ABI Commission to Study Reform of Chapter 11

Statement of

Hon. Joshua Gotbaum[1]

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The charge of this Commission is to revisit and rebalance Chapter 11, in pursuit of the twin goals of reorganization and just treatment of creditors.

I have some sympathy for these challenges, because PBGC does a similar balancing act in bankruptcy: We at PBGC balance the goals of successful reorganization with the rights of workers and retirees. When companies can successfully reorganize while preserving their pension plans, we work to preserve the plan, as we did with American Airlines. When companies cannot afford to keep their plans, we step in and pay their benefits. And, as it says in our own version of the Serenity Prayer, we pray for the wisdom to know which is which.

PBGC (and I personally) have worked in restructuring and reorganization for decades. PBGC is among the most active participants in committees of unsecured creditors and has litigated bankruptcy issues before many courts.

As with others who have participated in the Chapter 11 process since the 1978 amendments, it seems clear that the changes of the past 35 years have in many cases led to very different results from those foreseen four decades ago. I am not here to argue that the results have failed the objectives of the 1978 reforms. On the contrary, I think the bankruptcy process today is more flexible, more competent, and more efficient — better than pre-1978 and better than when I joined the restructuring world in the early 1980s.

However, in many cases financial institutions and financial markets have outstripped both the law's ability to comprehend them and bankruptcy courts' ability to preserve fair treatment of other constituencies in the face of them. In particular, the interests of employees, retirees and other unsecured creditors seem increasingly to receive short shrift. So I hope the Commission will take up its mandate to rethink and rebalance comprehensively and aggressively.

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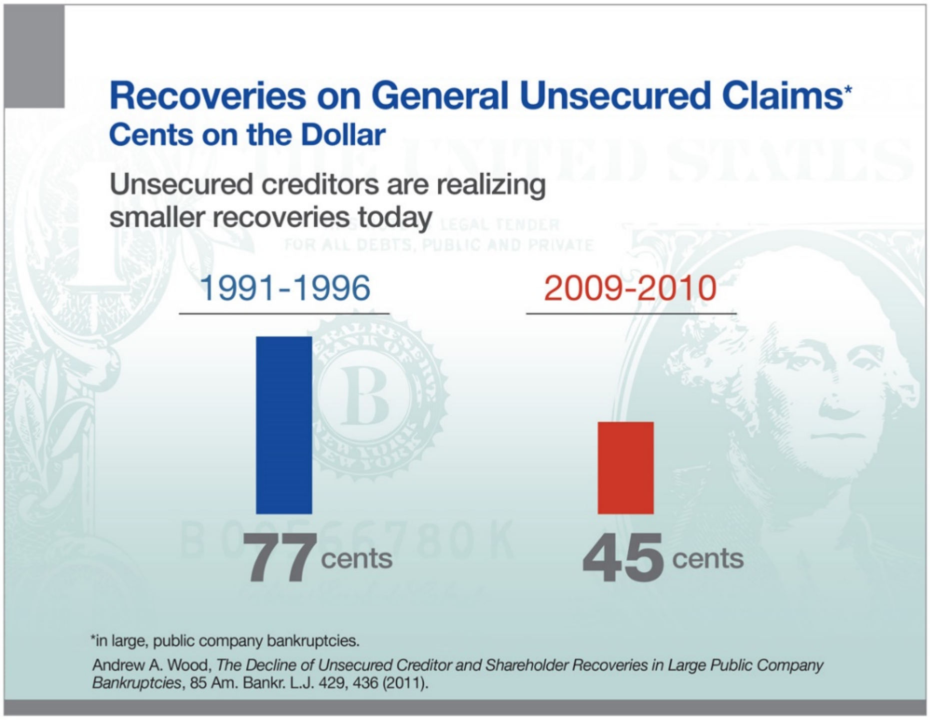
Keeping Bankruptcy Both Efficient and Fair

To balance the successful reorganization of companies in bankruptcy with the appropriate distribution of assets, bankruptcy law has to keep pace with external factors, such as the evolution of financing markets. Over the decades, the balance has tilted away from debtors, shareholders, and unsecured creditors, and toward secured creditors.



The evolution of secured lending, both origination and trading, and both in and out of Chapter 11, has permitted companies to obtain financing in circumstances that previously would not have been possible. As a result, there are companies operating today that otherwise would have been liquidated.

However, secured lending has also displaced other legitimate interests — both of trades and of other unsecured creditors: employees, retirees, and their families. The magnitude of this shift is breathtaking. According to a recent study, in the early 1990s, a general unsecured claim in a large public company bankruptcy paid on average 77 cents on the dollar. By 2010, that had declined to 45 cents on the dollar.[2]

Providers of secured debt in restructuring situations point out, accurately, that reducing their returns will raise the cost of such capital. What the Commission must consider is whether the increased fairness to other stakeholders is worth that price.

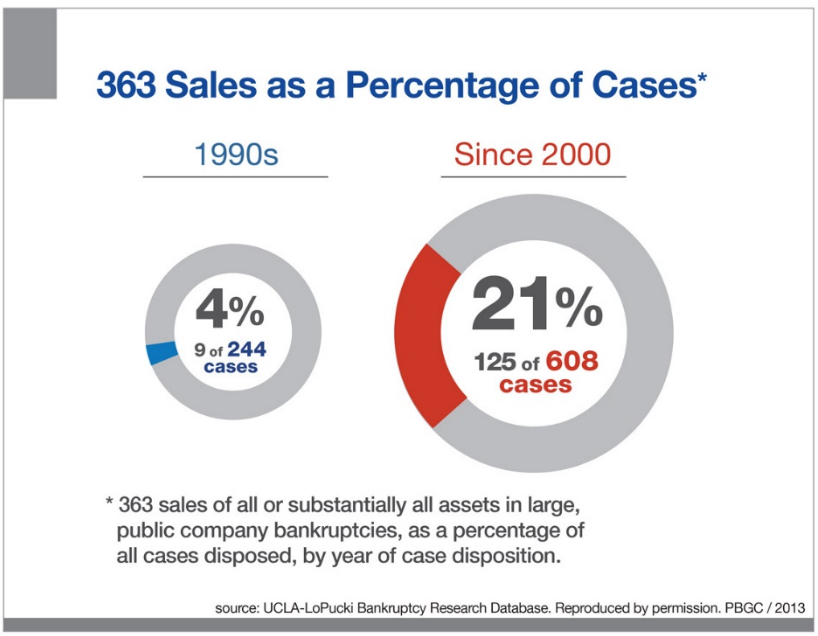
[2] Andrew A. Wood, *The Decline of Unsecured Creditor and Shareholder Recoveries in Large Public Company Bankruptcies*, 85 Am. Bankr. L.J. 429, 436 (2011).

Are 363 Sales Undercutting Bankruptcy Safeguards?

Increasingly, when an investor buys a company in bankruptcy, it structures the transaction as a purchase of assets — a 363 sale — rather than assuming and renegotiating the obligations of the reorganizing company via a plan of reorganization.

This mechanism has become a method of choice. The same study of large public company bankruptcies found that, in the early 1990s, 4 percent were 363 sales. Since 2000, that proportion has grown to 21 percent. Our review of our own cases, which includes non-public companies, suggests the trend is likely greater with private equity investors.

In the past decade, PBGC's stakeholders lost more than $650 million — including nearly $70 million in employee losses that PBGC does not insure — in 363 sales by debtors owned or controlled by private equity firms. They include household names like Friendly, Georgetown Steel, Levitz, Mosler, Oxford Automotive, and Relizon.



From the perspective of unsecured creditors, such sales are being used as to render moot traditional safeguards built into the requirements for a Plan of Reorganization. 363 sales avoid the need to renegotiate contracts and facilitate escape from pension obligations. Creditors using 363 sales both shift pension benefit payments to PBGC and avoid PBGC termination premiums.

This evasion of traditional bankruptcy requirements becomes even more frustrating when it turns out that a supposedly competitive third-party sale isn't competitive and isn't to a third party. In some cases, including Friendly, Georgetown, Oxford, and Relizon, the sale was to an affiliate.

In particular, credit bidding in 363 sales has become a mechanism to prevent competition in an apparently open sale. Credit bidding is often portrayed as pro-competitive, with claims that it "jump starts" the auction process. In practice, however, credit bidding appears to permit already controlling investors to maintain their control, because their claims are valued at face value instead of real value. A potential third-party bidder knows that the controlling investor can use claims that may have been purchased at pennies on the dollar as if they were worth par. In such circumstances, many potential third-party bidders will choose to look elsewhere.

Credit Bidding in 363 Sales: A Case Study

In October 2011, Friendly Ice Cream Corp. filed for Chapter 11 relief. From the inception of the case — and indeed from the time that Sun Capital funds gained control of Friendly in a leveraged buyout— Sun Capital had been the controlling party. Sun Capital created the debtors' capital structure, appointed the debtors' managers, provided financing during the prepetition period, and provided the DIP financing after the filing.

Almost immediately after filing, the debtors moved to sell substantially all of their assets. The debtors' assets were sold — via a credit bid — to another Sun Capital affiliate. After litigation regarding the unsecured creditors committee's (and PBGC's) objections to the terms of Sun Capital's asset sale, Sun Capital did pay a modest amount in settlement on December 14, 2011. On December 29, 2011, less than 3 months after filing, the court approved sale of substantially all the debtors' assets to the Sun Capital affiliate.

The "new" owner did not assume the company's pension plan. Unlike in the traditional bankruptcy process, in a 363 sale there is no hearing or other forum in which to argue that a plan can be afforded and could be preserved. Workers and retirees took an immediate loss of half a million dollars in unguaranteed benefits and PBGC assumed unfunded benefit liabilities of $115 million.

Should the 363 Process be Reformed?

There are a range of ways in which the 363 process might be modified to ensure both that it actually *is* competitive and that secured creditors are not the only beneficiaries.

For example, should credit bidding be barred and cash required instead in 363 sales? (Alternatively, might claims be valued at market rather than at par?)

Might it be fairer to all creditors to allocate the proceeds of such sales differently? For example, what if half the proceeds of a 363 sale were accorded to all creditors pro rata, and half under the current hierarchy?

Might a buyer in such a sale be required to take on the pension obligations as well, unless it can show that it cannot afford the plan — as is the case for the plan sponsor in other Chapter 11 bankruptcies?

These are only a few of the possibilities. There are others that have been proposed. We think they deserve the Commission's attention and would be happy to provide further information.

Putting People Second: Rethinking Employees in Chapter 11

Employees and retirees are frequently among a debtor's largest creditors, and retirement pension and health obligations are frequently by far the largest claims. Unfortunately, as we have seen, they and other unsecured creditors have found their interests subordinated, literally and figuratively, to secured claims.

PBGC acts as a surrogate for employees in regard to deferred compensation owed in the form of a pension, typically covering many years of work. When pension plans are terminated, the costs related to the plan's underfunding do not go away; rather, they shift to the plan's participants (who may lose some benefits when PBGC takes over); to PBGC's premium payers (who generally are healthy firms that shouldn't be supporting unnecessary termination costs); and to other creditors whose recoveries are diluted.

There are two other concerns here. First, it seems that the provisions of the Bankruptcy Code that protect employees have become outdated. While the wages owed to an employee pre-petition are treated as priority claims within limits, most of their other claims are treated as unsecured claims. In other cases, they seem to have been interpreted in ways that undermine their purpose (e.g., the 2nd Circuit's interpretations of Section 1113).

Several of your witnesses have focused, properly in my view, on imbalances that have arisen since section 1113 was enacted. As someone who has been on both sides of the issue more than once, as a witness for the Steelworkers and as the trustee in Hawaiian Airlines, I'd like to add my thoughts. Workers and their dependents are increasingly bearing the brunt of restructurings. In section 1113, Congress recognized this and established both separate procedures and substantive rules to keep the parties' leverage in some balance. Having worked within the 1113 framework, I personally think the original statute is effective and fair. However, I think the Second Circuit's decision in Northwest Airlines is a major departure from that time-honored view and changed that balance, so much that companies are now filing there primarily to take advantage of that decision.

In PBGC's work too, we have grown wary of 1113 proceedings. In AMR and many other cases, we have had to police the record to make sure pension termination issues — which are to be decided separately under ERISA — are not prejudiced. Judge Mitchell mentions one issue under ERISA's distress termination provision. There are others that concern us even more, such as the notion that if one plan is unaffordable, all plans must terminate in the interest of "equality." Many labor issues get settled, and for that matter so do many pension issues. But the Commissioners should keep in mind that the case law can have a major effect on the parties' relative leverage.

Harmonizing the Bankruptcy Code with Non-Bankruptcy Law

The second concern is that obligations under other provisions of law may be ignored by bankruptcy courts.

The Supreme Court has taught that rights should not change due to the "happenstance of bankruptcy," and that bankruptcy law generally looks to non-bankruptcy law.[3] As this Commission

[3] E.g., Raleigh v. Illinois Dep't of Revenue, 530 U.S. 15 (2000).

considers reform of the Bankruptcy Code to better balance the goals of reorganization and maximizing asset values for all stakeholders, much of its work might be made simpler if this principle were codified.

ERISA is the primary applicable non-bankruptcy law relating to worker benefits. It provides that employers who promise a pension must fund one. Unfortunately, bankruptcy courts sometimes treat such legally mandated payments as if they were discretionary. For example, under ERISA unfunded benefits give rise to excise taxes of up to 30 percent of the controlled group's net worth. However, most courts have not accorded them the priority status of uncollected taxes.

The failure to recognize non-bankruptcy law can frustrate Congress's purpose — and in the case of ERISA, all too often, it is workers and retirees who pay the price. PBGC has been representing these interests in hundreds of bankruptcies over the past three decades, and — like many who have testified here — we have thought through some other solutions that may help restore some employee rights. Besides those mentioned above, I would suggest the Code more clearly recognize that pensions are deferred wages, and therefore treat them as such, by:

- requiring that minimum funding contributions be paid during bankruptcy;
- treating unpaid minimum funding contributions due during bankruptcy as administrative expense claims; and
- allowing PBGC to perfect liens in bankruptcy for missed contributions.

Restoring Balance

I would like to thank this Commission for the opportunity to testify on these subjects. We are eager to follow up with any additional data or analysis we can offer. Judging by the list of witnesses who offered testimony to this Commission, it is clear that there is abundant interest in considering how best to incorporate the interests of employees into the bankruptcy process.

Whatever the specific proposals the Commission ultimately recommends, the key is to restore balance. And in restoring balance, we must remember not only employee rights in general, but the largest single claim that most employees have — their retirement benefits.

This Commission will hear a lot of pleas from many different interests for specialized treatment within the Code. To some extent, that is what has been happening to the Code since 1978, and has resulted in a loss of the original balance.

Rather than tweaks for this interest or that, I hope that this commission will think broadly -- in the spirit of the original 1978 reforms. In one sense, we're arguing to return equity to courts of equity. Think about what level of specificity is right for setting the priorities among creditors and the allocations of powers and leverage – and what should be reserved for bankruptcy judges. We have gained much efficiency from financial engineering, but we still need a Code that provides for equity and fairness, too.

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Background: PBGC's Participation in the Chapter 11 Process

PBGC was involved in bankruptcies almost from its inception. For example, a well-known early ERISA case, the Ouimet case, arose from a 1975 Massachusetts bankruptcy called Tenn-ERO. The Code generally took effect on October 1, 1979, and on that day Mansfield Tire filed for bankruptcy, followed about a year later by White Motor. We were heavily involved in those industrial bankruptcies, and many others. This participation has continued down to the present day, including cases like Ormet and Kodak.

PBGC has participated in eight of the 10 largest bankruptcies. In the mid-1990's PBGC moved from being an ex officio non-voting member of creditors committees to full membership. Since that time, PBGC has served on more than a hundred creditors committees. Unlike many potential creditors, PBGC expects and plans to participate in the reorganization process and is structured to do so.

Before taking over a plan, PBGC works to determine whether the plan is affordable and, if so, works to preserve it. In many cases, we have found that plans can be preserved for the workers and retirees who count on those plans.

One recent example is American Airlines. American Airlines entered bankruptcy in November 2011 and immediately announced intentions to terminate its four pension plans. American's plans, which cover 130,000 workers and retirees, were underfunded by $12 billion. Their termination would have resulted in losses to workers and retirees estimated at $1 billion. We worked actively to dissuade American from pursuing this path. Our financial analysts found that American's plans were less costly than some of its competitors' and that the airline could afford to retain them if it restructured other costs. We then worked with the other members of the committee of unsecured creditors, and with American's other creditors to show them the consequences of termination on their interests. We worked closely with other stakeholders, with the press, with the Congress, and with other government agencies. Eventually, American agreed it could afford its plans after all, and to freeze rather than terminate them. PBGC continued as an active member of the creditors committee, seeking to achieve the best possible form of reorganization. American has since agreed to merger with US Airways, with the result that AMR's creditors will emerge largely intact.

In other cases, companies can only afford some plans but not others. In Hawker Beechcraft's case, for example, pension plans are underfunded by $750 million. We have worked hard to try to preserve the pensions for the nearly 18,000 people in the plans. As a result of intensive negotiations, one of Hawker's plans is being preserved, covering more than 8,000 people and accounting for half of the underfunding. In this regard, we're especially troubled that debtors in other cases have argued that if one plan terminates, all of them should, to ensure "equality of sacrifice."

If companies cannot successfully restructure while maintaining their pensions, however, PBGC steps in and pays benefits. At that point, we become an unsecured creditor, often the largest unsecured creditor.

All told, in FY 2012 we opened 38 new bankruptcy cases. Companies that continued their pension plans following a bankruptcy filing include Great Atlantic & Pacific Tea Company (A&P), with more than 26,000 people, Lee Enterprises, with 4,200, and Houghton Mifflin Harcourt Publishing with 4,000. Each of those people will receive their full promised benefits.

Other companies that have continued their pension plans when they emerged from bankruptcy, or where plans have been assumed by other parties in connection with a bankruptcy, include household names like Abitibi, Lyondell, Pilgrim's Pride, Smurfit-Stone, Tribune, and Visteon.

I personally have worked in restructuring and reorganization since the bankruptcy of Braniff International Airways in 1982. I advised the United Steelworkers of America in various steel bankruptcies and was an expert witness in one of the first hearings held under Section 1113. I served as the Chapter 11 trustee for Hawaiian Airlines, and assisted both management & unions in restructuring in transportation, manufacturing, food processing, and other industries over the years.

Addressing Specific PBGC-Related Chapter 11 Issues

The Commission has asked its Labor and Pension advisory committee to address some PBGC-related issues. The Commission has added a PBGC lawyer to its Labor and Pension advisory committee, and we are happy to lend our expertise in that forum as well. PBGC staff are working with other committee members on responses. I'd be happy to provide my own views on those issues, but thought the initial focus of my testimony should be the broader issues involved in rethinking Chapter 11.