

KICKEM & TELLUS

MEMORANDUM

TO: Harry Hardnose
FROM: Kickem & Tellus
DATE: February 18, 2006
RE: Ability to Modify or Reject Collective Bargaining Agreements

Overview of Section 1113 of the Bankruptcy Code

Section 1113 contains the substantive and procedural elements of a debtor's ability to reject collective bargaining agreements ("CBAs"). A debtor may request approval of rejection of a CBA, but only after first seeking an agreement with the authorized representatives of the employees for a modification of the benefits and protections afforded under the CBA. These modifications must be only those "that are necessary to permit the reorganization of the debtor while still allowing all creditors, the debtor and all of the affected parties to be treated fairly and equitably." 11 U.S.C. § 1113(b)(1)(A). In conjunction with seeking union approval to modify the agreement, the debtor must provide the union with relevant information as is necessary to enable the union to evaluate the proposal. 11 U.S.C. § 1113(b)(1)(B). Finally, the debtor must meet with the union at reasonable times and confer in good faith to reach a satisfactory modification of the agreement. 11 U.S.C. § 1113(b)(2).

After complying with these requirements, a debtor failing to reach an agreement with the union may apply to the court for rejection of the agreement. The court "shall approve an application for rejection" upon finding the debtor in possession fulfilled these requirements, the union refused to accept the proposed modification "without good cause," and the balance of the equities "clearly favors rejection" of the agreement. 11 U.S.C. § 1113(c).

Prior to applying to the court to reject a CBA, a debtor must adhere to the terms of a prepetition CBA unless the court approves an application for rejection or grants interim relief under section 1113(e). 11 U.S.C. § 1113(e). As a result, debtors remain obligated to pay wages and benefits in accordance with the CBA as they become due, and the failure to do so is a unilateral alteration of the agreement in violation of section 1113(f), and not merely a breach of the agreement. **Courts are split on whether prepetition wage and wage-related claims under a CBA are entitled to administrative expense status pursuant to 1113(f).**

Standards for Rejecting a CBA

Prior to approving rejection under section 1113(c)(1), the court must find that the debtor has complied with the pre-application requirements of subsections 1113(b)(1)(A), (B) and (b)(2). Courts have identified nine factors that must be met to be able to reject a CBA. These nine requirements are:

- (1) Prior to filing a motion to reject a CBA, the debtor must make a proposal to the union to modify the CBA (1113(b)(1)(A));
- (2) The debtor's proposal must be based on the most complete and reliable information available at the time (1113(b)(1)(A));
- (3) The modifications must be necessary to permit reorganization (1113(b)(1)(A));
- (4) The proposed modifications must assure that all creditors, the debtor, and other affected parties are treated fairly (1113(b)(1)(A));
- (5) After submitting the proposal to the union, the debtor must provide the union with information to evaluate the proposal (1113(b)(1)(B));
- (6) Between the time of the proposal and the time of the hearing on the motion to reject, the debtor and the union must meet at reasonable times (1113(b)(2));
- (7) The debtor must confer with the union in good faith in an attempt to reach mutually satisfactory modifications of the CBA (1113(b)(2));
- (8) The union must refuse to accept the debtor's proposal without good cause (1113(c)(2)); and
- (9) The balance of equities must clearly favor the rejection of the collective bargaining agreement (1113(c)(3)).

Generally, the debtor must first submit to the union a proposal to modify the CBA which satisfies the prerequisites of section 1113(b); the parties must then meet in good faith to negotiate over the proposed modifications; the union must reject the proposal without good cause; and the balance of equities must favor rejection.

The Proposal

Prior to filing a motion to reject a CBA, the debtor must make a proposal to the union. The proposal must be made on the most complete and reliable information available at the time. 11 U.S.C. § 1113(b)(1)(A). The proposal is the first step in the court's analysis of whether to grant a motion to reject. It defines the parameters of the relief that the court may grant. This does not confine the court to the debtor's original proposal, but allows the court to consider the sufficiency of the last offer by the debtor.

1. Necessary Modifications

The debtor's proposal must include only those modifications in employees' benefits and protections that are necessary to permit the reorganization of the debtor. There is a split in authority regarding the definition of "necessary" in this context. The majority of courts have held that the proposed changes must be "necessary" to increase the likelihood of a

successful reorganization. Therefore, the proposal may go beyond the bare minimum needed to ensure the debtor's reorganization and avoid liquidation. Other courts have taken a more strict approach, finding that "necessary" is synonymous with "essential," and a debtor's proposal may include only those items absolutely necessary for the debtor's reorganization.

The necessity requirement presumes that the debtor will continue to operate the business which is employing those who work under the CBA. It presupposes that the debtor's reorganization will involve a rehabilitation of the business, not a liquidation or a sale of the business to a new employer. If the debtor is going to liquidate the business by laying off all the employees, terminating its operations, and selling its assets for scrap, it will have no employees left working under the contract. Consequently, no modifications will be necessary, because the contract will no longer have any effect on the operation of the business.

The debtor may sell the business to a new employer as a functioning operation. Under the Supreme Court's labor law successorship doctrines, a buyer of a business concern is not bound by the seller's CBA unless the buyer expressly assumes the contract. If a successor employer continues to employ a majority of the former owner's employees, it may be under a duty to recognize and bargain with the employee's union, but it is not bound by the debtor's CBA.

The few court opinions issued under section 1113 indicate that in order to find that proposed modifications are necessary, the debtor must introduce financial evidence showing that the modifications will have a significant monetary impact on improving the debtor's financial condition.

The focus of the necessity requirement has been on the monetary impact of any changes on the debtor's financial condition. At issue should be the economic items contained in a CBA, not its noneconomic provisions. Economic items, which include those 'directly susceptible to monetary evaluation, such as wages, vacations, holidays, and pension and welfare contributions,' are customarily considered only after agreement has been reached on noneconomic items. Noneconomic items include such things as a 'management rights' clause, grievance and arbitration provisions, union security, a no-strike promise, and seniority provisions. Under section 1113(b), changes in noneconomic items, such as work rules, seniority, and grievance and arbitration procedures, would not come within the scope of the permissible proposal unless the debtor can establish a clear monetary impact on reorganization.

2. All Affected Parties Must Be Treated Equitably and Fairly

The proposal must treat all affected parties fairly, to ensure that the burden of reorganization will be borne by all groups, and no one group will be disproportionately affected. "Fair and equitable" does not mean identical or equal treatment; equity means fairness under the circumstances, not a dollar for dollar concession. The purpose is to spread the burden of saving the company to every constituency while ensuring that all sacrifice to a similar degree. Courts do not look favorably on proposals which fail to require that other groups, especially managerial and other non-union employees, to bear their share of concessions. In analyzing whether a proposal satisfies the "fair and equitable" requirement, some courts have focused on whether the

proposal includes a “snap-back” provision which provides that benefits will be reinstated if the reorganization succeeds.

3. Negotiations over the Proposal

After making the proposal, the parties must negotiate its contents in good faith. Two main elements determine whether these negotiations were conducted in good faith: (1) was the union provided with the relevant information regarding the proposal; and (2) did the debtor and the union representative meet at reasonable times to discuss the proposal. The primary purpose of these elements is to encourage voluntary modifications and promote intelligent negotiations.

Section 1113(b)(2) directs the debtor to “meet at reasonable times” and “confer in good faith” in an attempt to reach “mutually satisfactory” modifications of the CBA.

4. Union Has Good Cause to Reject the Proposal

Pursuant to section 1113(c)(2), in order to approve rejection, the court must find that the union representative’s refusal of the debtor’s proposal is without “good cause.” The determination of whether the union has refused “without good cause” is a case-by-case determination. In interpreting the phrase “without good cause” courts have held that a union must articulate and discuss in detail with the debtor prior to the hearing its reasons for declining to accept a proposal. Even though the debtor bears the burden of showing that the union lacked “good cause,” the union must come forward with reasons for declining to accept the debtor’s proposal. If the union provides no evidence for its reason for declining the debtor’s proposal in the face of evidence provided by the debtor that it is not economically feasible for the debtor to continue operations under the original contract, it may be found that the union has rejected the proposal without “good cause.”

5. Balance of Equities Must Clearly Favor Rejection

Courts look at a number of factors in determining whether the equities favor rejection, including: the extent of the savings to be realized by the debtor and any alternate means of cost reduction; the relative amount of management salaries compared to union wages; the identity of the other creditors and the amounts of their claims; the likelihood and consequences of a strike if rejection is allowed; the possibility of employee claims for breach of contract if rejection is approved; the possibility of liquidation; the impact of the losses suffered by the individual employees in proportion to the losses suffered by the other creditors; and the good faith of the parties.

6. Court-Ordered Interim Changes Under Section 1113

Section 1113(e) provides that if it essential to the continuation of the debtor’s business, or in order to avoid irreparable damage to the estate, the court, after notice and a hearing, may authorize the trustee to implement interim changes to the terms, conditions, wages, benefits, or work rules provided by a CBA. Courts have interpreted this provision as permitting relief only if the debtor can show that without the interim modifications, it is likely to liquidate. The term ‘essential’ refers to interim relief that should be limited to the bare minimum, short-

term requirements for the debtor's immediate survival. Interim relief may be granted until the section 1113 process for rejection of a CBA is completed.

7. When Rejection is Denied

If the court denies the debtor's rejection application, the CBA continues in effect during the bankruptcy case until it expires by its own terms. The contract rates in the CBA will continue to set the rates for the valuation of any claims filed in the bankruptcy, whether they are administrative expense claims or priority claims. The union will continue to be bound by the CBA and by any agreement not to strike during its term.

8. When Rejection is Granted

Section 1113 does not address the post-rejection period. Section 1113 does not address whether the debtor can implement its own terms/conditions of employment. Section 1113 suggests that the employer may make unilateral changes only in conformity with its duty to bargain in good faith for a new CBA. If no CBA is in effect between the parties, the parties are subject to normal labor law obligations to bargain for a new contract. The employer may make unilateral changes in the prevailing status quo, but only after it has bargained to impasse with the union. If the court has approved interim changes, these interim changes along with the unilateral provisions of the CBA, constitute a new, temporary, status quo in the terms of conditions of employment. Any changes must be consistent with its last offer to union.

As soon as rejection is granted, regardless of whether the debtor is allowed to implement any unilateral changes immediately, the union is free to call a strike because it is as if there is no CBA in place. Once the contract ends, the union is released from its no-strike promise.

Treatment of Section 1113 Claims

While section 1113 imposes certain procedural and substantive requirements for a debtor to reject a prepetition CBA, it leaves unaddressed the fundamental issue of whether there is a claim for damages from the court-approved rejection of a CBA. There are two views on this issue. One view is that section 1113 completely removes CBAs from treatment as executory contracts under section 365, with the consequence that such a claim does not exist. The other view is that section 1113 provides a mechanism for rejection, and, once rejection occurs, a claim for rejection damages is allowable in the same manner as for other executory contracts under section 365.

Furthermore, courts that do allow damages are also split regarding the priority to be accorded to claims arising as a result of rejection. A bankruptcy court may give priority to claims stemming from post-petition reliance on a pre-petition CBA in the same fashion that is provided to other claims for post-petition compensation from non-union employees.