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Employment-Related Issues in Bankruptcy

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Robin Jeweler
Legislative Attorney
American Law Division

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Summary

This report provides an overview of the status of employee wages and benefits, including retiree benefits, when an employer files in bankruptcy, and the amendments made to the U.S. Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act. Private pensions, regulated by the Employee Retirement Income Security Act, are generally protected, although defined benefit pension plan payments may be substantially reduced. Health and life insurance benefits, which are not required by federal law, are vulnerable to an employer's bankruptcy-driven modification or termination. This report examines those provisions in the U.S. Bankruptcy Code which govern the priority of employee wage and benefit claims, including severance payments; procedures for a chapter 11 debtor to modify benefits under a collective bargaining agreement; and procedures for a chapter 11 debtor to modify retiree life and health insurance benefits. It examines the role of employees on creditor committees and procedures in bankruptcy that facilitate lawsuits that may be directed at an employer/debtor. Finally, it considers the treatment accorded some aspects of managerial compensation, such as retention bonuses.

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Employment-Related Issues in Bankruptcy

This report provides an overview of employment related issues when a business files in bankruptcy under the U.S. Bankruptcy Code, 11 U.S.C. § 101 *et seq.*, as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA).¹ A business employer will generally file under one of two of the operative chapters of the Code. It may seek to cease operation and liquidate under chapter 7, or to continue in business and reorganize under chapter 11. The status of basic benefits, such as wages, pensions, and health care for active and retired employees, which have to date been the subject of greatest concern to employees of a company in bankruptcy, are examined.

The behavior and compensation of a debtor's executives have become more controversial in recent years, corresponding to many high-profile bankruptcies, for example, those of Enron and Worldcom, that were caused, in part if not solely, by managerial malfeasance as opposed to external economic factors. This report considers compensation of debtor's management as well.

Employee Benefits

Many employees, especially retirees, fear loss of all employment benefits upon learning that their employer has filed in bankruptcy. Fortunately, this is not necessarily the case, although some benefits may be subject to modification or termination. It is important to know that employee benefits, including retiree benefits, have no universal legal referent; they may be covered by a wide variety of federal and state laws. More important though is the fact that specific employee welfare benefit plans are governed by contract terms which vary from plan to plan. And, each bankruptcy – and the consequences for each of the debtor's creditors, including its employees – is highly case specific. Unique to bankruptcy, however, is the demarcation between prepetition (pre-filing) and postpetition (post-filing) claims. Because the entire bankruptcy process is concerned with debt forgiveness of pre-bankruptcy indebtedness, the classification of a claim as pre- or postpetition is of great consequence. Determining whether a claim accrues pre- or postpetition is not always clear cut.

Active employees of an employer in a chapter 11 reorganization.

Typically, a chapter 11 debtor will get an order from the bankruptcy court permitting it to continue business and to compensate its employees just as it had prior to filing. Postpetition operating expenses are considered to be high priority administrative expenses, i.e., “the actual, necessary costs and expenses of preserving the estate, including wages, salaries, and commissions for services rendered after the

¹ P.L. 109-8 (2005).

commencement of the case.”² Thus, in many instances, employees of a chapter 11 debtor will realize no change in the terms and conditions of their employment. The BAPCPA amended the Code to also include back pay (i.e., prepetition wages) due to employees as a consequence of illegal behavior by the debtor as an administrative expense. The bankruptcy court must determine that the inclusion of back pay will not substantially increase the probability of layoff or termination of current employees.³

In traditional employment-at-will situations, a debtor/employer may lay off employees or attempt to renegotiate the terms of employment, just as the employee is free to accept a different compensation structure or terminate the employment relationship. These contingencies may occur in connection with the debtor/employer’s bankruptcy. But there are special requirements for a chapter 11 debtor seeking to renegotiate collective bargaining agreements with union employees.

Rejection of collective bargaining agreements. In 1984, the U.S. Supreme Court held that a collective bargaining agreement (CBA) could be rejected, i.e., terminated, by a debtor.⁴ In response to the Court’s interpretation, Congress enacted a statute which prescribes the procedures that a debtor in chapter 11 must take before it may alter the terms of or terminate a collective bargaining agreement.⁵

After a petition is filed, if the debtor wishes to alter or terminate the collective bargaining agreement, it must supply the authorized representative of the employees complete and reliable information to demonstrate the need, in order to facilitate a reorganization, for the modifications to the employees’ benefits and protections. The employees and debtor are required to engage in “good faith” negotiations with respect to proposals for alteration or termination of such agreements.

If the debtor files an application to reject a CBA, the court is directed to schedule a hearing for not later than fourteen days after the filing. All interested parties may attend and participate in the hearing and the court should rule on the application within thirty days after the beginning of the hearing.

The court may approve the application for rejection only if it finds (i) that the debtor, prior to the hearing, provided the authorized representative of the employees with the necessary information; (ii) the authorized representative has refused to accept the proposal without good cause; and, (iii) the balance of the equities clearly favors rejection.

² 11 U.S.C. § 503(b).

³ *Id.* at § 503(b)(1)(ii).

⁴ National Labor Relations Board v. Bildisco & Bildisco, 465 U.S. 513 (1984), holding that collective bargaining agreements are “executory contracts” under 11 U.S.C. § 365 and may be rejected by a debtor unilaterally if the debtor can show that the agreement burdens the estate and that the equities balance in favor of rejection.

⁵ 11 U.S.C. § 1113.

In addition the court may, after a hearing, authorize interim changes in the terms, conditions, wages, benefits or work rules provided by a collective bargaining agreement, when it is still in effect, if it is essential to the continuation of the debtor's business or is necessary to avoid irreparable damage to the estate. The implementation of interim changes does not, however, moot the procedures and requirements for an application for rejection.

Active employees of an employer in liquidation. If an employer must shut down, it is likely to file under chapter 7. In this chapter, the court appoints a trustee who oversees the debtor's liquidation. The debtor's assets are reduced to cash and distributed among creditors. Although chapter 7 traditionally governs liquidation, a debtor may also liquidate its business under chapter 11. When a business closes, health and life insurance benefits are terminated because, unlike pensions, they are not pre-funded. Pension assets, for the reasons discussed below, are generally held in trust for the employee and are not available to the debtor's creditors.

A common scenario in bankruptcy involves an employer who, at the time of filing, is in arrears in the payment of wages or contributions to employee benefit plans that require continuous funding. Employees who have a contractual claim to payment are considered "unsecured" creditors.

The Code establishes priorities for the payment of unsecured claims.⁶ With the exception of administrative expenses, discussed above, priority claims generally cover prepetition debts. Because priority unsecured claims are paid before nonpriority claims there is a much greater chance for a creditor to realize payment for those having priority status. As amended by the BAPCPA, fourth priority is designated for unsecured claims for wages, salaries, or commissions, but only to the extent of \$10,000 for each individual, including vacation, severance and sick leave pay earned by an individual or corporation within 180 days before the date of filing or the date of the cessation of the debtor's business, whichever occurs first; or, for sales commissions earned by an individual or by a corporation with only one employee acting as an independent contractor in the sale of goods or services for the debtor.⁷

Fifth priority is similar to the fourth but governs unsecured claims for contributions to an employee benefit plan arising from services rendered within 180 days before the filing or cessation of the debtor's business, but only to the extent of the number of employees covered by each such plan multiplied by \$10,000 less (1) the aggregate amount paid to such employees under the fourth priority and (2) the aggregate amount paid by the estate on behalf of such employees to any other employee benefit plan. Hence, the fourth and fifth employee priorities together have an aggregated cap of \$10,000 per employee. Creditors covered by this priority may

⁶ 11 U.S.C. § 507.

⁷ This amount will be adjusted at three-year intervals to reflect changes to the Consumer Price Index. 11 U.S.C. § 104.

include, in addition to the employees themselves, entities that administer employee benefits, such as health or worker's compensation insurers.⁸

Severance benefits. The bankruptcy priority for prepetition employee wages and benefits, including severance pay, is an important benchmark. In a liquidation scenario, it means that each employee with a claim in this category will be near the head of the line for distribution of the priority amount. Nonpriority unsecured claims will be distributed pro rata among unsecured creditors, including employees.

The priority is significant in a reorganization as well. The priority amount must be paid through the reorganization plan in order for it to be confirmed by the court. As noted above, the priority is conferred on claims accruing prior to the bankruptcy filing. Severance earned postpetition, however, may qualify for an administrative expense priority.⁹ Claims for severance, particularly those asserting priority as postpetition administrative expenses, will be evaluated according to several factors and decided under the law of the federal circuit. The court will consider the terms of the agreement establishing severance, including whether it is payable in a lump sum or is based on length of service, and when it was agreed to. A determination of when the benefit accrues – pre- or postpetition – is not always readily apparent and rules governing it may also vary among the circuits.

Prior to the BAPCPA, the priority amount for prepetition employee benefits, including severance, was capped at \$4,925 earned within 90 days of the bankruptcy filing. Nevertheless, at least one court took advantage of the flexibility inherent in the bankruptcy process to enlarge the amount allocated to employee severance pay. Invoking the court's equitable authority,¹⁰ the U.S. Bankruptcy Court for the Southern District of New York permitted an increased allowance for prepetition employee severance payments in both the Enron and WorldCom bankruptcies. The Enron decision implemented a settlement of litigation brought by former employees of Enron.¹¹ The court also allowed creditor committees to bring avoidance actions to recover certain prepetition lump sum payments made to selected employees labeled as "90-day retention bonuses" to help fund the severance claims. Parties

⁸ See *In re J.G. Furniture Group, Inc.*, 405 F.3d 191 (4th Cir.), *cert. denied sub nom. Ivey v. Great-West Life & Annuity Ins. Co.*, 2005 WL 2414231 (Oct. 3, 2005); *Howard Delivery Service, Inc. v. Zurich American Ins. Co.*, 403 F.3d 228 (4th Cir. 2005).

⁹ See *In re AcoustiSeal, Inc.*, 290 B.R. 354 (Bankr. W.D. Mo. 2003) (employees that debtor had terminated postpetition would be allowed administrative priority for the pro rata share of severance pay actually earned postpetition; and severance pay claims asserted by nonexecutive employees were in part prepetition claims entitled to priority to the extent that they were earned within 90 days of filing, and in part postpetition claims entitled to priority as administrative expenses to the extent they accrued postpetition.)

¹⁰ 11 U.S.C. § 105.

¹¹ *In re Enron Corp.*, Case Nos. 01-16034, *Order of Final Approval, under 11 U.S.C. §§ 105(a), 363(b), 1103(c)(5) and 1109(b) and Fed. R. Bankr. P. 9019, Approving Settlement of Severance Claims of Similarly-Situated Claimants and Authorizing the Official Employment-Related Issues Committee to Commence Certain Avoidance Actions on Behalf of Estates*, Aug. 28, 2002 at [<http://www.elaw4enron.com/default.asp>].

agreeing to the settlement received a maximum allowance of \$13,500 per employee.

In the WorldCom bankruptcy, the debtor requested – and the court granted – permission to pay prepetition severance pay due to terminated employees over the amount set by statute.¹² The debtor justified its request by asserting that adverse publicity from the terminated employees could negatively impact WorldCom’s relationship with its current employees. The payments were necessary to restore the confidence of current employees, whose cooperation and loyalty were essential to the reorganization effort.

Pension benefits. Federal law does *not* require an employer to provide health insurance or pensions to employees. Although the tax laws are designed to *encourage* employers to provide these benefits, they may be altered or terminated within or outside of bankruptcy.

The creation and administration of private sector pension plans are governed exclusively by the Employee Retirement Income Security Act (ERISA).¹³ In 1974, Congress enacted ERISA to protect the interests of private sector participants and beneficiaries in a wide variety of employee welfare benefit and pension plans. A prime underlying policy of the act, articulated by the Supreme Court, is the congressional guarantee that “if a worker has been promised a defined pension benefit upon retirement – and if he has fulfilled whatever conditions are required to obtain a vested benefit – he will actually receive it.”¹⁴ Because of ERISA’s comprehensive regulatory scheme, pension benefits are the *least* likely of employee benefits to be affected by bankruptcy, although they may be diminished or reduced in several situations. Thus, employees in many of the defined benefit “legacy” industries, such as steel, airlines, and, more recently, automobile parts manufacturers, have experienced substantial reductions in their pensions as a result of bankruptcy-related distress terminations.

There are a wide variety of tax-qualified employee pension programs. Among the most common are defined contribution and defined benefit plans. In the former,

¹² In re WorldCom, Inc., Case Nos. 02-13533, *Order Authorizing the Payment of Severance Benefits and Related Obligations to Terminated Employees and Rejection of Certain Severance Agreements*, Oct. 1, 2002 at [<http://www.elaw4enron.com/WorldComdefault.asp>].

¹³ 29 U.S.C. § 1001 *et seq.* Pension benefit plans generally fall into one of two broad categories, namely, defined contribution plans or defined benefit plans. The former is a plan in which contributions are fixed, but not benefits, e.g., a fixed amount or percentage of compensation is invested in the plan and comprises the basis for accruing plan benefits. The latter, a defined benefit plan, is a pension plan that specifies the benefits or method of determining the benefits, but not the contribution. The sponsor of the defined benefit plan bears the risk of investment performance and must compensate for any discrepancies between the amounts invested and the amounts promised to be paid as benefits. ERISA regulates private sector defined benefit and defined contribution plans. See CRS Report 95-926 EPW, *Regulating Private Pensions: A Brief Summary of ERISA*, by Patrick Purcell.

¹⁴ *Connolly v. Pension Benefit Guaranty Corp.*, 475 U.S. 211, 214 (1986), quoting *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 720 (1984).

which includes 401(k) plans, the employee, and perhaps the employer, makes contributions to the retirement account on behalf of the employee. The fund, though managed by an employer in accordance with requirements of ERISA and the U.S. Tax Code, is property of the employee. In the event of the employer's bankruptcy, defined contribution trust funds are *not* assets available to the debtor's creditors. Under a defined benefit plan, an employee is promised a set payment, typically one based upon salary and years of service. According to the Pension Benefit Guaranty Corporation (PBGC), there is a significant trend away from traditional defined benefit plans, discussed below, to new "hybrid" pension plans, such as cash balance plans, which are a form of defined benefit plan insured by the PBGC.¹⁵

Defined benefit pension plans may be terminated voluntarily by an employer or involuntarily by the PBGC. An employer may terminate a plan voluntarily in one of two ways. It may proceed with a standard termination only if it has sufficient assets to pay all benefit commitments. A standard termination does not, therefore, implicate PBGC insurance responsibilities.

If an employer wishes to terminate a plan whose assets are insufficient to pay all benefits, the employer must demonstrate that it is in financial distress as defined by ERISA. The concern connected with a distress termination is the adequacy of the plan's funding. That is, is there enough money to support payment of the pension commitment? This is where the PBGC's pension insurance program, which is funded by employer paid premiums, is implicated.¹⁶ If an under-funded corporate pension plan is terminated, the PBGC insurance program guarantees some payment to covered employees. The PBGC then seeks recovery of the deficiency from the employer, asserting a lien therefor, if necessary. Although the PBGC guaranty program is designed to minimize the impact of corporate bankruptcy on the debtor's retirees, when an under-funded pension plan is terminated, the PBGC imposes a statutory ceiling on guaranteed payments. Thus, beneficiaries of an under-funded terminated plan may receive payments that are substantially less than promised.

Neither a standard nor a distress termination by the employer is permitted if termination would violate the terms of an existing collective-bargaining agreement. But negotiations in bankruptcy are influenced by the prospect of the debtor's possible liquidation. The PBGC may, nonetheless, terminate a plan involuntarily, notwithstanding the existence of a collective-bargaining agreement. Likewise, termination can be undone and restoration ordered by PBGC. When a plan is restored, full benefits are reinstated and the employer, rather than the PBGC, is again responsible for the plan's unfunded liabilities.

¹⁵ PBGC, *A Predictable, Secure Pension For Life: Defined Benefit Plans 6* at [http://www.pbgc.gov/publications/defined_benefit_pens.htm]. See CRS Report RL30196, *Pension Issues: Cash-Balance Plans*, by Patrick Purcell.

¹⁶ Under ERISA pension regulation, participation, vesting, and funding standards are administered by the Internal Revenue Service; fiduciary standards and reporting and disclosure requirements are regulated by the Department of Labor; benefit insurance provisions are regulated by the Pension Benefit Guaranty Corporation.

The largest pension default in U.S. history occurred with the termination – and transfer to the PBGC – of four defined benefit plans administered by United Airlines.¹⁷ Over the strenuous objection of its union employees, United Airlines, in reorganization under chapter 11 of the Code, entered into negotiations with the PBGC, which agreed to assume them, invoking its involuntary termination authority. The plans, covering pilots, ground employees, flight attendants, and others, were collectively underfunded by \$9.8 billion, of which \$6.6 billion is guaranteed. The courts have, to date, upheld the plans' termination and transfer to the PBGC despite challenges by the Union of Flight Attendants.¹⁸

Retiree benefits. *Pensions.* As discussed above, retiree pension benefits are held in trust for the retiree and are regulated by ERISA.

Health and Life Insurance Benefits. Many employers reserve a right to modify or terminate employee welfare benefit plans and do so outside of bankruptcy.¹⁹ Courts reviewing plan alteration or termination generally base their decisions on the specific terms of a plan's documents or associated collective bargaining agreement. In bankruptcy, the status of retiree life and health insurance benefits is largely determined by the nature of the action – chapter 11 reorganization versus liquidation under chapter 7 or chapter 11.

The reorganization of the LTV Corp. proved to be a prime force behind clarification of the Bankruptcy Code's treatment of retirees' health and life insurance benefits *during* reorganization. On the same day it filed in bankruptcy in 1986, LTV Corp. notified more than 66,000 retirees of its intention to terminate health and life insurance coverage under the company's employee benefit plan. Acting swiftly to express its disapproval of LTV's interpretation of the Bankruptcy Code's requirements, Congress enacted legislation blocking LTV's cessation of insurance payments on the retirees behalf.²⁰ Then, in 1988, Congress amended the Code by adding new 11 U.S.C. § 1114 entitled "Payment of insurance benefits to retired employees." The procedures for a debtor's termination of retiree insurance benefits are modeled after those for termination of collective-bargaining agreements in chapter 11.

In summary, § 1114 provides that a debtor in reorganization may *not* terminate health and life insurance payment programs maintained for retirees and their spouses

¹⁷ *Judge Affirms Pension Default Pact Between United Airlines and PBGC*, 17 BNA BANKR. L. J. 659 (U.S. District Court for the Northern District of Illinois affirms decision of bankruptcy court). (July 28, 2005).

¹⁸ *See Assoc. of Flight Attendants-CWA v. PBGC*, 372 F. Supp.2d 91 (D.D.C. 2005); *In re UAL Corp.*, 2005 WL 1154264 (Bankr.N.D.Ill. 2005), *aff'd*, ___ F.3d ___, 2005 WL 2848938 (7th Cir., Nov. 1, 2005).

¹⁹ *See* U.S. Dept. of Labor, *Can the Retiree Health Benefits Provided By Your Employer Be Cut?*, at [<http://www.dol.gov/dol/pwba/public/pubs/brief1.htm>]. For general background, see CRS Report RL32944, *Health Insurance Coverage for Retirees* by Hinda Ripps Chaikind and Fran Larkins.

²⁰ P.L. 99-591, § 608 (1986); P.L. 99-656 (1986); P.L. 100-41 (1987).

and dependents *without first negotiating proposed modifications* in benefit payments with representatives of the retirees, and second, *seeking and receiving court approval* to make the modifications. If the debtor and the retirees cannot agree upon modifications, and the debtor believes them to be necessary to permit reorganization, the court may permit modifications, subject to statutory guidelines. The debtor must have negotiated with the representative of the retirees in good faith, and the court, after a hearing in which all parties have had an opportunity to be heard, must find that the proposed modification is *necessary* to permit the reorganization of the debtor and assures that all creditors, the debtor, and all of the affected parties are treated fairly and equitably. Thus, in the course of a chapter 11 reorganization in which the debtor continues to operate the business, it *must* continue to pay retiree health and life insurance benefits unless it has negotiated necessary modifications – or termination of payments – with the representatives of the affected group, or has received the bankruptcy court’s permission to do so. Payments made are accorded high priority “administrative expense” status.

The BAPCPA amended § 1114 to add a “look back” provision for eve-of-filing modification of retiree insurance benefits. If the debtor, while insolvent, modifies retiree benefits within 180 days of filing, the court may reinstate the benefits unless the balance of equities supports modification.²¹

If a corporate debtor’s reorganization is unsuccessful, it may liquidate. In a liquidation, the retirees’ claims for lost insurance benefits would be unsecured claims. The fourth and fifth priorities for employee benefits apply only to payments on behalf of present employees, not retirees. When Congress passed § 1114 ensuring the continuation of payments of retiree health and life insurance benefits throughout a reorganization if the debtor could afford to pay them, it did not appear to address the status of these claims in liquidation. Nor did it amend § 507 of the Code, which creates high priority unsecured claims. Obviously, when a company ceases operation, it cannot continue to incur business-related operating expenses. Retirees with insurance claims would be unsecured creditors of the debtor, and any amount they might recover would depend upon the nature and amount of claims outstanding relative to the funds available to satisfy them.²²

COBRA continuation coverage. Under the provisions of Title X of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA),²³ as amended, employers are required to permit employees or family members to continue their group health insurance coverage at their own expense, but at group rates, if they lose coverage because of designated work or family-related events.²⁴ Among the

²¹ 11 U.S.C. § 1114(l).

²² At least one court has held that § 1114 does not apply if the case is converted to chapter 7. Retiree benefit payments have administrative expense status only while a debtor operates under chapter 11. *In re Ionosphere Clubs, Inc.*, 134 B.R. 515 (Bankr. S.D.N.Y. 1991) .

²³ P.L. 99-272 (April 7, 1986).

²⁴ See U.S. Dept. of Labor, *Health Benefits Under the Consolidated Omnibus Budget Reconciliation Act, COBRA* at

“qualifying events” which trigger COBRA’s continuation coverage is an employer’s filing a case under the Bankruptcy Code (on or after July 1, 1986) *with respect to a covered employee who has retired*.²⁵ “To lose coverage” for COBRA purposes includes a substantial elimination of coverage that occurs within twelve months before or after the date on which the bankruptcy proceeding begins.²⁶

In general, a “covered employee” is an individual who is provided coverage by virtue of employment (or previous employment) with the employer. Hence, the definition includes retirees who receive health coverage in addition to their pension. In the case of a retiree of a bankrupt employer, the continuation coverage must be available until the death of the covered employee or the qualified beneficiary. In this situation, a “qualified beneficiary” includes a covered employee who has retired on or before the date on which coverage was eliminated, and any other individual who, on the day before the bankruptcy proceedings, was a beneficiary under the plan, either as the spouse, dependent child, or surviving spouse of the covered employee. For the surviving spouse or dependent children of the covered employee, the period of coverage is limited to 36 months after the death of the covered employee.

Although COBRA provides retirees’ lifetime coverage, it is contingent upon the employer’s maintaining the plan for current employees. Continuation coverage for all qualified beneficiaries terminates on the date when the employer ceases to provide any group health plan to *any* employee, i.e., when the plan ends.

COBRA may be a useful safety net if an employer in bankruptcy terminates a retiree health plan but continues to offer health benefits to current employees. In that event, retirees would be entitled to continuation coverage under the employer’s ongoing plan. But COBRA works in conjunction with ERISA and the Bankruptcy Code; it *does not* require an employer to fund independent health insurance for retirees or to maintain the plan on behalf of current employees notwithstanding other permissible termination provisions of ERISA or the Code.

Employee Participation in Bankruptcy Proceedings

Employee representation on creditor committees. Viewed broadly, a chapter 11 reorganization contemplates a negotiated settlement of claims by the debtor with its creditors under the supervision of the court and within the strictures of the Code. Creditors actively participate in the development of a reorganization plan, and ultimately vote to accept or reject it. Employees may have a limited voice or a more active role in reorganization negotiations.

Rules of bankruptcy practice expressly grant a labor union, an employees’ association, or a representative of employees a right to address the court “to be heard

²⁴ (...continued)

[<http://www.dol.gov/dol/pwba/public/pubs/COBRA/cobra99.pdf>] and CRS Report RL30626, *Health Insurance Continuation Coverage under COBRA*, by Heidi Yacker.

²⁵ 29 U.S.C. § 1163.

²⁶ 64 Federal Register 5165 (Feb. 3, 1999).

on the economic soundness of a plan affecting employees' interests."²⁷ The right is limited, however, because the employee representative does not generally have standing to appeal any of the bankruptcy court's rulings.

A more active role in the reorganization planning is reserved to creditor committees. Shortly after the bankruptcy petition is filed, the U.S. trustee will appoint an official committee of creditors holding unsecured claims.²⁸ In complex cases, the court may create additional committees if necessary to ensure adequate representation of creditors. The unsecured creditors' committee is generally comprised of persons willing to serve who hold the seven largest claims of the types represented by the committee. Among the committee's powers and duties is the authority:

- to consult with the trustee or debtor concerning the administration of the case;
- to investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuing it;
- to participate in the formulation of a plan, to advise those represented by the committee of any committee determinations and/or any plan formulated; and
- to generally represent the interests of creditors who are represented.²⁹

Every bankruptcy is intensely fact-specific with specific creditor claims dictating the composition of the creditor committee(s). When employees are unsecured creditors, they may be represented on creditor committees.³⁰ If and when appropriate, the court may allow the creation of official or unofficial committees composed solely of employee representatives. For example, in the Enron bankruptcy, the court appointed a committee "for the purpose of investigating the issues relating to: (1) the continuation of health or other benefits for former employees of the Debtors; (2) the investigation of claims uniquely held by employees, as such, against the Debtors; (3) the treatment of employees' claims under any plan(s) of reorganization or liquidation; (4) possible Warn Act violations by the Debtors in discharging employees; (5) possible violation by the Debtors of state labor laws and certain provisions of ERISA; and (6) dissemination of non-confidential information

²⁷ Fed. Rules of Bankr. Procedure, Rule 2018.

²⁸ 11 U.S.C. § 1102.

²⁹ 11 U.S.C. § 1103.

³⁰ See, e.g., *In re Altair Airlines, Inc.*, 727 F.2d 88 (3rd Cir. 1984)(Pilots' association, which was the exclusive bargaining agent for pilots holding claims for unpaid wages which amounted to the second largest unsecured claim against the debtor, was entitled to appointment to the unsecured creditors' committee.); *In re Salant Corp.*, 53 B.R. 158 (Bankr.S.D.N.Y. 1985)(When the creditor committee was made up of seventeen members, including one representative of managerial employees, the court was willing to grant a union's motion to add an additional three members to represent non-managerial employees.)

relating to items (1) through (5) hereof to employees[.]”³¹ Unofficial committees comprised of self-selected members may be free of the fiduciary responsibilities required of an official committee.

Section 1114 expressly provides for the appointment of committees of retired employees when a debtor seeks to modify or terminate retiree benefits. The U.S. Trustee appoints members to act as “authorized representatives” for retirees. Ordinarily, retirees whose benefits are covered by collective bargaining agreements are represented by the labor organization. Recognizing that there can be internal conflicts between the interests of active employees and retirees covered by a CBA and their interests in the bankruptcy case, the labor organization may elect not to serve as authorized representative. In that case, a committee may be comprised of other retirees found by the court to be appropriate.

Employee litigation-based claims against an employer. The bankruptcies of Enron and other companies, such as Polaroid, Global Crossing, and WorldCom, raised new concerns about corporate responsibility for harm employees experience as a result of illegal stock manipulation and other forms of corporate malfeasance. For example, employees’ defined contribution pension funds, when comprised of their employer’s stock, can be devastated by employer mismanagement. Discussed below is the process a bankruptcy court may use to consider a civil claim for damages that has not been reduced to judgment prior to the bankruptcy filing.

History teaches that the U.S. Bankruptcy Code is not an efficient vehicle to protect the funding and management of employment benefits.³² By the time an employer is in bankruptcy, if the system has already failed, it is generally too late to impose new management, auditing, fiduciary, or funding safeguards to restore benefits. Other laws, such as ERISA, the Tax Code, and COBRA, address these employment benefit programs prospectively. Nevertheless, employees who are victims of wrongdoing may wonder if they can assert those claims in the bankruptcy and increase their distributive share of the debtor’s assets.

It is frequently said that a debtor in bankruptcy “cannot be sued.” While it is correct that bankruptcy’s automatic stay stops the continuation of a judicial process to collect a money judgment,³³ it does not mean that a debtor corporation is immune from claims that have *not yet* been reduced to judgment. If employees want to sue

³¹ In re Enron, *Amended Appointment of Employment-Related Issues Committee*, (Bankr.S.D.N.Y. 2002), at 2002 Extra LEXIS 537.

³² After the LTV Corp. filed under chapter 11 in 1986, the debtor and the PBGC engaged in a great deal of litigation concerning payment of arrearages as a result of underfunding of the debtor’s pension plans. Although the PBGC was initially unsuccessful in asserting administrative and unsecured priority claims for underfunding arrearages, it ultimately succeeded in ordering restoration of the terminated plans. See *In re Chateaugay Corp.*, 115 B.R. 760 (Bankr.S.D.N.Y. 1990), *order vacated and withdrawn*, 17 Employee Benefits Cas. 1102 (S.D.N.Y. 1993). See also *PBGC v. LTV Corp.*, 496 U.S. 633 (1990).

³³ 11 U.S.C. § 362.

their employer/debtor, they may still have a “claim” in bankruptcy, even if it has not been reduced to judgment.³⁴

When a claim that must be established through a lawsuit is stayed, the bankruptcy court is permitted to estimate “any contingent or unliquidated claim, the fixing or liquidation of which, as the case may be, would unduly delay the administration of the case[.]”³⁵ The court may also estimate any right to payment “arising from a right to an equitable remedy for breach of performance.”³⁶ This occurs pursuant to the bankruptcy court’s mandate to allow or disallow claims against the estate. Estimating claims for the purpose of confirming a plan under chapter 11 is expressly cited as a core proceeding within a bankruptcy court’s jurisdiction.³⁷

Hence, the chapter 11 filing triggers a series of decisions by the court evaluating the stayed litigation. Do the best interests of the parties and the bankruptcy estate require the estimation of outstanding claims or should they be reduced to a sum certain, i.e., fixed by litigation authorized by the court? Agreeing on appropriate methodology to estimate a claim is in itself a complicated issue.

The courts have discretion to consider the most appropriate manner to handle an unliquidated, contingent claim – whether it should be estimated or whether the stay should be lifted. The goal of the bankruptcy process is to fix an amount, i.e., assign a value for a claim in order to expedite reorganization; to determine whether reorganization itself is feasible; and, to assist the parties in fashioning a plan. It is also necessary to create a yardstick to enable the court to apply the “best interests of the creditor” test for a chapter 11 debtor. The court cannot confirm a chapter 11 reorganization plan unless creditors will receive more under the plan than if the debtor were liquidated.³⁸

And, of course, creditors are constrained by practical strategic considerations. Litigation is an expensive proposition and it may not be worthwhile in the face of a looming prospect of the debtor’s having inadequate assets to satisfy the claim. Simply put, does the potential distribution warrant the costs of litigation? Some

³⁴ A “claim” in bankruptcy is defined broadly at 11 U.S.C. § 101(5) to mean “(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.”

³⁵ 11 U.S.C. § 502(c)(1). *See* In the Matter of Interco Incorp., 137 B.R. 993 (Bankr.E.D. Mo. 1992)(Claims of a multiemployer pension fund against a debtor may be estimated).

³⁶ *Id.*

³⁷ 28 U.S.C. § 157(b)(2)(B). A bankruptcy court may not, however, liquidate or estimate personal injury tort or wrongful death claims.

³⁸ 11 U.S.C. § 1129(a)(7).

portion or all of the creditors' damages may be discharged in the bankruptcy and any recovery will be reduced by distributions among all unsecured creditors.

Employees whose pensions have suffered under the fiduciary mismanagement of corporate debtors face many difficult decisions. Claims against their employers may be based on many legal theories grounded in many different laws. Claims may be directed at different parties within and without bankruptcy and this may also affect decisions regarding litigation. The bankruptcy process, however, does allow claims that have not been finalized to be considered. And, as in all bankruptcies, the outcome is dependent upon the unique situation of each debtor and its creditors.

The Enron bankruptcy is a case study. Numerous suits have been filed against the debtor by or on behalf of employees, and although few went to trial, several settlements have been announced. In December of 2001, a federal district court consolidated all of the ERISA claims brought in the Southern District of Texas under the caption, *Tittle v. Enron Corp.*³⁹ In June of 2005, the court approved a proposed settlement between former Enron employees and insurers for numerous pension plan fiduciaries that would give a judgment reduction credit of \$85 million, representing the policy limits on two fiduciary liability policies.⁴⁰ Basically, in return for releasing defendants from further claims for indemnity or contribution arising from ERISA-based claims, the plaintiffs will collect insurance proceeds. The district court judge is quoted as explaining:

Without question this settlement is driven by the need to preserve for the plaintiff class the insurance policy proceeds, which otherwise are likely to be consumed by litigation defense costs. This factor works to justify a settlement for less than what Plaintiffs might obtain if they continued to prosecute their claims through trial, only to find that the actual recovery has gone up in smoke[.]⁴¹

In another proceeding, the U.S. Dept. of Labor announced an agreement that would give participants in an Enron retirement plan a general unsecured bankruptcy claim of \$356.25 million.⁴² The announcement notes that the final distribution that plan participants receive will depend upon the total amount of assets available. Earlier in the bankruptcy, the PBGC announced an agreement it reached with Enron requiring it to place \$321 million in escrow to fund a standard termination of its defined benefit pension plan.⁴³

³⁹ For background on the litigation, see CRS Report RL31282, *Tittle v. Enron Corp. and Fiduciary Duties under ERISA* by Jon Shimabukuro.

⁴⁰ *Court Approves Partial Settlement in Enron Fiduciary Breach Litigation*, 17 BNA BANKR. L. REPTR. 488 (June 2, 2005).

⁴¹ *Id.*

⁴² *Labor Department Announces Agreement Giving Enron Participants Unsecured Claim*, 17 BNA BANKR. L. REPTR. 611 (July 14, 2005).

⁴³ *Enron Agrees to Pay \$321 Million To Preserve Plans' Defined Benefits*, 16 BNA BANKR. L. REPTR. 817 (Sept. 16, 2004).

A major bankruptcy may involve a great deal of litigation, much of which is designed to assess and/or settle claims both against and on behalf of the debtor. Just discussed are examples of employee and federal agency claims against Enron. Likewise, suits brought by Enron against others have been settled.⁴⁴ Claims settled in Enron's favor bring assets into the bankruptcy estate for ultimate distribution to creditors. Thus, the bankruptcy process does, to some extent, encompass procedures for addressing debtor wrongdoing. There are strong incentives for creditors and the debtor to attempt to evaluate and settle civil claims in order to reorganize.

Managerial Compensation in Bankruptcy

The substantial amounts that many attorneys and professionals earn as fees for work performed in a major bankruptcy case has been, and continues for many to be a subject of widespread interest. So too, more recently, has the amount of executive compensation earned by debtor's management on the eve of or in the course of the bankruptcy. In many cases, debtor companies retain "turn around" experts or bring in new executives to guide the company through the restructuring and bankruptcy process. Executive compensation, like other employee benefits, comes in many forms and is contract specific. Although a trustee is always appointed in chapter 7, chapter 11 is premised on the supposition that a reorganization is most likely to be successful and creditors and the public are most likely to benefit from continued operation of the business by existing management.⁴⁵ Under chapter 11, management may be removed "for cause, including fraud, dishonesty, incompetence, or gross mismanagement[.]"⁴⁶

In the ordinary course of a bankruptcy, certain claims are "disallowed. This means that even though a creditor may have a perfectly legal claim, bankruptcy law declines to permit, or allow it – generally for the purpose of maximizing the debtor's estate for distribution to all creditors. One example of such are claims by an employee whose employment contract is terminated for damages that exceed more than one year's compensation under the contract."⁴⁷

Like all bankruptcy claims, the disposition of executive compensation may depend upon when it was earned and/or paid, that is, before or after the bankruptcy filing. Postpetition payments are generally subject to court approval, and prepetition payments, to a more limited extent, may be subject to avoidance. Generally, the

⁴⁴ See *JPMorgan Chase Settles With Enron; Will Pay \$350 Million in Bankruptcy Case*, 17 BNA BANKR. L. REPTR. 742 (August 25, 2005).

⁴⁵ H.Rept. 95-595, 95th Cong., 1st Sess. 233 (1977), comprising part of the legislative history of the 1978 bankruptcy law. "Moreover, the need for reorganization of a public company today often results from simple business reverses, not from any fraud, dishonesty, or gross mismanagement of the part of the debtor's management."

⁴⁶ 11 U.S.C. § 1104. Pursuant to amendment by the BAPCPA, the U.S. Trustee shall seek appointment of a trustee if "there are reasonable grounds to suspect that current members of the governing body of the debtor...participated in fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting." § 1104(e).

⁴⁷ 11 U.S.C. § 502(b)(7).

debtor must assume the employment contract, that is reaffirm it after the bankruptcy filing, in order for an executive to lay claim to payments thereunder as an administrative priority.⁴⁸

Nevertheless, retention bonuses and similar compensation for executives are commonly sought and approved by the courts.⁴⁹ But they may be challenged by parties to the bankruptcy proceeding and denied in whole or part. In a pre-BAPCPA decision in the U.S. Airways bankruptcy, the court considered proposed severance and retention plans for its officer and non-officer managerial employees.⁵⁰ The proposed plan, called a Key Employee Retention Plan or KERP, affected executives and over 1,800 management employees and was formulated in contemplation of a merger of the debtor with another airline. The motion to approve the plan was supported by the Official Committee of Unsecured Creditors, which had negotiated a number of changes to the original proposal, and was opposed by the U.S. Trustee and by the unions representing the debtor's pilots, flight attendants, mechanics, and reservation agents. Explaining its rationale, the court observed:

The Bankruptcy Code does not specifically address so-called Key Employee Retention Plans, or KERPs, whether adopted before the filing of a bankruptcy petition or after. It is common, however, for bankruptcy courts to approve the adoption of post-petition KERPs, or the assumption of pre-petition KERPs, if the debtor has used "proper business judgment" in adopting the plan, and the plan is "fair and reasonable." In *re Aerovox, Inc.*, 269 B.R. 74, 80 (Bankr.D.Mass.2001). Nevertheless KERPs have something of a shady reputation. All too often they have been used to lavishly reward— at the expense of the creditor body— the very executives whose bad decisions or lack of foresight were responsible for the debtor's financial plight. But even where external circumstances rather than the executives are to blame, there is something inherently unseemly in the effort to insulate the executives from the financial risks all other stakeholders face in the bankruptcy process. Congressional concern over KERP excesses is clearly reflected in changes to the Bankruptcy Code that will become effective for cases filed after October 17, 2005. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub.L. No. 109-8, § 331, 119 Stat. 23, 102-03 (April 20, 2005). Those changes will severely

⁴⁸ *See, e.g.*, In *re* FBI Distribution Corp., 330 F.3d 36 (1st Cir. 2003)(Executive who was terminated by chapter 11 debtor after rendering postpetition services was not entitled to administrative priority claim for employment and retention benefits under prepetition employment agreement that was rejected by the debtor. The executive was entitled to the reasonable value of her postpetition services that benefitted the estate.).

⁴⁹ *See, e.g.*, In *re* Pacific Gas and Electric Co., 2001 WL 34133840 (Bankr.N.D.Ca. 2001)(Court approves management retention program supported by Official Committee of Unsecured Creditors over objections of U.S. Trustee.); In *re* American West Airlines, Inc., 171 B.R. 674 (Bankr.D. Ariz. 1994)(Court approves "success" bonus for chief executive officer and others who successfully downsized airline and settled substantial administrative claims despite seven hundred letters to the court from rank and file employees objecting to management bonuses. The court found that the executives had accomplished a "major feat" and were essential to the reorganization process.); In *re* Interco Incorp., 128 B.R. 229 (Bankr.E.D.Mo. 1991)(Court approves performance-based executive retention program to ensure that critical executives remained with debtors throughout reorganization.).

⁵⁰ In *re* U.S. Airways, 329 B.R. 793 (Bankr.E.D.Va. 2005).

limit both the circumstances under which severance and retention payments may be made to insiders as well as the amount of such payments, which will be limited to 10 times the average amount of severance or retention payments for non-management employees during the same calendar year.⁵¹

In support of their objections, the U.S. Trustee and the unions argued that the plan was overly broad and would undercut employee morale by sparing management from financial sacrifices that the unionized workforce had to bear.

First, the court considered whether the debtor made a threshold showing that it used sound business judgment in adopting the plan. It concluded that “[t]here can be little doubt, based on the evidence, that the plan is in response to a serious retention problem,” because there were 340 unfilled open positions. The court ultimately approved a modified KERP that applied to management employees below the officer level upon approval, but deferred applicability to senior level officers until plan confirmation.

Of the objections to the program, surely the most compelling, from a purely human point of view, is that it represents a betrayal of the principle of “shared sacrifice” that was championed by the company in the litigation and negotiations that resulted in over \$900 million of wage and other concessions by its unionized workforce. While management employees took some pay cuts and benefit reductions, the plain truth is that those cuts were significantly less than the cuts experienced by the non-management employees. It is hardly any wonder, therefore, that the rank and file employees have reacted to the proposal with considerable outrage, as evidenced, for example, by the petition that was admitted at the hearing signed by 2,209 members of the Communications Workers of America denouncing the proposed severance plan and urging this court not to approve it.

The court is certainly sensitive to what one witness described as the “uproar in the workplace” after the company announced it would seek approval of the severance plan. At the same time, the court cannot ignore the fact that the landscape has significantly changed. At the time the labor concessions were negotiated, the company was headed along a particular path, that of transformation. Now it is headed on a different path, that of merger. Under a transformation plan, employees--whether management or rank and file--were equally likely to keep their jobs (if the company successfully emerged from chapter 11 as a viable airline) or to lose them (if the company had to liquidate). Under the proposed merger, by contrast, few of the unionized employees are likely to face the loss of their jobs, since there is little overlap in the route structure of the two airlines. However, somewhere between one-third and one-half of the management employees are expected ultimately to lose their jobs. The problem the company faces is that those management employees will be needed up until the day their employment is terminated, perhaps two years from now. If they leave too soon, the merger itself (and with it, the jobs of the rank and file employees) will be threatened.

The argument that the program is too broad and that any retention benefits should be narrowly targeted to “critical” or “key” employees likewise misses the

⁵¹ *Id.* at 797-798.

mark. The evidence at the hearing convincingly established that the headquarters organization cannot afford further attrition without effectively eliminating its ability to carry the company through the merger. Put another way, once a football team has been reduced to 11 players, every one of them is “critical,” since you cannot field a team with fewer.⁵²

Although postpetition retention and severance payments are substantially modified by the BAPCPA, the foregoing illustrates how a bankruptcy court attempts to balance economic and non-economic competing interests and claims in the reorganization process.

The court has less control over prepetition payments, although they can be avoided in some circumstances, such as when they are found to be fraudulent, as discussed above in the Enron bankruptcy. Nevertheless, there is an inherent tension in the policy decision to allow existing management to steer a prospective debtor through reorganization when self-policing is also an issue. The implicit conflict of interest that can arise between a chapter 11 debtor company, its management and its creditors is acknowledged by the courts. A U.S. Court of Appeals considered whether a bankruptcy court can authorize a creditors’ committee to sue derivatively on behalf of the trustee to recover alleged fraudulent conveyances made by management.⁵³ It concluded that a court-approved derivative suit for the benefit of the debtor’s estate was permissible under the Bankruptcy Code.

As a component of its analysis, the court observed that avoiding a fraudulent conveyance could be a particularly “vexing” problem in a chapter 11 context:

This situation immediately gives rise to the proverbial problem of the fox guarding the henhouse. If no trustee is appointed, the debtor—really, the debtor’s management—bears a fiduciary duty to avoid fraudulent transfers that it itself made. One suspects that if managers can devise any opportunity to avoid bringing a claim that would amount to reputational self-immolation, they will seize it. For that reason, courts and commentators have acknowledged that the debtor-in-possession “often acts under the influence of conflicts of interest.” These conflicts of interest can arise even in situations where there is no concern that a debtor’s management is trying to save its own skin. For example, a debtor may be unwilling to pursue claims against individuals or businesses, such as critical suppliers, with whom it has an ongoing relationship that it fears damaging. Finally, even if a bankrupt debtor is willing to bring an avoidance action, it might be too financially weakened to advocate vigorously for itself. In any of these situations, the real losers are the unsecured creditors whose interests avoidance actions are designed to protect.⁵⁴

In conclusion, although the Bankruptcy Code presumes that a debtor company’s management is best qualified to lead the debtor through the reorganization process, there are equitable and statutory mechanisms to address intentional wrongdoing and

⁵² *Id.* at 799-800.

⁵³ Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548 (3d Cir.), *cert. denied*, 540 U.S. 1001, 1002 (2003).

⁵⁴ *Id.* at 573. (Citations omitted).

less damaging departures from sound business judgment. And, while there is substantial flexibility in the reorganization process and employees are provided some level of protection, there is no question that the reorganization process is used strategically by business debtors to shed what are perceived to be onerous employee benefit programs.