVIDENCE

The evidence submitted in support of the Motion to establish a new post-petition Management Retention Program is found in the Declaration of Russell N. Jackson (the "Declaration"), an officer of the Debtor with responsibility for human resources who presumably is a beneficiary of the program with a vested interest. Declarant is not an independent consultant[1].

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[1] See page 26 of the Proxy Statement issued jointly by the Debtor and its parent PG&E Corp. under date of April 16, 2001 (the "Proxy Statement") of the Debtor and its parent, PG&E Corporation ("PG&E Corp."), attached as Exhibit A to the Declaration of Irving Sulmeyer (the "Sulmeyer Declaration"), to the effect that the compensation committee of the parent retains Hewitt Associates to evaluate compensation policies for the parent and its subsidiaries.

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Declarant establishes no particular expertise to support the opinions which he gives relative to the need for and the reasonableness of the Management Retention Program.

Solely based on information and belief, Mr. Jackson purports to present the following evidence[2] relative to the need for and reasonableness of the Management Retention Program:

1. that the retention of the participant employees (the "Participants") is important (Declaration, ¶ 13);

2. that the current situation requires a more structured program (Declaration, ¶ 14);

3. that these most essential employees would be difficult or impossible to replace (Declaration, ¶ 14);

4. that PG&E expects the Management Retention Program to increase its ability to retain the knowledge and skills of its most essential employees (Declaration, ¶ 14);

5. that implementation of retention programs for essential employees is common for companies in bankruptcy (Declaration, ¶ 17); and

6. that the Management Retention Program is comparable (if not less generous) to similar retention programs approved by courts in other large chapter 11 cases as reflected in a summary chart (Declaration, ¶ 17 and Exhibit 4).

The description of the Management Retention Program shows that benefits will accrue only to 226 of the Debtor's senior management employees and, among those 226, are weighted strongly in favor of the most senior personnel. One hundred percent of the Debtor's most senior officers (Tier I and Tier II) will receive bonuses of 100% of base salary. Among n Tier III executives, directors and key attorneys will receive bonuses between 50% and 75%, while managers and other attorneys will receive bonuses of 25% to 50%. No names are given. No base salaries are set forth. (Declaration, ¶¶ 15, 16 and 18 and Exhibit 6)

[2] See evidentiary objections to the Jackson Declaration filed separately.

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Under the Management Retention Program, payment of the bonus is made in two installments. The Debtor's top six executive officers (Tier I) receive partial payment in the amount of one-third of their salaries as long as the Debtor files a plan by January 1, 2002, which is virtually guaranteed, since these senior executives control the Debtor's actions. The second installment of two-thirds of the bonus is payable at any time any plan filed by any party is confirmed.

The remaining executives covered by the Management Retention Program (Tiers II and III) would receive 50% of the bonus, paid upon the earlier of (1) April 8, 2002, or (2) the date on which the Debtor files a plan. The second 50% installment is paid upon the earlier of (1) April 7, 2003, or (2) the date of confirmation of a plan, regardless of whose plan it is.[3] In short, these executives receive guaranteed bonuses.

The proposed Management Retention Program patently favors those on top of the economic heap. The Proxy Statement discloses base salaries as of the year 2000 for the Tier I senior management officials of the Debtor as follows:

1.	Smith	$630,000
2.	Richard	260,000
3.	Randolf	305,000
4.	Rueger	310,000
5.	Harvey	260,000
6.	Peters	260,000
	Total	$2,025,000

(Proxy Statement, p. 31)

These top six executive will receive 11.6% of the total $17.5 million in awards. Put another way, the Debtor's six top executives, who constitute 2.65% of the 226 eligible Participants, will receive 11.6% of the bonuses.

Another troublesome problem with the Management Participation Program is that its administration is controlled by PG&E Corp. The description of the plan reveals that plan administrator is the chairman of the Debtor, Robert D. Glynn, Jr., who also just happens to be the

[3] For those 17 persons in Tier II who have less than two years of service with the Debtor as of the filing date the first installment would be one-third rather than 50% and the second installment would be two-thirds rather than 50%.

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CEO of PG&E Corp. (See Exhibit 6 to Declaration, ¶ 2 and p. 5; Proxy Statement) Since the plan administrator decides who is eligible under the Management Retention Program, PG&E Corp. has the power to exert significant influence on the actions of the Participants. (See Exhibit 6 to Declaration, ¶¶ 2, 3)

Further, the Debtor may amend the program anytime "*provided however* unless otherwise required by law or specifically provided herein, no such amendment, alternation, suspension or termination shall be made that would materially impair the previously vested rights of any Participant without his or her written consent." (Emphasis added.) (See Exhibit 6 to Declaration, ¶ 12) In other words, under the provisions proposed by the Debtor, the Debtor (or PG&E Corp.) could make the Participants even richer without ever coming back to court for approval.

In support of the Debtor's motion, Mr. Jackson states that, "with certain limited exceptions, to receive Retention Payments, Participants must be employed by PG&E at the time of such payments." (Declaration, ¶ 16) At best, the foregoing statement is disingenuous. At worst, it is misleading.

Under the Debtor's proposed Management Retention Program, a Participant's participation terminates "upon the first to occur of any one of the following events with respect to such Participant:

(a) Voluntary termination, or termination of employment and ineligible for rehire; and

(b) The Participant's retirement (as determined under the applicable company retirement program in which the Participant participates)." (Emphasis added.) (Exhibit 6 to Declaration, ¶ 7) This provision deserves very close analysis.

The plain language of subparagraphs (a) and (b) requires cancellation of participation only in the event of a combination of events. There must be either a voluntary termination and retirement or involuntary termination together with ineligibility for rehire and retirement, whichever occurs first.

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In other words, if a covered Participant quits and retires, he loses the benefits of the Management Retention Program. On the other hand, if the officer or employee quits but does not retire, he retains all his rights under the Management Retention Program. Similarly, if the officer or employee were terminated on a basis which made him ineligible for rehire but did not retire he would retain his rights under the Management Retention Program. Further if an officer or employee were terminated (for example by a trustee) but was not ineligible for rehire, that officer or employee would retain his rights under the Management Retention Program regardless of whether or not he retired. In short, the "certain limited exceptions" to the requirement that a Participant must be employed by the Debtor at the time of such payments are very broad indeed.

Furthermore, according to the Debtor's description, "The Program shall not affect or impair the rights . . . of . . . a Participant under any other written contract, arrangement, or pension, profit sharing or other compensation program, and all amounts payable under the Program shall be characterized as special bonuses and not as additional salary for purposes of such other contracts, arrangements or programs." (See Exhibit 6 to Declaration, ¶ 11) According to the Proxy Statement, with the sole exception of Mr. Smith (who is a director only of the Debtor), the directors of the Debtor are also directors of PG&E Corp. Based on information contained in the Proxy Statement, the directors hardly seem in need of or to require Tier III benefits.

These directors are no only compensated very well as a result of their positions, they and Tier I Participants hold significant and valuable shares in PG&E Corp., as shown in the Proxy Statement. (See Proxy Statement, pp. 8-11) Based on the closing price of PG&E Corp. stock on June 8, 2001, the current value of stock of PG&E held by these management executives is set forth in Exhibit B to the Sulmeyer Declaration.

Aside from the foregoing compensation and incentives, PG&E Corp. provides a long term incentive program that would cover the Debtor's management with different types of incentive awards for different purposes, a stock option plan, a performance unit plan, a directors stock incentive plan and separate incentive awards plan. (Proxy Statement, pp. 13-19) These rewards and incentives should be enough for the Debtor's senior management.

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According to its own publicity, the Debtor is solvent. Since the petition date, the Debtor has claimed numerous times that all creditors will be paid in full. Therefore, PG&E Corp. is the principal beneficiary of the Debtor's proposed Management Retention Program. PG&E Corp. already provides substantial incentive benefits to management and has the ability to provide additional benefits, at its own expense, as it deems appropriate or necessary. To the extent that the Management Retention Program benefits are paid by the Debtor rather than by PG&E Corp., the costs are ultimately borne not by the creditors but by the taxpayers and ratepayers of the State of California.

II.

ARGUMENT

This is an unusual case. The operation of the Debtor is being funded by the taxpayers of the State of California. The Debtor has prevailed upon the California Public Utilities Commission that investigations are in process, not only with regard to price manipulations by power suppliers to the Debtor, but also with regard to billions of dollars in dividends upstreamed to PG&E Corp., and with regard to alleged additional sums paid to the parent for the repurchase of the Debtor's stock from the parent. There is no evidence that PG&E Corp. has been forthcoming to render any assistance to its wholly-owned subsidiary, the Debtor. To the contrary, PG&E sought regulatory approval prior to the initiation of this case of measures serving to insulate itself from any responsibility for the debts incurred and being incurred by the Debtor.

In this posture, management of the Debtor chosen by the parent, sitting in office at the pleasure of the parent, comes before the Court and asks for additional bonuses weighted most heavily in favor of the most senior management. Any court would have to give careful scrutiny and require the strongest credible showing before granting in advance the bonuses proposed in the Management Retention Program.

The Debtor is quite correct in one respect. It has the burden of proof to establish by a preponderance of admissible, credible evidence that the Management Retention Program it seeks to create is necessary, fair and reasonable. San Francisco strongly believes that the Debtor has failed to carry that burden, and that the relief it proposes should be denied.

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The Debtor must show that a sound business purpose justifies the establishment of the Management Retention Program. Something more than a subjective "business judgment" test is required where the business judgment of management is compromised by management's self-interest. In those cases cited by Debtor enunciating a simple "business judgment" test, self-interest of management is not present to cloud the judgment of management. Stephens Industries, Inc. v. McClung, 789 F.2d 386 (6th Cir. 1986) involved a bankruptcy trustee's motion to sell assets under Section 363(b)(1). There was an articulated business reason that justified the sale. In Committee Equity Sec. v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063 (2d Cir. 1983), an order approving a sale of stock by the debtor, and one of its affiliates, pursuant to 11 U.S.C. § 363(b) was reversed and remanded because of a failure by the trial court to expressly find from the evidence presented a good business reason to grant the sale motion. In re Lady H. Col Co., Inc., 193 B.R. 233 (Bankr. S.D. W. Va. 1996), involved a motion for authority to sell property free and clear of liens and encumbrances. The court found that a sound business reason justified the sale, that the sale was proposed in good faith, and that the purchase price was fair and reasonable. In re Delaware and Hudson Railroad Ry. Co., 124 B.R. 169 (D. Del. 1991), involved the sale of the debtor's railroad assets which the bankruptcy trustee found to be a favorable deal according to his business judgment. None of these cases involved a motion solely benefiting the debtor's senior management.

The Debtor cites Official Committee of Subordinated Bondholders v. Integrated Resources, Inc. (In re Integrated Resources, Inc.), 147 B.R. 650, 656 (S.D.N.Y. 1992) for the proposition that once the debtor has articulated a rational business justification, a presumption attaches that the decision was made on an informed basis, in good faith and in the honest belief that the action was in the best interest of the debtor. Misleadingly, the Debtor fails to mention that the Integrated Resources court was referring to Delaware law which has no counterpart under California law in relation to a debtor that is a California corporation. Even if Delaware law applied to the Debtor, Integrated does not support the Debtor's position. As the court there noted:

> The business judgment rule's presumption shields corporate decision-making and their decisions from judicial second guessing when the following elements are present: (1) A business decision,

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(2) disinterestedness, (3) due care, (4) good faith, and (5) according to some courts and commentators, no abuse of discretion or waste of corporate assets.

(Id. at 656) (Citation omitted.)

The case at bar, as distinguished from the Integrated Resources (a case involving the question of a breakup fee arrangement between the debtor and a perspective purchaser should be approved), involves self-interest of top management, a potential lack of good faith and failure to disclose all of the other incentive programs available to top management, and an abuse of discretion or waste of corporate assets especially where, as here, there is a solvent parent with the apparent ability to provide additional incentive programs for the Debtor's top management. Further, in Integrated Resources, the court stated, "Courts are loath to interfere with a corporate decision absent a showing of bad faith, self-interest, or gross negligence." (Id. at 656) Here, the showing of self-interest is patent and the business judgment rule must be modified to take into account that self-interest. A stronger case than that presented by the Debtor is required.

In re Landmark Land Co., 136 B.R. 410, 413 (D.S.C. 1992), is cited by the Debtor for the general proposition that a debtor in possession would benefit by the retention of competent loyal employees without advising the court that Landmark involved a debtor's motion to continue a pre-petition personnel policy. The case had nothing to do with creating a brand new bonus program for top management, as the Debtor seeks to do.

The Debtor cites Dai-Ichi Kangyo Bank Ltd. v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.), 242 B.R. 147, 155 (D. Del. 1999) as approving a plan to "retain key employees who would be essential to the debtor's reorganization," but this opinion does not help the Debtor. In Montgomery Ward, there was independent evidence by an outside expert to the effect "that the employees' stock options have been rendered worthless by the current bankruptcy." (Id. at 150) According to the expert, this lack of an equity component triggered the need for the key employee retention program in question. (Id. at 150). In the case at bar, the benefited management executives not only hold extensive stock holdings and the stock options, they are far from valueless. (See Exhibit B to Sulmeyer Declaration) Moreover, PG&E Corp. is

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not in bankruptcy as was the corporate parent in Montgomery Ward. Therefore, PG&E Corp., as the Debtor's sole owner, should help the Debtor financially.

The Debtor also cites In re America West Airlines, Inc., 171 B.R. 674, 678 (Bankr. D. Ariz. 1994) for the proposition that a plan granting success bonuses to certain officers and employees of the debtor was held to be within the debtor's sound business judgment. That was three years after the filing of bankruptcy. That was after confirmation of the plan of reorganization. That was after consummation of the plan of reorganization.

In other words, in America West, unlike the situation in this case, the court was able to review the record before it and determine whether or not the executives had in fact been successful and whether or not the executives were entitled to a success bonus. No such record is before this court and no success is required in order to entitle the key executives here to a bonus. All they have to do is stay put (perhaps) to become entitled to the bonus.

Finally, the Debtor cites In Interco, Inc., 128 B.R. 229, 234 (Bankr. E.D. Mo. 1991) as a case which authorized the debtor to assume pre-petition severance contracts and a performance based retention program. That case, like all of the other cases cited by the Debtor, is factually distinguishable. In Interco "a material concern expressed by the debtors is the fact that current stock options are and are expected to remain worthless." (Id. at 231)

Further, whereas in Interco, "the total compensation package afforded critical executives is below industry norms" (id. at 231), the compensation and incentive packages revealed in PG&E's Proxy Statement are generous even before the additional bonuses the Debtor proposes. Likewise, while "the retention plan [in Interco was] based upon attaining operating performance targets during chapter 11" (id. at 231), in this case, the executives would receive guaranteed bonuses no matter whose plan is confirmed.

In Interco the debtor also sought to pay confirmed awards to the chairman of the board, president and chief executive officer and to the executive vice president and chief financial officer. The court authorized such confirmation awards provided that both senior executives "will forego any and all claims related to their existing Employment Agreements . . . and those Employment Agreements will be terminated." (Id. at 232)

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By contrast, under PG&E's proposed Management Retention Program, senior executives are retaining all of their existing incentive and retention programs, all of their bonuses, all of their stock options, all of their stock holdings and giving up nothing, even though we are barely two months into the case, and the senior executives' contributions to a successful plan of reorganization is entirely unknown.

III.

CONCLUSION

Courts decide to approve or disapprove employee bonus or retention programs on a case by case basis. The facts presented here militate against approving the Management Retention Program. The omission by the Debtor of essential information in its motion compounds the patent self-interest of management in declaring that they need additional bonuses to continue doing the job they undertook to perform.

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In cultures other than ours, it is not uncommon for management of a failed enterprise at the very least to resign and apologize . In our culture they ask for a bonus. The court should not grant it to them. The motion to create the Management Retention Program should be denied.

DATED: June 11, 2001

Respectfully submitted,

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