Hearing on H.R. 4677, the "Protecting Employees and Retirees in Business Bankruptcies Act of 2010"

Before the Subcommittee on Commercial and Administrative Law

Statement of:

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Mr. Chairman, Ranking Member, and members of the Subcommittee, thank you for inviting me to testify at your hearing on H.R. 4677, the "*Protecting Employees and Retirees in Business Bankruptcies Act of 2010*." I am a partner in the law firm of Arnold & Porter LLP and chair of the firm's national bankruptcy and corporate restructuring practice.[1] We represent debtors, creditors, committees, investors and other parties in a wide variety of bankruptcy and corporate restructuring matters. I have advised and represented debtors and other parties in connection with matters at the intersection of bankruptcy and labor law, and I have lectured on this subject, as well as on numerous other bankruptcy-related subjects. I am a Fellow of the American College of Bankruptcy and co-chair of the Labor and Employment Committee of the American Bankruptcy Institute. I have also written various books and articles. For example, I am co-author of *Bankruptcy in Practice* (4th ed. 2007), a comprehensive treatise on bankruptcy law and practice.

Chapter 11 of the Bankruptcy Code is intended to enable a financially troubled business to restructure its operations and obligations so that it is able to remain a going concern, and to emerge from bankruptcy as a viable and competitive enterprise.[2] A debtor that achieves this objective benefits its creditors, suppliers, customers, employees, local communities and other constituencies.

A successful reorganization ordinarily requires a debtor to achieve a competitive cost structure. This includes paying market-competitive wages and benefits to all employee groups,

[1] The views expressed herein are solely those of the author, and do not necessarily represent the views of my firm or any of its clients.

[2] While reorganization is the primary objective of chapter 11, as discussed hereinafter chapter 11 also permits orderly liquidation. There are some cases in which reorganization is not possible, or in which a sale of the debtor's assets will generate the greatest return to creditors.

from hourly workers to administrative and clerical employees, to mid-level management and senior executives.

Some labor union representatives have argued that current law -- and the way it is being interpreted by the courts -- imposes a disproportionate burden upon a debtor's employees and retirees. They seek legislative reform that would, among other things (1) give unions greater bargaining leverage in negotiations, (2) give union employees more and bigger claims in their employer's bankruptcy, and assign a higher priority to many types of employee claims, (3) make even more stringent the already very high burden on a debtor that seeks to modify its labor or retiree costs, and (4) largely eliminate bonuses, incentive compensation and similar payments to management employees, which they see as unfair in cases where union workers are being forced to make concessions.

While it is perhaps understandable that organized labor would like to see legislative change that increases its own bargaining leverage and gives its constituency a bigger share of the pie, many of the modifications in H.R. 4677 are difficult to reconcile with the fundamental goals of chapter 11, and would likely impair the ability of chapter 11 debtors to reorganize. This would in turn harm all stakeholders in the chapter 11 case, including employees and retirees, whose jobs and benefits depend on a successful reorganization and the emergence of a viable reorganized company.

There are a number of respects in which the bill would make chapter 11 reorganization more difficult to achieve. First, the bill would increase the already substantial cost and burden of chapter 11. It would do this in part by (i) creating new and potentially substantial claims, including priority claims; (ii) slowing down the § 1113 process; (iii) increasing the amount of §§ 1113 and 1114 litigation; (iv) requiring the debtor to pay the unions' professional fees; (v) discouraging new investment in chapter 11 debtors; and (vi) potentially limiting the availability, and increasing the cost, of secured credit, including prepetition loans, debtor-in-possession financing and exit financing.

Second, the bill would create substantial additional hurdles for a business that needs to modify its labor and retiree cost structure in order to remain viable. If a chapter 11 debtor that needs to reduce above-market or otherwise unsustainable labor costs is precluded from doing so, it will likely be unable to attract new capital and unable to reorganize.

Third, the bill would make it materially more difficult for chapter 11 debtors to attract and retain talented management employees. Because of the substantial risks, burdens and uncertainties that typically come with managing a company in chapter 11, it has historically been a challenge for debtors to retain and attract management talent. Numerous debtors have suffered from management defections, as their competitors cherry-pick the best management employees. The 2005 modifications to the Bankruptcy Code, enacted as part of the *Bankruptcy Abuse and Prevention and Consumer Protection Act of 2005* (BAPCPA), compounded this problem by effectively precluding debtors from paying retention bonuses to management employees. These bonuses had previously been an important means to compensate management employees for the risk and uncertainty of working for a debtor, and incentivizing such employees to remain with the debtor even though they may have more attractive, and more stable, opportunities elsewhere. The additional proposed modifications in H.R. 4677 would make it much more difficult (and perhaps impossible) for debtors to pay other sorts of compensation, including incentive payments, to officers, management employees, and consultants. This would further exacerbate the difficulty debtors face in retaining management talent. Moreover, certain provisions in the bill would link the wages and benefits paid to managerial employees to the wages and benefits of hourly employees. While there may be a superficial appeal to this linkage, it fails to take into account the different labor markets that exist for different types of employees. Simply put, a debtor must pay its hourly employees the going rate in the community in which it operates for employees with comparable skills and expertise. The same is true for all other employees, up to and including the most senior executives. Thus, while it may sound good to say "if labor suffers a ten percent pay cut, management employees should suffer the same pay cut," a more rational approach would be to say that: (i) each employee should be paid as close as possible to market-competitive wages and benefits, and (ii) the overall labor cost structure should not exceed what the company can afford to pay, in light of its financial circumstances.

Fourth, certain of the proposed provisions would substitute inflexible, one-size-fits-all rules for the judicial discretion that exists under current law. Because each company, each industry and each chapter 11 case is different, the reorganization goal of chapter 11 is better served by allowing judges to make decisions in each case, based on the evidence before them, rather than trying to create identical rules for every case, without regard to the facts.

Finally, as mentioned above, some of the proposed provisions would create potentially substantial new administrative and priority claims. Viewed in isolation, this may not seem particularly problematic. However, in evaluating the extent to which such priorities should be created, it is worthwhile to consider two factors. First, priority claims must be paid in full in order for a debtor to reorganize under a chapter 11 plan. Thus, the creation of new priority claims will make it more difficult -- and in some cases impossible -- for companies to reorganize. Second, priorities create "creditor versus creditor" issues more than "debtor versus creditor" issues. In other words, whenever you give priority to one type of claim, you are leaving less money for the holders of other types of claims. Thus, while it may be appealing to say "we are giving a greater priority to employee claims," it is important to keep in mind that, by doing so, you are likely to be diminishing or possibly eliminating the recovery of other types of creditors, such as taxing authorities, trade vendors, customers, or tort victims.

I have outlined below certain provisions in the bill that I believe would make reorganization more difficult to achieve, increase the cost of chapter 11 proceedings, and/or otherwise be inconsistent with the objectives of chapter 11. This is not intended as a complete analysis of every provision of the bill, but instead an effort to highlight some of the provisions that I find most problematic.

A. Title I: These Sections of the Bill Would Increase Priority Claims, Reducing the Recovery of Other Creditors and Forcing Some Debtors to Liquidate

Sections 101-105 of the bill would, among other things, increase the existing wage priority, create a new type of claim (available to some but not all employees) for lost value of stock in a defined contribution plan, and create new types of administrative expense obligations, including for severance pay and for WARN Act damages. Some of these new claims and administrative expenses could be very substantial -- diminishing or eliminating the recoveries of other creditors. And in the case of the administrative expenses, they would have to be paid in full in order for a debtor to confirm a plan of reorganization and emerge from bankruptcy.

Section 101 of the bill would amend § 507 to increase the wage priority.[3] Specifically, it would (i) amend § 507(a)(4) to increase the amount of the wage priority to $20,000, (ii) amend

[3] Section 507 of the Bankruptcy Code provides for priority payment status of certain types of claims. It currently gives employees a fourth level priority claim up to $11,725 for wages, salaries or commissions, including vacation, severance and sick leave pay, earned within 180 days of the bankruptcy filing (or the date of the cessation of business, if earlier) and provides a fifth level priority claim for contributions to an employee benefit plan arising from services rendered within 180 days of the bankruptcy filing (or the date of the cessation of business, if earlier) up to $11,725 (less the aggregate amount paid to the employee pursuant to § 507(a)(4)).

§§ 507(a)(4) and 507(a)(5) to eliminate the requirement that the claim be earned within 180 days of the bankruptcy filing (or the date of the cessation of business), and (iii) amend § 507(a)(5) to increase the amount of the employee benefit plan priority to $20,000 and to eliminate the provision that requires the claimant to subtract any amounts paid pursuant to § 507(a)(4).

Section 102 of the bill would amend the definition of "claim" set forth in § 101(5) of the Bankruptcy Code to include a right or interest in equity securities of the debtor, or an affiliate of the debtor, held in a defined contribution plan for the benefit of an individual who is neither an insider of the debtor nor one of the twenty most highly compensated employees of the debtor, where the employer or plan sponsor who commenced bankruptcy has committed fraud with respect to the plan or otherwise breached a duty to the participant that proximately caused the loss of value. This section of the bill would elevate employees' equity interests to the status of debt obligations, or claims. It is not clear how this section of the bill would work in conjunction with § 510(b) of the Bankruptcy Code. Section 510(b) subordinates securities fraud and similar claims. To the extent such claims relate to common stock, they are afforded the priority of common stock, rather than debt. To the extent § 102 is creating a claim, which would then be subordinated to all other claims and treated as an equity interest, the provision would accomplish nothing. On the other hand, if § 102 of the bill is intended to create a claim that is outside of the scope of § 510(b), it could potentially be an enormous claim, diminishing the recoveries of other creditors.[4] The interplay between this section of the bill and § 510(b) would also likely cause significant litigation and create uncertainty.

[4] The new "claim" created by § 102 would not apply to insiders, senior executive officers (a term that is not defined in the bill), or "any of the 20 next most highly compensated employees of the debtor . . . ." The use of "the 20 next most highly compensated employees," which also appears elsewhere in the bill, is arbitrary. In some cases, it would not capture the entire "top tier" of employees; in other cases it would be over-inclusive, covering employees who have no management role and including union as well as non-

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Section 103 of the bill would add a new administrative expense for severance pay owed to employees of the debtor, under a plan, program or policy generally applicable to employees of the debtor, or pursuant to a collective bargaining agreement, for termination or layoff after the petition date.[5] The Second Circuit has held that severance claims arising from postpetition terminations are entitled to administrative expense priority, and this amendment would be consistent with those decisions.[6] However, most courts have allocated such severance claims between the prepetition and postpetition periods, which typically results in only a small part of the claim being entitled to administrative expense treatment.[7]

The "allocation" approach is more consistent with the fundamental bankruptcy law notion that administrative expense priority is afforded to a claimant only to the extent that the debtor received postpetition value from the claimant. For example, if an employee worked 15 years prior to the bankruptcy filing and three months after the bankruptcy filing, and upon termination is entitled to a severance payment, it is difficult to argue that the consideration received by the debtor for that payment -- the employee's services -- was received postpetition.

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union employees. *See infra* pg. 17 (discussing § 201 of the bill) and pg. 34-44, n.38 (discussing §§ 301 and 302 of the bill). Such one-size-fits-all rules tend not to work well in bankruptcy.

[5] The administrative expense for severance pay would not apply to insiders, senior management, or consultants retained to provide services to the debtor, or to severance claims under individual employment contracts.

[6] *See, e.g.*, *In re W.T. Grant Co.*, 620 F.2d 319 (2d Cir.1980); *Straus-Duparquet, Inc. v. Local Union No. 3 Int'l. Bhd. of Elec. Workers, A F of L, CIO*, 386 F.2d 649, 651 (2d Cir. 1967) ("After the period of eligibility is served, the full severance pay is due whenever termination of employment occurs.").

[7] *See, e.g.*, Daniel A. Austin, *Payment of Pre-Petition and Post-Petition Employee Severance Benefits*, 22 AM. BANKR. INST. J. 1, 45 (Mar. 2003) ("The majority rule is that only the portion of the severance pay claim that can be apportioned to post-petition service may be afforded priority treatment as an administrative expense."); *In re Mammoth Mart*, 536 F.2d 950, 955 (1st Cir. 1976) ("whether a claim for severance pay . . . will be entitled to . . . priority will depend upon the extent to which the consideration supporting the claim was supplied during the reorganization"); *In re Public Ledger*, 161 F.2d 762, 771-73 (3d Cir. 1947).

Instead, a small part of the consideration was received postpetition, but most of the consideration was received prepetition because most of the services were provided prepetition. The "allocation" theory is thus more consistent with the premise of administrative expense priority.

The "allocation" theory also avoids unfair discrimination among employees based upon their date of termination. For example, assume that a debtor has two 20-year employees, each of whom is entitled to a $50,000 severance payment upon termination. The first employee is terminated a week before the bankruptcy filing and the second employee a week after the bankruptcy filing. Under § 103 of the bill, the two would be treated very differently -- the first might get only cents on the dollar, while the second would be paid in full.

Section 103 of the bill would also encourage debtors to terminate employees who are entitled to severance payments prior to the bankruptcy filing if there is a chance that they might have to terminate these employees, in order to avoid making the entire severance claim an administrative expense. A policy that allows the debtor to keep such employees working, without penalizing the debtor to such a great degree if it eventually has to terminate the employee during the bankruptcy case, would be a more sound policy, both from the debtor's and the employee's perspective.

Finally, as I have discussed elsewhere in my testimony, creating new administrative expenses makes reorganization more difficult -- since all such expenses must be paid in full on the effective date of any plan of reorganization -- and also effectively subordinates other claims, in a situation where there is not sufficient value to pay all creditors in full.

Section 105 of the bill would create a new administrative expense claim for WARN Act damages. In BAPCPA, a new administrative priority was created for:

> wages and benefits awarded pursuant to a judicial proceeding or a proceeding of the National Labor Relations Board as back pay

> attributable to any period of time occurring after commencement of the case under this title, as a result of a violation of Federal or State law by the debtor, without regard to the time of the occurrence of unlawful conduct on which such award is based or to whether any services were rendered, if the court determines that payment of wages and benefits by reason of the operation of this clause will not substantially increase the probability of layoff or termination of current employees, or of nonpayment of domestic support obligations, during the case under this title

11 U.S.C. § 503(b)(1)(A)(ii).

This bill would broaden the scope of the administrative expense so that it would include WARN Act damages that arise out of a pre-bankruptcy plant closure and termination of employees. It would thus reverse court decisions holding that Bankruptcy Code § 503(b)(1)(A)(ii) does not afford administrative expense priority to WARN Act damages arising from a pre-bankruptcy termination. *See In re Continentalafa Dispensing Co.*, 403 B.R. 653 (Bankr. E.D. Mo. 2009); *In re First Magnus Fin. Corp.*, 390 B.R. 667 (Bankr. D. Ariz. 2008); *In re Powermate Holding Corp.*, 2008 WL 4595199 (Bankr. D. Del. 2008).

Under the WARN Act, certain employees are entitled to at least 60 days' notice of a potential termination. When an employer that falls within the statute fails to give such notice, the affected employees are entitled to back pay and benefits for up to 60 days.[8] Under existing law, WARN Act damages arising from a pre-bankruptcy termination are entitled to the statutory wage priority up to $11,725 per employee, for wages earned within 180 days prior to the earlier of the bankruptcy filing or cessation of the debtor's business, and are a general unsecured claim to the extent they fall outside the scope of this priority (either because of timing or amount).

[8] There are various statutory and common law defenses to WARN Act claims.

While the language is less than perfectly clear, it appears that § 105 of the bill would (1) grant administrative priority for WARN Act damages even if the termination occurred prepetition (and therefore no services were rendered during the bankruptcy case), and (2) make the entire 60 days of WARN damages an administrative expense if any of the 60 day period falls postpetition. Thus, for example, if employees were terminated without notice on day 1, and the bankruptcy case was filed on day 58, the entire 60 day WARN Act damages would constitute an administrative expense -- even though no services were rendered postpetition -- because two days of the 60 day period following termination occurred after the bankruptcy filing.

This is potentially problematic for several reasons. First, it is inconsistent with the fundamental bankruptcy law principal, discussed above, that an administrative expense is allowed only to the extent that the bankruptcy estate receives a postpetition benefit. In the prepetition employee termination context, the debtor receives no postpetition benefit for the WARN Act damage claim because no services are rendered to the debtor after the petition date.

Second, as noted above, administrative expense claims must be paid in full in order for a debtor to confirm a chapter 11 plan of reorganization. The creation of material new administrative expenses would make reorganization more difficult. Congress has already added to the administrative expense burden of chapter 11 debtors by enacting § 503(b)(9) of the Bankruptcy Code as part of BAPCPA, which created a new administrative expense for goods sold to a debtor in the ordinary course of business and delivered within 20 days before the petition date[9] (another exception to the principal that administrative expense priority should be

[9] This created, in some cases, a significant additional administrative expense, thereby increasing the cost of chapter 11 reorganization. *See, e.g.*, Prepared Statement of Richard M. Pulchulski for the *Hearing on Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?* before the House Judiciary Committee's Subcommittee on Commercial and Administrative Law on March 11, 2009 (discussing the

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limited to circumstances in which the debtor receives a postpetition benefit). While there are many types of claims that might be said to be "worthy" of priority treatment, it must be recognized that every time a new priority is created, it will cause some number of debtors to be unable to reorganize and emerge from bankruptcy because of an inability to pay the priority claims in full. That is not in any stakeholder's interest. Certainly, employees do not benefit when a business is forced to liquidate.

Third, as previously noted, the establishment of new administrative expenses, such as the proposed WARN Act administrative expense, creates creditor-versus-creditor issues. Whenever one type of claim is elevated in priority, other claims are effectively subordinated. Except in those relatively rare cases in which there is enough money to pay all claims in full, creating a new WARN Act administrative priority (and the other substantial employee priorities that are contemplated by this bill) will diminish -- and in some cases perhaps eliminate entirely -- the recovery of other creditors. This creates fairness issues -- for example, whether it is fair to increase the recovery of employees at the expense of tort victims injured by a debtor's products, customers who paid the debtor for goods or services but did not receive what they paid for, taxing authorities, or small businesses that sold goods to a debtor.

I believe these factors should be considered, and that they counsel in favor of caution in increasing or creating new administrative expense claims.

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implications of § 503(b)(9) in the Circuit City bankruptcy (and subsequent liquidation) and providing it was the "final death knell" for Circuit City).

B. Title II: These Sections of the Bill Would Unduly Restrict a Debtor's Ability to Reduce Labor Costs

Sections 201 and 202: Rejection of Collective Bargaining Agreements and Payment of Insurance Benefits to Retired Employees

Section 1113 of the Bankruptcy Code sets forth the requirements for a debtor to reject a collective bargaining agreement. Unlike other contracts, which can be rejected by a debtor if doing so is found to be a reasonable exercise of the debtor's business judgment, rejection of a collective bargaining agreement is evaluated using a considerably more stringent standard.[10] Based on the text of § 1113, courts have established a nine-part test to determine whether a collective bargaining agreement may be rejected:[11]

(1) the debtor-in-possession must make a proposal to the union to modify the collective bargaining agreement;

(2) the proposal must be based on the most complete and reliable information available at the time of the proposal;

(3) the proposed modifications must be necessary to permit the reorganization of the debtor;

(4) the proposed modifications must assure that all creditors, the debtor and all of the affected parties are treated fairly and equitably;

(5) the debtor must provide to the union such relevant information as is necessary to evaluate the proposal;

[10] *See Comair, Inc. v. Air Line Pilots Ass'n, Int'l* (*In re Delta Air Lines, Inc.*), 359 B.R. 491, 498 (Bankr. S.D.N.Y. 2007) ("Congress enacted Section 1113 not to eliminate but to govern a debtor's power to reject executory collective bargaining agreements, and to substitute the elaborate set of subjective requirements in Section 1113(b) and (c) in place of the business judgment rule as the standard for adjudicating an objection to a debtor's motion to reject a collective bargaining agreement.").

[11] The test was initially articulated by the court in *In re Am. Provision Co.*, 44 B.R. 907, 908 (Bankr. D. Minn. 1984), and has subsequently been adopted by many other courts. *See, e.g.*, *In re Family Snacks, Inc.*, 257 B.R. 884 (B.A.P. 8th Cir. 2001); *In re Nat'l Forge Co.*, 289 B.R. 803 (Bankr. W.D. Pa. 2003); *see* also *In re Bruno's Supermarkets, LLC*, 2009 WL 1148369, at *4, n.13 (Bankr. N.D. Ala. Apr. 27, 2009) ("These [nine] elements are almost universally accepted as those that must be satisfied before a CBA may be rejected in a bankruptcy case"). Other courts have combined factors one, two, and five from the *American Provision* analysis, resulting in a seven-part analysis. *See, e.g.*, *In re Carey Transp., Inc.*, 50 B.R. 203, 207 (Bankr. S.D.N.Y. 1985), *aff'd sub nom Truck Drivers Local 807 v. Carey Transp., Inc.*, 816 F.2d 82 (2d Cir. 1987).

(6) between the time of the making of the proposal and the time of the hearing on approval of the rejection of the existing collective bargaining agreement, the debtor must meet at reasonable times with the union;

(7) at the meetings the debtor must confer in good faith in attempting to reach mutually satisfactory modifications of the collective bargaining agreement;

(8) the union must have refused to accept the proposal without good cause; and

(9) the balance of the equities must clearly favor rejection of the collective bargaining agreement.

The debtor must satisfy *all nine* of these standards in order to obtain relief. There are many cases in which a debtor's request for relief under § 1113 has been denied.[12]

The additional and modified requirements in § 201 of the bill would make it more difficult for a debtor to modify or reject a collective bargaining agreement. For example, under existing law any proposed modifications to a collective bargaining agreement must be "necessary to permit the reorganization of the debtor." In *Truck Drivers Local 807 v. Carey Transportation Inc.*, 816 F.2d 82, 89–90 (2d Cir. 1987), the court concluded that "'necessary' should not be equated with 'essential' or bare minimum . . . [rather] the necessity requirement places on the

[12] *See, e.g.*, *Teamsters Airline Div. v. Frontier Airlines, Inc.*, 2009 U.S. Dist. LEXIS 61699, at *3 (S.D.N.Y. July 20, 2009) (District Court vacated and remanded Bankruptcy Court's approval of modification of CBA); *In re Bruno's Supermarkets, LLC*, slip op., 2009 WL 1148369 (Bankr. N.D. Ala. 2009) (union refused proposal "with good cause"); *In re Delta Air Lines* (*Comair*), 342 B.R. 685 (Bankr. S.D.N.Y. 2006) (debtor failed to confer in good faith); *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, 89 (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, 35 (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, 63 (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 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."[13]

The bill would replace the "necessary to permit the reorganization" standard in § 1113 with "shall be not more than the minimum savings essential to permit the debtor to exit bankruptcy, such that confirmation of a plan of reorganization is not likely to be followed by the liquidation, or need for further financial reorganization of the debtor [] in the short-term."

This provision would be problematic for several reasons. First, the concept of "short-term" is so vague that it will likely lead to substantial litigation. Second, the goal of chapter 11 is not simply to allow a debtor to emerge from bankruptcy and survive "in the short-term." Instead, the goal is to enable a debtor to reorganize with a cost structure that will allow it to survive in the long-term as a viable and competitive enterprise. If a debtor is able to make only those modifications to its labor costs that are essential for it to exit bankruptcy and survive in the short-term, we will see more companies having to file second chapter 11 cases, or being forced to liquidate after emerging from chapter 11. Third, typically new investors are necessary in order to facilitate a chapter 11 reorganization. Such investors look for opportunities to invest in companies that have a rational cost structure, such that they are likely to survive and prosper. New investors are not likely to commit capital to a situation in which the debtor is able to

[13] The Third Circuit has interpreted the term "necessary" more strictly. *See Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of Am., AFL-CIO-CLC*, 791 F.2d 1074, 1088 (3d Cir. 1986) (holding that "[t]he 'necessary' standard cannot be satisfied by a mere showing that it would be desirable for the trustee to reject a prevailing labor contract so that the debtor can lower its costs" and suggesting that the use of the word "necessary" equates to "essential" and that rejection under § 1113 should be used only when necessary to prevent liquidation). This interpretation represents a minority view. *See, e.g., In re Mile Hi Metal Sys., Inc.*, 899 F.2d 887, 892 (10th Cir. 1990) (stating that "the majority of cases decided since *Wheeling-Pittsburgh* have declined to interpret section 1113(b)(1)(A) as requiring that a proposal be absolutely necessary").

rationalize its cost structure only to the extent necessary to "exit bankruptcy" or to avoid liquidation "in the short-term." If it were available at all, the cost of that new capital would be very high, to take into account the risk. Thus, this provision would make reorganizations materially more difficult to achieve.[14] Finally, it is not practical to require a debtor to emerge with a labor cost structure that reflects the bare minimum necessary for the company to exit bankruptcy. This would require a debtor to leave itself, in creating a post-emergence cost structure, so little leeway that even a minor unforeseen "bump in the road" after emergence could cause another bankruptcy filing. It would be a mistake for Congress to amend § 1113 in a way that would require debtors to emerge from chapter 11 with a cost structure that does not allow some flexibility for the usual ups and downs faced by businesses in the months and years following bankruptcy, as well as for some unforeseen circumstances.

The bill would also require any proposal to be "proposed only as part of a program of workforce and nonworkforce cost savings devised for the reorganization of the debtor, including savings in management personnel costs." Existing law already requires that a § 1113 proposal assure that all creditors, the debtor and all of the affected parties are treated fairly and equitably. This allows a court to deny § 1113 relief where the debtor seeks to shift too much of the cost-savings burden onto union employees, rather than "spreading the pain." No legislative change is needed to give a court this power. However, if the bill is instead intended to create a requirement that management costs must be reduced if labor costs are reduced, this provision would be a mistake. There are cases where a debtor is paying market-competitive (or below-market) wages to management employees but is paying above-market or otherwise unsustainable compensation

[14] Previously proposed legislation would have limited the cost savings that could be achieved through the §1113 process to two years. Investors would be very unlikely to invest in a company that could achieve a rational labor cost structure for only two years. Changing "two years" to "the short-term" does not solve the problem.

and benefits to represented employees. In those situations, the debtor should be able to reduce labor costs to a sustainable, market-competitive level, without necessarily having to make reductions in management employee salaries. There are also situations in which management compensation can and should be reduced without a need to reduce the wages and benefits of represented employees. The point is that a debtor should be able to look at each category of employees to determine whether the wages and benefits afforded to those employees are at a sustainable and market-competitive level -- and to make modifications where necessary to facilitate the debtor's reorganization -- rather than reflexively cutting the wages or benefits of all groups of employees, without regard to the relevant labor market or to the necessity or likely consequences of the reductions.

The bill would create a presumption that a debtor that implemented any incentive compensation or similar plan during the bankruptcy case, or within 180 days before the bankruptcy filing, "for insiders, senior executive officers, or the 20 next most highly compensated employees," fails to satisfy the standard for obtaining §1113 relief.

This provision is also, in my view, a mistake. The guiding principal should not be that every group of employees must take the same pay cut or reduction in benefits, but instead that each employee or group of employees should be paid and receive benefits at, or as close as possible to, a market-competitive level, and that the resulting overall cost structure should be sustainable for the reorganized debtor. For this reason, a provision that would "presume" that a debtor is not treating represented employees fairly if it has implemented any incentive plan for certain management or other highly-compensated employees within 180 days is short-sighted. Surely there are situations in which providing additional compensation to management employees while seeking labor cost reductions from union workers would be unfair -- such as, for example, where the management employees are already being paid above-market compensation for their services. However, there are other cases in which incentive or similar compensation is necessary to "meet the market" for management employees and/or to provide appropriate incentives, and in those cases paying such compensation should not be presumed to be unfair to labor. A debtor should not be put in the Catch-22 situation of having to choose between seeking labor cost reductions that are necessary for the company to reorganize or paying market-competitive compensation to its salaried and management personnel.[15]

Moreover, focusing on "the 20 next highly compensated employees" is arbitrary. In some cases, the top 20 will all be very senior management people, with substantial influence over the debtor and its decision-making. In other cases -- particularly smaller companies -- the 20 highest compensated employees may include individuals who are not particularly highly compensated, are not officers of the company, and who have no control or influence over the debtors. The top 20 may also include union-represented employees. Thus, tying the ability of a debtor to obtain labor cost reductions under § 1113 to whether incentive compensation has been provided to the 20 highest compensated employees will, in many cases, not achieve the desired result. Such one-size-fits-all rules do not work well in chapter 11. A better approach would be for the courts to be required to take into account whether the "pain" of a debtor's cost cutting effort is being shared in a fair and rational way, taking into account the realities of the marketplace. The reorganization process works better when judges are able to make these decisions on a case-by-case basis, based on the facts and circumstances and the needs and

[15] A typical component of management compensation is stock or stock options. In bankruptcy, such stock or stock options are typically worthless. Thus, incentive compensation may be necessary not to enhance compensation, but instead simply to replace a component of compensation that has been rendered worthless.

resources of the particular debtor, rather than being bound by arbitrary cut-offs and one-size-fits-all rules.

The bill would also amend § 1113(d) to slow down the § 1113 process. As amended, § 1113(d)(1) would require a court to schedule a hearing on a motion for rejection of a collective bargaining agreement on not less than 21 days notice (as opposed to current law which provides for a hearing "not later than fourteen days after the date of the filing"), unless the debtor and authorized representative agree to a shorter term. In addition, the bill would delete the current requirement in § 1113(d)(2) that provides that "[t]he court shall rule on such application for rejection within thirty days after the commencement of the hearing . . . ." Most significantly, though, the bill would limit the debtor's ability to file a rejection application until after "a period of negotiations" and only when the parties "have not reached an agreement over mutually satisfactory modifications, and further negotiations are not likely to produce mutually satisfactory modifications."

This provision is problematic for a number of reasons. First, it creates ambiguity about when a motion can be filed. What does "a period of negotiations" mean? At what point is it reasonable to conclude that further negotiations would be hopeless? This provision would create a new issue to litigate, concerning when the motion can be filed. One thing debtors and labor unions do not need is another issue to litigate about. Second, while the provision is presumably intended to foster negotiations, it could actually have the opposite effect. It might incentivize a debtor that needs to have relief by a certain date to rush through the negotiation process so that it could get to the point when a motion can be filed. That would not be helpful to the process. In prior cases, very productive negotiations have occurred after an § 1113 application has been filed. Third, addressing labor costs is often a gating item for other issues in the chapter 11 reorganization, such as reaching agreements with major creditor constituencies, and obtaining new investment and exit financing. Requiring a debtor to delay filing a § 1113 application is likely to delay the entire reorganization. Fourth, some debtors need relief promptly because of the burden of excessive labor costs. Debtors may simply be unable to afford the delay that this provision would impose. Finally, such a provision could unfairly tilt the balance of leverage, as the unions could drag out negotiations in order to preclude the debtor from filing a rejection application. If a debtor is prevented from even seeking the relief that it needs, it may be forced to accede to the union's demands simply to avoid the unbearable cost of delay.

Slowing down the process is not in any constituency's legitimate interest. Delay is likely to increase costs and to diminish the prospects for successful reorganization. Slowing down the § 1113 process, and therefore the reorganization process, is also inconsistent with Congress' intent to speed up the bankruptcy reorganization process, which is reflected in the shortening of the exclusivity and solicitation periods included in BAPCPA.[16] If anything, consistent with the shortening of the exclusivity and solicitation periods, and keeping in mind the substantial costs and risks associated with delay, the § 1113 process should be compressed, not drawn out.

The bill would also prohibit creditors and other interested parties from participating in a § 1113 hearing, even though their recoveries could be substantially affected by the outcome.[17] The court already has the authority to streamline hearings, to achieve efficiency and avoid repetition. But there is no valid reason to deny interested parties, such as a creditors committee,

[16] *See* 11 U.S.C. §§ 1121(d)(2)(A) and 1121(d)(2)(B). As amended, the statute provides that the 120-day period during which the debtor-in-possession has the exclusive right to file a chapter 11 plan "may not be extended beyond a date that is 18 months" after the bankruptcy petition date, and the 180-day period during which only the debtor-in-possession may solicit votes for a plan of reorganization "may not be extended beyond a date that is 20 months" after the bankruptcy petition date.

[17] This would be accomplished by inserting language in § 1113(d) that provides "[o]nly the debtor and the labor organization may appear and be heard at such hearing."

their right to be heard on such important issues in the chapter 11 case, and doing so would be inconsistent with § 1109(b) of the Code, which allows any party in interest to be heard on issues in a chapter 11 case.

The bill would also alter the standard in respect of when a court may grant a motion to reject a collective bargaining agreement. The bill would require "clear and convincing evidence" that the requirements in new § 1113(d)(2) are met before a debtor can reject a collective bargaining agreement. The import of this standard is not clear. As a practical matter, I suspect it would have little impact because I do not think bankruptcy courts grant § 1113 relief unless they find the evidence in support of doing so to be "clear and convincing." However, if this change -- alone or in combination with other changes that are proposed -- materially heightens the standard for obtaining § 1113 relief, the result could be at odds with the intention of Congress in enacting § 1113 and, more generally, with the goals of chapter 11. In enacting § 1113, Congress intended to foster consensual resolutions to the maximum extent possible.[18] This goal has been realized -- the vast majority of situations in which debtors seek labor cost modifications have been resolved consensually. But the balance is a delicate one. Cases are resolved by negotiation in part because each side has risk. If the standard for obtaining relief -- which is already quite high -- is made so high that it is nearly impossible to achieve, a result is likely to be fewer negotiated resolutions, and more litigation. The unions would have great leverage and therefore less incentive to compromise, yet companies would continue to seek the relief because their survival often depends upon it. Unduly raising the standard could also result in some companies that legitimately need labor cost relief in order to reorganize and emerge as viable and competitive

[18] *See, e.g.*, 130 CONG. REC. 20231 (June 29, 1984) (statement of Rep. Morrison) (discussing the proposed enactment of § 1113 and providing that "the overall policy of the provision which is to encourage the parties to reach their own agreement through collective bargaining . . . .").

enterprises being denied that relief. This would be counterproductive for all stakeholders, including labor.

Under the bill, granting relief under § 1113 would also require the court to find that implementation of the debtor's proposal to modify wages, benefits and work rules "shall not cause a material diminution in the purchasing power of the employees covered by the agreement." Depending upon how this provision is interpreted, it could make § 1113 relief nearly impossible to obtain. It is almost always the case that § 1113 relief will impact the affected employees' purchasing power. Even where the union employees' wages and benefits are materially above-market, and the debtor seeks relief in order to reduce wages and benefits to a market-competitive level, the result would impact the employees' purchasing power. The test should not be whether a reduction in wages and benefits affects the employees' purchasing power -- it nearly always does -- but instead whether the reductions are necessary to enable the debtor to reorganize, emerge from bankruptcy, and continue as a viable enterprise. In this regard, it is worth keeping in mind that if a debtor that needs labor cost relief does not obtain that relief, and is therefore forced to liquidate and/or to lay off large numbers of employees, the employees' purchasing power will also be diminished, and to a much greater extent than if their wages and benefits are reduced to a sustainable, market-competitive level.

The bill also provides that the court could not permit rejection of a collective bargaining agreement "that would result in modifications to a level lower than the level proposed by the trustee in the proposal found by the court to have complied with the requirements of this section." This appears to mean that the debtor is always bound by the highest and best offer that it makes during modification negotiations. It is not uncommon for a debtor, in § 1113 litigation, to agree that if it is granted relief it will implement the terms proposed in its most recent offer.

However, requiring every debtor to do this in every case is likely to reduce the number of consensual resolutions. If this were the law, the union would feel free to reject every proposal made by a debtor because that proposal would automatically become the union's "worst case scenario." Compromise is more likely if each side has some downside associated with litigating; this proposal would, to a large degree, eliminate that downside for the union. On the other hand, the debtor would be more reluctant to make its best offer during negotiations. In making a settlement offer, it is common for a debtor (or any party) to take into consideration the cost and distraction of litigation, the impact on business relationships, the public relations impact of litigation, the delay associated with litigation, and the like. Forcing a debtor to be bound in litigation to its best settlement offer will make the debtor more cautious in what it offers during negotiations. This can be expected to result in less favorable resolutions for unions and fewer negotiated resolutions.

The bill would also add a new section that would allow the union, at any time, to "apply to the court for an order seeking an increase in the level of wages or benefits, or relief from working conditions, based on changed circumstances," after a deal is reached or a court order is entered allowing rejection. This section of the bill appears to allow the union an unlimited right to relitigate the issues after they have been resolved. This provision is problematic for several reasons. First, it appears to be one-sided; it would permit the union to relitigate based upon changed circumstances, but appears not to allow a company the same right. Second, there does not appear to be any time limit on when such relief can be sought. This would be very problematic. Chapter 11 debtors need finality on the issue of labor costs so that they can do the other things necessary to reorganize and emerge from bankruptcy, such as reach agreements with creditor constituencies, line up new investors and exit financing, formulate a business plan, and determine the feasibility of their chapter 11 plan. As noted above, in a typical case, a debtor cannot do these things until there is finality with respect to its future cost structure. Having such an open-ended provision with no clear time limitations would make successful reorganizations materially more difficult.

In addition to the foregoing modifications, the bill would add other new provisions to § 1113. For example, proposed § 1113(f) would authorize a claim for "rejection damages" if a collective bargaining agreement were rejected under § 1113.[19] It would also authorize "self help" (presumably a strike or other job action) by labor representatives if the court grants a motion to reject a collective bargaining agreement or a motion for interim modifications to such an agreement.

Providing unions with the right to seek a claim for "rejection damages" if the collective bargaining agreement is rejected would reverse the decision in the Northwest Airlines bankruptcy case, which held that the union was not entitled to rejection damages under § 1113.[20] Proposed § 1113(f) would also provide that "[n]o claim for rejection damages should be limited by section 502(b)(7)."[21] This proposed amendment to § 1113(g) could substantially increase unsecured claims that a debtor would need to deal with under its plan, and diminish the

[19] This would be accomplished by inserting language in § 1113(f) that provides "rejection [of a collective bargaining agreement] shall be treated as rejection of an executory contract under section § 365(g) . . . ."

[20] *See Northwest Airlines Corp. v. Assn. of Flight Attendants--CWA, AFL--CIO* (*In re Northwest Airlines Corp.*), 483 F.3d 160, 170-75 (2d Cir. 2007) (the rejection "abrogated" the collective bargaining agreement which is distinguishable from a breach entitled to damages under § 365); *see also In re Blue Diamond Coal Co.*, 147 B.R. 720 (Bankr. E.D. Tenn. 1992), *aff'd*, 160 B.R. 574, 576 (E.D. Tenn. 1993) (providing that § 1113 "effectively withdrew the rejected collective bargaining agreement from the rubric of [] § 365 and § 501"). Some other courts have held that collective bargaining agreements are executory contracts and unions are entitled to damage claims related to the rejection of such agreements. *See, e.g., In re Moline Corp.*, 144 B.R. 75, 78-79 (Bankr. N.D. Ill. 1992); *In re Tex. Sheet Metals, Inc.*, 90 B.R. 260, 272-73 (Bankr. S.D. Tex. 1988).

[21] Section 502(b)(7) limits the claim of an employee for damages resulting from the termination of an employment contract to one year's compensation.

recoveries of other unsecured creditors. In some prior cases, debtors and labor unions have been able to reach modification agreements based on the debtor agreeing to some negotiated claim amount for the union employees in the bankruptcy case. If the union employees have that claim as a matter of right, the opportunity to reach agreement on that basis will be diminished. On the other hand, it is not unreasonable for employees who lose wages or benefits as a result of § 1113 relief to have a claim for the amount of their loss in the chapter 11 case.

The proposed amendment to provide unions with the right to "self-help" is also apparently a reaction to the Northwest Airlines decision which upheld, under the facts of that particular case and based upon certain provisions of the Railway Labor Act, an injunction to prevent a strike following the entry of a § 1113 order.[22] If a labor union, after the court finds that modifications are necessary for the debtor's reorganization and therefore grants § 1113 relief, is able to torpedo the company's reorganization by engaging in a retaliatory strike or other job action, the purpose of § 1113 (and of chapter 11 more generally) will be undermined, and the company and its stakeholders will suffer. The union will also have less incentive to negotiate because it can always turn to the "nuclear option" of a strike if the debtor does not accede to its demands, or as retaliation for the debtor's implementing § 1113 relief. A more balanced provision would be to authorize the bankruptcy court to enjoin a strike or similar job action after

[22] While airlines are governed by the Railway Labor Act ("RLA"), most other debtors are governed by the National Labor Relations Act ("NLRA"). Courts have suggested that in cases governed by the NLRA a union has the right to strike upon entry of a § 1113 order. *See Briggs Transp. Co. v. Int'l Bhd. of Teamsters*, 739 F.2d 341 (8th Cir. 1984) (rejecting request for injunctive relief in an NLRA case based on the Norris-LaGuardia Act's protection of the right to strike); *see also In re Northwest Airlines Corp.*, 349 B.R. 338 (S.D.N.Y. 2006), *aff'd*, 483 F.3d 160 (2d Cir. 2007). By contrast, under the RLA (which governs, *inter alia*, the airline industry), the Second Circuit has held that the right to strike does not exist. *See In re Northwest Airlines Corp.*, 483 F.3d at 167-68. As noted in the Second Circuit's decision, the analysis of whether a court can enjoin a strike under the NLRA depends upon the terms of the applicable collective bargaining agreement. *See id.* at 173.

granting § 1113 relief, but only where such an injunction is necessary in order to enable the debtor to reorganize and remain in business as a going concern.

Another newly proposed section, § 1113(g), would require a debtor to pay the union's fees and expenses. Chapter 11 is already very expensive, and this would create an additional administrative burden, to the detriment of creditors and other constituencies. Moreover, the union's obligation to pay its own attorneys' fees creates a disincentive to litigate excessively and an added incentive to reach negotiated resolutions where possible. The same is true for the debtor, which must pay its own attorneys, experts and advisors. If one party can litigate as much as it wants for free -- with the other party paying its legal fees -- that incentive gets skewed.

Finally, this bill would amend § 1114 of the Bankruptcy Code -- the section that sets forth the criteria pursuant to which a debtor may modify retiree benefits -- to provide more stringent requirements for modifying or terminating retiree health and life insurance benefits. Most of the proposed modifications to § 1114 track the modifications to § 1113. As a result, the proposed modifications to this section would create many of the same impediments to reorganization discussed above with regard to § 1113.

The bill would also amend § 1114(a), which defines the term "retiree benefits," to provide that the term applies "whether or not the debtor asserts a right to unilaterally modify such payments under such plan, fund, or program." The apparent purpose of this language is to overrule cases holding that if a trustee has a valid contractual right under non-bankruptcy law to modify or terminate retiree benefits, the provisions of § 1114 do not override that right.[23] To the

[23] *See, e.g., In re N. Am. Royalties, Inc.*, 276 B.R. 860, 866 (Bankr. E.D. Tenn. 2002) ("Section 1114 . . . says nothing about whether the debtor can exercise a power reserved in the contract to terminate it and thereby end any obligation for retiree benefits as defined in § 1114(a). Despite § 1114, the debtor can terminate the contract as allowed by the terms."); *In re Lykes Bros. Steamship Co., Inc.*, 233 B.R. 497, 517 (Bankr. M.D. Fla. 1997) (retiree benefits were terminable at will, and therefore, could be terminated

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extent that the bill would afford retiree benefits under § 1114 beyond the debtor's contractual obligation to provide such benefits, it seems inappropriate. Retirees should not have greater rights against the debtor in bankruptcy than they would have outside of bankruptcy.

Issues involving modification of collective bargaining agreements and retiree benefits are among the most difficult issues faced by the parties, and the courts, in chapter 11 cases. The prospect of reducing employees' wages and benefits, or retirees' benefits, is not something the courts take lightly. A debtor proposing to do this faces a heavy procedural and substantive burden. At the same time, courts recognize that some debtors are so hamstrung by above-market or otherwise unaffordable labor and retiree costs that, without relief from such costs, they will not be able to emerge from bankruptcy as viable and competitive enterprises. If these companies are forced to liquidate because they cannot reduce labor and/or retiree costs, all constituencies will suffer, including workers who will lose their jobs, retirees who will lose their benefits, creditors and shareholders whose recoveries will be diminished or eliminated, suppliers and customers, taxing authorities, and local communities. Sections 1113 and 1114 provide a framework for the parties, and when necessary the courts, to balance these competing concerns and interests.[24] In my experience, in the relatively few cases that are not resolved through

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without the requirement to comply with § 1114); *In re CF & I Fabricators of Utah, Inc.*, 163 B.R. 858, 574 (Bankr. D. Utah 1994) ("The Bankruptcy Code does not create new rights upon filing bankruptcy that were not in existence prior to filing.") (internal citations omitted); *compare In re Farmland Indus., Inc.*, 294 B.R. 903, 917 (Bankr. W.D. Mo. 2003) ("There is nothing in the language of the statute [§ 1114] to suggest that Congress intended to allow the termination of retiree benefits in those instances where the debtor has the right to unilaterally terminate those benefits under the language of the plan or program at issue.").

[24] *See* 130 CONG. REC. 20094 (June 29, 1984) (statement of Rep. Moynihan). (discussing the proposed enactment of § 1113 and providing that, "Mr. President, I know that few, if any, Members of this body want to see the abrogation of collectively bargained labor contracts, even in the course of bankruptcy proceedings. But in certain circumstances, we must recognize that costs, including labor costs, must be lowered for financially troubled firms to survive").

negotiations, bankruptcy judges do a good job of looking at the total picture and deciding whether relief sought by a debtor is necessary, and whether it is fair. Given the "human dynamic" of these decisions, debtors already face a heavy burden in making their case to the court. Legislation that would further skew the playing field against debtors, or eliminate judicial discretion, is not necessary, and indeed would be counterproductive.

While in any given case, one party or the other may be more or less satisfied with the outcome, as a general matter current law is sufficient to guard against any modifications of collective bargaining agreements and retiree benefits other than those that are necessary for the company to be able to reorganize and successfully emerge from bankruptcy. Sections §§ 1113 and 1114 have worked well in achieving a balance between the objectives of preserving bargained-for wages, benefits and work rules to the maximum extent possible and achieving a cost structure that will enable chapter 11 debtors to reorganize and survive. Congress' goal of placing a heightened burden on debtors seeking to modify labor agreements, providing all parties with bargaining leverage, and encouraging negotiated resolutions has been largely achieved.

Section 203: Protection of Employee Benefits in a Sale of Assets

Section 203 of the bill would amend § 363 of the Bankruptcy Code[25] to require that, in order to approve an asset sale, the court must consider "the extent to which a bidder has offered to maintain existing jobs, preserve terms and conditions of employment, and assume or match pension and retiree health benefit obligations in determining whether an offer constitutes the highest or best offer for such property."

[25] Section 363 permits a debtor to use, sell or lease property in the ordinary course of business without court approval, or outside the ordinary course of business with court approval. 11 U.S.C. § 363(b)(1).

If this section is merely providing that courts should consider all of the possible implications of a sale, including the impact on employees and retirees, then I agree that is appropriate. However, the provision is unnecessary because courts already have the authority to take such factors into account.

If, instead, this provision is suggesting that a court should not be able to approve a sale unless the buyer commits to maintain existing jobs or preserve retiree health benefits, that is, unfortunately, not realistic. The reality is that in many cases there is no buyer who is willing to preserve all of the debtor's employees' jobs and assume all of its retiree liabilities. Passing new legislation will not change that economic reality. Instead, the buyer will simply decline to enter into the transaction. I agree that as between two otherwise equivalent sale offers, the one that preserves jobs and retiree benefits would be preferable to the one that does not. I suspect most bankruptcy judges would share that view. But the law should be clear that asset sales that do not result in job and retiree benefit preservation may still be approved where they are the only alternative, or where, taking all factors into account, they are the best available alternative.[26]

Section 204: Claim for Pension Losses

Upon a debtor's termination of a defined benefit plan, the Pension Benefit Guaranty Corporation (the "PBGC") is entitled to assert a claim in the debtor's bankruptcy case for the amount by which the plan is underfunded. ERISA requires the PBGC to share its recovery on account of such claim with the plan participants, according to a statutory formula. Section 204 of the bill would give an individual plan participant (or a labor union on the participant's behalf)

[26] Noticeably absent from this section of the bill is the requirement that was included in H.R. 3652, a similar bill proposed in 2007, that would have imposed a flat $20,000 per retiree charge upon all § 363 sales that result in a cessation of retiree benefits. It is encouraging that this provision is not included in the current bill, since it is another one of those one-size-fits-all provisions that be unworkable in many cases and would make it impossible to consummate certain asset sales even if they were in the best interest of the debtor's estate and creditors.

a claim for any shortfall in benefits as of the termination date, as a result of the plan termination and the limitation on benefits that are guaranteed by the PBGC, "notwithstanding any claim asserted and collected by the [PBGC] with respect to such termination." [27] It appears to allow such claim in addition to the sharing that the participant would receive in the PBGC's recovery on account of its claim. This provision would result in duplicative claims -- that is, claims asserted by the PBGC and by the plan participants for the same underfunding amount. Congress should consider the implications of allowing such duplicative claims, which could be expected to diminish the recovery of other creditors. The provision could also result in a plan participant receiving more than payment in full, depending upon the extent to which the participant recovers from the PBGC's sharing of its recovery and the recovery on account of the participant's own claim. It would not make sense for a plan participant to receive a windfall as a result of the bankruptcy and the termination of the debtor's defined benefit plan.

Section 204 of the bill also allows a claim by a participant in a defined contribution plan for the loss in value of stock in the plan from the time that the stock was contributed to (or purchased by) the plan to time of the bankruptcy filing. This section works along with § 102 of the bill (discussed above) to elevate a claim for lost value of stock in a defined contribution claim, arising from fraud or breach of duty, to the priority of unsecured debt. As I discussed above, there is likely to be an issue -- at least in some cases -- of whether this claim is subject to subordination under § 510(b). To the extent the claim is not subordinated, it may be quite large, and could be expected to diminish the recovery of other creditors. This provision may also create a disparity between the beneficiaries of a defined contribution plan and other similarly

[27] This would also effectively overrule prior case law holding that employees may not assert claims with respect to the unfunded benefit liabilities in a pension plan. *See, e.g., United Steelworkers of Am., AFL-CIO, CLC v. United Eng'g, Inc.*, 52 F.3d 1386 (6th Cir. 1995).

situated shareholders, who also purchased stock that subsequently lost value. It would seem to make sense for all shareholders who lost stock value -- or in the case of this bill, all shareholders who lost stock value as a result of fraud or breach of duty by the company to the shareholder -- to be treated in parity, rather than employee shareholders being treated preferentially to non-employee shareholders.

Section 205: Payments by Secured Lender

Bankruptcy Code § 506(c) currently provides that the trustee may surcharge a secured creditor's collateral to pay the reasonable and necessary costs and expenses of preserving or disposing of the collateral to the extent the secured creditor benefits from the expenditures. This surcharge right is sometimes waived by a debtor in exchange for the prepetition secured lender's consent to the use of cash collateral or providing postpetition financing.

Section 205 of the bill would amend § 506(c) to treat wages, accrued vacation, severance, and other benefits owed pursuant to a collective bargaining agreement for services rendered on or after the commencement of the bankruptcy case as necessary costs and expenses, for surcharge purposes, regardless of any waiver of the surcharge right.[28]

In the overwhelming majority of cases, secured lenders consent to the use of their cash collateral to pay employee wage and benefit obligations and will include such expenses in a postpetition financing budget. However, making this a "mandatory surcharge" would be likely to decrease the availability, and increase the cost, of secured credit. Particularly in a tight credit environment, such as we are currently facing, it would not be prudent to enact legislation that would impede the ability of a debtor to obtain financing.

[28] The provision states that such amounts "shall be deemed necessary costs and expenses of preserving, or disposing of, property securing an allowed secured claim . . . ."

Moreover, it is not true that, in every case, employee wages and benefits are a necessary expense of preserving or disposing of a lender's collateral. Thus, this provision would "deem" something to be true that is, in fact -- at least in some cases -- not true. To illustrate the point, imagine a situation in which a debtor has one plant in Tennessee and another in Arizona. The lender has a lien only on the Tennessee facility. All wages and benefits of the employees at that facility have been paid in full. However, some wages and benefits at the Arizona facility have not been paid. This bill would appear to "deem" the unpaid wages and benefits at the Arizona facility to be "necessary costs and expenses" of preserving the Tennessee collateral. The law should not "deem" something to be true that is demonstrably untrue. Instead, in each case the court should determine whether, in fact, the unpaid employee wages and benefits are a necessary expense of preserving, or disposing of, the secured lender's collateral.

Section 206: Preservation of Jobs and Benefits

Section 206 of the bill would (i) insert a statement of purpose before § 1101 in the Bankruptcy Code and (ii) amend § 1129.

The "statement of purpose" would provide that: "[a] debtor commencing a case under this chapter shall have as its principal purpose the reorganization of its business to preserve going concern value to the maximum extent possible through the productive use of its assets and the preservation of jobs that will sustain productive economic activity."

It is true that the "classic" goal of chapter 11 is to enable a company to reorganize and thereby to preserve going-concern value. However, an alternative purpose of chapter 11 is to enable a company to sell its assets and pursue an orderly liquidation. There are some cases in which a sale/liquidation is the best way to maximize value. It is not clear to me what effect, if any, this "statement of purpose" would have. But if a "statement of purpose" is to be enacted, it should be modified so that it does not raise questions about whether chapter 11 may properly be used to effectuate an orderly liquidation.

The amendments to § 1129 (which establishes the criteria for confirming a plan) would add additional criteria. The bill would add a new § 1129(a)(18), which would require, as a condition to plan confirmation, that "[t]he debtor has demonstrated that the reorganization preserves going concern value to the maximum extent possible through the productive use of the debtor's assets and preserves jobs that sustain productive economic activity." As with the "statement of purpose," Congress should be careful not to enact legislation that will make it impossible for a debtor to confirm a liquidating chapter 11 plan, where doing so is in the estate's best interest.

The bill would also amend § 1129(c) to mandate that, in a situation in which competing chapter 11 plans are proposed, the court must confirm the plan that better serves the interests of retirees and employees. It would create a presumption that the plan that incorporates the terms of a settlement with a labor union constitutes the better plan.[29] I agree that, in deciding between competing plans, each of which satisfies the other requirements for plan confirmation, it would be appropriate for a court to take into account the interests of the debtor's employees. However, this provision appears to require the court to consider those interests *to the exclusion of* other interests, such as those of trade creditors, bondholders, lenders, tort victims, taxing authorities, and customers. Elevating one interest, to the exclusion of others, is inconsistent with the balancing of competing interests that is at the heart of the chapter 11 process.

[29] The presumption might be difficult to implement, in practice. One can imagine a situation in which each competing plan incorporates a settlement with some, but not all, of the debtor's unions. Which plan would then receive the benefit of the presumption?

Section 207: Termination of Exclusivity

Section 207 would amend § 1121(d) to allow for termination of the period during which the debtor has the exclusive right to propose and solicit acceptances of a plan in cases in which the debtor seeks § 1113 relief. This provision could put a debtor in the impossible situation of being forced to chose between the need to modify unsustainable labor costs, in order to be able to reorganize, and the need to preserve exclusivity.

Because of the number of diverse interests in the typical chapter 11 case, exclusivity is critical in order for debtors to be able to manage the reorganization process and pursue confirmation of a plan that balances the various competing interests.[30] The alternative of having each stakeholder be able to file a plan that serves its own parochial interest would make the chapter 11 process far more difficult to manage, and far more expensive.

This provision is obviously intended to create a disincentive for debtors to seek § 1113 relief by threatening that, if they do so, they will be forced to deal with the chaos that may result from termination of exclusivity. However, debtors should not be forced to chose between two goals that foster successful reorganization -- modifying labor cost, where necessary in order to facilitate successful emergence, and preservation of exclusivity.

[30] *See, e.g., In re Texaco, Inc.,* 81 B.R. 806, 809 (Bankr. S.D.N.Y. 1988) ("It [§ 1121] was intended that at the outset of a Chapter 11 case a debtor should be given the unqualified opportunity to negotiate a settlement and propose a plan of reorganization without interference from creditors and other interests.") (citing H.R. Rep. No. 595, 95th Cong., 2d Sess. 221-222 (1978), U.S. CODE CONG. & ADMIN. NEWS 1978, p. 5787); *see also In re Lehigh Valley Prof'l Sports Clubs, Inc.,* 2000 Bankr. LEXIS 237 (Bankr. E.D. Pa. Mar. 14, 2000) ("[e]xclusivity is intended to promote an environment in which the debtor's business may be rehabilitated and a consensual plan may be negotiated") (internal citations omitted).

C. Title III: These Sections of the Bill Would Limit a Debtor's Ability to Retain Management Employees During a Chapter 11 Proceeding and to Determine Appropriate Management Compensation After Bankruptcy

Section 301 and 302: Executive Compensation Upon Exit From Bankruptcy and Limitations on Executive Compensation Enhancements

Sections 301 and 302 of the bill would make it materially more difficult for a debtor to pay bonus or other incentive-based compensation to its officers, directors, management employees and consultants, and would allow the bankruptcy court authority to determine a debtor's management compensation even after the debtor emerges from bankruptcy.

One of the many challenges a chapter 11 debtor faces is how to retain talent, including management talent, through the bankruptcy.[31] Maintaining competent management, without excessive turnover, is important to maximize the debtor's prospects for a successful reorganization. In order to retain management employees, debtors must be able to offer market-competitive compensation and benefits, including, in many cases, incentive or bonus compensation.

By enacting § 503(c)(1), BAPCPA made it nearly impossible for debtors to pay "stay bonuses" to insiders.[32] As a result, debtors have for the most part abandoned the practice of paying such bonuses.

[31] The job of managing a debtor through the chapter 11 process is quite challenging and requires substantial skill and dedication. The hours tend to be long, since many debtors have reduced the size of their management teams, and the remaining managers must both run the business and supervise the bankruptcy process. The job also involves considerable risk and instability. Managers are understandably concerned that their company may end up in liquidation, or may be sold to a buyer who will have its own management team. History has shown that these concerns are legitimate; many managers -- and even entire management teams -- have lost their jobs during or at the conclusion of a bankruptcy case. The people who are willing to do this job and can do it well tend to be in demand, and have many opportunities.

[32] Section 503(c)(1), enacted as part of BAPCPA, requires retention bonus payments to a debtor's insiders (payments intended to induce an insider to remain with the debtor through the chapter 11 process) to meet a set of strict criteria that had never before been imposed. These criteria are typically, as a

Footnote continued on next page

However, recognizing that management defections could severely damage the company and its reorganization prospects, debtors have, since BAPCPA, often sought (and obtained) court permission to pay other types of bonus compensation, such as incentive compensation.[33] Creditors and committees frequently support these payments, recognizing that the amounts at issue are typically inconsequential in the scheme of the overall case, but that the consequences of losing key managers during the reorganization process can be dire.[34]

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practical matter, impossible to satisfy. They require a finding that (i) the person receiving the payment has a bona fide job offer from another business at the same or greater rate of compensation, (ii) the services provided by the person are essential to the survival of the business, and (iii) the proposed payment is not greater than 10 times the average amount of similar payments made to non-management employees for any purpose during the same calendar year or if no similar payments during such calendar year, the amount of the payment is not greater than an amount equal to 25 percent of the amount of any payment made to the insider during the calendar year before the year in which such payment is made or incurred. 11 U.S.C. §§ 503(c)(1)(A)-(C)(ii). *See also In re Dana Corp.*, 358 B.R. 567, 576 n.11 (Bankr. S.D.N.Y. 2006) ("Under this section [§ 503(c)(1)], a company will now be required to show not only that each key management employee has another offer, but also that they will take the offer absent a KERP. This is nearly an impossible standard to satisfy and would require that each such employee come to court and testify that they have another offer and will leave absent the KERP.") (internal citations omitted).

[33] The difference between retention bonuses and incentive compensation is that incentive compensation is conditioned upon the achievement of specified objectives. The courts have been vigilant to ensure that the objectives are real and that they confer a material benefit on the estate, rather than simply being an "end-run" around the restrictions on retention bonuses. *See, e.g., In re Dana Corp.*, 351 B.R. 96, 102 (Bankr. S.D.N.Y. 2006) (denying a request to authorize compensation where the bonus included "an amount payable to the [executive employees] upon the Debtors' emergence from chapter 11, regardless of the outcome of [the chapter 11 case]" and finding that "compensation scheme walks, talks and is a retention bonus"); *compare with In re Dana Corp.*, 358 B.R. at 584 (approving a request to authorize compensation where payment of the bonus required the executives to reach certain EBITDAR benchmarks before they would be eligible for any payment and also providing for the imposition of "an appropriate ceiling or cap on the total level of yearly compensation to be earned by the CEO and Senior Executives during the course of the bankruptcy proceedings"); *In re Calpine Corp.*, Case No. 05-60200, Hearing Tr. at 84-85 (Bankr. S.D.N.Y. Apr. 26, 2006) (order approving the incentive plans entered May 15, 2006) ("the record before me validates that the focus of the plans and agreement is to maximize value for all the estates . . . [t]hey are not retention plans, although anyone can always make an argument that if people are made happier than they were before, then they are excited enough to stay with the company, but that's not the focus of these plans").

[34] Typically, any proposed management bonus or incentive compensation plan will be discussed with the creditors committee, and in some cases with other major creditor constituencies, before it is proposed to the court for approval. Thus, creditors ordinarily have input into the plan before it is put before the court for approval.

For bonus compensation that is intended to incentivize as opposed simply to retain insiders, and any compensation to non-insider managers, the § 503(c)(1) standard does not apply. Instead, the code requires only that these payments be "justified by the facts and circumstances of the case."[35] Most courts have held that the § 503(c)(3) standard is the same as the "business judgment test,"[36] although some courts have articulated a higher standard.[37]

Section 302 of the bill would amend § 503 to do four things. First, it would extend the strict requirements imposed on insiders in § 503(c)(1) to "a senior executive officer, or any of the 20 next most highly compensated employees or consultants." Second, for insiders, senior officers and the "20 next most highly compensated employees," it would extend the requirements imposed by BAPCPA in § 503(c)(1), which now apply only to "retention bonuses" to insiders, to ***all*** bonuses, all incentive or performance compensation, and any "financial returns designed to replace or enhance incentive, stock, or other compensation . . . ", essentially making it impossible to make any such payments. Third, for these insiders, executive officers and the "20 next most highly compensated employees," it would heighten the standard a court would have to apply in awarding compensation from "based on evidence in the record" to "clear and convincing evidence in the record." Fourth, for compensation to all other managers and

[35] *See* 11 U.S.C. § 503(c)(3).

[36] The business judgment standard is the same standard that governs other debtor conduct, such as the decision to sell assets under § 363 or to assume or reject executory contracts under § 365. *See, e.g., In re Dana Corp.*, 358 B.R. at 576-77 (acknowledging that courts review key employee incentive programs by considering the standards of the sound business judgment test); *In re Nobex Corp.*, Case No. 05-20050, Hearing Tr. at 86-87 (Bankr. D. Del. Jan. 12, 2006) (order approving the management incentive plan at issue was entered Jan. 20, 2006) (stating that § 503(c)(3) is the "catch-all and the standard . . . for any transfers or obligations made outside the ordinary course of business . . . that are justified by the facts and circumstances of the case . . . I find it quite frankly nothing more than a reiteration of the standard under 363 . . . the business judgment of the debtor . . .").

[37] *See In re Pilgrim's Pride Corp.*, 401 B.R. 229 (Bankr. N.D. Tex. 2009) (holding § 503(c)(3) sets a higher bar than the business judgment test).

consultants hired by a debtor, it would replace the current "business judgment" standard in § 503(c)(3) with a considerably more stringent standard, requiring that the court find "based upon clear and convincing evidence" that any payments are "essential to the survival of the debtor's business," and "reasonable compared to individuals holding comparable positions at comparable companies in the same industry and not disproportionate in light of economic concessions by the debtor's nonmanagement workforce during the case."

Modifying the Bankruptcy Code to implement the proposed amendments in § 302 of the bill would, in my view, be a mistake.

First, the amendment to § 503(c)(1), which would effectively disallow ***any*** bonus or incentive compensation for senior management or any of the "20 next most highly compensated employees,"[38] would preclude a court from authorizing such compensation even where the evidence shows that paying such compensation is necessary and in the estate's best interest. I believe that bankruptcy judges are in the best position to determine, under the facts of the particular case and after hearing the evidence and arguments from all interested parties, whether a proposed bonus or incentive compensation plan is in the estate's best interest. Divesting the court of this authority -- and replacing it with a rule that would effectively preclude such payments regardless of the facts or the merits -- will not further the goals of chapter 11.

As noted above, under current law, payments made to a debtor's insiders for incentive purposes (*i.e.*, payments that are conditioned upon the accomplishment of specified objectives),

[38] As I discussed above, inclusion of the "20 next most highly compensated employees" is arbitrary. *See supra* pg. 6, n.4 and pg. 17. The purpose of § 503(c)(1) is to ensure that there is oversight and scrutiny of compensation that is awarded to "insiders" of the debtors -- those individuals who control the debtor and have decision-making authority. However, in some cases, these 20 employees will include employees who have no decision-making control or authority, and no input regarding the company's compensation decisions. Indeed, in some cases the "top 20" will include union represented employees. Requiring that, in all cases, the twentieth highest paid employee will be treated differently than, say, the twenty-first highest paid employee, is irrational.

as opposed to retention or stay bonuses, are not subject to the § 503(c)(1) restrictions, but are instead evaluated under the "business judgment" standard in § 503(c)(3). However, these incentive payments are not made without significant prior scrutiny. Such payments are not only reviewed by the debtor's board of directors (typically including outside directors), but also by the creditors committee, bank lenders, the United States Trustee and the bankruptcy judge. Any interested party can object to payments the debtor proposes to make. This scrutiny precludes a debtor from paying excessive or unnecessary compensation to its managers during a chapter 11 bankruptcy, but it permits the court to authorize such compensation where the evidence shows that it is appropriate and in the estate's best interest.[39] This scrutiny by interested parties, and by the court, is a good thing, and it should continue. But a provision making it effectively impossible to pay senior managers (or the "20 next most highly compensated employees") any incentive or similar compensation, even where doing so is in the estate's best interest, would be counterproductive, and is likely to lead to a loss of management talent.

Second, amending § 503(c)(3) to condition any payments to managers (including non-insiders) or consultants on a finding by the court that such proposed compensation is "reasonable compared to individuals holding comparable positions . . ." and "not disproportionate in light of economic concessions . . ." is, at least potentially problematic, depending on how the provision is interpreted.

The first part of the provision -- "reasonable compared to individuals holding comparable positions at comparable companies in the same industry" -- standing alone, would not be

[39] *See In re Pilgrim's Pride Corp.*, 401 B.R. at 237 ("section 503(c)(3) is intended to give the judge a greater role: even if a good business reason can be articulated for a transaction, the court must still determine that the proposed transfer or obligation is justified in the case before it. The court reads this requirement as meaning that the court must make its own determination that the transaction will serve the interests of creditors and the debtor's estate").

particularly problematic since few debtors seek to pay materially above-market compensation to their managerial employees, and even under current law the court has the authority under § 503(c)(3) to decline to approve above-market or otherwise excessive payments to managers or consultants. So, on the one hand, this part of the amendment would not be troublesome, but on the other hand, it is not necessary because the concern is addressed adequately under existing law.[40]

However, the second part of the provision, which represents an effort to tie management compensation to union workforce compensation, is more troublesome. The requirement that management and consultant compensation be "not disproportionate in light of economic concessions by the debtor's nonmanagement workforce during the case" language is obviously somewhat vague, but appears to be intended to create a basis for disallowing or reducing management compensation -- even if that compensation is already at or below market-competitive levels -- in cases where the debtor has obtained, through negotiations or court relief, labor cost concessions.[41]

If this provision were construed to prohibit courts from authorizing bonus or other incentive compensation payments to management employees or consultants in cases in which represented employees agree to, or are compelled to, accept concessions, the provision would be problematic. There are some cases in which a debtor must obtain wage, benefit and work rule

[40] One concern, however, is that the "same industry" is not always the best measure of appropriate compensation. In some cases a better measure might be the geographic market in which the debtor operates. Courts should have flexibility to evaluate these issues on a case-by-case basis.

[41] One could potentially construe the "not disproportionate" language to mean that management should not be paid above-market compensation while represented workers are paid below-market compensation. However, because the "not disproportionate" language is ***in addition to*** the provision that limits payments to market-competitive levels in the particular industry, I assume that the "not disproportionate" language is intended to mean more than simply limiting each group of employees to market-competitive compensation for their particular job.

concessions from union employees in order to bring labor costs in line with the market for comparable services -- in other words, to reduce above-market compensation and/or benefits to a market-competitive level. If a debtor that obtains such concessions is thereby precluded from providing market-competitive wages and benefits (including incentive compensation) to management employees, or from paying consultants market-based fees for their services, it would essentially punish the debtor and its management for undertaking difficult but necessary cost-cutting measures, and would interfere with the debtor's ability to retain management employees.[42] I agree that a debtor should not pay its management employees materially above-market compensation (in other words, compensation that goes beyond what is reasonably necessary to retain their services and to incentivize them to accomplish relevant objectives), while paying represented employees below-market wages and benefits. But going beyond that, and creating some artificial linkage between management compensation and the compensation of represented employees, would ignore the economic reality that there are different labor markets for different jobs, and would make retention of management employees even more difficult than it already is.

The provision that would preclude incentive or similar compensation to managers unless it is "essential to the survival of the debtor's business" sets an unreasonably high standard. A more appropriate standard would be whether the payments are in the best interest of the bankruptcy estate.

For many of the same reasons noted above, implementing the amendments proposed in § 301 of the bill would also be imprudent. First, § 301 of the bill would, through an amendment

[42] This may be a part of the purpose of this provision -- the intent may be to create a disincentive for managers to seek labor cost concessions by threatening the managers' own compensation if they do so. Other provisions of the bill, including § 304, appear to have a similar objective. *See infra* pg. 45.

to § 1129(a)(4),[43] require that payments made to insiders, senior officers, or any of the "20 most highly compensated employees or consultants providing services to the debtors," could be approved only "as part of a program of payments or distributions generally applicable to employees of the debtor, and only to the extent that the court determines that such payments are not excessive or disproportionate compared to distributions to the debtor's nonmanagement workforce." I agree that it is appropriate to ensure that compensation is not excessive. However, the standard should be whether the services rendered were necessary, the extent to which the debtor and its estate received value from such services, and the market rate for such services. A standard that creates artificial linkage between union employees' wages and benefits, on the one hand, and payments of the type contemplated by § 1129(a)(4) on the other hand, is not useful.

Section 301 of the bill also would, through an amendment to § 1129(a)(5),[44] require the bankruptcy court (i) to approve the compensation to be paid to insiders of the debtor ***after*** emergence from bankruptcy, and (ii) to find the post-emergence compensation to be "reasonable when compared to persons holding comparable positions at comparable companies in the same industry and not disproportionate in light of economic concessions by the debtor's non-management workforce during the case."

Requiring bankruptcy courts to approve post-bankruptcy compensation plans for senior managers is inconsistent with the notion that, once reorganized, a debtor should make its own

[43] Section 1129(a)(4) sets forth the requirements that payment, made or promised by the debtor or person issuing securities or acquiring property under the plan, for services in connection with the bankruptcy case or plan, be disclosed and approved by the court.

[44] Section 1129(a)(5) requires that, in order for a court to confirm a plan of reorganization "the proponent of the plan has disclosed the identity of an insider that will be employed or retained by the reorganized debtor, and the nature of any compensation for such insider." 11 U.S.C. § 1129(a)(5)(B). Under current law, the debtor is required to disclose compensation to insiders, but court approval of such post-bankruptcy compensation is not required.

business decisions and freely compete in the marketplace. Typically the court's supervision of a debtor ends after its plan becomes effective (other than limited post-confirmation proceedings, intended to wrap-up the bankruptcy, such as claim objections). Bankruptcy courts should not be in the business of approving or disapproving a debtor's compensation plans -- or other business decisions made by the company -- after the debtor emerges from bankruptcy.

The provision in § 301 of the bill requiring the court to find the post-emergence compensation to insiders to be "reasonable when compared to persons holding comparable positions at comparable companies in the same industry and not disproportionate in light of economic concessions by the debtor's nonmanagement workforce during the case," is nearly identical to the provision in § 302 of the bill regarding approval of management and consultant compensation during a bankruptcy case under § 503(c)(3) of the Bankruptcy Code, and would suffer from the same failings. A provision that could preclude a company from paying market-competitive wages and benefits to insiders upon emergence from bankruptcy, on the basis that it obtained labor cost concessions during the chapter 11 case, could doom reorganizations to failure, to the detriment of all constituencies, including labor. Debtors emerging from bankruptcy need strong and properly incentivized senior management teams. Moreover, investors who make chapter 11 reorganizations possible are less likely to fund a debtor's emergence from chapter 11 if there are unreasonable restrictions on the reorganized debtor's ability to pay competitive wages and benefits, including appropriate incentives, to the reorganized debtor's management team. In addition to these issues, the proposed amendment to § 1129 could to lead to time-consuming and costly litigation at the time of plan confirmation, as plan opponents seek to exert leverage to obtain unrelated plan modifications, and labor unions seek revenge for §§ 1113/1114 relief. The provision would thereby make plan confirmation more difficult, more time consuming and more expensive.

Simply put, the problem with both §§ 301 and 302 of the bill is that debtors should not be forced to choose between obtaining necessary concessions from labor groups or providing market-competitive wages, benefits, and incentives to management employees. Instead, all employee groups should, to the extent of the debtor's ability to do so, be paid market-competitive wages and benefits, recognizing that there are distinct markets for different types of employees.

Indeed, in order to retain and attract management talent, a debtor *must* be able to pay market-competitive wages and benefits to its management employees. In many cases, this will include bonus or other incentive-based compensation. This is true for at least five reasons. First, bonus and incentive compensation is a typical component of executive pay, which the debtor's competitors are likely to pay -- so the debtor must pay similar bonuses just to remain competitive. Second, because managing a debtor is typically a less attractive job than managing a financially stable competitor -- a harder job with more stress and materially greater risk -- the debtor may need to pay greater bonus amounts than financially stable (non-bankrupt) competitors. Third, and related to the preceding point, competitors of a chapter 11 debtor often see the bankruptcy as an opportunity to "pick off" the competitor's best talent, both at the senior levels and at mid-level management. This can cause tremendous instability for a debtor and diminish the prospects for successful reorganization. Bonus and incentive compensation is often the debtor's only defense to these efforts. Fourth, unlike their competitors, debtors ordinarily cannot offer their management employees compensation in the form of equity (stock or options), because their equity is most often out-of-the-money. In order to remain competitive with other companies that offer stock compensation, the chapter 11 debtor must pay additional cash compensation. Fifth, chapter 11 debtors find incentive compensation to be a useful tool in motivating their management teams to achieve challenging objectives and to produce results that inure to the benefit of all constituencies.

For all of these reasons, implementing this bill which imposes additional restrictions on the payment of management and consultant compensation would be a mistake. Judges are already, under current law, able to police excessive compensation, and creditors' committees, the United States Trustees, and other constituencies have been active in raising these issues with the courts where they believe the proposed management bonus or other compensation is excessive. However, if this bill is enacted, and it precludes debtors from paying market-competitive compensation, including bonus and incentive compensation, to their managers and consultants during the chapter 11 case and after emergence, their best managers and consultants are likely to find alternative employment, thereby imperiling the debtor's reorganization efforts.

Section 303: Recovery of Executive Compensation

Section 303 of the bill would amend Bankruptcy Code § 365, which deals with the assumption, assignment and rejection of executory contracts, to add two new subsections, (q) and (r). Subsection (q) would preclude a debtor from assuming a deferred compensation plan for the benefit of insiders, senior officers or any of the "20 next most highly compensated employees" of the debtor, if the debtor has terminated its defined benefit plans during or within 180 days prior to the bankruptcy filing. Subsection (r) is almost identical; except it would preclude a debtor from assuming a plan, fund, program or contract to provide retiree benefits to these same senior officers and "20 next most highly compensated employees," if the debtor had obtained

§ 1113/1114 relief in respect of health benefits for active or retired employees during or within 180 days prior to the bankruptcy filing.

There are some cases in which it is necessary to terminate a defined benefit plan (or impose § 1113/1114 relief) in order for a company to be able to remain a viable going concern. Under these circumstances, termination of the plan or benefits is consistent with the fiduciary duty of officers and directors. This provision would punish management for the proper exercise of their fiduciary duty by eliminating what is often an important element of management compensation. It would thereby make the job of attracting and retaining management talent to a company in or on the verge of bankruptcy materially more difficult.

This section also seeks to create an equivalence between unrelated plans -- a management deferred compensation plan and an employee defined benefit plan. Instead of this artificial linkage, a company (and a court) should look at each plan in terms of whether it serves a legitimate business purpose, whether it provides benefits that are competitive in the marketplace, whether the debtor's obligations under the plan are affordable in light of the debtor's financial circumstances, and what would be the likely consequences of a proposed assumption, rejection or termination.

Section 304: Recovery of Executive Compensation

Section 304 of the bill would add a new provision to the Bankruptcy Code, § 563, to create a cause of action against certain officers and directors for the return of their personal compensation in an amount equal to the percentage reduction of collective bargaining obligations (or retiree benefits) implemented by a debtor pursuant to §§ 1113 and 1114, including any reduced benefits as a result of the termination of a defined benefit plan after the date that is 180 days before the petition date. This provision apparently seeks to create a disincentive for a company to seek to modify collective bargaining agreements or retiree benefits, or to terminate a defined benefit plan, by threatening the personal compensation of individuals involved in making the decision to seek such relief.

As discussed above, §§ 1113 and 1114 relief is available only when a clear case has been made that such relief is necessary for the debtor to reorganize, and where, after the company engaged in good faith bargaining, the union unreasonably refused to make the necessary concessions. Where such circumstances exist, it is appropriate for a debtor to seek relief. Indeed, in such a situation, the debtor's failure to seek relief may well result in liquidation, with a resulting loss of jobs and creditor recoveries. The debtor's officers and directors should not be forced to operate under a threat that, if they do what is in their company's best interest, they will be sued and required to disgorge their own compensation. This would create an inappropriate disincentive for officers and directors. It would put such individuals in a Catch 22 position -- they either decline to implement labor cost reductions that are necessary for their company to reorganize, or they implement such reductions but thereby expose themselves to a lawsuit to disgorge their own compensation. As with several other provisions in the bill, this provision would make it more difficult for a troubled company (particularly one with labor cost issues) to retain and attract officers and directors.

Section 305: Preferential Compensation Transfer

Another provision of the bill that would impose a burden on senior management employees is § 305. This section would amend § 547 of the Code (which establishes the criteria for preference actions) to add a new subsection, § 547(j), providing that transfers made or obligations incurred in anticipation of bankruptcy, to or for the benefit of an insider (or to a consultant who was formerly an insider, and is retained to provide services to the debtor), can be recovered as a preferential transfers. In addition, new subsection § 547(j) would eliminate the § 547(c) defenses to any such preference action.

By subjecting senior managers and consultants to preference actions, this provision would create an additional disincentive for anyone who had other viable options to contract with or remain employed by a financially troubled company that is considering bankruptcy. Discouraging qualified individuals who are familiar with a debtor and its business from remaining with the company during its chapter 11 case is inconsistent with the reorganization objective of chapter 11. Courts already have sufficient tools to ensure that debtors do not pay excessive compensation to their managers or consultants, whether as a result of obligations incurred in contemplation of bankruptcy or otherwise.

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In enacting chapter 11, Congress observed that, "[i]t is more economically efficient to reorganize than liquidate, because it preserves jobs and assets." H.R. Rep. 95-595, 95th Cong., 1st Sess. 220 (1977). More than thirty years of chapter 11 history proves that this is true. Where a company is able to reorganize, creditors tend to recover more, customers and suppliers enjoy continued relationships, taxing authorities continue to receive revenues, employees retain their jobs, and local communities benefit. Unfortunately, chapter 11 reorganization is not easy. First, it is expensive. Second, it requires a stable and talented management team to lead the effort. Third, it requires hard decisions, including sometimes painful cost cutting, to bring costs in line with revenues, and with the competitive marketplace. Fourth, it typically requires financing, which is increasingly hard to obtain. Fifth, it requires a balancing among competing interests which are often difficult to reconcile.

In an effort to protect the interests of, and maximize value for union employees, H.R. 4677 is likely to impede chapter 11 reorganizations. It would increase costs. It would make attracting and retaining talented management much more difficult. It would impair a debtor's ability to bring labor costs into line with the competitive marketplace, even when doing so is necessary in order for the company to remain viable. It would make financing less available and, where available, more expensive. And it would, by moving labor to the front of the line, diminish the recoveries of other constituencies, and thereby make the balancing of interests that is at the heart of the chapter 11 process more difficult to achieve.

Therefore, H.R. 4677, may ultimately, if enacted, have the opposite impact of what is intended -- it may make it more difficult for employees to preserve their jobs or retiree benefits because such legislation may cause more companies to liquidate instead of reorganize. In the end, if this bill is enacted, it is likely to be a pyrrhic victory for employees and unions.