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Bankruptcy and Restructuring: Navigating Employment Issues Under the Code

Best Practices to Negotiate, Modify and Terminate Employment Agreements and Benefit Plans

A Live 90-Minute Audio Conference with Interactive Q&A

Today's panel features:

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Thursday, August 20, 2009

The conference begins at:

1 pm Eastern
12 pm Central
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10 am Pacific

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Bankruptcy/Employment CLE

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Pre-Petition Priority Wages

- Basic position on voluntary business cases – Effective 2nd after Administrative Claims [§ 507] Domestic support or Involuntary Petition claims rarely applies
- Scope
  - Wages, salaries, commissions, vacations, severance, sick leave
  - Earned within 180 days earlier of petition or business cessation
  - Single employee independent contractor/75% income

Pre-Petition Priority Wages

- Limitation Wage Priority
  - $10,900 + per employee (CPI boost from 2005)
- Employee benefit generally
  - $10,900/covered employee less wage payment received

Pre-Petition Priority Wages

- Advance Payments
  - First Day Orders
  - Priority dollar limits
  - Must be essential employees

Pre-Petition Priority Wages

- Class Claims
  - State statutory authority
  - Wisconsin rule – Joy Global Cases-severance claims, OR retraining payments
  - Administrative costs – Blue Cross Plan Falcon Products
- Direct Liability in 9th CA/ Boucher vs. Shaw 7/27/09
  - Fair Labor Standards Act
  - Post filing, direct claim vs. manager.
  - BK stay no impact – 1st and 2nd CA authority

Post-Filing Administrative Claims

- Scope – wages, salaries, commissions if reasonably necessary for benefit of estate 503(b)
  - Can include back pay for post-filing violation of federal or state law
  - Set limitation on key employee compensation
  - Executive compensation negotiable in many plans
  - WARN Act claims typically not administrative

COBRA Payments

- Not typically company benefit
- Will fall within per person limits if were employer cost
- Can be first priority in chapter 13 plans if debtor paying for family

WARN Act

- Definition – required pre-layoff notice
  - 60 days – 100 employees or 50 @ single site
  - Pending legislation will reduce numbers, expand notice period, and enhanced damages
- Adversary class action – Bill Heard
- Claims process – First Magnus
- Issue of number of claimants/class size
- Pre-petition termination vests, so priority claim not administrative

ARNOLD & PORTER LLP

Severance, Bonus Plans, and Health and Welfare Plans Under the Bankruptcy Code

Stafford Publications CLE Teleconference – August 20, 2009

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Severance Payments: Section 507

- Section 507 lists those claims that are entitled to priority.
- Section 507(a)(2) provides a priority for claims that constitute administrative expenses allowed under section 503(b).
  - Section 503(b)(1)(A) -- "administrative expenses" include "the actual, necessary costs and expenses of preserving the estate, including wages, salaries, and commissions for services rendered after the commencement of the case."
  - Courts have held that certain severance payments can fall within this section.
- Section 507(a)(4) provides a priority claim for "wages, salaries, or commissions, including vacation, ***severance***, and sick leave pay earned by an individual," provided, however, an individual must have earned the wages within 180 days of either the employer's bankruptcy filing or the cessation of business, whichever occurs first, and the priority attaches only to the extent of $10,950 for each employee.

Determining the Priority Status of Severance Pay

- Courts sometimes have a difficult time determining the priority status to be assigned to severance payments.
- Factors:
  - Termination date
  - Type of severance
    - Payment based on length of service
    - Fixed payment at termination

Differing Views of Severance Pay

- *Post-petition Termination = Administrative Priority for Severance*
  - "Severance pay is not earned from day to day and does not 'accrue' so that a proportionate part is payable under any circumstances. After the period of eligibility is served, the full severance pay is due whenever termination of employment occurs." *Straus-Duparquet, Inc. v. Local Union No. 3 Intern. Broth. of Elec. Workers, A F of L, CIO*, 386 F.2d 649 (2nd Cir. 1967).
    - *Straus-Duparquet* was decided under the old Bankruptcy Act. The Second Circuit has not directly addressed the Straus-Duparquet proposition under the Bankruptcy Code.
- *Post-petition Termination = Administrative Priority Only to the Extent Earned Post-Petition*
  - "The First, Third, and Ninth Circuits have held that severance pay claims should not be accorded priority status just because the right to payment arose postpetition. However, the Second Circuit has accorded priority to severance pay claims in full as costs of administration." *In re Microwave Prods. of Am., Inc.*, 100 B.R. 379 (Bankr. W.D.Tenn. 1989).
  - The focal point is not the time the right to severance pay matured, but when it was "earned."

Attributes Generally Associated with Severance Payments

esignation of a payment as “severance” may not be controlling.

ttributes consistent with severance:

- Payment characterized as severance; rather than termination pay or “golden parachutes.”
- Based on length of service; rather than significant lump sum or multiple of base salary.
- Compensates for the economic hardship of temporary joblessness.
- May include an obligation to mitigate damages.

See, *e.g.*, William R. Fabrizio and Vanessa Abrahams-John, *The Deflation of the “Golden Parachute” in Bankruptcy,* Nov. Am. Bankr. Inst. J. (2004).

Section 503(c) Limitations

- Section 503(c) was enacted as part of BAPCPA.
- Limits retention incentives or severance payments to the debtor's insiders.
- Three parts to section 503(c):
  - (c)(1) -- limitation on retention payments to insiders
  - (c)(2) -- limitation on severance payments to insiders
  - (c)(3) --requirement that payments outside of the ordinary course of business be justified by the facts and circumstances

Definition of an Insider

- Insider is defined as including directors, officers and/or persons in control of debtor. *See* 11 U.S.C. 101(31).

- Difficulty determining insider status:

  - "Titles listed ... are not determinative of whether an employee is an 'officer' when there is apparently nothing in the company's books and records electing an employee to officer status." *In re CEP Holdings, Inc.,* 2006 WL 3422665 (Bankr. N.D. Ohio 2006).

  - "A person holding an officer's title is presumptively an officer and, thus, an insider. A party seeking to rebut that presumption must present evidence sufficient to establish that the person holds the title of an officer in name only and, in fact, does not meet the substantive definition of the same, *i.e.,* he or she is not taking part in the management of the debtor." *In re Foothills Texas, Inc.*, 2009 WL 2241747 (Bankr. D. Del. 2009).

Section 503(c)(2) Limits on Severance Payments

- Section 503(c)(2) precludes severance payments to insiders unless:

  (A) the payment is part of a program that is generally applicable to all full-time employees; and

  (B) the amount of the payment is not greater than 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made."

Section 503(c)(1): Bonus and Retention Plans

- Debtors historically implemented "KERPs" to retain key employees.

- Section 503(c)(1) prohibits payments to an insider of the debtor "for the purpose of inducing such person to remain with the debtor's business" unless:

  1) The person receiving the payment has a bona fide job offer from another business at the same or greater rate of compensation;

  2) The services provided by the person are essential to the survival of the business; and

  3) The proposed payment is not greater than 10 times the average amount of similar payments made to nonmanagement employees for any purpose during the same calendar year or if no similar payments during such calendar year, the amount of the payment is not greater than an amount equal to 25 percent of the amount of any payment made to the insider during the calendar year before the year in which such payment is made or incurred.

Reason for Bonus Plans

- Often both retention and incentive goals.
- Need for management stability during reorganization process.
- Compensate for added workload, stress, risk and uncertainty during bankruptcy.
- Address the risk of poaching by competitors.
- Compensate for inability to pay stock bonuses.
- Bonus often necessary to make compensation market-competitive.
- Create incentives to achieve reorganization objectives and to maximize value.

Retain vs. Incentives

- The strict statutory limitations apply to “retention” programs. The solution to this has been for debtors to create incentive-based programs intended to fall outside the scope of section 503(c)(1).
- Courts struggle with determining whether an incentive compensation plan is merely a disguised retention plan.
- Courts have allowed bonus payments to employees where the bonus is tied directly to enhancing EBITDA, sales, return to creditors, successful asset sale, or other specific criteria.
- Evidence of the incentivizing nature of the plan is often required to be presented to the court and interested parties.

Section 503(c)(3): Limitation on Payments Outside Ordinary Course of Business

- Although incentive based bonus plans are not subject to the section 503(c)(1) limitation, they remain subject to section 503(c)(3), which states --"there shall neither be allowed, nor paid – other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition."

- As one court stated, "section 503(c)(3) is intended to give the judge a greater role: even if a good business reason can be articulated for a transaction, the court must still determine that the proposed transfer or obligation is justified in the case before it. The court reads this requirement as meaning that the court must make its own determination that the transaction will serve the interests of creditors and the debtor's estate." *In re Pilgrim's Pride Corp.,* 401 B.R. 229, 237 (Bankr. N.D. Tex. 2009).

Facts and Circumstances

- Section 503(c)(3) is not particularly difficult to satisfy. The requirements are similar to those of section 363 for the use of property outside of the ordinary course, though some courts may use a heightened standard.

- Courts have generally used a form of the "business judgment" standard to determine whether incentive programs and the payments thereunder meet the section 503(c)(3) "facts and circumstances" standard.

- *See*, *e.g.*, *In re Dana Corp.,* 358 B.R. 567, 576-77 (Bankr. S.D.N.Y. 2006) (acknowledging that courts review a key employee incentive program by considering the standards of the sound business judgment test); *In re Nobex Corp.,* Case No. 05-20050 (Bankr. D. Del. Jan. 12, 2006) (order approving the management incentive plan at issue was entered Jan. 20, 2006) (ruling that section 503(c)(3) is the "catch-all and the standard . . . for any transfers or obligations made outside the ordinary course of business . . . that are justified by the facts and circumstances of the case . . . I find it quite frankly nothing more than a reiteration of the standard under 363 . . . the business judgment of the debtor . . ."); *but see In re Pilgrim's Pride Corp.,* 401 B.R. 229 (Bankr. N.D. Tex. 2009) (holding section 503(c)(3) sets a higher bar than the simple business judgment test).

Selected Post-BAPCPA Retention/Bonus Plan Decisions

- *Dana*
  - Judge Lifland found the debtors' initial management incentive plan violated section 503(c) and stated "[w]ithout tying [the bonus] to anything other than staying with the company until the Effective Date, this Court cannot categorize a bonus of this size and form as an incentive bonus"; the court nonetheless went on to state, "I do not find that incentivizing plans which may have *some* components that arguably have a retentive effect, necessarily violate section 503(c)'s requirements."
  - Following the denial of the debtors' first motion, the debtors modified the compensation plan to require certain benchmarks. The court approved the modified compensation plan, although it imposed certain yearly ceilings on senior executives total compensation, and in so doing stated, "merely because a plan has some retentive effect does not mean that the plan, overall, is retentive rather than incentivizing in nature."

Selected Post-BAPCPA Retention/Bonus Plan Decisions

- *Nellson Nutraceutical:* approving a modified compensation plan which included EBITDA targets and "performance milestones" and finding that "although the modification of the [] bonus program has some retentive effect, it is for the primary purpose of motivating the employees and, thus, the limitations of section 503(c)(1) are not applicable."
- *Movie Gallery:* granting debtor's motion for approval of the management incentive plan where payouts under the plan were predicated upon the debtor's achievement of specific EBITDA targets.
- *Global Home Products*: discussing "pay to stay" versus "pay for value", the court approved bonus plans with payments tied to EBITDAR and cash flow objectives or sales targets; court found that the plans were "primarily incentivizing and only coincidentally retentive."
- *Calpine:* approving an incentive plan with payments tied to market and plan adjusted enterprise value and performance goals; the court found that the plan was designed to enhance the value of the estate and that the plans "are not retentive plans, although anyone can always make an argument that if people are made happier than they were before, then they would be excited to stay with the company, but that's not the focus of these plans."

Practical Issues

- Negotiation with stakeholders:
  - Official Committee of Unsecured Creditors
  - Bank lenders
  - Office of United States Trustee
  - Unions
  - Public/Media

Lessons Learned

- Courts look at the substance of the plan/arrangement to see if the intent of the plan is merely to induce the employee to remain with the debtor or instead to incentivize the employee.
- Bonus compensation should not be a “lay-up.”
- Plans should be tied to enhancing value for creditors/estate and include measureable metrics.
- Get stakeholder buy-in before filing motion for approval.
- Consultants may be necessary to testify regarding reasonableness and purpose of the plan.

Health and Welfare Plans

- Health and welfare plans include plans for medical, dental, life or disability benefits.
- Benefits are generally earned on the date the claim/injury incurred; rather than date claim submitted/paid.

Bankruptcy Implications Regarding Health and Welfare Plan Benefits

- Self-funded vs. insured plans
- Pre-petition vs. post-petition coverage
- Ability to terminate or reduce health and welfare plans
- Individual employee liability
- Fiduciary duty claims
- First Day Wage & Benefits Motions

See Collier, *Employee Benefits and Executive Compensation in Corporate Bankruptcy* (2008).

Bankruptcy and Restructuring: Navigating Employment Issues Under the Code

Modifying and Rejecting Collective Bargaining Agreements and Retiree Benefits

Issues and Approaches

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August 20, 2009

Collective Bargaining Agreements - Section 1113

Chapter 11 debtors seeking to modify of reject their collective bargaining agreements must utilize the procedures set forth in section 1113 of the Bankruptcy Code

Prior to modifying or rejecting a CBA Company must:

- Make a proposal to the union representative.
- Provide the union with relevant information to evaluate the proposal.

Collective Bargaining Agreements - Section 1113

Meet with the union to attempt to negotiate an agreed modification.

If agreed, the parties may seek court approval.

If no agreement, the company may seek a court order permitting rejection and unilateral implementation of modified terms if the company has fulfilled its obligation to provide a proposal and information, and to meet with the union; the proposal was rejected by the union without good cause; all affected parties are treated fairly and equitably; modification is necessary to permit reorganization; and modification is clearly favored by the equities.

Section 1113 - Detailed Requirements

The Proposal:

The proposal to modify must be based upon the most complete and reliable information available at the time of the proposal.

No bright line test, but complete financial information regarding the company, its long-term business plan, and the level of savings to be realized by the proposed modifications must be provided.

Section 1113 - Detailed Requirements

Proposal must provide for modifications necessary to permit reorganization

Standards vary among the Circuit Courts of Appeal

Prevailing view--modifications must be necessary to increase the likelihood of a successful reorganization, recognizing the need for long-term flexibility in order to have a truly successful reorganization, one that results in a healthy company emerging in the process.

Minority view--the proposed modification must be "essential" to prevent liquidation of the debtor.

Section 1113 - Detailed Requirements

Although a plan of reorganization is not required to begin Section 1113 process, forecasted financial information and a sense of the treatment of similarly situated creditors will be necessary.

The Representative:

The union is the employees' representative for purposes of Section 1113.

Unlike Section 1114, there is no appointment process or statutory committee.

Section 1113 - Detailed Requirements

Procedural Steps:

- Company submits proposal to union.
- Company provides information to permit full and fair review.
- Company meets with union and negotiates to agreement or impasse.
- Company moves court for hearing to approve settlement or force modification.
  - Hearing within 14 days, but court may extend for seven days, and parties may agree to two additional extensions.
- Court must rule on motion within thirty days.
  - Failure to rule permits unilateral implementation of modifications pending ruling.

Section 1113 - Detailed Requirements

The court will enter the order permitting rejection of CBA and unilateral modification of terms and conditions of employment if it finds that: the debtor fulfilled its obligation to provide a proposal and information, and to meet with the union; the proposal was rejected without good cause; all affected parties are treated fairly and equitably; and modification is clearly favored by the equities.

Interim Modifications:

Section 1113(e) permits interim modification of a collective bargaining agreement for a limited period of time if essential to the continuation of debtor's business, or in order to avoid irreparable harm to the estate.

Section 1113 - Detailed Requirements

Practical Concerns:

- Company can significantly influence timing
  - Unless there is a liquidity crisis, union will not be motivated to act quickly.
  - Company must actively pursue negotiations.
  - Rejection versus agreed modification

- Company must have a realistic understanding of its modification needs and data to support request
  - A confirmable plan of reorganization is not required prior to requesting relief, but requirements to propose necessary modifications and achieve fair treatment of similarly situated creditors will require the company to have a detailed plan of action in place.
  - Confidentiality concerns

Section 1113 - Detailed Requirements

Practical Concerns cont'd:

Length of process can vary greatly

- The predisposition of the court, relationship with the union, and the extent of the requested modifications can all influence the timing of modification process.
- Accurate projection of timing from delivery of proposal to ultimate resolution is not possible.

Retiree Medical and Other Benefits Section 1114

Chapter 11 debtors seeking to modify or terminate their retiree benefits obligations must generally submit to the procedures set forth in section 1114 of the Bankruptcy Code.

Retiree Benefits include: payments to any entity or person for the purpose of providing or reimbursing payments for retired employees, their spouses and dependents, for medical, surgical, or hospital care benefits or benefits in the event of sickness, accident, disability, or death.

Section 1114 applies to payments under any plan, fund or program (through the purchase of insurance or otherwise) maintained or established in whole or in part by debtor prior to filing a chapter 11 petition.

Prior to modifying or terminating retiree benefits a debtor must:

Make a proposal to the authorized retiree representative

Provide the representative with relevant information to evaluate the proposal

After making the proposal and prior to a modification hearing, the debtor must meet with the representative and confer in good faith to attempt to reach a agreement on mutually satisfactory modifications

The parties may agree to modifications and seek court approval

Absent agreed modifications, the court may enter an order modifying or terminating benefits if: the company has fulfilled its obligation to provide a proposal and information, and to meet with the union; the proposal was rejected without good cause; all affected parties are treated fairly and equitably; modification is necessary to permit reorganization; and modification is clearly favored by the equities.

Section 1114 - Detailed Requirements

The Proposal:

- The proposal to modify or terminate must be based upon the most complete and reliable information available at the time of the proposal
  - Like 1113, very complete financial information regarding the company, its long-term business plan, and the level of savings to be realized by the proposed modifications must be provided.

- Proposal must provide for modifications necessary to permit reorganization
  - Definition of "necessary to permit reorganization" same as under Section 1113
  - Prevailing view--modifications necessary to increase the likelihood of a successful reorganization
  - Minority view—essential to prevent the liquidation of the debtor

- The proposal must assure that all creditors, the debtor and all affected parties are treated fairly and equitably
  - Although the company is not required to have a plan of reorganization at the time of the proposal, the requirement to treat all creditors fairly and equitably will require forecasted financial information and a sense of the treatment of similarly situated creditors.

Section 1114 - Detailed Requirements

Retiree Representative:

- Upon motion of any party in interest, the court shall appoint a committee to represent retirees
  - If the company prepares the requisite information for a proper modification proposal, it could make its own motion to form the committee.

- Labor organizations act as the authorized representative for retires receiving benefits pursuant to CBAs, unless the union elects not to serve or the court finds different representation is appropriate
  - The union's focus on the rights of dues-paying members may cause retiree representation to be inappropriate; nevertheless, in many cases, unions are the primary contact for settling such retiree benefits. Settlement may be approached separately or as part of a more global collective bargaining strategy.

- For the purposes of carrying out the purposes of section 1114, the retiree committee has the same rights, powers and duties as other court appointed committees

Section 1114 - Detailed Requirements

Procedural Steps:

- Company files a motion to form retiree committee, or waits for outsiders to file
- Company submits a proposal to committee for negotiation
- Company provides the committee with additional information to permit full and fair review of proposal
- Company meets and negotiates with the committee, to resolution or impasse
- Company moves the court to approve settlement or implementation proposal
    - Court schedules hearing within 14 days of the motion. Date may be extend for up to seven days where circumstances and the interests of justice warrant, or for additional agreed periods.

Section 1114 - Detailed Requirements

Procedural Steps cont'd:

Court to rule on motion within ninety days of the commencement of hearing

Time may be extended by agreement of the parties. Failure to rule within required time period permits the company to implement the proposal pending ruling.

A modification order may be entered upon finding that: the company fulfilled obligation to provide proposal and information and to negotiate; the representative refused to accept the proposal without good cause; the proposal is necessary to permit reorganization of the company; all affected parties treated fairly and equitably, and modification is clearly favored by the equities.

Section 1114 - Detailed Requirements

Exceptions:

Section 1114 does not apply to retirees, their spouses and dependents if the retiree's gross income equals or exceeds $250,000 for the 12 months preceding the petition filing, unless the retiree can demonstrate to the court the inability to secure other coverage

If the debtor adequately reserves the right to amend or terminate retiree benefits, resort to Section 1114 may not be required

If retiree benefits are not vested, there are no Section 1114 rights.

When faced with ruling that no Section 1114 rights exist, at least two courts have appointed limited scope retiree committees to determine whether the right to amend or terminate was adequately reserved. Though limited in scope, the committees in such cases did lengthen and complicate the termination process.

Section 1114 - Detailed Requirements

Practical Concerns:

- Company can significantly influence timing
  - Company need not wait for a committee to form on its own. Company can approach parties and put together a coalition to present to court with motion to form committee.
- Company must have a realistic concept of its modification needs and data to support request
  - Although a confirmable plan of reorganization is not required prior to requesting relief, requirements to propose necessary modifications and to achieve fair treatment of similarly situated creditors will require the company to have a detailed plan of action in place.

Section 1114 - Detailed Requirements

Practical Concerns cont'd:

- Length of process can vary greatly
  - The predisposition of the court, the make-up of the committee, and the facts surrounding the company's retained right to amend or terminate plans can all influence the timing of modification process.
  - Accurate projection of timing from committee formation to ultimate resolution is not possible.

Section 1114 - Detailed Requirements

Other Issues:

Section 1114/1113 Overlap

Legislative history of section 1114 indicates that modification of retiree benefits under a collective bargaining agreement may trigger overlap of the sections.

Cases addressing the issue have held that retiree benefits arising under CBAs are exclusively subject to section 1114 and not section 1113.

Notwithstanding, section 1114 issues related to union retirees may be settled during the section 1113 bargaining process.