Hearing on H.R. 3652, the "Protecting Employees and Retirees in Business Bankruptcies Act of 2007"

Before the Subcommittee on Commercial and Administrative Law of the Committee on the Judiciary

U.S. House of Representatives

Statement of:

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June 5, 2008

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Introduction

Good morning Madame Chairwoman and members of the Subcommittee. I would like to express our appreciation to you, to the members of the Subcommittee and to Chairman Conyers for convening this hearing on H.R. 3652, the "Protecting Employees and Retirees in Business Bankruptcies Act of 2007." This bill would amend the Bankruptcy Code to add urgently needed protections for employees and retirees when businesses file bankruptcy cases. I am appearing today on behalf of the AFL-CIO, a labor federation with affiliates representing over 10.5 million workers. Many AFL-CIO affiliates, such as the United Auto Workers, the United Steelworkers, and labor organizations representing workers in the airline industry, including the Air Line Pilots Association, Association of Flight Attendants-CWA, the International Association of Machinists and others have experienced the business bankruptcy process first-hand, some with tragic frequency in recent years.

When the bankruptcy laws were comprehensively revised in 1978, Congress designed the business reorganization system to prevent the liquidation of viable businesses – to preserve jobs and going concern value for all stakeholders.[1] At the heart of the concerns behind our business bankruptcy system is the preservation of jobs, in particular the preservation of jobs worth having. But workers' experience with the bankruptcy system is the opposite of what Congress intended. Business bankruptcy has become a process by which management (and the legions of professionals that support the restructuring process) lower the living standard of employees and enrich themselves in the process. In recent years, we have seen major corporate bankruptcies work very well for powerful, moneyed constituencies, but workers – with no ability to diversify risk, and little ability to absorb losses – end up losing jobs, decent wages, pensions and

healthcare. Indeed, preserving jobs – the first goal Congress cited in its redesigned chapter 11 – can become a tortured rationale for the harsh consequences faced by workers in these cases.[2]

Congress has long recognized that obligations to employees are different from debts owed to other creditors. Early business bankruptcy laws established a payment priority for wages, which has been increased and expanded over the years to take into account different forms of payroll and deferred compensation and the employee benefits plans that pay workers' health, pension and other benefits.[3] In 1984, Congress passed Section 1113 of the Bankruptcy Code[4] to protect collective bargaining agreements when companies blatantly used bankruptcy as a strategic weapon against organized labor. Congress responded again in 1986, when LTV Steel Company, in its first bankruptcy case, stopped paying retiree health benefits for 70,000 retired steelworkers by claiming that these obligations were really bankruptcy debts that could not be paid until all other creditors received their bankruptcy recoveries. In response, Congress passed Section 1114 to require the continuation of retiree health and life insurance benefits and prohibit other companies from taking similar action.[5] Most recently, in 2005, Congress increased the wage priority[6] and added other amendments to safeguard employee payroll deductions for health and pension plan contributions and improve recovery for back-pay awards where companies violated federal and state laws.[7]

It is time for Congress to act again. Comprehensive reform is needed because too many features of bankruptcy law provide too little protection for employees and retirees. The wage priority remains inadequate as applied to earned compensation and pits payroll wages against contributions to employee benefit plans. Section 1113 has been misconstrued and misapplied by many courts almost since its enactment in 1984, and with disastrous results for employees. Debtors are taking aim at retiree health costs notwithstanding Section 1114, in many instances by

trying to evade the statutory requirements altogether. Asset sales in bankruptcy have become pitched battles where buyers pick up distressed assets and leave employees and benefits behind.

As a result of serious deficiencies in the law, workers and retirees are bearing a grossly disproportionate burden of an employer's bankruptcy: more than investors who can absorb a loss in diversified portfolios or trade out of their positions; more than vendors or suppliers, who can take steps to shore up credit or pricing terms or seek new business, and certainly more than the company's top management. Workers are suffering because more can be taken away, much more easily, and with wholly inadequate remedies. Just last year, the Court of Appeals for the Second Circuit ruled that airline workers could be denied their most basic right – to withhold their services – when their contracts were rejected in bankruptcy,[8] an unprecedented ruling that badly subverts established bankruptcy and labor law precedent. And despite the wide-reaching effects of business bankruptcies on workers, their jobs and their retirement security, executive pay continues to flourish, notwithstanding Congress's recent action to reign in executive bonus, severance and other compensation programs in bankruptcy cases.[9] Business bankruptcy cannot function effectively and credibly if workers – vital to any business recovery – are sacrificing their jobs, pay and benefits while executives are treated to generous compensation enhancements and rewards.

H.R. 3652 would correct many deficiencies in current law and establish important protections for workers and retirees. The bill would the amend the Bankruptcy Code in five major ways:

First, H.R. 3652 would increase workers' recoveries for their losses.

Second, the bill would restore a balanced process, principally through collective bargaining, where a debtor seeks to modify a labor agreement.

Third, the bill would enhance protections against losses in retirement security.

Fourth, the bill would enhance the preservation of jobs and benefits as an explicit goal of business bankruptcy.

Fifth, the bill would strengthen restrictions on executive pay schemes.

1. <u>H.R. 3652 would increase workers' recoveries for their losses</u>

As a result of the amendments to the Bankruptcy Code in 2005, the wage priority is now $10,950 per employee for compensation earned within 180 days of bankruptcy, and contributions to employee benefit plans based on those services. But for a long time, courts have limited the amount of the wage priority that can actually be collected through decisions that treat some earned compensation, like vacation, sick leave and severance pay less favorably than wages.[10] In addition, the current wage priority statute pits payroll compensation against pension and health benefits by splitting the wage priority into two sections. Priority payments are made for unpaid contributions to health, pension and other benefit plans only to the extent an employee hasn't used up $10,950 in payroll compensation.[11] Benefit plans are getting the leftovers, if there are any.

H.R. 3652 [Section 3] raises the total amount of the wage priority to $20,000 per employee to take into account the varied forms of payroll compensation and fringe benefits workers now earn and eliminates the court-made distinctions among different types of earned compensation that have prevented workers from collecting the full amount of the priority. The bill also de-links the wage priority from the plan contribution priority and gives unpaid contributions owed to benefit plans a separate $20,000 per-employee priority. In addition, the bill provides that the full amount of severance pay owed to employees (other than insiders or senior management) who are terminated during the bankruptcy qualifies as administrative

expenses of the estate, so that workers can pay their bills and living expenses when they lose their jobs, and can cover continued or replacement health insurance. [Section 5] The bill also allows workers to recover compensation due for preserving a lender's collateral, in the event a debtor waives that right in a lending agreement. [Section 13]

2. H.R. 3652 restores a balanced process, principally through collective bargaining, where a debtor seeks to modify a labor agreement.

A. Why Section 1113 no longer works

In 1984, Congress acted, through Section 1113, to stop the use of bankruptcy as a strategic weapon in collective bargaining. Section 1113 established rules designed to protect the collective bargaining process and apply a more stringent legal standard to rejection of labor agreements than the standard applicable to the rejection of other contracts. But Section 1113 was not well understood by most courts. A legal standard informed by both labor policies and bankruptcy policies was soon rejected by most courts in favor of a bankruptcy-centered standard that disregarded the labor policies Congress took deliberate action to protect.[12] The legal standard that has been predominantly applied by the courts has allowed debtors wide latitude in labor cost cutting despite extreme hardships the courts have acknowledged workers will face. This lenient standard, combined with more expansive use of bankruptcy to address industry-wide problems, has been disastrous for workers.

In recent years, airlines, auto parts suppliers, steel and other manufacturing companies, have filed bankruptcy cases when faced with problems that, to a great degree, cannot be solved merely be filing for bankruptcy because the company's financial circumstances are also shaped by global market conditions, or industry-wide problems indicative of fundamental industry change. Beginning in the late 1990s, approximately 40 steel companies such as LTV Steel, Wheeling-Pittsburgh Steel and others filed bankruptcy cases to try and survive global market

overcapacity and depressed steel prices. In 2002, large airlines began filing chapter 11 cases following the 2001 economic downturn, 9/11, and in response to other industry-wide challenges, such as the growth of low-cost carriers and extraordinarily high fuel prices. Most recently, in the automobile sector, numerous auto supply companies have sought bankruptcy protection in response to industry globalization and the pressures now facing the OEM's.

Many of these companies targeted deep cuts in labor costs, pension funding and retiree health obligations as a principal focus of their bankruptcy cases.[13] Bankruptcy can do little to lower fuel prices or raise fares; bankruptcy cannot reverse trade policies that disadvantage American manufacturers; bankruptcy cannot solve the changing demand for OEM automobiles. But bankruptcy offered powerful tools for rejecting contracts. Even though some sacrifices were needed to weather difficult financial times, debtors aggressively overreached and targeted deep cuts in wages and benefits, pension funding and retiree health benefits. Bankruptcy tools compensated for forces that were uncontrollable. As a result, workers and retirees paid dearly in lost jobs, lower pay and benefits, harsher working conditions and weakened retirement security. The protections Congress intended by enacting sections 1113 and 1114 – to prevent workers and retirees from bearing a disproportionate burden of their employer's bankruptcy – could not stop the broad assault on jobs, labor agreements, pensions and retiree health benefits.

B. Amendments to Section 1113 [Section 8]

H.R. 3652 would remedy serious deficiencies in the operation and application of Section 1113. Some of the amendments address defects in the rejection process and are intended to restore the paramount use of collective bargaining processes when companies seek concessions in bankruptcy. In response to recent court decisions, the new provisions would clarify the remedies available upon rejection. In addition, hearing and scheduling rules that have become

unduly burdensome for the parties – and for the courts – would also be modified. Other changes adopt language from Section 1114 in order to eliminate anomalies between the two statutes that have been cited by the courts.

(1) Changing the contract modification process

The bill addresses two major problems related to the contract modifications process. First, debtors are ignoring the fundamental rule that meaningful bargaining must take place before the debtor initiates a court process seeking contract rejection. Rather than apply to the court as a last resort, which was the original design, debtors are using the court process as leverage and relegating important procedural requirements to perfunctory check lists. Debtors are setting up litigation processes very early on, even before any meaningful negotiations have taken place. Delphi Corporation, for example, asked for a litigation schedule for its section 1113 proceedings against five unions on the very first day of its bankruptcy case – a schedule that was extended repeatedly and then finally suspended so that the parties could take the time needed to negotiate what turned out to be a globally comprehensive, highly complex agreement.[14] Dana Corporation, another automotive supplier, established a litigation schedule for its Section 1113 and Section 1114 motions having tendered its proposals only days earlier.[15]

A so-called "two track" system of litigation and bargaining, now routinely imposed by management and permitted by the courts in large chapter 11 cases, is not what Congress intended in crafting Section 1113, and does not lead to better or earlier negotiated agreements. Instead, it wastes considerable time and money, needlessly consumes court time, and distracts the parties from the serious work of trying to find a negotiated solution. The process has become very lucrative for bankruptcy firms, which get to bill the estate for teams of litigators engaged in expensive and wasteful pre-trial litigation activity and court trials, but little else is accomplished.

H.R. 3652 corrects this misuse of the process by making it clear that a motion to initiate the court process "shall not be filed" unless the debtor has met with the union to confer in good faith "for a reasonable period in light of the complexity of the case" and may only be filed if the parties have reached an irreconcilable stalemate in the negotiations. [Section 8 (1), amending Section 1113 (b)(1) and (c)(1)]

(2) Alternate dispute resolution by a Neutral Panel [Section 8 (4), adding new Section 1113(i)]

In addition, the amendments would permit a dispute over proposed modifications to be resolved by arbitration rather than by the bankruptcy court. Arbitration conducted by a neutral panel of experienced labor arbitrators offers a process that labor and management negotiators are familiar with and one which is recognized and well-regarded as a vehicle for the resolution of labor disputes.[16] Arbitration is also less formal than court litigation and may prove less costly than engaging in litigation in the bankruptcy court. Disputes over contract modification often involve issues that are endemic to the business and best understood by the bargaining parties. Neutral arbitrators selected by the parties are experienced in dealing with such issues and will be respected by both sides. They may also be used as mediators and thus offer another means of resolving a dispute short of litigation.

(3) Making sacrifices that are fair to workers and retirees

The second major deficiency in the Section 1113 process is that there is no effective limit to the concessions that can be sought from workers. Because courts that have addressed Section 1113 have favored a legal standard that permits a debtor wide latitude and virtually ignores labor policies, Section 1113 offers employees little effective protection against broad cost cutting aimed at jobs, pay and benefits that not only affect employees in the near term, but extend to their retirement security, through pension plan terminations and cuts in other retiree benefits.

United Airlines engaged in two rounds of Section 1113 cuts, and also sought Section 1114 relief as well as termination of its defined benefit pension plans.[17] By the time its second bankruptcy case was complete, US Airways had engaged in multiple rounds of Section 1113 proceedings, slashed its retiree health benefits obligations and terminated all of its defined benefit pension plans.[18] Dana Corporation, an automotive supplier that emerged from bankruptcy earlier this year, targeted an ambitious program of plant closures, transfer of work to low-cost economies, elimination of retiree health benefits obligations and rejection of all of its labor contracts in its bankruptcy case. In its Section 1113 proposals, Dana even asked to eliminate modest benefits such as tuition reimbursement programs and perfect attendance awards.[19]

The relief debtors are seeking is both stunningly broad and long-term. Employees must bear the hardships of concessionary agreements for years after a company has emerged from bankruptcy. United Airlines, for example, had money to pay a special, $250 million dividend to its shareholders earlier this year, and awarded generous contracts to its executives, but has resisted the unions' requests to begin their contracts talks early, before the 2009 amendable date of the agreements reached with its labor groups while in bankruptcy.[20] Mesaba Aviation rigidly sought a six-year concessionary agreement and a fixed level of savings in its Section 1113 court case – both approved by the court – even though in private negotiations, the airline agreed to less draconian savings, a shorter agreement and a form of wage increase snapback it emphatically rejected in court.[21]

H.R. 3652 addresses these problems by requiring that a proposal define the amount of labor savings sought for each labor group, so that labor groups can address and evaluate a specific share of the necessary sacrifice, rather than open ended "labor transformation"

demands.[22] The bill would also limit the scope of employees' sacrifices by getting rid of marathon-length concessionary agreements and limiting the extent of workers' sacrifices to two years following emergence from bankruptcy. [Section 8 (1), amending Section 1113(b)(1)(A)]

H.R. 3652 also requires that proposed modifications "shall not overly burden the affected labor group, either in the amount of the savings sought from such group, or the nature of the modifications, when compared to other constituent groups expected to maintain ongoing relationships with the debtor, including management personnel." [Section 8(1), amending Section 1113(b)(1)(C)] In ruling on a motion under Section 1113, the court must find that the debtor has complied with the new procedural requirements, that the debtor's proposals meet the specified conditions, and must consider the effect of the proposal on the affected labor group. The court must also consider how the modifications will affect the ability of the debtor to retain an experienced and qualified workforce. The court must also consider the effect of a strike. [Section 8 (1), amending Section 1113(c)] Concessions made by the labor group before bankruptcy must be taken into consideration in determining whether the proposed modifications are disproportionate. [Section 8 (1), amending Section 1113(c)]

(4) Information requirements

The amendments maintain the requirement under current law that the debtor provide relevant and sufficient information so that the union can engage in meaningful negotiations. [Section 8(1), amending Section 1113(b)(2)] In order to encourage a broad exploration of solutions, the amendment would require the court to look at the whole of the company's business as well as proposals made by the union that meet the requisite savings standard in evaluating a rejection motion. [Section 8 (1), amending Section 1113(c)(2)]

(5) Contract rejection remedies

H.R. 3652 would correct the Court's ruling in the *Norwest Airlines* case that denied the right of airline employees to engage in economic self-help following rejection of their labor agreement. That decision reflected serious errors in the application of labor law and bankruptcy principles never before questioned in bankruptcy cases. Before *Northwest*, no court had ever questioned that employees whose contracts are rejected in bankruptcy have a right to strike.[23] The bill would restate what was well understood before *Northwest*, that economic self-help by a labor organization is permitted upon a court order rejecting a labor agreement. [Section 8(2), adding a new Section 1113(g)]

In addition, before the *Northwest Airlines* ruling, only one lower court had ruled that contract rejection under Section 1113 did not give rise to a rejection damages claim. The majority of courts held otherwise.[24] The *Northwest* court erroneously concluded that a labor union has no remedy for contract rejection even though it is well established that counterparties to rejected executory contracts are entitled to rejection damage claims. H.R. 3652 makes this remedy explicit for labor agreements. [Section 8(2), adding a new Section 1113(g)] However, the bill does not change current law that rejection of a labor agreement is prospective only. A debtor cannot seek retroactive relief from a labor agreement.[25] Unless and until a labor agreement is rejected under section 1113, it remains in effect. That is the law today and that would be the law under H.R. 3652.

(6) Hearing and scheduling modifications

H.R. 3652 also adjusts the current timeline built into Section 1113 by increasing the required minimum notice of a Section 1113 motion to 21 days from 14 days. [Section 8(2), amending Section 1113(d)(1)] A compressed schedule was originally incorporated into the

statute based on concerns that the newly crafted process not be unduly lengthy.[26] However, the statutory time limits are often ignored (or routinely extended) by the parties and by the courts. And because Congress has now acted to limit the exclusive time for a debtor to propose its plan to 18 months, all stakeholders must adjust to a shorter time line to propose a reorganization plan. There is no purpose to be served by singling out the Section 1113 process for compressed timetables that are routinely extended now any way. Interim relief under Section 1113(e) would continue to be available in the event of an emergency that threatened the business. The bill also clarifies that only the debtor and the affected labor organization may appear and be heard at the hearing.[27] [Section 8(2), amending Section 1113(d)(1)]

(7) Other amendments to Section 1113

Other changes to Section 1113 in H.R. 3652 are designed to address differences in language between Section 1113, enacted in 1984, and Section 1114, enacted in its final form in 1988. Courts have cited these differences, for example, in denying administrative expense status to certain payments arising under labor agreements because, unlike Section 1114, Section 1113 does not explicitly state that payments have the status of an allowed administrative expense. [Section 8(3), amending Section 1113(f)] H.R. 3652 adds other language consistent with provisions of Section 1114 to clarify that, in areas where courts have raised questions, the statutes should operate in the same way. [Section 8(4), adding new subsections (g)("No claim for rejection damages shall be limited by section 502(b)(7)"); (h)(permitting a labor organization to seek relief from a modified agreement or a rejection order based on changed circumstances)][28]

3. H.R. 3652 would enhance protections against losses in retirement security

The third major area addressed by H.R. 3652 is retirement security. When LTV Steel Corporation stopped paying retiree health benefits, Congress stepped in to require continuation

of retiree health and life insurance benefits in bankruptcy. Like Section 1113, Section 1114 established a stringent process to be followed in the event a debtor sought to reduce its retiree benefits obligation. The procedures for seeking to modify those obligations were patterned on the Section 1113 process. Notwithstanding these protections, retiree health obligations are often viewed merely as large numbers on financial balance sheets instead of obligations that reflect hospital, medical, prescription drug and other healthcare expenses that are a lifeline for retirees. As balance sheet numbers, however, they have become irresistible targets for cost-cutters and financial investors.

A. Changes to Section 1114 [Section 9]

H.R. 3652 amends Section 1114 to provide greater protection for retiree health and life insurance benefits with changes similar to those proposed for Section 1113 and for the same purpose: to strengthen the requirements for seeking a negotiated resolution, restrain the debtor's ability to use the court process as heavy-handed leverage, and limit the scope of permissible changes so that retirees do not disproportionately bear the cost of the bankruptcy. In addition, H.R. 3652 aims to stop court-shopping by opportunistic debtors, by providing that the Section 1114 procedures apply whether or not a company thinks it can make changes to retiree health benefits unilaterally by applying non-bankruptcy law that varies widely by jurisdiction. [Section 9(1), amending Section 1114(a)][29]

B. Other retirement security protections

H.R. 3652 also protects retirement security by establishing a contract damages claim for the termination of a defined benefit pension plan in bankruptcy. The claim would be treated as a general unsecured claim. [Section 12] In addition, a debtor would be required to treat pension and retiree health benefit plans for rank and file employees the same as those for senior

management in the bankruptcy. If workers' pension plans have been terminated, or retiree health benefits have been modified, then senior management pension plans and retiree health programs cannot ride through the bankruptcy unaffected. [Section 15, adding a new Section 365(q), restricting assumption of pension plans for insiders or senior management and Section 9 (6), adding a new Section 1114(m), restricting the assumption of retiree health benefits plans for insiders or senior management]

The bill also establishes a priority claim for losses incurred when stock held in a defined contribution pension plan loses value as a result of fraud committed by the employer. [Section 4]

4. H.R. 3652 would enhance the preservation of jobs and benefits as an explicit goal of business bankruptcy

Fourth, H.R. 3652 adds explicit protections for job preservation and the preservation of benefits in key transactions in a bankruptcy case. First, under current law, a debtor that sells all or part of its business must conduct an auction to determine the highest or best offer for the assets.[30] A buyer might offer less in sale proceeds, but hire the debtor's employees and assume responsibility for accrued vacation or other benefit obligations. The bill provides that in approving a sale, the bankruptcy court shall consider the extent to which a bidder will maintain existing jobs, has preserved retiree health benefits or assumed pension obligations in determining whether an offer constitutes the successful bid. [Section 10, adding a new Section 363(b)(3)]

More generally, where a debtor is reorganizing as a going concern, its reorganization plan must reflect that every reasonable effort has been made to maintain existing jobs and mitigate losses to employees and retirees. Where competing plans are presented, the court must take into consideration the extent to which each plan would maintain existing jobs and benefits. [Section 14(2), amending Section 1129(a)] By making explicit that these attributes can be considered in

determining the outcome, the amendment puts prospective investors and other stakeholders on notice that these contributions count towards assessing the success of an offer.

In addition, in order to prevent the recurrence of circumstances where buyers have taken assets but made no provision for continuation of retiree health benefits, leaving those obligations to be wiped out in the bankruptcy, the bill would require a set aside of sale proceeds for retirees to use towards replacement coverage.[31] Alternatively, the buyer could put those funds towards the provision of health benefits coverage in a plan or program already sponsored by the buyer. [Section 10 (2), adding a new Section 363(q)] In addition, where a debtor has proposed a liquidating plan, either through the sale of the business or cessation of operations, the bill clarifies that existing labor law obligations to negotiate an orderly transition of the workforce, including payment of accrued obligations not assumed by a buyer, and other terms related to a sale or closure apply except as otherwise addressed as part of the sale or as part of the Section 1113 process. [Section 8(4), adding a new Section 1113(k)]

5. H.R. 3652 would strengthen restrictions on executive pay schemes

Fifth, the bill would amend the Bankruptcy Code to provide more stringent regulation of executive pay schemes that are put in place in anticipation of bankruptcy, proposed during bankruptcy, or incorporated in reorganization plans for emerging companies.

A. Executive compensation schemes continue to flourish

Under current law, executive compensation schemes have been addressed in a bankruptcy case in the following ways:

Section 363(b). For cases not subject to the 2005 amendments to the Bankruptcy Code, debtors still seek court approval under Section 363(b) of the Code as a use of its property "other than in the ordinary course of business." Through these motions, programs formerly known as

"Key Employee Retention Plans," or "KERPS," severance programs for senior executives and other schemes designed to award cash, stock and other value to management are presented for court approval under a generally lenient "business judgment" legal standard.[32] The rationale is that the programs would prevent key talent from leaving the company, although little hard evidence has been required under the relaxed standard of review, in which the courts look broadly for a "sound business purpose."

Section 503(c). In the 2005 amendments, Congress acted to crack down on "pay to stay" "KERPS" and oversized severance packages through a new Section 503(c), intended to strictly limit the instances in which these programs could be approved. The most specific limits applied to "insiders" (those who are officers, directors, or other persons in control of the debtor). In addition, Congress added a "catch-all" provision that required compensation programs designed for those who are not insiders to be "justified by the facts and circumstances of the case."

The 2005 amendments have not worked as intended. Debtors and their professionals have crafted any number of ways around them (for example, by re-labeling the programs "incentive" plans through the use of difficult to assess financial or "milestone" targets that trigger payments).[33] Some courts have not even required input from independent compensation consultants if the programs are found to be "ordinary course" programs, or programs that were similar to pre-bankruptcy plans.[34] And despite aggressive targeting of labor costs and benefit obligations owed to rank and file workers, debtors have also been able to implement management bonus and other pay schemes at the same time that they are seeking cuts in the pay and benefits of rank and file workers.[35]

Section 1129(a)(5). In order to emerge from bankruptcy, a business must confirm a reorganization plan that meets certain statutory criteria. One of the requirements is that the

debtor disclose "the identity of any insider that will be employed or retained by the reorganized debtor, and the nature of any compensation for such insider." Courts have not engaged in analysis of the compensation disclosed under this provision because the statute provides only for disclosure and not for review and approval.

B. Reigning in Executive Compensation Schemes

H.R. 3652 would strengthen the current law to reign in executive compensation programs proposed in anticipation of, or during a bankruptcy case. Section 7 of the bill expands the provisions of Section 503(c). The strict criteria that now apply to payments "for the purpose of inducing" an insider to remain with the business would also apply to payments for performance or incentive bonuses of any kind, or other financial returns designed to replace or enhance incentive, stock or other compensation in effect prior to bankruptcy. In addition, the "catch-all" provision would be bolstered to apply to compensation obligations incurred for the benefit of officers, managers or consultants retained before or during bankruptcy, and to impose a more stringent standard. The court would review the proposal without applying the deferential business judgment standard. Instead, the Court must determine whether the proposed payments are essential to the survival of the business (or, in the case of a sale of the business, the orderly liquidation of assets).

The court must also find that the proposed compensation is reasonable compared to persons holding comparable positions in comparable companies in the same industry and not disproportionate in light of economic concessions made by the non-management workforce during the bankruptcy. This standard has been added to counteract the practice of justifying compensation schemes through the use of unrealistic comparables and other flawed compensation consulting practices.[36]

In addition, Section 1129(a)(5) would be amended for insider compensation disclosed as part of a plan of reorganization. Because such compensation will likely include emergence grants of stock and/or cash and other compensation "perks," under the amendment, insider compensation that is disclosed under this section would be reviewed for reasonableness when compared with persons holding comparable positions at comparable companies in the same industry and to ensure that it is not disproportionate in light of economic concessions made by the non-management workforce. [Section 6] To avoid eve of bankruptcy awards that might otherwise escape the scrutiny of the court or creditors, the bill also provides that a transfer made in anticipation of bankruptcy to or for the benefit of an insider or to a former insider who becomes a consultant to the debtor can be recovered as a preferential transfer. [Section 18]

To address circumstances where a debtor proposes an executive compensation scheme in a case that has targeted cuts in labor costs, the bill provides that where a debtor has implemented a bonus program or other financial returns for insiders or senior management personnel during or prior to bankruptcy, the court must apply a presumption that labor concessions sought by the debtor would be overly burdensome to the affected labor group when compared to other constituent groups. [Section 8(1), amending Section 1113(c)(3)] In addition, the estate is granted a claim for the return of a portion of director compensation if a court orders rejection of a labor agreement or termination of a defined benefit pension plan. [Section 16]

Other technical changes

H.R. 3652 also contains other amendments of a more technical nature, generally intended to codify existing practices. The bill adds statutory provisions for two widely accepted practices, the filing of a proof of claim by a labor organization on behalf of its members [Section 11] and an exception to the automatic stay for ordinary course grievances and labor arbitrations pending

at the time of the bankruptcy case.[37] [Section 17] In addition, the bill adds a new Section 1113 (j) permitting the reasonable fees and costs incurred by the labor representative in the Section 1113 process be paid by the debtor. Reimbursement of a labor organization's professional fees incurred during the restructuring has become an accepted practice and fosters informed review and negotiations concerning the debtor's restructuring issues.[38]

Concluding Remarks

Bankruptcy, and chapter 11 in particular, affords debtors broad flexibility to direct the course of their restructuring cases. Management remains in control of the business, has an 18-month "exclusivity" period to file a reorganization plan, and many powerful tools at its disposal. H.R. 3652 will undoubtedly be criticized for encroaching on the broad discretion that management and their restructuring professionals guard very closely. We are under no illusions about the reaction this bill will generate from defenders of the status quo. They will tell you that debtors cannot possibly pay workers more towards their claims, even though they routinely continue their ordinary course payroll and benefits following a bankruptcy filing as part of their efforts to stabilize the business.[39] They will even tell you that changes like those proposed in this bill will doom a reorganization.

We urge you not to fall prey to these types of charges. Perceived threats to vigorously guarded bankruptcy prerogatives will yield all manner of high-pitched exaggerations about the calamities that could befall a company if the law is changed. We are not here to turn reorganizations into liquidations. No groups work harder than labor groups to achieve pragmatic and fair outcomes under the extraordinarily difficult conditions of a bankruptcy case.

We are here to say that workers are sacrificing too much to too many other interests in bankruptcy. Employees *can* and *should* recover more of their losses. Workers' interests *can* and

should be taken into consideration when companies sell assets. The Section 1113 process *can* – indeed was supposed to be – and *should* operate so that management and labor representatives can craft solutions to difficult business and industry challenges without the circus of litigation and the threat of a court process that does not recognize workers' unique role and vital interests. Job preservation should not simply be empty rhetoric. Debtors that use bankruptcy to slash decent wages, send thousands of jobs overseas, and gut workers' retirement security are not fulfilling the obligations Congress established in its design of business reorganizations.

H.R. 3652 will provide long-overdue and much needed protection for employees and retirees in business bankruptcy cases and we urge Congress to take prompt action on this bill.

Thank you once again for the opportunity to appear today in support of this important legislation.

[1] *See* H.R. Rep No. 95-595 at 220 (1977) ("The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap … It is more economically efficient to reorganize than to liquidate because it preserves jobs and assets.").

[2] *See, e.g., In re Kaiser Aluminum Corp.*, 456 F.3d 328 (3d Cir. 2006) (citing the application of bankruptcy aims, including job preservation, in holding that Kaiser could aggregate the costs of multiple pension plans in meeting the test for approval of plan terminations in bankruptcy).

[3] *See Howard Delivery Service, Inc. v. Zurich American Insurance Co.*, 514 U.S. 651 (2006) (reviewing the expansion of the wage priority to include contributions to employee benefit plans).

[4] The Bankruptcy Amendments and Federal Judgeships Act of 1984, Pub. L. No. 98-353, § 541 (1984).

[5] The Retiree Benefits Bankruptcy Protection Act of 1988, Pub. L. No. 100-334, §2, (1988).

[6] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 212 (2005), codified at 11 U.S.C. §§ 507(a)(4),(5).

[7] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, §§ 323, 329 (2005), codified at 11 U.S.C. § 541(b)(7) and § 503(b)(1)(A).

[8] *Northwest Airlines Corp. v. Association of Flight Attendants*, 483 F.3d 160 (2d Cir. 2007).

[9] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1501 (2005), codified at 11 U.S.C. § 503(c).

[10] Most courts distinguish between "length of service" severance pay and "pay in lieu of notice" severance (*see, e.g., In re Roth American, Inc.*, 975 F.2d 949 (3d Cir. 1992); *In re Public Ledger*, 161 F.2d 762 (3d Cir. 1947)). Where courts make this distinction, severance pay in which the amount is based on length of service is allocated between "earned" periods. Under *Roth*-type cases, employees are left with a small fraction of their contractual severance pay if they lose their jobs during a bankruptcy. However, the Second Circuit recognizes severance pay as earned in full upon termination of employment, and does not distinguish between pay in lieu of notice and length of service severance. *See Straus-Duparquet, Inc. v. Local Union No. 3, International Brotherhood of Electrical Workers*, 386 F.2d 649 (2d Cir. 1967). H.R. 3652 follows the *Straus-Duparquet* rule so that workers receive meaningful payments if they lose their jobs. Vacation pay is typically allocated by the court to earnings periods, even where fully earned as of a specified date. *See, e.g., In the Matter of Northwest Engineering Company* , 863 F.2d 1313 (7th Crr. 1988). Under H.R. 3652, the wage priority cap would apply to all earned, unpaid vacation.

[11] 11 U.S.C. § 507(a)(5)(B) (describing calculation of $10,950 per employee priority for unpaid benefit plan contributions, "less (ii) the aggregate amount paid to such employees under paragraph 4 of this subsection.…"

[12] Babette A. Ceccotti, "Lost in Transformation: The Disappearance of Labor Policies in Applying Section 1113 of the Bankruptcy Code," 15 ABI Law Rev. 415 (Winter 2007) (hereafter, *Lost in Transformation*). This article reviews the history of Section 1113, legal developments in key decisions following its enactment, and the application of the statute in recent bankruptcy cases. A copy is submitted with this Hearing Statement.

[13] *See* U.S. Gov't Accountability Office, GAO 07-1101, "Many Factors Affect the Treatment of Pension and Health Benefits in Chapter 11 Bankruptcy" (2007) (identifying companies that rejected labor agreements and terminated pension and/or non-pension benefits obligations in bankruptcy); *Lost in Transformation*, 15 ABI Law Rev. at 417 and note 10.

[14] Delphi's Motion for Scheduling Order to Establish Notice Procedures, Briefing Schedule, and Hearing Date Regarding Debtors' Conditional Applications for Relief Under 11 U.S.C. § 1113 if Voluntary Modifications to Collective Bargaining Agreements Cannot Be Reached [Docket # 14, Oct. 11, 2005] and Sixth Amended Order Suspending Further Proceedings on Debtors' Motion for Order Under 11 U.S.C § 1113(c) Authorizing Rejection of Collective Bargaining Agreements and Authorizing Modification of Retiree Welfare Benefits Under 11 U.S.C. § 1114(g) [Docket No. 8880, Aug. 3, 2007], *In re Delphi Corporation*, No. 05-44481 (RDD) (Bankr. S.D.N.Y.).

[15] Motion of Debtors and Debtors in Possession, Pursuant to 11 U.S.C. Section 105(a) for Entry of a Scheduling Order in Connection with Debtors' Section 1113/1114 Process [Docket No. 4278, Dec. 6, 2006] and Joint Objection to Motion on behalf of International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW), United Steelworkers [Docket No. 4341, Dec. 14, 2006], *In re Dana Corp.*, No. 06-10354 (BRL) (Bankr. S.D.N.Y.).

[16] *See* Stipulation and Consent Order Under Bankruptcy Rule 9019 Between Delta Air Lines, Inc. and the Air Line Pilots Association, International, *In re* Delta Air Lines, Inc., No. 05-17923 (PCB) (Bankr. S.D.N.Y.) [Docket No. 1552, Dec. 13, 2005].

[17] *Association of Flight Attendants-CWA v. P.B.G.C.*, No. Civ. A 05-1036 ESH, 2006 WL 89829, at *2 (D.D.C. Jan. 13, 2006) (describing Section 1113 and pension plan termination proceedings in United's bankruptcy).

[18] *See In re USAirways, Inc.*, 329 B.R. 793 (Bankr. E.D. Va. 2005) (describing Section 1113, Section 1114 and pension plan termination proceedings in USAirways' bankruptcy cases).

[19] First Amended Disclosure Statement With Respect to First Amended Joint Plan of Reorganization of Debtors and Debtors in Possession at 29-32, *In re Dana Corp.*, No. 06-10354 (BRL) at 30-32 (Bankr. S.D.N.Y. Oct. 18, 2007) [Docket No. 6600] (describing labor-related cost savings targeted in Dana's bankruptcy).

[20] Source: UAL Corporation Form 8-K (December 5, 2007) and Press Release (disclosing United's announcement that its Board of Directors approved a special distribution of approximately $250 million to holders of UAL common stock and term loan pre-payment under an amendment to the company's credit agreement). *See also*, "United Workers Join For Fight," Chicago Tribune, March 28, 2007 (describing efforts by United's unions to begin early talks to replace contracts negotiated in United's bankruptcy case).

[21] *In re Mesaba Aviation, Inc.*, 350 B.R. 435 (D. Minn. 2006); Motion to Approve Compromise and For Relief Under 1113(c) Approving Amended Agreements with ALPA, AFA and AMFA, at 5-7, *In re Mesaba Aviation, Inc.*, No. 05-39258 GFK, (Bankr. D. Minn. Nov. 7, 2006).

[22] *Lost in Transformation*, 15 ABI Law Rev. at 417-18 (describing use of bankruptcy by companies to achieve "transformation" objectives, *i.e.*, the "strategic use of bankruptcy to bring about broad changes … largely through substantial cost cutting, to address conditions that are ascribed to fundamental industry change").

[23] *See* Richard M. Seltzer and Thomas N. Ciantra, "The Return of Government by Injunction in Airline Bankruptcies," 15 ABI Law Rev. 499 (Winter, 2007). The article is a comprehensive examination of the *Northwest* decision. The authors represented the Air Line Pilots Association, International in the strike injunction lawsuit. A copy is submitted with this Hearing Statement.

[24] *See generally*, Michael St. Patrick Baxter, "Is There a Claim for Damages From the Rejection of a Collective Bargaining Agreement Under Section 1113 of the Bankruptcy Code?" 15 Bankr. Dev. J. 703 (1996).

[25] *See, e.g., Peters v. Pikes Peak Musicians Association*, 462 F.3d 1265 (10th Cir. 2006).

[26] *Lost in Transformation*, 15 ABI Law Rev. at 426-7 (describing legislators' concerns that led to the inclusion of the time limits in the statute).

[27] *See In re UAL Corp. (Appeals of Independent Fiduciary Services, Inc.)*, 408 F.3d 847 (7th Cir. 2005)(ruling that the parties to a Section 1113 hearing are those legally capable of modifying the agreement).

[28] *In re Ionosphere Clubs, Inc*., 22 F.3d 403 (2d Cir. 1994); *In re Roth American, Inc*., 975 F.2d 949 (3d Cir. 1992) (noting that when Congress intends to alter the priority scheme it has done so explicitly, as in Section 1114(e)). *See also In re Northwest Airlines Corp.*, 366 B.R. 270 (Bankr. S.D.N.Y. 2007) (citing statutory provision of Section 1114 permitting relief from Section 1114 order, and absence of similar provision in Section 1113).

[29] *See In re Farmland Industries, Inc.*, 294 B.R. 903 (Bankr. W.D. Mo. 2003) (ruling that Section 1114 procedures apply even where debtor asserted the right to make unilateral changes in retiree health benefits).

[30] *See, e.g., In re After Six, Inc.*, 154 B.R. 876 (Bankr. E.D. Pa. 1993) (reviewing factors courts may consider in approval of a sale).

[31] This provision addresses hardships resulting from the bankruptcy case of Horizon Natural Resources, in which the bankruptcy court rejected the labor agreements and eliminated retiree health obligations when the prospective buyer purchased Horizon's assets but did not assume these obligations as part of the sale. *In re Horizon Natural Resources Co.*, 316 B.R. 268 (Bankr. E.D. Ky. 2004).

[32] *See, e.g., In re USAirways, Inc.*, 329 B.R at 797 (describing legal standard for review of "KERP's").

[33] *See* Maryjo Bellow and Edith K. Altice, "Tackle §503(c) by Structuring a 'MIP' – And Other Strategies to Have in Your Playbook," 27 APR Am. Bankr. Inst. J. 34 (offering strategies for devising compensation packages in light of the Section 503(c) restrictions).

[34] *E.g., In re Global Home Products, LLC*, No. 06-10340, 2007 WL689747 (Bankr. D. Del. 2007) (approving program as incentive plan in the ordinary course of the debtor's business and not as a KERP; court excused the absence of independent consultant because the program was similar to a pre-bankruptcy plan); *In re Nellson Neutraceutical Inc.*, 369 B.R. 787 (Bankr. D. Del. 2007).

[35] *See In re Dana Corporation*, No. 06-10354, 2006 WL 3479406 * note 30 (Bankr. S.D. N.Y. 2006) (approving, as modified, revised executive contracts and noting that the CEO, "with curious timing, issued a letter to employees and former employees in the days after the Executive Compensation Motion was filed" indicating that the debtors, in aid of their reorganization "would have to close plants, terminate employees, modify collective bargaining agreements and potentially terminate retiree [health] benefits.").

[36] *See* "Executive Pay: Conflicts of Interest Among Compensation Consultants," U.S. House of Representatives, Committee on Oversight and Governmental Reform (Majority Staff) (December, 2007).

[37] *See, e.g., In re Ionosphere Clubs, Inc.*, 922 F.2d 984 (2d Cir. 1990); *In re Fulton Bellows & Components, Inc.*, 307 B.R. 896 (Bankr. E.D. Tenn. 2004) (automatic stay does not bar contractual arbitration proceedings).

[38] *See United States Trustee v. Bethlehem Steel Corporation*, 2003 WL 21738964 (S.D.N.Y. July 28, 2003) (affirming bankruptcy court's approval of debtor's reimbursement of union advisor fees in bankruptcy).

[39] Debtors now routinely seek authority in their initial bankruptcy court filings to pay wages and other forms of compensation accrued as of the date of the bankruptcy filing, either under the bankruptcy court's equitable authority or as a payment under Section 363(b) of the Bankruptcy Code, citing the need to stabilize the business, maintain employee morale, and mitigate economic hardships. *See* Eisenberg and Gecker, "The Doctrine of Necessity and Its Parameters," 73 Marq. Law Rev. 1 (Fall, 1989).