STATEMENT OF

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BEFORE

THE COMMERCIAL AND ADMINISTRATIVE LAW

SUBCOMMITTEE

OF

THE COMMITTEE ON THE JUDICIARY

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

DECEMBER 16, 2009

PROTECTING EMPLOYEES IN AIRLINE BANKRUPTCIES

Good afternoon, Mr. Chairman, Ranking Member, and honorable members of the Subcommittee. Thank you for inviting me to testify today. I am Marshall Huebner, co-chair of the insolvency and restructuring department at Davis Polk & Wardwell LLP. I have authored many articles on bankruptcy law as well as the forthcoming Oxford University Press treatise on Chapter 11 reorganization. Among other things, I was lead counsel to Delta Air Lines in its out-of-court restructuring and Chapter 11 proceedings, and advised Frontier Airlines and the Star Tribune in their Chapter 11 proceedings. I have also represented the lenders in several of the largest loans ever extended to Chapter 11 debtors, experience whose relevance I will address in a few moments. I would like to note that I am here today to provide the Subcommittee with what is hopefully useful information in my individual capacity, and I represent neither the views of Davis Polk & Wardwell as a firm, nor the views of any of its clients.

As the Subcommittee and my fellow witnesses know all too well, the topic of Chapter 11 in general, and sections 1113 and 1114 in particular, presents a very difficult set of issues and balances. On the one hand, debtors, especially those with substantial legacy liabilities, are frequently fighting for their very lives at a severe disadvantage to newer entrants in the industry and foreign competition, both of whom often have substantially lower costs. And debtors usually need all the help they can get. On the other hand, respect for the rights and needs of employees is also a core value of our great nation.

To help set the context for the hearing and these difficult issues, attached as Exhibit A is a chart that lists the approximately 185 U.S. airline bankruptcies since 1978. About 90% of them ended in liquidation. So while we must collectively figure out how to ensure fairness for employees who have suffered major salary and benefit cuts at the 10% that are still flying, the deepest pain has of course been taken by those who lost 100% of their salary, pensions and benefits. It is for that reason that the changes that I am suggesting enhance the protections for workers without unduly risking the survival of their employers, against whom the odds are frighteningly stacked. Frontier, for example, would not have survived in an even slightly less favorable legal system.

Those who lead and represent troubled companies have taken on a sacred trust to try to save them, and a critical part of that responsibility is to preserve, to the greatest extent possible, the jobs, wages, pensions and benefits of those who depend on and constitute the enterprise. For example, I'm very proud of the fact that my client Frontier Airlines is the only airline to have entered bankruptcy since January 2006 and avoided liquidation. I am equally proud of Delta, which worked out groundbreaking deals with its unions and retirees in Chapter 11, and also implemented the first ever broad-based equity grant to <u>all</u> employees upon emergence from Chapter 11.

While section 1113 works fairly well and achieves its intended goals much of the time, it does need some revisions. I will highlight four this afternoon:

(1) The courts should be expressly directed to consider, as part of all 1113 proceedings, management compensation, management sacrifices and any enhancements to management compensation made not only during the bankruptcy case, but during the year prior to the bankruptcy case as well. Perhaps the greatest flashpoint, often justifiably so, of anger and frustration with the bankruptcy system is the not infrequent mismatch between the lack of sacrifice in the executive suite and the sacrifice as one moves down the payscale. Bankruptcy courts should be directed to consider the comparative position and compensation of people at all levels of the company when considering section 1113 proposals. To be clear, this is not to say that in every case management must take pay cuts or lose this or that benefit. Sometimes, management has made substantial sacrifices prior to or during the bankruptcy or is underpaid compared to market and what is necessary for survival. This, for example, was true of the Delta, Frontier, and Star Tribune bankruptcy cases, where management led by example. That said, it certainly isn't always the case – each situation, who must or should accept adjustments differs. To stop and guard against abuses, however, courts must be obligated to consider the compensation of all, including management, as part of the fair and equitable component of section 1113.

(2) Debtors' section 1113 proposals should not be able to extend past four years from the effective date of emergence from Chapter 11. As someone who frequently represents lenders in Chapter 11, my experience is that a shorter period would be dangerous and unwise. It is critical that a debtor's cost structure be locked in long enough for it to procure exit financing and to encourage counterparties to do business with it. Too short a period of contract cost stability will likely result in one of two things: either the debtor will not be able to emerge at all because potential investors and lenders simply will not come to the table, or, if the debtor has to reopen negotiations while still recovering from the weakness and trauma that Chapter 11 invariably represents, it may well fail again. In some cases, however, 1113 has been used to impose inappropriately long term concessionary agreements on unions. I see no justification for this, and do not think it should be permitted.

(3) Unions, like all other counterparties whose contracts are rejected, deserve a claim in Chapter 11 cases for the damages that they suffer when section 1113 relief is awarded. To be clear, this change risks upsetting a negotiating dynamic that is often conducive to consensual agreements, because debtors currently have the ability to offer the union – as part of an agreed deal that avoids litigation -- a claim that often has very substantial value in the Chapter 11 case. Nonetheless, since section 1113 does represent rejection of a contract and, in all other contexts other than 1113, rejection gives rise to a damage claim, it is ultimately difficult to defend unions not getting compensated for their damages in the claim process. Moreover, this claim can have very substantial value, and, because it is often paid in equity, can provide real upside to union members if their employer's situation improves, without impacting cash flows and weakening the company. In Delta, for example, in addition to $650 million in notes and participation in a robust profit sharing plan, the pilots' union received a $2.1

billion agreed claim in connection with the consensual amendment of its collective bargaining agreement. That $2.1 billion claim translated to something like 13% of the equity of reorganized Delta. In other airline cases, union members owned an even greater percentage of the company at emergence.

(4) It is critical that courts be able to consider not only the proposal made by the company and the union as of the commencement of the hearing, but also any additional proposals made while the pleading cycle and even the hearing is going on. Bankruptcy judges not infrequently send signals as to their views regarding which side, and in many cases both sides, need to exhibit more flexibility and greater willingness to compromise in their negotiations. In at least one case in which I was involved, the company materially improved its offer to the union during the 1113 process under substantial pressure from the judge to do so. Ironically, on appeal, because the bankruptcy judge had ruled that the debtor's final offer was fair and equitable, but did not rule on the offer made several rounds earlier prior to the commencement of the proceedings, the District Court reversed. Because the goal of 1113 is and should be to force the parties to the table, and to encourage the debtor's continued negotiation and flexibility, the statute should be clarified so that there is no doubt that courts should weigh both sides' final proposals.

But, while I feel strongly that section 1113 does need revisions, I feel equally strongly that an **apparently** pro-union fundamental rewrite of the statute will not help workers in the end. It will only leave many more of them with no jobs, no pensions and no benefits.

First of all, there is the context. As noted above, the airline chapter 11 failure rate is already in the 90% range, which is shockingly high. And many informed observers, for very good reason, believe that making 1113 yet more challenging (or even unavailable) will doom yet more airlines to liquidation.

Moreover, a debtor seeking to address a collective bargaining agreement under section 1113 already faces the most daunting procedural and substantive hurdles in the Bankruptcy Code. Virtually every other contract of a Chapter 11 company can be rejected in the debtor's sole discretion. By contrast, when a debtor seeks to reject a collective bargaining agreement, it must: (1) make a proposal to the union; (2) base the proposal on the then-most complete and reliable information; (3) propose (only) modifications that are "necessary to permit reorganization"; (4) assure that all creditors, the debtor and all of the affected parties are treated fairly and equitably; (5) provide the union with such relevant information as is necessary to evaluate the proposal; (6) between the time of the making of the proposal and the 1113 hearing, meet with the union at reasonable times to negotiate; (7) negotiate with the union in good faith to attempt to reach mutually satisfactory modifications of the agreement; (8) the union must refuse to accept the proposal without good cause; (9) the balance of the equities must clearly favor rejection of the agreement. Clearly, the 1113 system is designed to force the parties together in negotiation, and while there are certainly

some bad outcomes that have transpired that need to be addressed through appropriate statutory changes, in the vast majority of cases, good faith negotiation takes place. Indeed, in many cases most, and in some cases all, of a debtor's unions work out consensual amendments to the CBAs.[1]

I am aware that there are very strong views on the union side that the Railway Labor Act should not be interpreted to prevent unions from striking in the Chapter 11 section 1113 rejection context. With all due respect to those views, I believe that the right to strike should not be available to unions subsequent to 1113 rejection. Under the statute, the company can prevail only if its proposal contains only changes that are necessary to permit reorganization, the proposal is fair and equitable to all, the company has negotiated in good faith and provided full information, the union has rejected the proposal without good cause, and the balance of the equities clearly favors rejection. This is, properly applied, a very demanding set of standards that was enacted at the request of organized labor. Under the system put in place by Congress, the union is the party that is in the wrong if it loses a section 1113 fight, and it is difficult to see why that should change or override the RLA's important focus on protecting the public and the economy from disruption. Moreover, sanctioning the possibility that a union could stonewall or refuse to negotiate in good faith (or even refuse to negotiate at all), as sometimes happens, and then strike when the debtor prevails in a federal court, tilts the playing field far too strongly and unfairly, and introduces very perverse incentives.

The unfortunate reality of insolvency is that a company cannot honor all of its obligations and cannot pay all of its debts. Many constituencies suffer. Whether it is small businesses who may themselves go out of business because of the financial hit they have taken by virtue of the debtor's bankruptcy; individuals who invested in the debtor's stocks or bonds; pension funds that invested in the

[1] Nor is it the case that the company always prevails. As Michael Bernstein noted last year before this Subcommittee during a legislative hearing on this same topic, due to the strict requirements of section 1113, many courts do in fact deny debtors' requests for relief. *See, e.g., In re Delta Air Lines (Comair),* 342 B.R. 685 (Bankr. S.D.N.Y. 2006) (debtor did not meet its fair and equitable burden); *In re Nat'l Forge Co.,* 279 B.R. 493 (Bankr. W.D. Pa. 2002) (debtor did not meet its burden of proving that the proposed modifications were fair and equitable); *In re U.S. Truck Co.,* 165 L.R.R.M. (BNA) 2521 (Bankr. E.D. Mich. 2000) (debtor failed to meet its burdens of proving the proposal to be necessary, fair and equitable); *In re Jefley, Inc.,* 219 B.R. 88 (Bankr. E.D. Pa. 1998) (court concluded ''that the proposal, as presented, is not 'necessary' to the Debtor's reorganization; [and] does not treat the union workers 'fairly and equitably'''); *In re Liberty Cab & Limousine Co.,* 194 B.R. 770 (Bankr. E.D. Pa. 1996) (debtor's proposal was not fair and equitable); *In re Lady H Coal Co.,* 193 B.R. 233 (Bankr. S.D. W. Va. 1996) (debtor failed to treat all parties fairly and equitably and did not bargain in good faith); *In re Schauer Mfg. Corp.,* 145 B.R. 32 (Bankr. S.D. Ohio 1992) (debtor ''has failed to show that the Proposal which it made to the Union makes 'necessary modifications . . . that are necessary to permit the reorganization of the debtor . . . .''); *In re Sun Glo Coal Co.,* 144 B.R. 58 (Bankr. E.D. Ky. 1992) (''the debtors have failed to sufficiently quantify the results of such proposed changes to allow this Court to find that they are 'necessary' to the reorganization of the debtors.'').

debtor's securities; airports and communities who find themselves with empty terminals or no service because their leases have been rejected; the losses are often massive. However, if each sympathetic counterparty were able to convince Congress to protect *its* contract or give *its* claim a priority, no company would survive Chapter 11, and the losses *to all* would be immeasurably greater. By way of example, it is commonly held in the bankruptcy bar and bench that the 2005 bankruptcy amendments, which shortened exclusivity and substantially limited a debtor's time to assume or reject certain real property contracts, directly caused or were a major contributor to the liquidation of many large retailers who might otherwise have been able to reorganize and keep their workers employed. Making 1113 yet substantially more onerous on struggling employers will likely have dire consequences. The employees of airlines who took substantial pay cuts and lost material pension rates certainly tell an absolutely compelling and sympathetic story. But the employees who lost their jobs entirely, as well as their pensions, health benefits, and incomes in the many airline liquidations, including ATA, Aloha, Eastern Airlines, Pan Am, TWA, Florida Coastal, and Skybus, present a story that is at least equally compelling.

Finally, I would like to address one topic that may be on the minds of some of the committee members: the courts' interpretation of the standard of "necessary to permit the reorganization of the debtor" under section 1113(b)(1)(A). The overwhelming majority of the courts across the country to have considered the issue have held that "necessary to permit the reorganization of the debtor" means necessary for the long term health and survival of the debtor, not merely necessary to avoid immediate liquidation in the short run.[2] In contrast, a very early case decided in 1986 held it to mean "necessary to avoid liquidation."[3] It quickly became apparent, however, that this was neither a

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[2] *See, e.g.*, *United Food & Commercial Workers Union v. Family Snacks, Inc.* (*In re Family Snacks, Inc.*), 257 B.R. 884, 896-97 (B.A.P. 8th Cir. 2001)*; In re Maxwell Newspapers, Inc.*, 981 F.2d 85 (2nd Cir. 1992)*; In re Mile Hi Metal Sys., Inc.*, 899 F.2d 887, 892-93 (10th Cir. 1990); *In re Royal Composing Room, Inc.*, 848 F.2d 345 (2nd Cir. 1988); *Truck Drivers Local 807 v. Carey Transp. Inc.*, 816 F.2d 82, 89–90 (2d Cir. 1987) (holding that '''necessary' should not be equated with 'essential' or bare minimum. . . . [rather] the necessity requirement places on the debtor the burden of proving that its proposal is made in good faith, and that it contains necessary, but not absolutely minimal, changes that will enable the debtor to complete the reorganization process successfully.''); *In re Appletree Mkts, Inc*., 155 B.R. 431, 441 (S.D. Tex. 1993); *In re Mesaba Aviation Inc*., 350 B.R. 192 (Bankr. D. Minn. 2006); *In re Northwest Airlines Corp.*, 346 B.R. 307 (Bankr. S.D.N.Y. 2006); *In re Delta Air Lines*, 342 B.R. 685 (Bankr. S.D.N.Y. 2006); *In re Horsehead Indus., Inc.*, 300 B.R. 573, 584 (Bankr. S.D.N.Y. 2003); *In re Valley Steel Prods. Co., Inc.*, 142 B.R. 337 (Bankr. E.D. Mo. 1992); *International Union etc. Local 1431 v. Gatke Corp.*, 151 B.R. 211 (N.D. Ind. 1991); *In re Indiana Grocery Co., Inc.*, 136 B.R. 182 (Bankr. S.D. Ind. 1990); *In re Express Freight Lines, Inc*., 119 B.R. 1006 (Bankr. E.D. Wis. 1990); *In re Big Sky Transp. Co*., 104 B.R. 333, 335 (Bankr. D. Mont. 1989); *In re Texas Sheet Metals, Inc*., 90 B.R. 260, 265 (Bankr. S.D. Tex. 1988); *In re Walway Co.*, 69 B.R. 967 (Bankr. E.D. Mich. 1987); *In re Amherst Sparkle Market, Inc*., 75 B.R. 847, 851 (Bankr. N.D. Ohio 1987); *In re Allied Delivery System Co.*, 49 B.R. 700 (Bankr. N.D. Ohio 1985).

[3] *Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of Am., AFL-CIO-CLC*, 791 F.2d 1074, 1088 (3d Cir. 1986).

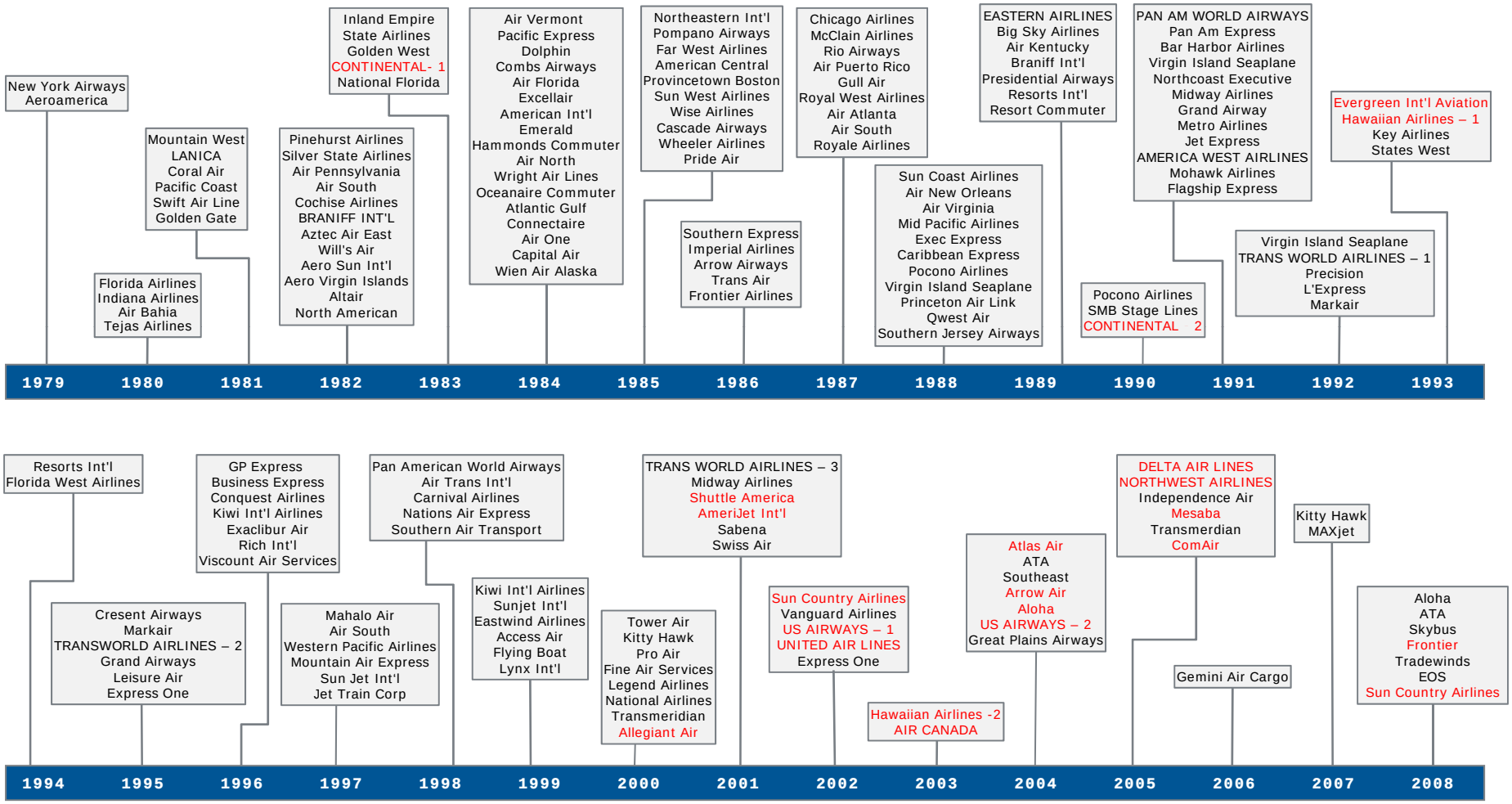
workable nor the correct interpretation of the standard, and almost no other courts have followed it in the last 23 years for at least two valid reasons. One, it would merge the "necessary to permit the reorganization of the debtor" test under section 1113(b)(1)(A) with the statute's emergency interim relief standard under section 1113(e), articulated by Congress as "essential to the continuation of the debtor's business." This cannot have been Congress' intent, since a higher bar must clearly be met by companies seeking emergency interim relief. Second, it will cause more airline liquidations. If the relief available to the debtor is limited to merely avoiding short-term liquidation, and not to creating viable and financeable business plans, it is all but certain that the airline failure rate will not be 90% – it will be 95% or 98%. They simply will not get financing.

Filing for Chapter 11 relief cannot increase demand for one's product, nor can bankruptcy lower the price of fuel or allow a company to buy fuel or airplanes or pretzels below current market prices. Therefore, it is an unfortunate but enduring reality that the relatively small number of costs that are potentially adjustable, including labor and benefits, will have to continue to be an area where debtors struggling to avoid liquidation have to be able to seek savings in order to survive Chapter 11 and emerge on the other side. And section 1113, properly applied, already contains a set of strict procedural and substantive hurdles that go a very long way towards striking the right balance. But there are at least four changes Congress should consider better to protect the American worker, while not making it materially less likely their employers will survive: (1) mandatory consideration of executive compensation in the 1113 process (better to ensure fairness); (2) a limitation on debtors' 1113 proposals to 4 years from their emergence date (so that bankruptcy cannot be used to force unduly long concessionary agreements onto unions); (3) a mandatory damage claim arising out of 1113 rejections (which will often provide equity participation and "upside" for employees); and (4) mandatory consideration of the good faith bargaining and proposals made by both sides until the Court has actually ruled on the 1113 issues presented to it.

Thank you for giving me the opportunity to testify before you today.

Airline bankruptcies timeline

Since 1978 there have been over 185 airline bankruptcies – with few successes



ALL CAPS – Major Airlines operating as of Dec 2009