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# GO SLOW ON AMENDING H.R. 3

## INTRODUCTION

Bankruptcy courts and procedures are receiving attention on Capitol Hill this week. At the center of a flurry of activity are two Supreme Court decisions. In June 1982, the nation's highest court issued a ruling that placed the status of bankruptcy judges in doubt. And this February, the Court affirmed that labor contracts can be set aside temporarily when a company reorganizes under the protection of Chapter 11 bankruptcy.

Without a clarification by Congress before midnight March 31, the bankruptcy courts will be forced to close until the constitutional status of their judges is determined. Using this impending deadline as a means of focusing attention, interest groups are lobbying for major bankruptcy law revisions. Following the Court's Chapter 11 ruling, labor unions have demanded that Congress change the law to protect union contracts from renegotiations during corporate bankruptcy reorganization.

Union concern over the bankruptcy law has heightened because in a number of recent business failures, reorganizing companies have set aside union contracts in an effort to overcome immediate cash flow problems. These contracts, however, are not actually abrogated. Contrary to what labor leaders imply, a company's decision to restructure wage and benefit scales is subject to later judicial review, and the original contract, together with back pay, can be reimposed on the company. But the recent Supreme Court decision upholding management's right to change contracts temporarily under the bankruptcy law is confusing politicians and the public and encourages labor to step up its lobbying to change the law so that labor contracts no longer could be set aside even temporarily.

*Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.*

The arguments made by the Air Line Pilots Association and other labor groups within the AFL-CIO on the surface may appear to be reasonable. A statement by the AFL-CIO Executive Council condemned the recent Supreme Court decision for granting "employers wide permission to use the bankruptcy laws to destroy collective bargaining agreements."[1] Laurence Gold, Special Counsel to the AFL-CIO, characterized the decision as "obviously enhanc[ing] the opportunity for union-busting techniques."[2] These charges gain added credibility when supposedly bankrupt companies reopen their doors a few days after announcing sharp wage reductions. In some respects, the law certainly seems to be heavily on the side of management.

But the issues raised by labor's attempts to rewrite the bankruptcy laws are much more complex than they first appear. For example, the statutory changes proposed by labor could well force more companies into Chapter 7 bankruptcy (that is, complete liquidation), by removing any breathing space during which troubled corporations could reorganize. Any increase in the number of outright failures obviously would exact a heavy toll in union and non-union jobs lost.

Existing legal safeguards applying to union contracts should be carefully examined before changes are made. The courts have yet to find a single case in which charges of "bankruptcy for the sake of union-busting" were substantiated. The fact remains, however, that abruptly setting aside union contracts may impose substantial costs on the families affected, and so a means of expediting court reviews of contract abrogations does appear justified.

The evidence points to the need for careful and extensive consideration of the relationship between bankruptcy laws and union contracts. Hasty changes may have little understood but far-reaching impacts on the long-term health of the U.S. economy. A number of questions should be addressed before any substantial revision of the bankruptcy code in this area is undertaken. But labor leaders are seeking to attach a floor amendment to H.R. 3, the bill clarifying the judges' status, when it comes to the floor this week. Such a move would require legislators to vote on substantive changes in the bankruptcy code without an opportunity fully to investigate and appreciate the potential impact on the financial health of countless unionized firms in this country. In dealing with an issue as complex and potentially damaging as this one, legislators should demand a full accounting from those on both sides of the issue before making a decision.

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1 Statement of the AFL-CIO Executive Council on The Bildisco Decision, February 23, 1984, Bal Harbour, Florida.

2 William Serrin, "Labor Leaders Voice Concern," New York Times, February 23, 1984.

## HOW THE BANKRUPTCY LAW WORKS

The February Supreme Court ruling has confused legislators and the public regarding the way the bankruptcy law works. This confusion has no doubt been fanned by those who wish to change the law to benefit themselves. But a careful examination of the question surrounding the bankruptcy debate shows that the truth is very different from the picture painted by labor union lobbyists.

### How does bankruptcy work, and what role do union contracts play in the bankruptcy process?

Bankruptcy often results in a reorganization of the ailing company rather than the company's complete liquidation.

Under Chapter 11 (or reorganization) proceedings, the courts and the bankrupt company work together in an effort to keep the company alive. The company is provided a respite from creditors while its debts are reorganized and revised payment schedules are established. This reorganization under Chapter 11 includes not only debts that are owed for past services, however, but also obligations that have been made by the bankrupt company for future services. A union contract is such an obligation--the bankrupt company promised to buy labor for a fixed period of time at the union wage rate. Reexamination of these future promises to pay is often necessary to relieve a troubled firm's immediate cash flow problems and to allow essential cutbacks in production.

### Should labor contracts receive special protection under the bankruptcy code?

Labor union contracts already receive special protection from the bankruptcy laws. A company that sets aside its union contract under Chapter 11 must later defend this decision in court. If the court finds the company acted in bad faith, or without sufficient economic justification, not only is the union contract reinstated but the firm is also liable for back wages. In its February decision (National Labor Relations Board v. Bildisco, No. 82-818, February 22, 1984), the Supreme Court ordered the bankruptcy courts to apply a "stricter standard" to union contracts than to other contracts and obligations.

The Supreme Court held that:

> ...because of the special nature of a collective-bargaining agreement, and the consequent "law of the shop" which it creates, a somewhat stricter standard should govern the decision of the Bankruptcy Court to allow rejection of a collective-bargaining agreement.

In addition to applying this stricter standard, the Court ruled that "before acting on a petition to modify or reject a collective-bargaining agreement...the Bankruptcy Court should be persuaded

that reasonable efforts to negotiate a voluntary modification have been made and are not likely to produce a prompt and satisfactory solution."

Why not simply exempt labor contracts completely from the provisions of the bankruptcy code?

Labor costs are often too large a part of an ailing company's total expenses to be ignored. Take the troubled airline industry, for example. Labor costs are a major expense for airlines, and are particularly high for unionized airlines. Major unionized carriers allocate between 33 and 37 percent of their operating budgets to wages and benefits; by contrast, newer non-unionized airlines spend only 19 to 27 percent on labor costs.[3] A survey of Security and Exchange Commission filings by the major airlines confirms the importance of labor costs in unionized companies.[4] As the survey noted:

> Wages, salaries, and benefits are TWA's largest single category of expenses, accounting for more than a third of total costs, and are a major factor in the operating cost competitive advantage that newly-formed carriers enjoy over TWA and other major established carriers.
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> The airline business is very labor intensive. American's salaries and benefits represent 35.3 percent of AMR's consolidated operating expenses at December 31, 1982. As a consequence of the increasing level of competition which has arisen since deregulation, American believes that it must make more productive use of its employees to remain competitive.

Given the importance of wages and benefits, if the ailing firm were legally prevented from reducing operating budgets by renegotiating labor costs, the chances for a successful reorganization under Chapter 11 would be reduced substantially.

Are the proposed labor modifications really that severe? The unions do not want a complete exemption from the bankruptcy laws, they simply want a hearing in court before their contracts are modified or rejected.

In the opinion of some bankruptcy experts, such a requirement would amount to a de facto exemption, because the delay involved

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3 "Airlines in Turmoil," Business Week, October 10, 1983, p. 99. The average salary for union pilots is $69,000 per year. Mechanics average up to $30,000 a year, plus fringe benefits. Id.

4 Securities and Exchange Commission 1982 10K reports for Trans World Airways, Inc. and AMR Corporation (American Airlines).

in such a hearing would rule out contract changes in any emergency plan to save an ailing company. In many cases, a delay of even a few days can make the difference between a Chapter 11 and a Chapter 7 filing. When Continental Airlines filed for reorganization, for instance, it had only eight days of cash left, given existing contracts. Having to wait for a hearing on its labor agreements could well have forced the company into liquidation. At the very least, requiring court decisions before contracts are modified would impose a severe, and perhaps unnecessary, cash drain on a financially ailing company. At worst, it could assure a company's complete collapse, and the loss of the very jobs the unions would want to save.

The issue is simply one of urgency. The unions do receive a hearing on the fairness of any wage concessions surrendered during the bankruptcy proceeding, and the union members are eligible for back pay if the concessions are later ruled inequitable by the bankruptcy court. Current bankruptcy laws simply recognize that any wage change must occur immediately if a financially ailing company is to survive.

Under the current bankruptcy laws, do not successful companies file for bankruptcy, just so they can get rid of their unions?

There is absolutely no evidence of this. The courts consistently have found that companies renegotiating labor contracts under the bankruptcy laws are in genuine financial trouble.

The two best-known recent examples of the law in action are Continental Airlines and Wilson Foods. Continental Airlines lost almost $160 million in the first nine months of 1983, while Wilson Foods Corporation lost nearly $43 million in fiscal 1983.[5] Both were facing cash flow crises when they filed for reoganization. Clearly, these were legitimate bankruptcies. The renegotiation of labor costs played a critical role in restoring both companies to financial health.

The only significant example of a healthy company declaring bankruptcy is the Manville Corporation, which filed for bankruptcy despite making a profit of over $65 million in the first nine months of 1983.[6] Yet this action was not undertaken to "bust" a union, but as a defense against its virtually unlimited liability in asbestos-related lawsuits.

What prevents profitable companies from following Manville's lead, and filing for bankruptcy simply to get rid of the union?

There are legal and economic reasons why a healthy unionized company would not file for bankruptcy simply to de-unionize.

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[5] For Continental Airlines, Moody's Transportation Manual (1983 Supplement). For Wilson Foods, Moody's Industrial Manual (1983 Supplement).

[6] Moody's Industrial Manual (1983 Supplement).

The Supreme Court has ruled that "the Bankruptcy Court should permit rejection of a collective-bargaining agreement...if the debtor can show that the collective-bargaining agreement burdens the estate and that, after careful scrutiny, the equities balance in favor of rejecting the labor contracts."[7] It is virtually impossible for a healthy, profitable company to show that its union contract "burdens" the company within the meaning of the bankruptcy code.

From an economic viewpoint, the costs of filing for bankruptcy in terms of investor confidence and capital formation are so enormous that only a major crisis, such as Manville's virtually unlimited liability problem, would justify a bankruptcy filing by a successful corporation. Union contracts would not carry that kind of massive and unlimited potential cost.

Even financially troubled companies hesitate to file for bankruptcy because of the impact it could have on the confidence of suppliers, creditors and investors. Eastern Air Lines recently spent considerable time and effort in negotiating concessions from its unions because of the company's desire to avert costly and potentially destructive bankruptcy proceedings.

Why does the issue of unions and bankruptcy seem to particularly affect certain industry groups, such as airlines?

The airlines developed within the protective cocoon of regulation. Shielded from the ups and downs of the marketplace, the airlines made economically unjustified wage and benefits concessions to their unions. The cost of those concessions could be routinely passed through to the consumer in the price of an airline ticket thanks to the controlled marketplace and the Civil Aeronautics Board's price setting mechanisms. When the airline industry was deregulated, however, non-unionized airlines appeared, providing the consumer with the benefits of low-priced competition, and the wage scales of the older companies began to catch up with them.

The current bankruptcy laws have allowed established airlines more freedom to renegotiate their grossly uneconomic labor costs. Without the current laws, the larger, established airlines, employing thousands of people, would probably have collapsed with massive layoffs as new non-union airlines took their place. This would have meant a tragic and unnecessary shakedown for the employees of the established airlines. The availability of relief under current bankruptcy laws has, therefore, eased the necessary transitions from a regulated industry to a deregulated one.

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[7] National Labor Relations Board v. Bildisco, U.S. Supreme Court, February 22, 1984.

Would union members actually benefit from the union-backed proposed changes to the bankruptcy code?

Not always. In many cases, in fact, the union-supported changes could cost union members their jobs. If ailing companies are prevented from modifying union contracts on an immediate, but temporary, basis, a Chapter 11 reorganization may have little chance of success. Given no other alternative, the bankrupt company may elect a Chapter 7 liquidation--and the company's union (and non-union) jobs would be permanently lost.

What about workers who are not employed by a company filing for bankruptcy, but work for the company's suppliers? Would they be affected by the proposed union modifications to the bankruptcy code?

If a large company is forced to liquidate because of labor costs, suppliers of the company may face economic problems, requiring cutbacks in production and potential layoffs. In severe cases some suppliers may even be forced into liquidation, increasing the number of failed companies and the rate of unemployment.

The net economic effects of a unionized company's liquidation may be minimal in the long term. Smaller non-union companies can be expected to form, filling the market void created by the larger bankrupt firm. But this painful transition may be avoided simply by allowing the currently distressed companies to renegotiate wage contracts.

## CONCLUSION

There have been no documented cases of bankruptcy laws being used solely to break union contracts. In fact, a union cannot be decertified under the bankruptcy code; although wages are decreased at least temporarily, the union remains the official bargaining agent for the employees. While no profitable company has successfully filed for bankruptcy merely to get rid of its union, many companies in serious financial trouble have gained another chance of survival by reducing their labor, as well as other, costs through the bankruptcy laws.

Labor leaders apparently misunderstand the likely effects of the "reform" they are pressing Congress to enact. Rather than protect their members, the changes they urge would have the opposite effect. If the proposed modifications are enacted:

- Unemployment among union and nonunion workers would increase;

- Deregulated industries will go through a much more difficult and dangerous transition period;

□ The number of failed companies in the United States will almost certainly increase.

Certain modifications to the bankruptcy laws may be desirable. Expedited reviews of corporate decisions to set aside labor contracts may be needed, for example. But proposed modifications that would allow labor unions even more protection than they already receive would be unwise--not only for union members themselves, but for the rest of the economy as well. The issue is too important to be dealt with lightly or hurriedly. Proposed changes in the way the bankruptcy code deals with union contracts deserve a thorough hearing, free of the political emotionalism characterizing the present campaign to push major amendments through the Congress with minimal discussion.

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