

INDEPTH

EMPLOYMENT AND LABOUR CONCERNS DURING BANKRUPTCY AND RESTRUCTURING



REPRINTED FROM:
MAY 2010 ISSUE

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Employment and labour concerns during bankruptcy and restructuring

BY MUAZZIN MEHRBAN



Across most developed economies, the common theme for employers weighing up bankruptcy proceedings is maximising value for the sake of their stakeholders. All components of an employer's operating expenses must be reviewed. Often, labour costs are a significant expense. As part of a company's review of its cost structure, among other things, employee headcount, salaries and benefit schemes come under review. Managers will assess how employee obligations and any competitive bargaining agreements match up to industry standards, and identify which aspects potentially threaten the viability of the business. Such action should take place early on in the process, so that an employer, in locations such as the US for example, can determine whether it can reach a consensual resolution with its unions and reorganise, or whether it no longer has a viable business and therefore needs to liquidate. In some jurisdictions, like Canada and the US for example, legislators have taken steps to ensure employee protection. In the US, unionised workers are protected from an employer unilaterally modifying their collective bargaining agreements by Section 1113 of the Bankruptcy Code. Meanwhile in Canada, employee protections relate to their employer's inability to pay wages and the preservation of bargaining rights of unionised workers.

Most Canadian workplaces are governed by provincial employment and labour legislation, whereas the bankruptcy process falls under federal law legislated under the Bankruptcy and Insolvency Act (BIA). "It is important to note that, in Canada if not elsewhere, insolvent and bankrupt are not synonymous," explains Matthew Certosimo, a partner at Borden Lad-

ner Gervais LLP. "The legal status of bankruptcy, whether voluntary or involuntary, involves the vesting of assets in a trustee responsible for selling the debtor's assets and distributing the proceeds to creditors. Such distribution, to proven creditors, is in accordance with a priority scheme primarily prescribed by the BIA. Insolvency, on the other hand, simply refers to the inability to meet financial obligations or liability exceeding assets. In certain circumstances, an insolvent company may initiate a reorganisation under another federal statute, the Companies' Creditors Arrangement Act (CCAA), which is similar to Chapter 11 in the US." Insolvent employers can also find themselves placed into receivership, at the request of a secured creditor, under a security agreement. "Whether we are dealing with a bankruptcy under the BIA, a CCAA reorganisation, the appointment of a receiver or simply an insolvent employer determines, in many respects, the labour and employment issues that must be addressed."

Assessing employment

When an employer files for bankruptcy, it should consider, among other things, how it plans to alter its workforce and their respective benefit entitlements. To the extent that a company's cost structure needs to be correctly sized as part of its restructuring, management should carefully consider whether an out-of-court labour resolution is realistic so as to avoid the myriad of complications that comes with a bankruptcy filing. If an in-court restructuring is determined to be the way forward, the employer's goals should be evaluated in connection with the relevant bankruptcy legislation, as restructuring law varies by jurisdic-

tion. John Furfaro, a partner at Skadden, Arps, Slate, Meagher & Flom LLP, emphasises that careful planning and assistance from experienced advisers will also help to minimise disruptions caused by the bankruptcy process. "In the US, before a bankruptcy is ever filed, it is imperative that the employer understand timing considerations that may affect the pre or post petition status and recovery valuation of employee claims, or the likelihood to prevail in an employer's efforts to reject a collective bargaining agreement under Section 1113 of the Bankruptcy Code. It is likewise imperative that the employer understand the constraints of operating as a debtor under the Bankruptcy Code and adhere to its required procedures to accomplish the desired labour reorganisation," he says. Indeed, the best way for businesses to function under Section 1113 is through consensual resolution with their unions. Not only does a consensual resolution avoid the uncertainty of a judicial process as to whether labour agreements can be rejected, it can also save time and expense while allowing the union to feel a vested part in achieving a resolution. However, employers should be warned that such a resolution can only be achieved through intense negotiations, and heavy guidance from professionals is usually needed on both sides.

Hiring experienced counsel is one of the key ways that employers can limit the risks related to the restructuring process. They can reduce the potential for liability that officers or directors of a company can face in relation to a poorly executed bankruptcy. With regards to Canadian law, directors are advised to pay particular attention to their liability concerning the last six month's wages and vacation pay accrued over the last 12 months owing to the employees of the corporate employer, when the corporation is bankrupt or insolvent and the trustee or receiver has failed to satisfy claims. "Also, a debtor needs to consider how its pensions and benefit plans will be funded during the bankruptcy process. In particular, if a defined benefit plan is in deficit, the debtor may not have the ability to continue deficit funding payments," says Mr Certosimo. "In several high-profile Canadian bankruptcy proceedings, the pension deficit was a key cause of the debtor's financial distress. Dealing with that deficit was a key element of the arrangement for emerging from bankruptcy protection." The priority of pension deficiency during insolvency has been a common subject of litigation in Canada.

Despite priorities on the whole becoming settled, regulators, unions and employee groups ►►

have been trying to seek ways to heighten the priority of such claims. “When entering or during a restructuring process, particularly if a sale of the business is a consideration, it is wise to negotiate with any unions with bargaining rights over affected employees, to realign terms and conditions to reflect the new business reality. A purchaser will, of course, be less attracted to an operation saddled with an expensive collective agreement that restricts business flexibility,” says Mr Certosimo. In order to mitigate potential claims, debtors should ensure that wages in relation to services already performed are paid prior to insolvency and bankruptcy proceedings.

Employee retention

Retention of key employees can be crucial to a successful reorganisation. Experts suggest that management teams which propose programs aimed at retaining staff can improve their chances of obtaining bankruptcy court approval by creating an incentive based plan, as opposed to a retention based one. In the former plan, bonus payments are tied to the accomplishment of meaningful performance goals that add value for all creditors, whereas in a retention plan, bonuses are triggered by continued employment through a certain schedule or event. Indeed, the distinction between incentive and retention plan took on significant importance in the US after Congress amended the Bankruptcy Code to address scenarios in which executives were receiving retention bo-

nuses merely for staying with the company.

The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) proved a major turning point. Under this legislation, courts would no longer approve a retention bonus to an insider unless: (i) such a payment is essential to the retention of the person because the individual has an offer from another business offering greater compensation; (ii) the employee provides services that are essential to the survival of the company; and (iii) the amount to be paid is not greater than an amount equal to 10 times the amount of the mean of a similar kind of payments made to non-management employees during the past year or, if no one got a similar payment, then 25 percent of payments made to that employee in the past year. “Once a debtor successfully proposes a performance-based incentive plan, courts will consider a variety of factors, including whether there is a reasonable relationship between the program proposed and the results to be obtained, whether the scope and cost of the program is fair and reasonable in the context of the debtors’ assets, liabilities and earning potential, and if the plan is consistent with industry standards and is within the range of plans approved in other bankruptcy cases,” says Mr Furfaro. In addition, the debtor’s due diligence efforts in deciding the need for such a plan will also be assessed. The decision of whether to seek independent counsel as part of the due diligence and authorisation of the incentive compensation would also be taken into

account. Looking at recent examples, Delphi Corporation entered bankruptcy shortly before the 2005 amendments to §503(c) took effect, but it nevertheless formulated its management compensation plan with those amendments in mind. The debtors implemented a series of six-month compensation plans under which management had the opportunity to receive incentive compensation based on the financial performance of the company and its divisions in relation to earnings targets that were derived from the company’s business plan, with potential adjustments for each management member based on individual performance. The court approved the plans on the grounds that, among other things, any compensation awarded under the plans was tied to the achievement of earnings objectives that would enhance the value of the debtors and their estates for the benefit of creditors and other stakeholders.

Indeed, labour issues of this nature are perhaps the most challenging and unpredictable factor for companies facing or in the midst of insolvency. If left unaddressed, disputes can grow and together with regulation, compromise a firm’s exit from bankruptcy. Experts urge businesses to take heed of previous cases in which companies have face heavy litigation as result of having failed to review their contractual obligations and labour relations, and take prompt action, even prior to an impending bankruptcy, in order to make sure the actual process itself is as smooth and litigation-free as possible. ■

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