ANALYZING THE INADEQUACIES OF EMPLOYEE PROTECTIONS IN BANKRUPTCY

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I. INTRODUCTION

In this age of corporate scandals and mega-bankruptcies, hardly a day passes without reports of corporate corruption or downsizing. Much is made of the severe repercussions such calamities cause: the loss of investor confidence, the lack of corporate accountability, or the hundreds of millions of investor dollars lost. Despite intense media coverage, one group remains largely overlooked: the employees. In the large majority, if not all, of the cases, these employees are innocent bystanders caught up in the whirlwind. With their jobs, corporate investments, and financial well being at risk, there is no doubt that employees have a great deal at stake.

Of the many corporations faced with financial problems, some will undoubtedly end up filing for bankruptcy protection, thereby affecting the lives of thousands of people. A corporation's journey through bankruptcy can be long and treacherous, often resulting in the loss of jobs and millions of dollars. Whether the company's demise resulted from the actions of honest leaders who made poor business decisions or by crooked accountants often has very little effect on its employees. They are placed in the unenviable position of being employed by a bankrupt (or soon to be bankrupt) company. What is the employee to do? What protections are provided to them? Will these protections prove to be adequate? These are all questions that will be examined in this note. Part II will explore the fundamental protections given employees by the Bankruptcy Code. While these provisions are well-intentioned, in practice they often fall short of providing sufficient security. Part III will explore the Worker Adjustment and Retraining Notification ("WARN") Act. The WARN Act attempts to give employees greater protections by requiring employers to provide notice of any corporate restructuring that would terminate their employment. However, because of the many exceptions and limitations of the Act, this goal can be, and often is, thwarted. Part IV will discuss various state measures aimed at providing employees with greater remedies against an employer who either fires them without warning or neglects to pay them. Part V will analyze the treatment of collective bargaining agreements in bankruptcy, emphasizing the process by which a collective

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bargaining agreement can be rejected. Part VI will highlight some of the deficiencies in the current level of protections afforded employees. The interplay between bankruptcy law and other laws, both on the state and federal level, often provides for inadequacies and shortcomings. Finally, Part VII will suggest future reforms that would allow for greater protection for employees. Business failures are an inevitable consequence of a market economy, but ample protections would at least give employees a fighting chance of surviving such a tragedy and moving on.

II. PROTECTIONS AFFORDED EMPLOYEES BY THE BANKRUPTCY CODE

A. ORIGINS OF THE BANKRUPTCY CODE

The origins of bankruptcy law in the United States are traced back to England, where bankruptcy laws were known to have existed as early as the sixteenth century.[1] At that time, bankruptcy was seen as a crime, with punishments ranging from imprisonment to the loss of an ear.[2] English law governed in America throughout the colonial period and the first federal bankruptcy law, The Bankruptcy Act of 1800, closely mirrored it.[3] The status of federal bankruptcy laws remained in flux throughout the latter part of the nineteenth century, enduring amendments, revisions, and legislative disinterest.[4] Finally, twenty years after the repeal of the Bankruptcy Act in 1878, a new Bankruptcy Act was enacted in 1898 amid great debate.[5] While the Bankruptcy Act was replaced by the Bankruptcy Code in 1979, its legacy lives on, as it provided the foundation of the current Code.[6]

B. WHY EMPLOYEES SHOULD BE PROTECTED IN BANKRUPTCY

The Bankruptcy Code includes several provisions designed to protect employees of a debtor.[7] The special treatment prescribed in the Code for employees is justified by the unique position they find themselves in when their employer goes bankrupt.[8] Unlike the supplier or service provider of the debtor, whose source of income is usually diversified among many customers, the employee has but one income source: the bankrupt debtor. While the trade creditor is in a much better position to cushion the blow

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[1] WILLIAM D. WARREN & DANIEL J. BUSSEL, BANKRUPTCY 17 (Univ. Casebook Series 6th ed. 2002).

[2] *Id.* at 17-18.

[3] *Id.* at 19.

[4] Charles Jordan Tabb, A Century of Regress or Progress? A Political History of Bankruptcy Legislation in 1898 and 1998, 15 BANKR. DEV. J. 343, 353-55 (1999).

[5] *See id.* at 353-65.

[6] Warren & Bussel, *supra* note 1, at 19.

[7] *See* 11 U.S.C. § 507(a)(3)-(4) (2002); 11 U.S.C. §§ 1113-1114 (2002).

[8] *See* United States v. Embassy Restaurant Inc., 359 U.S. 29, 32 (1959).

and defer the cost of the loss to her other customers,[9] the employee has no such luxury.

A secondary motive for providing employees special treatment in bankruptcy has nothing to do with the interests of employees, but rather with those of the bankrupt debtor. The primary goal of a Chapter 11 debtor is to avoid liquidation by continuing the operation of the business, while formulating and seeking approval of a reorganization plan that will allow the debtor to emerge from bankruptcy.[10] It is no surprise that the employer needs employees who will continue to work regardless of the business' financial distress and uncertain future in order to remain in operation.[11] By affording employees special rights in a bankruptcy, employees are less likely to "desert a leaky ship, speeding up the firm's collapse."[12] Since the continued labor of employees will improve the chances for successful reorganization, all creditors benefit from it because it will increase the asset pool from which they must seek recovery.[13] Some courts, recognizing the critical nature of continued employment, have allowed for the immediate payment of pre-petition wages, up to the statutory limit, in order to keep the employees happy and on the job.[14]

C. U.S.C. Section 507 Priorities

Bankruptcy Code section 507 provides the order by which distributions from bankruptcy estates are to be paid out.[15] Among the nine priorities listed, two are particularly pertinent to the interests of employees, sections 507(a)(3) and (4).[16] These provisions allow for the prioritization of up to $4,650 of back wages and unpaid contributions to an employee benefit plan earned but not yet paid to the employee within the ninety days preceding filing of the bankruptcy petition.[17]

1. *U.S.C. Section 507(a)(3) Priority for Wages*

Both the text and the operation of section 507(a)(3) are fairly straightforward. Wages, salaries, commissions, severance, and vacation

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[9] *See* Daniel Keating, *The Fruits of Labor: Worker Priorities in Bankruptcy*, 35 ARIZ. L. REV. 905, 907 (1993); Donald R. Korobkin, *Employee Interests in Bankruptcy*, 4 AM. BANKR. INST. L. REV. 5, 6 (1996); KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM 152 (1997); *In re* Northwest Engineering Corp., 863 F.2d 1313, 1318 (1988).

[10] MARK S. SCARBERRY et al., BUSINESS REORGANIZATION IN BANKRUPTCY 1-3 (Am. Casebook Series 2nd ed. 2001).

[11] *See, e.g., In re* Northwest Engineering, 863 F.2d at 1315; Keating, *supra* note 9, at 917-18; Scarberry, *supra* note 10, at 441.

[12] *See In re* Northwest Engineering, 863 F.2d at 1315.

[13] Gross, *supra* note 9, at 152.

[14] *Id. See In re* Gulf Air, Inc., 112 B.R. 152, 153 (W.D. La. 1989); *In re* Chateaugay Corp. 80 B.R. 279, 285-87 (S.D.N.Y. 1987); Tom Morrow, Jay Alix & Associates, *How to Improve Communication with Vendors Careful Planning is the Key to Success*, Am. Bankr. Inst. J., *available at* 2000 ABI JNL. LEXIS 96 (Oct. 2000).

[15] *See* 11 U.S.C. § 507 (2002).

[16] 11 U.S.C. § 507(a)(3)-(4) (2002).

[17] *Id.*

and sick pay are all subject to this prioritization process.[18] The Code does not allow these types of claims to go unrestricted; only wages earned in the ninety days prior to filing, not to exceed $4,650, are subject to section 507(a)(3) priority.[19] Employers are usually not over ninety days late with paychecks, so this provision rarely acts as a limit on a claim, however, the monetary limitation can often impair full recovery. Any portion of the claim that exceeds the $4,650 threshold is treated as a general unsecured claim against the bankruptcy estate, greatly reducing the likelihood of recovery.[20]

2. *U.S.C. Section 507(a)(4) — Unpaid Contributions to Employee Benefit Plans*

This provision allows for the recovery of any contribution that should have been but was not paid by the employer to an employee benefit plan. Two important limitations are placed on this recovery. First, only unpaid contributions arising from services rendered during the preceding 180 days are recoverable.[21] Second, the amount of recovery is limited to the portion of the $4,650 not used by section 507(a)(3) claims.[22] Each employee is permitted to prioritize only $4,650, regardless of the actual amount due under sections (a)(3) and (4). Beyond this, the claim is reduced to a general unsecured claim.

3. *Administrative Priority Status of Post-Petition Earnings and Contributions*

The overriding goal of a Chapter 11 reorganization is the eventual emergence out of bankruptcy followed by continued success and prosperity.[23] As mentioned above, employees are vital to this process.[24] Without employees, it is nearly impossible to manufacture goods, take orders, deliver goods, or even collect on accounts receivable. It should not be surprising that most employees, upon hearing of their employer's bankruptcy, have an immediate urge to leave on the assumption that the employer can no longer afford to pay them. Recognizing the correlation between employee loyalty and a successful reorganization, the Code provides special priority for wages earned after the bankruptcy petition has been filed. Section 503(b) permits all wages and other compensation earned post-petition to be paid as an administrative expense of the estate.[25] Administrative expenses are entitled to first priority under section 507,

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[18] *Id.*

[19] *Id.* However, Congress periodically increases this threshold every three years to adjust for increases in cost of living and inflation.

[20] *Id.*

[21] 11 U.S.C. § 507(a)(4)(A) (2002).

[22] 11 U.S.C. § 507(a)(4)(B) (2002).

[23] Scarberry, *supra* note 10, at 1-3; NLRB v. Bildisco & Bildisco, 465 U.S. 513, 527 (1984).

[24] *See generally supra* note 11 and accompanying text.

[25] 11 U.S.C. §503(b)(1)(A) (2002).

second only to the claims of the secured creditor.[26] As a result of this elevated status, there is a greater chance of these claims being paid in full by the estate. Other claims that fall into this category include payments to attorneys and other professionals who assist in the administration of the estate.[27] Another benefit of being classified as an administrative expense is that there is no limit to the claims, as there is in sections 507(a)(3) and (4). This promotes allegiance to one's employer, improving the likelihood for a successful reorganization, as well as a measure of stability for the employee who elects to aid in the reorganization effort.[28]

III. PROTECTIONS AFFORDED EMPLOYEES BY THE WORKER ADJUSTMENT AND RETRAINING NOTIFICATION ("WARN") ACT

A. ORIGINS OF WARN

The early predecessors of the Worker Adjustment and Retraining Notification ("WARN") Act were introduced in Congress in 1973, yet received only moderate support at the time.[29] In succeeding years, the Senate and House of Representatives debated the issue and each ultimately adopted their own versions of the bill.[30] After endless negotiations, countless revisions, and a veto by President Reagan in 1988, the bill finally passed into law on August 4, 1988, and became effective six months later.[31]

B. WARN'S PROVISIONS

At the heart, WARN is a notice statute. It requires employers to provide sixty-day advance written notice of any mass layoff or plant closing.[32] The definitions of the statute's key terms are critical to the understanding of the scope of WARN's protections.[33] "Employer" is defined as any business enterprise that employs either one hundred or more full time employees, or one hundred employees who, in the aggregate, work at least 4,000 hours a week.[34] A "plant closing" is the permanent or temporary shutdown of a single site of employment, if the shutdown results in the employment loss for at least fifty employees during any thirty-day period.[35] A "mass layoff" is a reduction in force that is not the result of a plant closing, in which there is an employment loss of either five hundred

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[26] Warren & Bussel, *supra* note 1, at 26; GEORGE M. TREISTER ET AL., FUNDAMENTALS OF BANKRUPTCY LAW 325 (4th ed. 1996).

[27] *Id. at* 325; 11 U.S.C. §503(b)(4) (2002).

[28] Keating, *supra* note 9, at 907.

[29] Laura B. Bartell, *Why WARN? The Worker Adjustment and Retraining Notification Act in Bankruptcy*, 18 BANKR. DEV. J. 243, 245 (2002).

[30] *Id.* at 247.

[31] *Id.* at 248.

[32] 29 U.S.C. §2102(a) (2000).

[33] 29 U.S.C. § 2101 (2000).

[34] 29 U.S.C. § 2101(a)(1) (2000).

[35] 29 U.S.C. § 2101(a)(2) (2000).

employees, or at least fifty employees representing one third or more of the total workforce.[36]

Despite the benefits provided by the WARN Act, the exceptions and exclusions proved to be vital to its ultimate passage.[37] The Act provides three exceptions where the mandatory sixty-day notification period can be reduced, or in some cases, eliminated all together.[38]

The "faltering business" exception allows for the reduction of the mandatory sixty day notice if the employer meets certain statutory criteria. To take advantage of this defense, the employer must prove that at the date such notice would have been required under WARN: (1) the employer was actively seeking capital or business, which, (2) if obtained, would have enabled the employer to avoid or postpone the shutdown, and, (3) the employer reasonably and in good faith believed that giving the required notice would have prevented the employer from obtaining the capital or business it sought.[39]

A second exception permits fewer then sixty days notice if the closing or layoff is caused by business circumstances that were not reasonably foreseeable at the time such notice would have been required.[40] Despite extensive congressional debate as to the definition of "not reasonably foreseeable," Congress did not include specific qualifying events, thereby delegating this task to the courts.[41] Courts that have considered the issue have found three principle circumstances that would justify the lack of notice: (1) the loss of a major contract, (2) a government-ordered shutdown, or (3) sudden economic or financial changes.[42]

The third exception to WARN liability applies to situations where a natural disaster causes a plant closing or mass layoff.[43] To date, no reported cases have expressly dealt with this issue.

C. Damages for WARN Violations

An employer failing to strictly comply with the notice requirements prescribed in the WARN Act is liable for damages. The statute itself provides its own enforcement mechanisms, regulating the remedies available to the aggrieved employee.[44] The statute is straightforward, calling for the payment of wages that would have been earned if the employee continued to work pursuant to the sixty day notice.[45] However, the amount and terms of any damages is cast in doubt when the employer is

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[36] 29 U.S.C. § 2101(a)(3) (2000).
[37] Bartell, *supra* note 29, at 250.
[38] 29 U.S.C. § 2102(b).
[39] 29 U.S.C. § 2102(b)(1) (2000).
[40] 29 U.S.C. § 2102(b)(2)(A) (2000).
[41] Sandra J. Mullings, *WARN: Judicial Treatment of Exceptions, Exclusions, and Excuses*, 39 Ariz L. Rev. 1209, 1243 (1997).
[42] Bartell, *supra* note 29, at 251.
[43] 29 U.S.C. §2102(b)(2)(B) (2002).
[44] *See* 29 U.S.C. § 2104(a) (2002).
[45] *Id.*

in bankruptcy. Employee claims against the debtor for WARN violations are subject to different levels of priority depending on when the claims arose.[46] When deciding where to affix liability, it is important to determine whether the violation of WARN, occurred pre or post petition.[47]

1. *Pre-Petition Violation*

A pre-petition violation of WARN can occur in one of two ways. First, the employer can order a closing or layoff without the requisite notice and subsequently file for bankruptcy more than sixty days later. Alternatively, the employer may order the firing without notice and, within sixty days, file for bankruptcy protection.

When the filing of the bankruptcy occurs more then sixty days after the layoffs, damages are measured from the day of the firing and continue for sixty days. Any employee who did not receive the required notice would have a claim against the employer's bankruptcy estate. The claim would be entitled to section 507 priority to the extent that the violation occurred within ninety days of the bankruptcy filing. Any portion of the violation that occurred more than ninety days before the filing date would result in an unsecured claim against the estate.

When the bankruptcy follows within sixty days of the firing, the issue becomes more vexing. For example, suppose an employer closes a plant without notice and files for bankruptcy thirty days later. The differences between this situation and the previous one may be subtle, but they carry severe consequences. Had the employer complied with WARN, notice would have been given on the day the firing actually occurred, with the employee continuing to work for the next sixty days. The employee therefore would have earned thirty days of pre-petition wages, and another thirty days of post-petition wages. The thirty days pre-petition claim is entitled to priority under section 507(a)(3) as back wages.[48] Such claims, however, would be subject to the $4,650 limit imposed by section 507(a)(3). When the WARN claim is added to any unpaid wage claims or unpaid contribution claims, there is a possibility that the total claim will exceed $4,650, leaving the employee with a general unsecured claim as to the amount in excess of the cap. Had the employee actually worked, the thirty days of post petition earnings would be viewed as a cost of administering the estate, and therefore subject to section 503 priority.[49] Hence, had the statute been strictly adhered to, the employee's claim would be bifurcated into the amount afforded section 507(a)(3) priority and the amount entitled to section 503 priority. When the employer violated WARN, however, the same bifurcation would not occur. The thirty days representing the section 507(a)(3) claim remains the same, but the thirty days post-petition claim, which would have been entitled to section 503

[46] Bartell, *supra* note 29, at 257-58.
[47] *Id.*
[48] 11 U.S.C. § 507(a)(3) (2002).
[49] 11 U.S.C. §503(b)(1)(A) (2002).

priority is now reduced to section 507(a)(3) priority status, further increasing the likelihood that the claim will exceed the $4,650 cap. Courts have uniformly held that, because the employee did not actually work during this time, and therefore did not provide a benefit to the estate, the claim is not entitled to administrative priority.[50] The reduction in the priority status resulting from an intentional disregard for the WARN Act highlights one of the many conflicts that arise when WARN operates within the context of the Bankruptcy Code.

2. *Post-Petition Violation*

While the operation of WARN violation claims subsequent to the filing of a bankruptcy petition are problematic, they are not as problematic as those associated with a pre-petition violation. A trustee in bankruptcy, or debtor in possession,[51] is subject to the requirements of WARN to the same extent as any other business. That is, if the business has the requisite number of employees and meets all other statutory prerequisites, the fact that the business is a reorganizing debtor does not absolve it of the WARN notification requirements.[52] There is, however, one circumstance in which a trustee will not be held liable for WARN violations. If the trustee is acting as a fiduciary "whose sole function in the bankruptcy process is to liquidate a failed business for the benefit of creditors . . . [he] is not operating a 'business enterprise' in the normal commercial sense"[53] and is therefore not an "employer" required to give WARN notification.[54] This issue is more prominent in a business that files for bankruptcy under Chapter 7 of the Bankruptcy Code, often considered a straight liquidation,[55] than Chapter 11, which is designed for businesses' that are attempting to reorganize.[56] However, this issue becomes more difficult if the trustee, or debtor in possession, decides to forego the reorganization effort and liquidate the assets of the estate without converting the case to Chapter 7, as the Code allows.[57] Courts confronted with the problem of line drawing as to when the debtor in possession became a liquidating fiduciary, thereby eliminating their WARN liability, have searched for other indicators that would clarify whether or not the debtor in possession was operating the business or attempting to liquidate it altogether. Courts frequently evaluate the specific facts and circumstances of the case to make such a

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[50] *In re* Kitty Hawk, Inc., 255 B.R. 428, 438 (N.D. Tex. 2000); *In re* Jamesway, 235 B.R. 329, 348 (S.D.N.Y. 1999) ("We have already determined that Jamesway's obligation to give WARN notice to all plaintiffs arose [before the bankruptcy petition was filed]. As such, the plaintiffs' damages claims are not entitled to priority under 503(b)(1)(A) or 507(a)(1) of the Bankruptcy Code.").

[51] 11 U.S.C. §1101(1), 1107 (2002).

[52] Worker Adjustment and Retraining Notification, 54 Fed. Reg. 16,042, 16,045 (Apr. 20, 1989)[hereinafter *WARN*]; Bartell, *supra* note 29, at 270.

[53] *WARN*, *supra* note 52, at 16,045.

[54] *Id.*

[55] Treister, *supra* note 26, at 17.

[56] *Id.* at 17-19.

[57] 11 U.S.C. § 706 (2002).

determination.[58] In *In re United Healthcare System, Inc.*,[59] the court found that, because the debtor had surrendered its certificates of need to the state department of health and had released all patients immediately after the filing, it was not operating a business but was acting as a liquidating fiduciary, and was therefore not required to give WARN notification.[60]

IV. STATE MEASURES DESIGNED TO PROTECT EMPLOYEES

A. THE CALIFORNIA VERSION OF WARN

In an effort to supplement federal WARN protections, California recently enacted its own version of a worker notification and retraining law.[61] Recognizing that WARN only applied to large-scale labor changes, California lawmakers sought to enact a law that would govern smaller layoffs and plant closings because of the fact that incidents of labor restructuring that fall short of the threshold required to trigger WARN could still have devastating effects on a community. For example, for WARN protections to be triggered in the event of a mass layoff, either five hundred employees need to be affected, or fifty or more employees representing at least a third of the workforce need to be effected.[62] Thus, large corporations, with hundreds of thousands of employees, could layoff 499 workers without triggering WARN. The California legislature wanted to close this loophole to provide more protections to workers and their communities. While the California version closely mirrors its federal counterpart, the differences serve to broaden the applicability and scope of the required notice while greatly reducing the exceptions that are available under the federal law.

The California law lowers the threshold requirements for notification.[63] Labor changes that affect at least fifty employees trigger the notification requirements.[64] Only businesses employing fewer then seventy-five employees are exempt from the notification requirements.[65]

The exception provisions in the California statute differ greatly from those found in WARN. The California law does not allow for the forgiveness, or even a reduction, of notice as the result of unforeseen business circumstances. In fact, California only has one exception that is similar to the federal law: the faltering business exception.[66] Yet, even this single exception is shrouded with limitations.[67] The structure of the

[58] *See In re* Jamesway, 235 B.R. 329, 342-43 (S.D.N.Y. 1999).
[59] *In re* United Healthcare Systems, Inc., 200 F. 3d 170, 178 (3d Cir. 1999).
[60] *Id.* at 178.
[61] CAL. LAB. CODE §§ 1400-08 (West 2003).
[62] *See supra* note 36 and accompanying text.
[63] CAL. LAB. CODE § 1400(d) (West 2003).
[64] *Id.*
[65] CAL. LAB. CODE. § 1400(a) (West 2003).
[66] *See* CAL. LAB. CODE § 1402.5 (West 2003).
[67] *Id.*

exception looks similar to its federal counterpart, requiring evidence of the ongoing search for capital, the consequences of receiving the capital, and the likely detrimental effect on continued success of the business if notice had been provided.[68] However, an exception to the exception is found in section 1402.5(d), which prohibits the use of the exception when the required notice is triggered by a mass layoff.[69] Since the statute only governs layoffs, relocations, and terminations, the limitation found in section 1402.5(d) severely limits the applicability of the exception, thereby making the notification requirements all the more potent.

The damages allowed under the California law are very similar to those that are permitted under WARN. An employer is liable to each employee for wages that the employee would have been entitled to, had the employment not been lost, for up to a maximum of sixty days.[70] An employer is also subject to civil suits to establish liability with a maximum penalty of $500 for each day of violation.[71] The prevailing employee may also be awarded attorney's fees in such a suit.[72]

The California worker notification statue has only been effective since January 2003. There has yet to be any court to interpret and apply the statute to an actual case, much less a bankruptcy case. However, the language of the statute substantially broadens the duties of the employer attempting to downsize its workforce. There is no doubt that the statute will come under attack for some of the very reasons WARN has been criticized.

B. STATE LIEN STATUTES

Long before there was WARN, or any comparable state counterpart, the legislatures of various states enacted laws designed to protect the interests of employees by granting liens on the assets of their employers for any unpaid wages. While some of these statutes have been repealed, many are still enforceable.[73] Since their passage, these statutes have resulted in substantial amounts of litigation. The central issue in the majority of these cases is the validity of these statutes and the relative priority of the liens created by them.[74] Employees have sought to utilize their statutorily-created liens to assert claims against their employers that are superior to the claims of a pre-existing mortgage or similar security interest. In other

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[68] CAL. LAB. CODE § 1402.5(a)(1)-(3) (West 2003).

[69] CAL. LAB. CODE § 1402.5(d) (West 2003).

[70] CAL. LAB. CODE § 1402(b) (West 2003).

[71] CAL. LAB. CODE § 1403 (West 2003).

[72] CAL. LAB. CODE. § 1404 (West 2003).

[73] *See generally* KAN. STAT. ANN. § 44-312 (2001); KY. REV. STAT. ANN. § 376.150 (2002); WASH. REV. CODE § 60.24.020 (2003); CAL. CIV. PROC. CODE § 1205 (Deering 2001); DEL. CODE ANN. tit. 8, § 300 (2001).

[74] *See* Seymour v. Berg, 81 N.E. 339 (Ill. 1907); W.E. Chapman v. A.H. Averill Machinery Company, 152 P. 573 (Idaho 1915); Wimberly v. Mayberry & Co., 10 So. 157, 158-60 (Ala. 1891); Warren v. Sohn, 13 N.E. 863, 868 (Ind. 1887); Pierce v. Blair, 149 N.E. 560, 562-63 (Ind. 1925); Abraham Crosky *v.* Northwestern Mfg. Co., 48 Ill. 48, 483-85 (1868).

words, they desire to usurp the highest level of priority from other secured creditors.[75] Rulings have turned on whether the court views the statute in question as one that creates a true lien in favor of employees or one that merely gives employees a preference among the employer's unsecured claims.[76] However, even among the courts that have found that a statutory lien was created, no uniform definition about the scope of the lien has been provided.[77]

1. *Statute Creates a Preference*

A number of courts have held that state statutes attempting to prioritize employee claims over those of the secured creditors create preference in favor of employees, but not a lien.[78] In *First National Bank v. Family Medicine*,[79] the court justified this holding by citing instances where the legislature expressly created a statutory lien intended to be preferred to any prior lien.[80] The court found that, in the absence of such express language in the statute, the court should not assume the legislature intended to grant such a lien.[81] Similarly, a California court held that a California lien statute[82] cannot impair the rights afforded to creditors by way of contract liens, unless the statutes' language clearly indicates an intention to do so.[83] The court further found that the California statute creates a preference in favor of wage claimants, but the preference only affords these claimants priority over the unencumbered assets of the estate.[84]

2. *Statute Creates a Lien*

Some courts that have found that employee preference statutes do create a lien in favor of the employee have differed as to the scope of that lien.[85] Courts have treated such liens in one of three ways: (1) the lien is completely superior to those of secured creditors,[86] (2) the lien is partially superior to that of the secured creditor,[87] or (3) the lien, while recognized by the court, is nevertheless subordinate to the liens of preexisting secured creditors.[88]

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[75] *See* T.H. Mastin & Co. v. Pickering Lumber Co., 2 F. Supp 605, 608 (9th Cir. 1933).

[76] *Id. See also Seymour*, 81 N.E. at 342; Myzer v. Emark Corp., 53 Cal Rptr. 2d 60 (Cal. Ct. App. 1996).

[77] *Wimberly*, 10 So. at 162-64; *Croskey*, 48 Ill. at 483.

[78] *See T.H. Mastin*, 2 F. Supp at 608; *Seymour*, 81 N.E. at 342.

[79] First Nat'l Bank of Med. Lodge v. Family Med. Clinic of Med. Lodge, 798 P. 2d 519 (Kan. Ct. App. 1990).

[80] *Id.* at 520.

[81] *Id.*

[82] CAL. CIV. PROC. CODE § 1205 (Deering 2001).

[83] *T.H. Mastin*, 2 F. Supp at 608.

[84] *Id.*

[85] *Compare* Myzer v. Emark Corp., 53 Cal Rptr. 2d 60 (Cal. Ct. App. 1996), *and Warren*, 13 N.E. at 868-69, *with Wimberly*, 10 So. at 162-64, *and Croskey*, 48 Ill. at 485.

[86] *See* Graham v. Magann Fawke Lumber Co., 80 S.W. 799, 800 (1904); *Warren*, 13 N.E. at 868-69; *Pierce*, 149 N.E. at 563; *W.E. Chapman*, 152 P. at 575.

[87] *See Wimberly*, 10 So. at 162-64.

[88] Crandell v. Cooper, 62 Mo. 478, 479-81 (1876).

Courts that have granted employee liens absolute supremacy over preexisting liens cite various rationales for so holding. Many courts look to the fact that the statutes authorizing the prioritization of employee liens were in force at the time the security interest was created.[89] The timing factor becomes important because some courts view these statutory provisions "entered into and form[ing] a part of such mortgages,"[90] and that "[mortgagees] acquired their mortgage liens on the mortgaged property subject to such statutory liens as might thereafter, in the vicissitudes of the mortgagor's business, attach to such property for work and labor preformed."[91]

Some courts faced with a lien priority statute in favor of employees have been more reluctant to grant the employee outright superiority and have instead chosen a more limited approach. In *Wimberly v. Mayberry & Co.*,[92] the Supreme Court of Alabama held that the priority of the employee lien created by the state statute is dependant on several factors, including the type of work performed by the employee and the value of that work.[93] The court found that when a laborer undertakes a project upon land with an existing lien, the subsequent lien that arises by operation of the state statute upon non-payment of the laborer cannot take priority over the existing lien.[94] However, the court did grant superior status to the laborer whose work product increased the value of the property in excess of the value of the pre-existing lien.[95] Thus, if, upon the commencement of work on a piece of property, the value of the existing land hypothetically was $10,000, and after the work was completed, and as a result of said work, the value of the land was $15,000, the laborer's lien would have priority with respect to the increased value, or $5,000.

While most of the above cases are removed from the bankruptcy context, they are helpful because they address the fundamental issue of lien priority when preexisting encumbrances conflict with state lien laws. The rationales and reasoning cited in these cases are likely to influence courts in the future when they are forced to address the issue of state lien statutes in favor of employees of a bankrupt business. However, it can hardly be said that these cases form a uniform set of precedents that guides the hand of the bankruptcy court faced with these issues. Indeed, the diversity of the rulings leaves no doubt that courts considering the issue could base a ruling on any of a host of rationales.

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[89] *See Graham*, 80 S.W. at 800; *Warren*, 13 N.E. at 868.
[90] *Warren*, 13 N.E. at 868.
[91] *Id.*
[92] *Wimberly*, 10 So. at 157.
[93] *Id.* at 162-64.
[94] *See id.*
[95] *See id.*

C. POLICY CONSIDERATIONS: WHO IS IN THE BEST POSITION TO WITHSTAND THE LOSS

Courts are often faced with the arduous task of picking a loser between two innocent parties. A court will encounter such a scenario in a bankruptcy case when determining the relative lien priority between the employee and the secured creditor. Balancing the equities and considering the public policy undertones of a case can often guide the court toward its ruling.[96] Courts can be faced with the proposition of determining whether the employee or the secured creditor is in the best position to withstand the loss of payment due to bankruptcy. It is an understatement to say that such an undertaking is problematic.

Secured creditors are vital to the operation of a business. They provide capital for expansion efforts, money to sustain the business in difficult times, or even the necessary funds for a merger with, or acquisition of, another company. But this service does not come without cost. Usually the lender will only lend money if the borrower grants the lender a security interest in the property of the borrower, which serves as the collateral for the loan. Most commonly, this security interest takes the form of a lien. As the name implies the security interest "secures" the debt, and if necessary can be seized and sold to repay the debt.

A finding that an employee's lien is superior to that of the secured creditor would not be unduly detrimental. The standard lien on real property is always vulnerable to being subordinated by a tax lien. Mortgagees are aware of this possibility and consider it when determining the risk of a loan. They are very capable of assessing this risk and modifying the terms of the loan accordingly. Granting employee liens the same priming effect that tax liens have would not only greatly benefit the employees, but also would only slightly modify the practices of lenders, as they would be required to make one more risk determination before setting the terms of the loan.

Secured creditors enjoy a great deal of bargaining power when negotiating the terms of their loans,[97] and because of this power, they are capable of factoring in the increased risk of superior employee liens and dictate their loan terms accordingly. Lenders control the LTV (loan to value) ratio of loans. A lender fearful of another lien coming into existence in the future that would trump their security could make adjustments to the LTV ratio, requiring more collateral for a loan, thereby leaving a larger equity cushion between the debt and value of the collateral in the event that a superior lien was asserted. A second possible precautionary measure creditors could employ is to require borrowers to finance an independent impound account that will hold sufficient funds to pay any employees trying to assert an employee lien. Impound accounts, which are fairly common in real estate practice, guarantee money is available should

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[96] *See* Ware v. Hamilton Brown Shoe Co., 9 So. 136, 138 (1891).
[97] *See* Warren & Bussel, *supra* note 1, at 115.

unforeseen circumstances arise. While the maintenance and structure of such an account would need to be carefully constructed, this would allow the secured creditor a measure of protection against the uncertain future.

Employees, like secured creditors, are essential to the success of a business.[98] However, the necessity is a two-way street. Businesses and, hence, jobs are crucial to the well being of the employee. A secured creditor may be capable of enduring the bankruptcy, and subsequent loss of money, of a borrower better than an employee can withstand the bankruptcy, and subsequent loss of income, of an employer. Whereas lenders have all the power in negotiating the terms of their loans, employees have little input regarding the terms of their employment contracts. Another reason for shifting the risk of loss to the secured creditor is because of their strong ability to assess risk. Lenders are in the business of gauging risk and charging for it. Employees generally do not assess the financial stability of their employer on a regular basis.

The notion that employees represent a unique class, entitled to special protections, is not novel. The protections provided by section 507 of the Bankruptcy Code reflect the view that employees need to be given special consideration. State laws also reflect this ideal as many states have enacted laws that specifically make it illegal to bounce a check to an employee.[99] This further indicates the legislative acknowledgement that employees have unique and fragile interests that are entitled to exceptional protections.

Determining the "better" party to bear the loss in the event of a bankruptcy is a difficult undertaking. It requires an inquiry into the particular aspects of the case, public policy, and the precedents of the jurisdiction. While secured creditors appear to be in the best position to bear the loss, courts may be reluctant to interfere with the deal that creditors negotiated. Due to these competing ideals, employees cannot be assured that they will be protected in the event of the bankruptcy of their employer. In order to provide such protection, Congress must address these issues and outline clear and concrete protections that employees can count on.

V. COLLECTIVE BARGAINING AGREEMENTS

Collective bargaining agreements play a large role in labor relations. As many factions of today's workforce are unionized, the treatment of collective bargaining agreements in bankruptcy is of considerable importance to employees. A collective bargaining agreement is essentially a contract entered into between the management and the workforce of a company. Issues such as working conditions, medical benefits, wages, and the number of hours in the workweek can all be laid out in a collective bargaining agreement. Despite their frequent appearance in Chapter 11

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[98] *See* Keating, *supra* note 9.

[99] *See* NEV. REV. STAT. 205.100 (2002); MISS. CODE ANN. § 71-1-39 (2003); FLA. STAT. ANN. § 448.24 (West 2002); CAL. LAB. CODE § 212 (Deering 2002).

bankruptcies, the original Bankruptcy Code contained no provisions expressly dealing with collective bargaining agreements.[100] It was not until 1984, after the Supreme Court had ruled on the issue, that Congress finally enacted a provision specially addressing collective bargaining agreements in the bankruptcy context.[101]

A. TREATMENT OF COLLECTIVE BARGAINING AGREEMENTS BEFORE SECTION 1113

Prior to the enactment of section 1113, bankruptcy courts uniformly viewed collective bargaining agreements as executory contracts. However, courts did differ as to the standard to apply when determining whether or not to permit their rejection. Bankruptcy Code section 365 prescribes how executory contracts and unexpired leases are to be dealt with.[102] While the term "executory contract" is not defined anywhere in the Code, courts have widely accepted the definition first articulated by Vern Countryman.[103] According to Countryman, an executory contract is "a contract under which the obligation[s] of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[104] Section 365 articulates the procedure for rejecting an executory contract. To reject a contract, the debtor must satisfy the business judgment standard, by convincing the bankruptcy court that rejection of the contract is in the best business interest of the debtor. If the debtor is successful, the contract can be rejected, usually leaving the non-debtor party to the contract with a pre-petition unsecured claim against the estate. Prior to 1984, bankruptcy courts had no trouble determining that an unexpired collective bargaining agreement was an executory contract, and therefore subject to section 365. However, federal circuit court decisions varied on whether or not the debtor needed to establish a higher burden when attempting to reject a collective bargaining agreement opposed to any other type of executory contract. Some courts held that a collective bargaining agreement could only be rejected if such action was necessary to avoid liquidation.[105] Others, meanwhile, held that a debtor could reject a collective bargaining agreement if the court, after balancing the equities of the case, determines that rejection is appropriate in light of the circumstances surrounding the case.[106] In was in light if this disparity that the Supreme Court heard *National Labor Relations Board v. Bildisco & Bildisco* ("*Bildisco*").[107]

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[100] *See* Stephen S. Ritchey, *Rejection of Collective Bargaining Agreements: Section 1113*, 4 BANKR. DEV. J. 171 (1987).

[101] 11 U.S.C. § 1113 (2002).

[102] 11 U.S.C. § 365 (2002).

[103] Vern Countryman, *Executory Contracts in Bankruptcy, Part I*, 57 MINN. L. REV. 439, 460 (1972).

[104] *Id.*

[105] Daniel Keating, *The Continuing Puzzle of Collective Bargaining Agreements in Bankruptcy*, 35 WM. & MARY L. REV. 503, 508-09 (1994).

[106] *Id.*

[107] *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984).

B. NATIONAL LABOR RELATIONS BOARD V. BILDISCO & BILDISCO

The Supreme Court granted cert in *Bildisco* to resolve a conflict between the Third and Second Circuits regarding the rejection of collective bargaining agreements in the process of a Chapter 11 Reorganization. A unanimous Court held that collective bargaining agreements are executory contracts, and are therefore subject to section 365.[108] The Court further held that in order to validly reject a collective bargaining agreement, the debtor must meet a burden higher than the usual business judgment test, but lower than the "necessary to avoid liquidation" standard.[109] The Court adopted a "balance the equities" standard, which required an analysis of the circumstances implicated by the particular case.[110] The collective bargaining agreement could be rejected if the bankruptcy court found that the equities involved favored rejection:[111]

> The Bankruptcy Court must consider the likelihood and consequences of liquidation for the debtor absent rejection, the reduced value of the creditors' claims that would follow from affirmance and the hardship that would impose on them, and the impact of rejection on the employees. In striking the balance, the Bankruptcy Court must consider not only the degree of hardship faced by each party, but also any qualitative differences between the types of hardship each may face.[112]

The decision in *Bildisco* was initially seen as a victory for debtors and a crushing defeat for organized labor, making it easier to reject a collective bargaining agreement in the course of a bankruptcy.[113] But the perceived victory was short-lived. Soon after the *Bildisco* decision, and after intense lobbying from labor leaders, Congress enacted Bankruptcy Code section 1113, substantially modifying the rule handed down in *Bildisco.*[114]

C. THE CONGRESSIONAL RESPONSE TO *BILDISCO*: SECTION 1113

The congressional response to *Bildisco* was immediate. On the same day the court handed down the *Bildisco* opinion, the first version of section 1113 was also introduced in the Senate[115] — its purpose being to overturn the court's decision in *Bildisco*. According to Senator Edward Kennedy, the purpose of the new law was "to overturn the *Bildisco* decision which ha[d] given the trustee all but unlimited discretionary power to repudiate labor contracts and to substitute a rule of law that encourage[d] the parties

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[108] *Id.* at 521-22.
[109] *Id.* at 523-26.
[110] *Id.* at 527.
[111] *Id.*
[112] *Id.*
[113] Carlos J. Cuevas, *Necessary Modifications and Section 1113 of the Bankruptcy Code: A Search for the Substantive Standard for Modification of a Collective Bargaining Agreement in a Corporate Reorganization,* 64 AM. BANKR. L.J. 133, 160-61 (1990).
[114] *Id.* at 162-63.
[115] Keating, *supra* note 9, at 504 n.2.

to solve their mutual problems through the collective bargaining process."[116]

Section 1113 can be broken down into two main components: (1) the requirements placed upon the debtor, and (2) the standard the court is to use in determining whether to allow the rejection of the collective bargaining agreement.[117] The debtor must satisfy these two requirements before the court will consider approving the rejection of the collective bargaining agreement. More specifically, the debtor must first provide the authorized employee representative with a proposal for changes that are necessary if the reorganization is to be successful.[118] Next, the debtor must meet and confer with the employee representative in a good faith attempt to reach a mutually satisfactory compromise.[119] Once the debtor satisfies these criteria and if a mutual compromise is not reached, the court will determine if rejection is proper. Thus, the court may approve the rejection only if: (a) the debtor has made a proposal that satisfies the above requirements, (b) the employee representative rejected the proposal without good cause, and (c) the balance of the equities clearly favors the rejection of the collective bargaining agreement.[120]

1. *Debtor's Duty*

By the terms of section 1113(b)(1)(A), the debtor's proposal must satisfy three criteria. First, it must be based "on the most complete and reliable information available at the time of such proposal."[121] Second, it must "[provide] for those necessary modifications in the employee's benefits and protections that are necessary to permit the reorganization of the debtor[.]"[122] Third, it must assure "that all creditors, the debtor and all of the affected parties are treated fairly and equitably."[123]

While the first requirement is self-explanatory and not the source of any significant controversy, the second element has been the source of extensive litigation, as it is of critical importance to organized labor. Unions fear that the debtor may try to use this provision to alter terms of the collective bargaining agreement, not because it is necessary for the reorganization, but because the terms are unfavorable to the debtor. Legislatures, while acknowledging this possibility, felt that the language of the provision would guard against such action.

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[116] Richard Gibson, *The New Law on Rejection of Collective Bargaining Agreements in Chapter 11: An Analysis of 11 U.S.C. §1113*, 58 AM BANKR. L.J. 325, 327 (1984) (quoting 130 Cong. Rec. 58898 (daily ed. June 29, 1984)).

[117] *See generally* Harvey R. Miller & Debra A. Dandeneau, *Bankruptcy Reorganization and Rejection of Collective Bargaining Agreements — An Alternative to Oppressive Labor Contracts?, in* Labor Law and Business Change, Theoretical and Transactional Perspectives, 288-95 (Samuel Estreicher & Daniel G. Collins eds., 1988).

[118] 11 U.S.C. § 1113(b)(1)(A) (2002).

[119] 11 U.S.C. § 1113(b)(2) (2002).

[120] 11 U.S.C. § 1113(c) (2002).

[121] 11 U.S.C. at § 1113(b)(1)(A) (2002).

[122] *Id.*

[123] *Id.*

> [O]nly modifications which are necessary to a successful reorganization may be proposed. Therefore, the debtor will not be able to exploit the bankruptcy procedure to rid itself of the unwanted features of the labor agreement that have no relation to its financial condition and its reorganization and which earlier were agreed to by the debtor. The word 'necessary' inserted twice into the provision clearly emphasizes this required aspect of the proposal which the debtor must offer and guarantees the sincerity of the debtor's good faith in seeking contract changes.[124]

Courts have been strict in their interpretation of the term "necessary," denying any modifications considered to not be strictly "necessary."[125]

The debtor's third and final requirement, that the modifications be fair and equitable, attempts to ensure that employees covered by the collective bargaining agreement "will not have to bear an undue burden to keep the company solvent."[126] Thus, "[t]he union would have to make [only] the necessary concessions."[127] The likely precursors to this requirement can be found in bankruptcy court rulings conditioning the denial of labor contracts on a fair and equitable distribution of pay cuts.[128]

2. *A Rejection "Without Good Cause"*

Courts have wrestled with the meaning of "without good cause" since the inception of section 1113. In *In re Salt Creek Freightways*,[129] the court held that if the debtor satisfies the requirements of (b)(1) — the suggested modifications are necessary for the reorganization of the company and the debtor negotiated in good faith — then any rejection by the union was "without good cause."[130] Commentators have generally agreed, contending that the "without good cause" requirement is not only redundant,[131] but also completely useless.[132] At its best, the "without good cause" requirement allows for judicial discretion in evaluating the union's rational for termination.

3. *Equities of the Case Clearly Favor Rejection*

The final finding the court must make before approving the rejection of a collective bargaining agreement is that the equities of the case clearly favor the rejection.[133] It is worth noting that this standard is substantially

[124] 130 CONG. REC. 20,092 (June 29, 1984) (statement of Senator Packwood).
[125] *In re* Total Transportation Service, Inc, 37 B.R. 904, 907 (S.D. Ohio. 1984).
[126] 130 CONG. REC. 20,094 (June 29, 1984) (statement of Senator Moynihan).
[127] *Id*.
[128] *In re* Blue Ribbon Transportation, 30 B.R. 783, 787-88 (Bankr R.I. 1983); *In re* Parrot Packing Company Inc, 42 B.R. 323, 332 (N.D. Ind. 1983).
[129] *In re* Salt Creek Freightways, 47 B.R. 835 (Bankr. D. Wyo. 1985).
[130] *Id.* at 840-42.
[131] *See* Keating, *supra* note 9, at 517.
[132] *See* Gibson, *supra* note 116, at 340.
[133] 11 U.S.C. § 1113(c)(3) (2002).

similar to the one endorsed by the Supreme Court in *Bildisco.*[134] However, the balancing of the equities standard did not originate there, but rather was first adopted in 1965 by a district court in *In re Overseas National Airways, Inc.*[135] The standard was subsequently adopted by the Second,[136] Third,[137] and Eleventh[138] Circuits before the Supreme Court finally embraced it in *Bildisco*.[139] The balancing of the equities standard, which has been referred to as a "broad [and] equitable one[] lacking rigidity"[140] gives the court the flexibility to analyze the particular facts and circumstances of each case. However, courts do not have unlimited discretion. A collective bargaining agreement can be rejected only when the balance of the equities *clearly* favors rejection.[141] Contrary to the seemingly pro-labor language of this requirement, unions have not found much support in this requirement.[142] If the debtor can convince the court that the collective bargaining agreement is an impediment to reorganization, the majority of courts find that the equities balance in favor of rejection.[143]

Once the bankruptcy court authorizes the rejection of the collective bargaining agreement, the union is not without options. The rejection of a collective bargaining agreement does not effect the union's representation of the debtor's employees. Because employees are vital to reorganization efforts,[144] the debtor must continue to negotiate with the union to keep the employees working. While the union loses a great deal of bargaining leverage when the collective bargaining agreement is rejected, they still have one remedy — the power to strike.[145] The threat of a strike could be an incentive for the debtor to make some concessions to the union when negotiating a new labor agreement. While it is clear that the new labor agreement will be less favorable to the employees than the collective bargaining agreement — or else the debtor would not have moved for its

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[134] *See Bildisco, supra* note 107, at 527.

[135] *In re* Overseas Nat'l Airways, Inc., 238 F. Supp at 361.

[136] Shopman's Local Union No. 455 v. Kevin Steel Products, Inc., 519 F.2d 698, 707 (2nd Cir. 1975).

[137] *In re* Bildisco, 682 F.2d 72, 79 (3rd Cir. 1982).

[138] *In re* Brada Miller Freight System, Inc., 702 F. 2d 890, 898 (11th Cir. 1983).

[139] *See Bildisco*, 465 U.S. at 513..

[140] *In re* K & B Mounting , Inc., 50 B.R. 460, 466 (N.D. Ind. 1985).

[141] 11 U.S.C. § 1113(c)(3).

[142] *See* Keating, *supra* note 9, at 519.

[143] *Id. See also In re* Allied Supermarkets, 6 B.R. 968, 979 (E.D. Mich. 1980); *In re* Hoyt, 27 B.R. 13, 15 (Bankr. Or. 1982; *In re* Reserve Roofing, 21 B.R. 96, 98-100 (Bankr. N.D. Fla. 1982) (approving the rejection of the collective bargaining agreement upon finding that the high costs of unionized labor was the primary cause of the debtor's financial troubles); *In re* Braniff Airways, Inc, 25 B.R. 216, 220 (N.D. Tex. 1982) (approving the rejection of the collective bargaining agreement upon a finding that its continued existence blocked a merger that was necessary for reorganization) ;*In re* J.R. Elkins, 27 B.R. 862, 863 (E.D.N.Y. 1983); *In re* Southern Electronics Company Inc., 23 B.R. 348, 361 (E.D. Tenn. 1982) (approving the rejection of the collective bargaining agreement upon a showing that the only hope of reorganization was a buy-out, and the only buyer refused to accept the union contract).

[144] *In re Northwest Engineering Corp.*, 863 F.2d at 1315.

[145] *See* Keating, *supra* note 9, at 523. *But see* THOMAS R. HAGGARD & MARK S. PULLIAM, CONFLICTS BETWEEN LABOR LEGISLATION AND BANKRUPTCY LAW 199-28 (University of Pennsylvania 1987); MURIEL E. MERKEL, YOUR RIGHTS AS AN EMPLOYEE 106-08 (The Vanguard Press 1985).

rejection — the threat of a strike could be a beneficial bargaining tool for the union when drafting a new labor contract. However, employees must use restraint when threatening to strike. If the employees strike in the course of a bankruptcy, the likely result is a complete shutdown and a total liquidation of the business. Clearly, however, this is not in the best interests of the employees. Thus, employees must realize that while the threat of a strike may nominally help their cause, following through with it could destroy the entire reorganization effort.

The safeguards Congress established in section 1113 regarding the treatment of collective bargaining agreements in the course of a bankruptcy do, however, provide some protections to employees. The requirements placed on the debtor, coupled with the bankruptcy court's enforcement of those requirements, ensure that the sacrifices inherent in a reorganization effort do not fall disproportionately on the shoulders of the employees. While employees will still be debilitated by the rejection of their collective bargaining agreement, section 1113 guarantees that they will be treated fairly and justly.

VI. PROBLEMS WITH CURRENT EMPLOYEE PROTECTIONS

Despite the well-intentioned actions of both Congress and the state legislatures, the protections provided to employees are often ineffective when administered in the context of a bankruptcy case. In other words, the protections discussed above could potentially become worthless when invoked during the course of a bankruptcy proceeding.

A. WARN ACT

Despite the straightforward appearance of the statute, its application is still ambiguous in some situations. The statute has received a fair amount of criticism, being described as "riddled with exceptions and ambiguities"[146] and a "clumsily drafted and unduly confusing statute."[147] Thus, these weaknesses, in addition to the three exceptions,[148] provide for a statute that, at times, can be ineffective. An analysis of the interaction between bankruptcy law and WARN illustrates some of the problems that are particularly troublesome.

WARN's first exception, the "faltering business" exception[149] allows for the reduction in the notification period if a company is actively seeking capital at the time notice would have been required.[150] As Chapter 11 bankruptcies are primarily designed for businesses that wish to work through their financial problems and continue as a viable enterprise,

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[146] John F. Meyers, *Notice of Plant Closing and Layoffs — Significant Case Developments*, 18 EMP. REL. L.J. 297 (1992).

[147] Wilson McLeod, *Judicial Devitalization of the WARN Act?*, 44 LAB. L.J. 220, 221 (1993).

[148] *See* 29 U.S.C. § 2102(b).

[149] 29 U.S.C. § 2102 (b)(1).

[150] *Id.*

debtors are often likely to be seeking capital up until the day the bankruptcy is filed. This seems to allow such businesses to fall under this exception and excuse them from providing notice under WARN.

The second exception under WARN is available when the closing or layoff is caused by unforeseen business circumstances.[151] Courts have found that the loss of a major contract, a government-ordered closing, or sudden economic change would be among the situations considered to be unforeseen business circumstances.[152] Moreover, when a business is in financial distress, the debtor's creditors are often uneasy about continuing their business relationship. For example, creditors may be scared of not being paid for supplies or for services rendered. They may also feel as if they were cheated or swindled by the debtor.[153] In the end, creditors' refusals to continue business relationships with debtors become a "punishment" for their financial instability.[154] Ironically, the Code does protect the creditor who continues to deal with the debtor by allowing these costs to be paid as administrative expenses.[155] Nevertheless, creditors, either because of their ignorance regarding their rights or mistrust of the debtor, may be hesitant to do business with the debtor. While a contract cancellation following the bankruptcy would be forbidden by an automatic stay[156] or executory contract provisions,[157] the creditor could certainly end the business relationship with the debtor, which may result in the loss of a significant amount of work. Such actions could trigger the exception to WARN and excuse late or no notice to employees.

B. STATE LIEN STATUTES

The state statutes discussed above aim to aid employees in the recovery of back wages from employers. Regardless of whether the particular state statute is deemed to be a preference statute or a lien statute, another hurdle must be overcome before such protections will be successful in bankruptcy. To be effective in bankruptcy, a statute must withstand an attack by the debtor in possession on Bankruptcy Code section 545 grounds. Section 545, which deals specifically with the interaction of statutory liens in the course of a bankruptcy, allows the debtor in possession to avoid certain statutory liens that would otherwise be valid outside of a bankruptcy case.[158]

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[151] 29 U.S.C. § 2102 (b)(2)(4*)*.

[152] *See* Bartell, *supra* note 29, at 251.

[153] *See* Tom Morrow, Jay Alix & Associates, *How to Improve Communication with Vendors Careful Planning is the Key to Success*, 2000 Am. Bankr. Inst. J. *available at* LEXIS 96 (2000).

[154] *Id.*

[155] *See* 11 U.S.C. § 503(b)(1)(A)(2000) (this priority is the same available to employees for post petition services rendered).

[156] Such action could be seen as an act "to collect, assess, or recover a claim against the debtor that arose before the commencement of the case." *See* 11 U.S.C. § 362(a)(2000).

[157] Until the debtor in possession has assumed or rejected the contract, the non-debtor party must continue to perform. *See* 11 U.S.C. § 365 (2000).

[158] 11 U.S.C. § 545 (2000).

Section 545 allows the debtor in possession to avoid two types of statutory liens: those that arise either because of or in response to the debtor's insolvency proceedings, and those that were not perfected against a bona fide purchaser who purchases at the commencement of the case, whether or not that purchaser actually exists.[159]

Section 545(1) invalidates liens that become effective only upon the happening of a specified event, including a debtor's bankruptcy or insolvency. This provision is designed to prohibit secret liens existing under state law that disturb the established priority structure found in the Bankruptcy Code. Many state statutes that attempt to aid employees by providing them with such liens only arise after the debtor becomes insolvent and fails to pay employees. As a result, section 545 would probably render such statutes void.

In the absence of a bankruptcy, however, these state statutes are completely valid and enforceable. State legislatures are free to grant special rights to any group they see fit. When these state protections contravene the methods and policies of federal bankruptcy law, though, federal law prevails and invalidates the state lien.[160]

The second restriction placed on statutory liens is only implicated if the statutory lien is not struck down by section 545(1). This second method of invalidating statutory liens turns on when the lien becomes effective against a bona fide purchaser. The lien either becomes effective when the employee performs the labor or when the lien is attached against the debtor. The court in *In re Napco Graphic Arts, Inc.*[161] held that the lien in favor of the employees was not created until the wage claims were assigned to the state agency, which had occurred post-petition. Therefore, the trustee avoided the lien because the lien would have been unenforceable against a bona fide purchaser when the case was filed. Very few statutes creating employee liens outline the process by which the lien is perfected or enforceable. The ambiguity of these statutes makes them vulnerable to attack by the trustee or debtor in possession on section 545(2) grounds.

Both of these tests illustrate how the efforts of state legislators to help employees often afford little to no protection in the course of a bankruptcy case. Further reforms and improvements are necessary to ensure that employees are granted effective and successful protections.

VII. SUGGESTIONS FOR REFORM TO IMPROVE EMPLOYEE PROTECTIONS

The provisions outlined above illustrate the uncertain state of employee protections in bankruptcy. Modifications can and should be made in order to give employees greater security in the event of a bankruptcy.

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[159] *Id.*
[160] *See* U.S. Const. art. VI.
[161] *In re* Napco Graphic Arts, Inc., 83 BANKR.R. 558, 562-63 (E.D. Wis. 1988).

Summarized below are three suggestions for reform that would facilitate such progress.

A. INCREASED EMPLOYEE PARTICIPATION

The Bankruptcy Code allows for a creditors' committee to be formed at the outset of a Chapter 11 case.[162] An attempt is usually made to create a committee that is composed of a representative set of the debtor's creditors. Committee members are fiduciaries to all of the unsecured creditors represented by the committee,[163] and accordingly have an array of powers and responsibilities. It may investigate the conduct of the debtor, participate in the formation of a plan of reorganization, and hire professionals to represent its interests.[164] Creditor committees may therefore be vital to the reorganization effort.

Despite the importance of employee interests in reorganization, employees or their representatives rarely serve on creditor committees.[165] Some courts have allowed for the appointment of a labor union representative to the creditor committee, but such occurrences are rare. The primary reason for the lack of representation on the committee is the unique nature of employee claims,[166] which are fundamentally different from the claims of other creditors. Other creditors are primarily concerned with recovering all, or the greatest percentage possible, of the debt due them. While employees are concerned with recovering the money due them, they have concerns that are unique to employees — mainly their continued employment.[167] As employee interests may conflict with those of other unsecured creditors, it would be improper for the employee to sit on the committee.[168] Some courts, in rare circumstances, allow for the appointment of a separate employee committee to specifically represent the interests of the employees of the debtor.

While the appointment of additional committees is not specifically mentioned in the Bankruptcy Code, the U.S. trustee has considerable discretion to form an additional committee in light of the particular circumstances of the case.[169] A bankruptcy court must always be cautious when authorizing multiple committees because of the substantial increase in cost. Additional committees enjoy the same powers and duties under section 1102 as the unsecured creditors committee, and so they have the right to hire professionals and conduct investigations, thereby escalating the cost to the estate. Nevertheless, courts have authorized the formation of

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[162] 11 U.S.C. § 1102 (2002).

[163] Kenneth N. Klee & K. John Shaffer, *Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 44 S.C. L. Rev. 995, 1053-55 (1993).

[164] 11 U.S.C. § 1103 (a)–(c)(3) (2002).

[165] *See* Haggard & Pulliam, *supra* note 145, at 250-65.

[166] *Id.* at 257-58.

[167] *Id.*

[168] Klee, *supra* note 163, at 1005.

[169] *Id.* at 1027-30.

employee committees when employee interests have been so unique and significant as to warrant such additional protections.[170]

B. SEPARATE CLASSIFICATION OF EMPLOYEE CLAIMS

Another means by which employee interests may be protected is by varying the way in which employee claims are classified in the plan of reorganization. The acceptance of a reorganization plan requires the fulfillment of all requirements found in sections 1123 and 1129 of the Bankruptcy Code. Section 1122, which deals with the classification of claims in the plan, is of the utmost importance to the plan process, since the formation of classes often can determine if the plan is ultimately accepted.

A claim can be placed in a particular class only if it is substantially similar to the other claims of the class.[171] However, the Code does not prohibit the placement of similar claims in different classes. Courts have allowed creditor groups with particular and unique interests to be placed in their own classes.[172] As a result of separate classification, these creditors may receive different treatment under the plan. When employees are placed in a class with other unsecured creditors they must receive the same treatment as the other creditors.[173] However, as is noted above, employees often have distinctive needs and interests in bankruptcy, and separate classification permits the plan to recognize their exceptional circumstance appropriately. When drafting a plan of reorganization, debtors should take strides to establish separate employee classes, thereby giving the employees the special treatment they deserve.

C. INCREASING PRIORITY LIMITS

A third reform that would immediately provide a significant benefit to employees is the raising of the statutory limit on the amount of claims that can be prioritized under section 507. In the majority of cases, general unsecured claimants recover very little, if anything, on their claims, and as such, the section 507 limit not only restricts the amount of the priority claim, but all too often serves as the de facto limit on any recovery. As noted above, the current $4,650 cap encompasses claims for wages, contributions to benefit plans, and any WARN violation recovery. Assuming the employee has a claim equal to or in excess of the cap, increasing the amount of the claim that is entitled to prioritization would result in a virtual dollar for dollar increase in the employee's recovery.[174]

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[170] *Id.* at 1030; *In re* Manfield Ferrous Castings, Inc., 96 B.R. 779, 780-81 (N.D. Ohio 1988).

[171] 11 U.S.C. § 1122 (2002).

[172] *Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co.*, 800 F.2d 581, 587 (6th Cir. 1986) (holding that because employees often have a different stake in the future viability of the reorganized company separate classification of employee claims is permitted).

[173] 11 U.S.C. § 1123(a)(4) (2002).

[174] A prerequisite for plan confirmation is the payment, in full, of all § 507 priority claims, thereby guaranteeing that any claim that fits under the cap will be paid. *See* 11 U.S.C. § 1129(a)(9) (2002).

VIII. CONCLUSION

There can be no doubt that business failures and bankruptcies are a natural aspect of any market economy. Employees, like all others associated with such ill-fated companies, will suffer the consequences of that collapse. But the unique interests of employees entitle them to distinctive protections. The loss of a job means more to the employee than does the non-payment of a bill to a trade creditor or service provider. Employees have much to lose and, therefore, deserve higher levels of protection. The federal and state legislatures have agreed, passing numerous laws that aim to do just that. Unfortunately, within the context of a bankruptcy, these protections often do not produce the intended results. More must be done to ensure that employees do not get lost in the shuffle, but get the protections that they deserve.