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Unions, Pensions, and Executive Compensation in Chapter 11

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Some pending cases could alter compensation payable to employees of companies in Chapter 11.

On September 14, 2005, Delta Air Lines, Inc., the nation's third largest airline, and Northwest Airlines, the number 4 U.S. carrier, commenced Chapter 11 reorganization cases. In addition to high fuel costs and competition from lower-cost carriers such as Southwest Airlines and JetBlue, Delta and Northwest entered Chapter 11 as a vehicle for reducing labor costs and, in particular, unfunded pension liabilities. They joined United Airlines, the second largest U.S. carrier, which had entered Chapter 11 in December 2002, and US Airways, which was in its second bankruptcy case since the September 11, 2001, terrorist attacks.

At least through the end of the last century, it was generally perceived that workers had the security of knowing that if a company such as Delta or Northwest filed bankruptcy, their pensions were insured by the federal Pension Benefit Guaranty Corporation ("PBGC") and fully protected. Following a series of bankrupt steel companies, United Airlines has transferred, with bankruptcy court approval, its four defined benefit pension plans to the PBGC. The PBGC is now obligated for tens of billions of

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dollars of pension liabilities in excess of its assets. At the time that Northwest and Delta filed Chapter 11, the PBGC warned that employees of those airlines might lose more than $5 billion in pension benefits.
Similar issues face other companies currently in Chapter 11, including auto suppliers, Delphi Corp. and Tower Automotive Inc. The pattern followed in these Chapter 11 cases involving the restructuring of unionized labor obligations and pension liabilities is predictable. It is a common refrain for senior management of the company to acknowledge that communities and people will be hurt, but that proposed pay and benefit reductions under labor contracts and relief from pension obligations are necessary for the company's survival. Accordingly, the company typically asserts in bankruptcy court that the reduction of labor costs and the modification of pension obligations is crucial for its survival. The unions respond that modification of these obligations would be a devastating blow to employees and would be met with a massive strike. Generally, employees face the loss of thousands of dollars each year from their pensions when assumed by the PBGC (payouts made by the PBGC will generally result in retirees receiving substantially less than the promised benefits under their pension plans). Nonetheless, the proposed modification of collective bargaining agreements and retiree benefits by companies in Chapter 11 should not be viewed as nefarious when associated costs outstrip a company's ability to pay and remain viable. Further, companies may face the economic reality that they are unable to afford to maintain existing employee benefits that their key competitors do not provide (e.g., Southwest Airlines and JetBlue Airways do not have employee pension plans).

DELPHI'S VIEW

Delphi Corp.'s chief restructuring officer told the judge presiding over Delphi's Chapter 11 case in late May 2006, that the company would cancel its union contracts only if driven to the brink of collapse and that it was committed to reaching an agreement with the UAW and General Motors Corp. In the *United Airlines* case, the bankruptcy court, approving the termination of United's pension obligations, stated that it was "choosing the

least bad of unfortunate choices." In this context of difficult choices, the Bankruptcy Code requires that companies engage in serious negotiations with their employees' unions before obligations under collective bargaining agreements or pension plan liabilities can be modified. Further, bankruptcy judges push the parties to work out their differences with regard to collective bargaining agreements and/or retiree benefits and reach agreement outside of court. As a result, bankruptcy court decisions on these matters are frequently delayed to promote further negotiations.

During May 2006, for example, judges presiding over Chapter 11 cases involving Delphi Corp., Northwest Airlines, its commuter carrier Mesaba Airlines, and Tower Automotive delayed ruling for one side or the other and continue to push the parties to reach agreement. The threat of an adverse ruling can be particularly severe for employees. In the *Northwest* case, for example, its baggage handlers and ramp workers reached a tentative agreement with the company on May 19, 2006, aimed at slashing the airline's labor expenses. The union representative stated, at the time, that it was not recommending ratification because the terms were favorable, but rather because the alternative was worse. The tentative agreement came just hours before a hearing with respect to which the judge had previously advised the parties he might rule on the company's motion to reject the company's collective bargaining agreement.

Juxtaposed with these cases where significant sacrifices are imposed on employees are situations where additional compensation was proposed for senior management in order to induce them to remain with the company during the reorganization process. In the wake of management abuse and excesses in highly publicized cases such as Enron, WorldCom, and Adelphia, as part of the 2005 Amendments to the Bankruptcy Code (the "2005 Amendments"), Congress essentially eliminated a Chapter 11 debtor's ability to obtain court approval of a Key Employee Retention Program ("KERP") based solely on the requirement that officers (or other insiders) remain with the company. The bankruptcy court's discretion to approve such programs has been eliminated. At the same time, subject to a company in Chapter 11 meeting the statutory requirements, the courts continue to exercise broad discretion when presented with requests relating to modification of collective bargaining agreements and pension plans.

While the 2005 Amendments to the Bankruptcy Code stripped bankruptcy courts of much of their discretion when addressing executive compensation (at least as it has traditionally been presented) in Chapter 11 cases, the courts retain broad discretion when considering proposed modifications to a company's obligations under collective bargaining agreements and pension plans. The courts generally exercise this discretion, in a manner designed, to the extent feasible, to push the parties toward a negotiated resolution. However, as the stakes get higher for an expanding number of workers and retirees, these difficult decisions to be addressed by bankruptcy courts will likely have dramatic ramifications and face intense scrutiny.

UNDERFUNDED PLANS

In 2005, the PBGC estimated that there were $473 billion in underfunded defined benefit pension plans. These underfunded plans had an average ratio of assets to liabilities of 69 percent. Further, the number of inactive versus active participants has been growing. As a result, an increasing amount of pension underfunding must be spread over a declining base of active workers.

In light of these realities, plan participants should be concerned whether PBGC payments will still be there for them, if needed, if other airlines and businesses with enormous pension liabilities, such as General Motors Corp., transfer pension liabilities to the PBGC. It seems that many Americans face the least secure retirement prospects in three generations.

Pending before the bankruptcy court in the Delphi Corp. Chapter 11 case during May 2006, were the company's requests for modification of its collective bargaining agreements and retiree benefits. The UAW had threatened to strike if wages and/or benefits are unilaterally reduced. Some analysts have said that such a strike would shut down General Motors Corp., the world's largest automaker, and would also affect North American production of Chrysler, Toyota, and Honda.

The bankruptcy process often involves threats on both sides of disputes and, in particular, labor disputes. These threats can ultimately move the process toward resolution. The company threatens to cancel union

contracts and terminate pension plans and the unions threaten to strike if the company follows through. In this context, the bankruptcy judge often aims to calm the discussions so that a solution can be found without either side going to the extremes threatened. While the judge has the power to impose a resolution on the parties, the threat of that power can force the companies and unions to do it themselves. Further, the applicable Bankruptcy Code provisions require the parties to come together and attempt to reach an accord. Often the judge will use the deadline for a decision as a tipping point to get both sides back to the table or may simply delay a decision to allow the parties more time to reach an agreement.

CONCLUSION

The courts presiding over the large Chapter 11 cases of Delphi, Tower Automotive, and Mesaba Airlines (Northwest's commuter carrier) have delayed ruling and continued to push the parties to reach agreement. How these matters and similar labor and retiree issues in other Chapter 11 cases are resolved could have widespread impact on workers, retirees, the bankruptcy system, and how it is perceived, the national and global economies, and American society in general.