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Committee on the Judiciary

Executive Compensation and Business Bankruptcy
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Good morning, Chairwoman Sanchez, my name is Damon Silvers and I am an Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations. First, let me express the labor movement's gratitude to you and the Committee for holding this hearing on the enormously important question of whether executive compensation in our business bankruptcy system is fulfilling the overall purposes of the bankruptcy code.

In 2002, the AFL-CIO assisted over 5,000 laid off non-union Enron workers in their efforts to obtain the severance payments they needed to live on while they found new work. After months of litigation in the bankruptcy courts, we obtained a settlement which paid the workers up to $13,500 in lost severance pay. During that time the Chief Executive Officer of Enron was Steve Cooper, a principal in the turnaround firm of Zolfo Cooper. Enron of course liquidated, and when the case completed, Steve Cooper's firm asked from the court a $25 million "success fee," even though the Justice Department's U.S. Trustee Program uncovered unacceptable billing practices (Cooper eventually agreed to cut this fee in half). This was after Cooper and his firm were already paid $107 million for their work. Cooper recently bought a $20 million penthouse on 5th Avenue, one of the most expensive apartments sold in Manhattan during the real estate boom.
Contrast Steve Cooper's fate with that of Louis Allen, a mid-level executive at Enron. Lewis was a single father, the first person in his family to go to college and work in management. He lost his job, his 401k, his health insurance and his home, and with his daughter had to return to living with his mother, who worked as a grocery clerk in Houston. Lewis Allen in the end only got a fraction of the severance he was promised. In the fall of 2002, still without a job and living with his mother, Lewis had a stroke and died at the age of 44. Neither he nor his mother nor his daughter has to date received any meaningful recovery from his lost pension.

The AFL-CIO is extremely proud of the role the working people of this country played in standing up for the Enron workers. But we do not believe the outcomes I just described could be described by any sane person as just. And the outcome at Enron has much in common with the grotesque inequities workers experience throughout the business bankruptcy system today.

Let me give you a couple of examples from some well-known recent bankruptcies.

Polaroid – Upon filing for Chapter 11 in 2001, Polaroid reneged on its severance policies, and cut off all company payments for employees' health, dental and life insurance plans. Six months later, a bankruptcy judge approved Polaroid's plan to pay $4.5 million in retention bonuses to forty executives. The plan approved by the court provided for the most senior executives in the pool to receive bonuses of as much as 62.5% of their base pay as well as severance payments also equal to 62.5% of their base pay. Other executives would be eligible to receive bonuses and severance payments equaling 25 to 50% of their base salaries.

United Airlines – United went into bankruptcy as a strategy to extract significant labor cost cuts. All United employees lost their defined benefit pension plans and retirees ended up with substantial cuts in their retiree health benefits. United employees took 15% to 40% pay cuts, including a 17% cut for flight attendants and 40% cut for pilots. In total, over 50,000 United employees gave up several billions of dollars. At the end of the case, United proposed emergence stock grants for management worth $150 million in its reorganization plan--about 9% of the new stock of the company. Last year pay and stock worth $39 million was awarded to United CEO Glenn Tilton, including an $840,000 bonus (over 120% of his base salary).

Delphi Corporation – Delphi, a large automotive supply company went into bankruptcy in 2005. Delphi immediately proposed to eliminating thousands of U.S-based jobs and cutting the middle class wages earned by people making sophisticated auto parts down to as little as $12.50 an hour. At the same time – mere weeks into its bankruptcy case – Delphi unveiled a Key Employee Compensation Program of six-month "bonus opportunities" and an emergence bonus plan consisting of $88 million for some 486 managers--some payments as much as 280% of salary. In addition, Delphi proposed to grant 10% of the reorganized Delphi's equity to 600 executives, a program valued at $400 million, including $12.5 million in restricted stock for its top five executives. Just prior to bankruptcy, Delphi enhanced its severance program for 21 executives – severance that would pay out between $30 million and $145 million. So far, Delphi has gotten approval of bonus plans worth about $40 million a year but the severance payments were not even subject to court oversight, nor was a signing bonus paid to Delphi's new CEO in lieu of salary, since they were in place before Delphi filed its case mere days before the new Bankruptcy Code amendments took effect.

Dana Corporation – Dana is another automotive parts supplier that filed a bankruptcy case in New York last year. Dana's restructuring plan is to send as many good-paying U.S. manufacturing and assembly jobs as it can to Mexico and other low cost economies. For the jobs that are left, Dana asked the bankruptcy court to cut pay, and cut or eliminate a wide range of benefits such as life insurance, long and short term disability--even tuition reimbursement programs, and completely eliminate Dana's obligation to pay retiree health benefits. Before they got to bankruptcy court on the workers' pay and benefits, though, Dana's senior executives renegotiated their employments contracts. Those contracts, which included significant stock-based compensation pre-bankruptcy, were not worth what the executives thought they'd be worth as a result of Dana's bankruptcy. Under their renegotiated contracts, Dana's CEO, between a base salary of $1 million per year plus bonuses, can earn $6.5 million a year while the company is in bankruptcy. The other five senior executives can earn combined annual compensation of $ 7 million while their company is in bankruptcy.

US Airways-- US Airways went through two bankruptcy cases in which the pilots' pay alone was cut up to 50%. In addition, by the time the two cases were over, all the employees lost their pension plans and retiree health was all but eliminated. US Airways' management got a bonus and severance program worth some $20-30 million.

Workers in chapter 11 cases across a wide range of industries (manufacturing, airline, trucking, retail and other service industries), are paying an enormous price under threats that their labor agreements will be rejected, their jobs will be outsourced and retirement security threatened. Meanwhile, company executives and management move quickly to secure their own agreements and replace compensation such as supplemental executive retirements plans and stock-based compensation rendered worthless by the bankruptcy payment priorities with new, lucrative programs that insulate them from the economic dislocation of the bankruptcy.

Like so much of our system of business regulation and corporate governance, our business bankruptcy system has become a vehicle for the transfer of ever more staggering amounts of wealth from a variety of parties, but in particular long term employees, into the hands of a very, very small number of executives and turnaround specialists. Recently, Congress tried to rein in this intolerable trend by placing strict limitations on so-called retention bonuses in bankruptcy. In response, the management community and their compensation consultants, with the full cooperation of the bankruptcy bench, appear to have continued the same type of post-petition payments to pre-bankruptcy management under new labels—most prominently now as "incentive pay," where highly speculative incentive targets are designed to guarantee some payment, even for delivering a business plan or reorganization plan, something reorganization fiduciaries are required to do anyway.

Runaway executive compensation in bankruptcy takes place in two contexts—the context of the general explosion in executive compensation in American business, and the second is the unique and not well-understood context of corporate governance in bankruptcy.

The bankruptcy system necessarily gives the debtor (aided by the bankruptcy courts) great latitude in crafting the path for businesses in Chapter 11 to return to financial health. Part of this approach is both explicitly by statute and even more so in practice for bankruptcy judges to grant substantial deference to both the immediate requests of the debtor in possession, and to give the debtor initial exclusivity in proposing a plan. These basic structures of the Code are absolutely necessary—but they left the courts ill-prepared to deal with the culture of CEO excess because what that culture is all about is the executives of the debtor in possession proposing a series of self-enriching transactions, usually with the support of a coterie of experts, again paid by the debtor in possession. The Lake Wobegon effect that has long been noted in executive compensation is particularly powerful in bankruptcy, where courts tend to apply a reasonableness test to applications for enormous post-petition executive pay packages based on the representations of one or more consultants that this package is within the third quartile for companies of this type.

The bankruptcy system has become a mere mirror of the excess found in the larger corporate culture. The dimensions of that excess have recently been explored by the House Financial Services Committee. It is sufficient to point out here that Chief Executive Officer pay in 350 public companies with revenue in excess of $1 billion has risen by 300% in the last fifteen years, and that CEO pay is on average 411 times that of the average worker, up from 107 times in 1990 and 42 times in 1980.
But runaway executive pay in bankruptcy is not just another example of this larger problem. There are structural reasons why when the excess and inequity that characterizes our corporate economy as a whole is moved to the bankruptcy setting it is both even less defensible and does significantly more harm.

Much modern thinking in corporate governance begins from the distinction between constituents of the corporation with fixed contractual claims (lenders, suppliers, customers and workers) and those with variable, and in particular marginal claims (equity holders). But in bankruptcy the one thing that is clear is that contractual claims to one degree or another are not going to be honored.

Secondly, the purpose of the Code is very clear—it is to preserve as much going concern value as possible, and in the process preserve the bankrupt firm for the explicit purpose of preserving both jobs and community economic structures. It is not to maximize the value of any given constituency of the firm—be that secured creditors, unsecured creditor, or most inappropriately, the pre-petition equity holders.

Thus the notion, always ultimately hard to defend in any context, that corporate executives should be

working to maximize one constituent's value, is particularly inappropriate to bankruptcy law. And yet, as recent both journalism and academic articles make clear, debtors are increasingly organizing themselves around one dimensional measures of business success that easily allow for excessive executive compensation when those measures are achieved.
This trend is a departure from the historic experience of distressed companies. Writing in 1994, Professors Stuart Gilson and Michael Vetsuypens found that one of the key forces ensuring accountability by incumbent management in a distressed company was the pressure from courts and creditors for executives to "share the pain. "

Congress should be most concerned about these dynamics when they involve management teams that have taken their companies into bankruptcy and then seek large compensation packages. Courts' indulgence of this pattern creates reasonable expectations on the part of company managements that they can use the bankruptcy process to wipe out the equity (to which they have a fiduciary duty) and renege on contractual commitments to the most vulnerable of the company's constituencies – long term employees and host communities – and they will be ensured of not only keeping their pre-petition compensation, they are likely to receive further lavish rewards in addition to the packages they began with.
The result is not only an imbalance in outcomes. These arrangements encourage bankruptcy processes that are dominated by an alliance of incumbent management with subgroups of creditors to the detriment often of the firm as a whole (see Gretchen Morgenson's April 15 New York Times report of a new study of asset sales in bankruptcy) and of the very people the Code was intended to protect. After all, if we just wanted liquidations for the benefit of the secured creditors, we wouldn't need a Bankruptcy Code in the first place.

The AFL-CIO believes that Congress in response to the destabilization of the traditional balance represented by the Code, should take two steps to address the problems with executive pay in bankruptcy. First, the sorts of procedural protections that Congress recently put in place with respect to KERPS should be broadened to cover executive pay in bankruptcy as a whole. Second, Congress should mandate that pre-petition executives seeking to breach contractual commitments to their employees should have to personally share the pain in an amount proportional to what they are asking their colleagues to bear. Such a measure would focus the minds of executives contemplating bankruptcy as a "war of choice" against their employees and their communities.

The AFL-CIO looks forward to further hearings as part of a larger examination of the fairness of the business bankruptcy process. Thank you.