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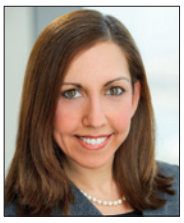
LABOR RELATIONS

Expert Analysis

Considerations for Businesses Thinking About Chapter 11 Bankruptcy



By **David E. Schwartz**

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The economic impact of the COVID-19 pandemic cannot be overstated. Many employers have shut down, while others have implemented employee furloughs, layoffs and other cost-saving measures. As many troubled companies will continue to "downsize" and seek to restructure mounting debts, this column addresses important considerations for employers contemplating Chapter 11 bankruptcy.

Contract Rejection

Chapter 11 of the Bankruptcy Code encourages reorganization of financially distressed companies by allowing them to, among other things, reject burdensome contracts. In particular, employers facing bankruptcy should carefully evaluate existing employment agreements as they balance their financial situation with the need to retain talent to successfully restructure.

An employment agreement is considered an "executory contract"—a contract under which both parties have material unperformed obligations on the date of the bankruptcy filing—which can be rejected by the debtor with approval from the bankruptcy court. A bankruptcy court will analyze whether rejection will benefit the debtor and not prejudice creditors. If a debtor's proposed rejection of an employment agreement reflects sound business judgment, a bankruptcy court generally will approve the rejection.

Employers facing bankruptcy should carefully evaluate existing employment agreements as they balance their financial situation with the need to retain talent to successfully restructure.

If a court approves a debtor's rejection of an employment agreement, the employee will have an unsecured claim against the bankruptcy estate. Pursuant to §502(b)(7) of the Bankruptcy Code, the unsecured claim is capped at the compensation provided for in the employment agreement for the one-year period following either the date the bankruptcy petition is filed, or the date on which an employee terminates performance under the employment agreement, whichever is earlier, plus any unpaid compensation due as of such date. 11 U.S.C. §502(b)(7). Such unsecured claims will be distributed pro rata after the bankruptcy estate pays administrative expenses, priority unsecured claims and secured claims.

Labor Agreements

Modifying or rejecting collective bargaining agreements (CBAs), typically including costly pension plan obligations, is often key in an employer's efforts to reorganize and reduce expenses. CBAs also are considered executory contracts. However, §1113 of the Bankruptcy Code provides CBAs with enhanced protection and requires a debtor satisfy significant additional steps before a bankruptcy court will allow rejection of a CBA. 11 U.S.C. §1113.

Before filing a motion under §1113 to reject a CBA, an employer must propose to the union modifications of the CBA "necessary to permit the reorganization of the debtor" based on the most complete and reliable

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information available at the time the proposal is made. The proposed modifications must treat all affected parties—including creditors, the union and the debtor—fairly and equitably, and the debtor must provide the union with all relevant information necessary to evaluate the proposal. After the proposed modifications are presented to the union, the parties must confer and attempt, in good faith, to reach a mutually acceptable modification. If these steps are followed and the union "refuse[s] to accept such proposal without good cause," a court may approve a debtor's proposed rejection of a CBA if the balance of equities clearly favors the rejection.

Whether proposed modifications to a CBA are "necessary to permit the reorganization of the debtor" is frequently litigated. The Second Circuit has held that "necessary" modifications are not restricted to those that are essential or the "bare minimum," and that "reorganization" refers to the long-term financial viability of the debtor, rather than the short-term goal of preventing the debtor's liquidation. See *Truck Drivers Local 807 v. Carey Transp.*, 816 F.2d 82 (2d Cir. 1987) (upholding bankruptcy court's conclusion that debtor needed to obtain CBA modifications of greater magnitude than mere break-even cost reductions).

Like the necessity requirement, parties also frequently dispute the "good cause" prong. Good cause for the union to reject the company's proposal generally will not be found if a union refuses to negotiate or offer specific reasons for rejecting a proposal. See *In re Maxwell Newspapers*, 981 F.2d 85 (2d Cir. 1992) (holding bankruptcy court did not clearly err in determining union rejected debtor's proposed CBA modification without cause where union adhered to demand that debtor could not fund and failed to offer alternative focused on needs of debtor's reorganization).

Before filing for Chapter 11 relief, employers with unionized workforces are advised to carefully review their CBAs along with concrete financial projections, consider which modifications are necessary for the company's long-term survival, and engage in good faith negotiations with their unions.

WARN Notice

Businesses considering filing a bankruptcy petition often are faced the duty to comply with the Worker Adjustment and Retraining Notification Act (WARN). WARN is a federal statute that requires employers with 100 or more employees to provide 60 days' advance notice to affected employees, certain state and local authorities and, if applicable, union representatives before a covered plant closing or mass layoff. A "plant closing" is a temporary or permanent shutdown of a single site of employment, or one or more facilities or operating units within a single site, resulting in an employment loss at the site for 50 or more full-time employees. A "mass layoff" is a reduction-in-force resulting in an employment loss for 50 or more full-time employees who comprise at least 33% of the full-time employees at a site of employment, or for 500 or more full-time employees at the site. Many states have enacted mini-WARN laws that require additional notice and cover a broader range of employment actions. For example, New York WARN covers employers with 50 or more employees and requires 90 days' advance notice of plant closings or mass layoffs affecting 25 or more employees.

> Employee claims for violation of WARN may be entitled to either priority unsecured or administrative expense treatment in a Chapter 11 case, depending on the timing of a plant closing or mass layoff.

Federal and state WARN obligations remain applicable to an employer that files for bankruptcy. However, WARN provides for several exceptions to the requirement to provide the full 60 days' notice which often arise in bankruptcy cases. The faltering company exception applies when, before a plant closing, a company is actively seeking capital or business and reasonably in good faith believes advance notice would preclude its ability to obtain such capital or business, and this new capital or business would allow the employer to avoid or postpone a shutdown for a reasonable period. The unforeseeable business circumstances exception applies when the closing or mass layoff is caused by business circumstances that were not reasonably foreseeable at the time 60-day notice would have been required. This exception may apply when a "sudden, dramatic, and unexpected action or condition" occurs. 20 C.F.R. §639.9(b)(1). Even if a WARN exception applies, an employer must give as much notice as practicable.

The U.S. Department of Labor has not explicitly said COVID-19 related closures and layoffs fall under the unforeseeable business circumstances exception. Its regulations, in place prior to the COVID-19 pandemic, state that "an unanticipated and dramatic major economic downturn" and "a government ordered closing of an employment site that occurs without prior

notice" might each be considered a business circumstance that is not reasonably foreseeable. Id. However, the point in time the effects of COVID-19 became unforeseeable and how long such effects remain unforeseeable are questions of fact and may depend on the nature and location of a particular business.

Prior case law addressing this exception prove instructive. In *United Steel Workers of Am. Local 2660 v. U.S. Steel*, 683 F.3d 882 (8th Cir. 2012), a union challenged a steel producer's failure to provide a full 60 days' WARN notice prior to conducting a mass layoff of over 300 employees in the wake of the 2008 financial crisis. The union contended the recession began prior to October 2008—more than 60 days prior to the layoffs—while the employer argued the severe effects of the recession on the steel industry were not apparent until late November 2008, just before the layoffs occurred. The appeals court agreed with the employer, finding although the company was aware the economic downturn would reduce demand for products, the sudden, dramatic collapse of the U.S. steel industry in late November—less than 60 days before the layoffs—constituted an unforeseeable business circumstance under WARN.

On the other hand, the court in *United Paperworkers Int'l Union v. Alden Corrugated Container*, 901 F. Supp. 426 (D. Mass. 1995), held the decision by a company's lender to call its loans and order that it cease operations was not an unforeseen business circumstance under WARN, given the business had sustained losses for over two years, the company's suppliers would no longer accept its credit, and its loans were in a workout mode with the bank.

New York WARN recognizes the unforeseeable businesses exception and has acknowledged on its website the exception may apply in connection with "government-mandated closures, the loss of your workforce due to school closings, or other specific circumstances due to the coronavirus pandemic." The Department advises businesses that have had to close unexpectedly to provide as much information as possible when filing WARN notices about the circumstances of the closure so the Department can determine if an exception to New York WARN applies.

California WARN does not recognize the unforeseeable business circumstances exception. However, Governor Newsom issued Executive Order N-31-20 which, for the period March 4, 2020 through the end of the California state of emergency declared as a result of the COVID-19 threat, suspends the obligation to give a full 60 days' notice under California WARN where a closing or layoff is caused by COVID-19-related business circumstances that were not reasonably foreseeable. Covered employers must provide as much notice as practicable and explain the basis for reducing the notification period.

Claim Priority

Section 507 of the Bankruptcy Code sets forth the priority order in which claims against a debtor are paid. Claims arising post-petition, including post-petition wages and benefits, are administrative expense claims, which are afforded second priority. 11 U.S.C. §507(a)(2). Claims for pre-petition wages are unsecured claims and are given fourth level priority. However, this priority is limited to wages, salaries or commissions, including vacation, severance, and sick leave pay, up to a cap (currently $13,650 per employee), which have been earned within 180 days prior to the filing of the bankruptcy petition. 11 U.S.C. §507(a)(4)(A).

Employee claims for violation of WARN may be entitled to either priority unsecured or administrative expense treatment in a Chapter 11 case, depending on the timing of a plant closing or mass layoff. For example, in *In re Powermate Holding*, 394 B.R. 765 (Bankr. D. Del. 2008), where employees were terminated without proper WARN notice prior to filing of the bankruptcy petition, the Delaware bankruptcy court found employees' WARN claims vested pre-petition and were not entitled to administrative expense status. Relying on opinions that have held WARN damages are like payment at termination in lieu of notice, the court found rights of employees discharged in violation of WARN accrued upon their pre-petition termination and, therefore were governed under §507(a)(4)-(5) granting priority unsecured claim status to pre-petition wages. See also *In re Beverage Enterprises*, 225 B.R. 111 (Bankr. E.D. Pa. 1998) (holding union's WARN claim was entitled to administrative expense status where employees were terminated post-petition).

Because rulings in this area vary by jurisdiction, employers contemplating Chapter 11 relief should consult relevant case law in the jurisdiction where the bankruptcy case will be filed. Proper preparation should enable businesses to minimize potential claims against the bankruptcy estate and move towards a successful reorganization.