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Chapter 11 Reorganization: Creative Management Or An Abusive Of The System?

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CHAPTER 11 REORGANIZATION:

CREATIVE MANAGEMENT

OR

AN ABUSE OF THE SYSTEM?

by

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TABLE OF CONTENTS

CONTENTS CONTINUED

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PREFACE

The world in which we live is constantly changing. We are fortunate enough to live in a free society, where new ideas are welcomed and nourished, then tested, and finally accepted or rejected. Change here in America is frequent, and considered a necessary part of the continuing evolution of our Nation. But a dynamic society produces an obligation upon its members to stay constantly informed of changes and trends, not only in our personal areas of expertise, but in all aspects of the world around us. While no one can hope to stay completely informed of all fields of knowledge affecting his life, the more studious can, with some effort, remain aware of the most significant trends and patterns in his fields of interest.

As a student of business and management, one of my deeper interests is in the legal environment in which the American business person must operate. As one of the cornerstones of our society, the free enterprise system encourages and respects creative approaches to both new and old problems. New ideas, if accepted, continue the development of our society. Free enterprise gives to all the chance

to succeed, but the right to succeed carries with it an equal right to fail. This is true in business as elsewhere, where successful businesses create profits, expand and mature, while unsuccessful businesses wither and die.

This winnowing process is touted as one of the great strengths of our society, the end product being the distribution of the greatest amount of resourses to the greatest amount of people. However, a strict Darwinian survival-of-the-fittest process would mean simply grow or die. Our business people do not operate in such a social vacuum, and our policies are tempered by another of our society's great strengths: compassion. In the business world, this compassion is manifested by the addition of a safety net to the right to fail - that is the right to begin again. The laws of bankruptcy are intended to administratively support the inevitable failures by mandating an orderly process by which unsuccessful businesses are dissolved, but only after they are given every possible opportunity to change, recover and prosper once again. A business that is in a poor financial condition is to be protected during its convalescent period in hopes that it may once again be successful and contribute to the overall well-being of society.

ABSTRACT

CHAPTER 11 REORGANIZATION:

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OR

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William Rush Zilliott

The University of North Dakota Graduate Center, 1984

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Recent developments within the Bankruptcy Court system are controversial. Several of the largest corporations in the United States are currently undergoing reorganization. To some companies, Chapter 11 is the only way out of staggering debt, to others Chapter 11 is a means to stall liability suits, and to still others Chapter 11 represents a way to force wage concessions in the place of honoring union contracts. The entire Bankruptcy Court system itself has been successfully challenged as being Unconsititutional, and continues to operate only by a special dispensation from Congress.

When these developments are placed in an historical context, they point to a critical period in the evolution of bankruptcy law. Observant reporters of the business world have followed the more important cases in Chapter

11, and have written about them extensively in magazines, The Wall Street Journal and in legal textbooks. This paper consolidates that information, organizing the more pertinent facts in a manner that facilitates an understanding of the bankruptcy system. Three cases are examined and their impact upon American business law is put in perspective. Chapter 11 Reorganization represents a way for society to balance the need for continuing employment against the need to protect creditors' rights. But the manner in which certain corporations are taking advantage of the provisions of Chapter 11 begs the question: Is this creative management or an abuse of the system? The answer is a little of both.

CHAPTER ONE

INTRODUCTION

1.1 ORIENTATION

The subject of this paper is the process of reorganization of insolvent businesses. Chapter 11 is the specific section of the Federal Bankruptcy Code dealing with the convalescent period of an ailing business. It provides a certain degree of sheltering of the business as well as for the orderly process by which attempts are made to restructure and regain strength.

This area of business law is fascinating because of its current impact on very fundamental aspects of the business community. Recent developments within Chapter 11 have altered traditional balances between labor and management. The redress of injured workers against industrial manufacturers of hazardous materials is profoundly affected by another development in this field, and the bankruptcy court system itself is presently being challenged. Bankruptcy law is young as legal principles go, and its maturation process is a continual evolution. The impact of bankruptcy law has never been more strongly felt as during the current period, and its evolution is certain to provide a greater impact in the future.

1.2 RESEARCH OBJECTIVE

The objectives of this paper are to (1) examine the recent developments in Bankruptcy Law - specifically Chapter 11 Reorganization, (2) place these developments in an historical context, and (3) formulate an educated approach to the question of whether or not the recent developments in this area represent its continuing evolution, or constitute the malignant abuse of the concept of bankruptcy.

1.3 METHODOLOGY AND PROCEDURE

This paper compiles the evidence currently available in the public domain through magazine articles, legal texts, newspapers and trade journals, and as such, is secondary research. No attempt is made to provide new statistical data, nor are the facts given by authors in this field subjected to primary verification. However, when comparing the body of facts stated by varying writers on Chapter 11, a certain degree of verification can be assumed when similiar facts are stated from different sources. The integrity of authors and editors in the articles given as reference for this paper is assumed, and as far as the necessity for accuracy is required, this assumption is

justified. For example, it is not significant if the number of asbestos liability suits against Manville Corp is fifteen thousand, eighteen thousand, or twenty thousand. The important point is the magnitude of the number of such suits, and the fact that the impact of such a tremendous number of tort suits on an industrial manufacturer is the same regardless of the precise number. In another instance, the change in work load of airline pilots involved in Continental Airlines' Chapter 11 proceeding is variously stated by different authors as increasing from fifty-four flying hours per month to eighty hours per month or to eighty-five hours per month. Both authors may be right, depending on the timing of their research, but the difference does not matter here. It is the significance of the change that is important.

1.4 ORGANIZATION OF STUDY

In order to provide an historical context, the development of bankruptcy law is traced from early Roman law through the revisions of the U.S. Bankruptcy Code in 1978. Because it is an evolutionary process, certain principles of the law are deemed more important at different epochs, and the varying emphasis on different principles reflects, to a large extent, the prevailing mood of the times. For example, bankruptcy law in its infancy was intended to be

a deterrent against irresponsible financial dealings by providing an unmistakable stigma as the sign of business failure. Today, society's mood is to provide every opportunity for rehabilitation, and the 1978 revisions reflect this current attitude. Chapter 11 specifically is the vehicle for court fostered reorganization. It is intended to preserve an ongoing business, maintain employment, and at the same time protect creditors' interests.

Following the historical background, one case is given as an example of how Chapter 11 is intended to be utilized. This corporation, Braniff Airlines, made the wrong decisions at the wrong time, and defaulted to its creditors. Notable for its enormous assets, number of employees, and magnitude of its debt, Braniff makes an interesting case study because of its attempt to reorganize and survive.

Following Braniff are two cases that represent an extension of previous legal principles of court protection. Manville Corp represents the utilization of Chapter 11 by an argueably solvent firm as a method to deal with a mountain of asbestos liability suits. As such, its reorganization is under scrutiny as a possible abuse of the bankruptcy system.

Continental Airlines is given as a subsequent case because of the impact of its use of Chapter 11 to dramatically alter the balance of labor-management relations.

The legal principle used in this case is called the abrogation of existing labor contracts. It was given expanded importance by one small firm utilizing liberal changes in the 1978 Code revision, and Continental has applied this principle wholesale in an attempt to significantly restructure the entire wage level of the airline industry. Critics claim that this is not simply a creative management approach to a difficult problem, but more accurately represents a reversal of hard gained labor rights, and as such flies in the face of national policy.

The summary collects various points of view from knowledgeable people in the industries involved and concludes with this author's assessment of the problems previously stated.

1.5 THEORETICAL FRAMEWORK

Chapter 11 of the U.S. Bankruptcy Code is currently undergoing a critical growth period as a legal concept. The revision of the Code in 1978, coupled with liberal court interpretations of that law and with an economic recession have thrust the reorganization of troubled businesses into the business-world spotlight. Recent developments are controversial, with the ultimate outcomes subject to speculation. The resolution of these controversies will have profound effects on the legal climate in which

all businesses operate. As a component in the evolution of business law, Chapter 11's development is somewhere between infancy and maturity. These growing pains are part of the evolutionary manner in which a civilized society attempts to solve complex problems.

CHAPTER TWO

BACKGROUND AND HISTORY

Chapter 11 Reorganization is a relatively new legal concept. To understand that perspective, a look at the history of straight bankruptcy is necessary. Bankruptcy is basically a court supervised liquidation of the estate of an embarrassed debtor, initiated upon his own or his creditors' petition. Bankruptcy's history shows (1) a development in both voluntary and involuntary proceedings, (2) an expansion of the concept from the individual to small business to large businesses, and (3) a shift in emphasis from quasi-punishment to rehabilitation.

2.1 ROMAN LAW

The concept of bankruptcy goes as far back as classical Roman days. Business success was, as now, never guaranteed, and some debtors incurred more obligations than they could possibly meet. To prevent the wrath of his creditors from venting in a lawless vendetta, a debtor could voluntarily appeal to the courts to hold his creditors at bay long enough to liquidate his estate. This process

was called CESSIO BONORUM.[1]

Creditors in those days as well as today could recognize that a debtor had gotten himself into a position of not being able to pay, and could force the debtor into court involuntarily in a process called MISSIO IN BONA.[2] This court action would stop the bankrupt from incurring even more debts and from watering down the recovery the creditors hoped to get from his estate.

The development of bankruptcy law in the centuries following the demise of the Roman Empire centered on three features: (1) that when a debtor owed several creditors, each of them should participate and share in whatever estate was available. This feature of the law was designed to preclude one creditor from getting to the bankrupt first, taking the entire estate to satisfy his claim, and leaving nothing for the other creditors. (2) The courts will protect the bankrupt from angry creditors' attempts to resolve their claims with threats of violence, and (3) the bankrupt will wear his shame and carry a stigma as a warning to others to avoid financial irresponsibility. In fact, the term bankruptcy stems from BANCA ROTTA, meaning a spoiled trading place. A merchant would customarily display his wares at his bench in the market place. Unsatisfied

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[1]Samuel J.M. Donnely et al., Bankruptcy, Arrangements, and Reorganization (New York: Practicing Law Institute, 1972) p. 503.

[2]Ibid.

creditors would smash his bench and preclude the bankrupt from doing further business.[3]

Medieval Italian city-states adopted these three features, and their acceptance as the mainstay of bankruptcy proceedings spread throughout Europe. Two Spanish legal authorities in particular, Baldus and Somoza, are recognized for codifying and elaborating the basic principles of bankruptcy. Working independently, both scholars consolidated the ancient legal thought on the subject, offered commentaries and recommended court procedures.[4]

2.2 ENGLISH LAW

Henry VIII of England brought the concept of bankruptcy to his country in 1543. However, he favored only the involuntary proceedings initiated by creditors. Voluntary petitions were not a part of English law until 1844. The English contributed to the evolution of bankruptcy law by introducing the discharge provision in 1705. Through discharge, the debt was no longer owed. Creditors would have to be satisfied with whatever distribution the court made of the debtor's estate. Instead of being required to continually pay on the old debt through the years, he could begin again with a clean slate -- a fresh start.

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[3]Ibid., p. 503.

[4]Ibid., p. 504.

Lest the courts be regarded as being too soft on debtors, the custom of requiring the wearing of degrading ing clothes was continued, and the stigma remained. With the liberalization of discharge provisions that occurred during the the Twentieth Century, this stigma has all but disappeared. Critics of current bankruptcy law attribute the rapid rise in consumer bankruptcies that has occurred in the 1970's to this feature. The discharge provision is however a distinguishing feature between Continental European countries and English-speaking countries.[5]

2.3 UNITED STATES LAW

Bankruptcy law in America developed from the English, or more accurately, Scottish law. The framers of the U.S. Constitution, in their recognition of the rights of the common man and small merchant included a clause giving the Federal government the right to create uniform laws on the subject, although bankruptcy was then still in the backwaters of legal thought. Regardless, it has not been until the necessities brought on by financial crises that any federal legislation was enacted. Accordingly, the development of bankruptcy legislation in this country closely parallels periods of economic depression.

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[5]Stefan A. Riesenfeld, Creditors Remedies and Debtors Protection (St. Paul: West Publishing Co., 1979), p. 28.

Over-speculation in real estate at the end of the 1700's precipitated the enactment of the first American bankruptcy statute. In 1800, a stringent law became effective, and applied primarily to traders, bankers, brokers and underwriters. It was modeled after existing Scottish law. The discharge provision was included, but the voluntary provision was removed.[6] This Federal law was repealed in 1803, and it was not until thirty-eight years later that Congress again acted on the subject. Once again, over-speculation and the resulting Panic of 1837 was the impetus for new legislation. The bankruptcy law of 1841 expanded the relief provisions in the 1800 law to include not only mercantile bankruptcies, but also all individual bankruptcies. Discharge provisions were liberalized, and voluntary petitions were introduced into Federal law at that time.[7] Creditor lobbies strongly objected to these provisions, and the Law of 1841 was repealed after only eighteen months of operation.

The economic crisis that immediately followed the Civil War brought about the third Federally legislated statute, enacted in 1867. This act introduced into American law the feature of termination of bankruptcy proceedings by arrangement. Assent by three-fourths (in value) of the creditors placed the distribution of the assets into

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[6]Ibid., p. 29.

[7]Ibid., p. 30.

the hands of one or more trustees. An amendment in 1874 reduced the percentage of creditors required for assent to termination to simply a majority (in value).[8]

Current bankruptcy law is regulated by the National Bankruptcy Act of 1898, and the Bankruptcy Reform Act of 1978. The 1898 act contained a section called composition that was designed to deal with larger business failures. But the reorganization needs required by increasingly more complex capital structures quickly outgrew this section. Out of necessity then, a concept of equity receiverships was developed by the courts.[9] Receiverships were limited to corporations having a large and continuous business and to companies involving a significant public interest, such as railroads and public utilities.

It was legislation in the 1930's, however, that developed the role of reorganization as it is known today. Rehabilitation provisions were added to the law in 1933, and the debtor under these provisions was no longer labeled a bankrupt.[10] These provisions were strengthened by the Chandler Act in 1938 with the additions of Chapter X (Corporate Reorganizations) and Chapter XI (Arrangements).

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[8]Donnelly, Bankruptcy, Arrangements and Reorganization, p. 506.

[9]David C. Epstein and Myron M. Sheenfeld, Business Reorganization Under the Bankruptcy Code (St. Paul: West Publishing Co., 1979), p. 117.

[10]Riesenfeld, Creditors Remedies and Debtors Protection, p. 28.

As a reult of the expansion of the provisions for arrangements, the financially embarrassed debtor with significant assets would most frequently resort to court supervised reorganization rather than to dissolution and distribution. This was precisely the intent of the Depression era law -- to give financially strapped businesses every chance of continuing to provide employment. Another significant contribution of the Chandler Act was a chapter providing relief for local governmental units unable to meet their financial obligations.[11]

Although this law served its purpose into the 1960's, the Bankruptcy Law came under mounting criticism for a number of reasons. A major flaw of the law was the lack of uniformity of interpretation. Actual practices of the referees in bankruptcy varied greatly from district to district. Also the mounting load of consumer bankruptcies created increased burdens on the combination of judicial, investigatory and administrative functions assigned to referees.

Congress responded to these problems in 1964 by empowering the Supreme Court to resolve conflicting procedural provisions of the Bankruptcy Act. Congess also established a Commission on the Bankruptcy Laws of the United States to "study, analyze, evaluate and recommend changes

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[11]Donnelly, Bankruptcy, Arrangements and Reorganization, p. 508.

to the Bankruptcy Act of 1898."[12] The result was the Bankruptcy Reform Act of 1978.

2.4 BANKRUPTCY REFORM ACT OF 1978

The principle changes in the bankruptcy system made by the new law were:

1. Establishment of bankruptcy courts with comprehensive jurisdiction over all cases governed by Title 11 (Bankruptcy) and all civil suits relating to cases under Title 11. It is this feature that raises the Constitutionality issue explained below;
2. Strenghtening the judicial status of the former trustees in bankruptcy;
3. Launching of an official trustee system as a pilot project;
4. Consolidation of arrangements under former Chapter XI and reorganization under former Chapter X into a single chapter called Reorganization. The decision in a case named U.S. Realty had already blurred the distinction between the proceedings of these two chapters;
5. Transfer of rules governing automatic stays into the law and restriction of the rule-making power of the Supreme Court in bankruptcy matters;

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[12] Public Law 9-354, 84 Stat. 468 (1970).

6. Abolition of the balance sheet test of solvency as a condition for involuntary proceedings. It is the absence of this feature that has allowed the Manville case to remain in Chapter 11.[13]

2.5 THE JURISDICTION ISSUE

The Constitutionality of the Reform Act of 1978 was successfully challenged in 1982 in a case named Northern Pipeline Construction Co. v. Marathon Pipe Line Co.[14] This challenge rested on the fact that the issues to be decided by the bankruptcy judges fell within the judicial power as defined by Article III of the Constitution, yet the judges did not possess the guarantees of judicial independence -- life tenure and irreducible salary -- as set forth by Article III. This, in effect, halted the jurisdiction of the Bankruptcy Court system, and left the question for Congress to decide. The current debate centers on one of two alternatives -- to limit the bankruptcy judges to the technical question of bankruptcy itself, leaving the resolution of related claims to the ordinary courts, or to create Article III status for bankruptcy judges. As yet, Congress has not resolved the issue, but by a special

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[13]Donnelly, Bankruptcy, p. 509.

[14]Northern Pipeline Construction Co., v Marathon Pipe Line Company and the United States, 102 Supreme Court Reporter, p. 2858.

Congressional arrangement the Bankruptcy Court system continues to operate.

2.6 SUMMARY

Bankruptcy law in the United States has its very roots in the Constitution. But the actual working laws have always been written as a reaction to an economic crisis. It was only after the administrative workload on the bankruptcy court system became over-burdensome that the law was revised in 1978. While these revisions were intended primarily to ease the administration of the bankruptcy system, in practice it has had an altogether different affect. By combining related civil suits as well as the basic question of insolvency within the bankruptcy court system, Congress has both subjected the entire bankruptcy proceedure to Constitutional challenges, and has opened the door for innovative uses of Chapter 11, some of which may produce results far different from what was intended. These innovative uses of Chapter 11 will be shown in the specific cases to follow in chapters three through five.

CHAPTER THREE

BRANIFF AIRLINES

Besides the jurisdictional problem of the bankruptcy court system, there is currently debate as to whether the use of Chapter 11 protection has been extended too far. A couple of on-going reorganizations involving Manville Corp and Continental Airlines are centers of controversy. Although Manville Corp was considered healthy as an operating concern, it sought court protection to stall a multitude of asbestos related liability claims. Continental Airlines, on the other hand, has been accused of using Chapter 11 as an excuse for wholesale abrogation of union contracts. Both these cases will be examined, but only after a summary of one case that can be described as the classic Chapter 11 proceeding.

3.1 FINANCIAL CONDITION

Braniff Airlines, in 1982, was in the financial predicament envisioned by the framers of the 1978 law. After deregulation of the airlines, Braniff promptly opened new routes in the U.S., Europe and Asia. The entire airline

industry typically uses a great deal of leverage, and Braniff was no exception, financing this rapid expansion with debt. But it was not long until the combination of soaring energy costs, recession, and fare wars resulted in Braniff's failure to meet its debt obligations.

In 1981, Braniff had a net loss of $160.6 million. Current assets were exceeded by current liabilities by $204.8 million. Redeemable preferred stock plus total liabilities exceeded total assets by $94.4 million. In an effort to avoid bankruptcy, Braniff took several strong financial measures. Principle payments to creditors were delayed from February 1981 to October 1982. In 1981 employees accepted a ten percent pay cut, releasing $25 million in working capital during that year.[1] These actions were not enough to keep the company operating. On May 12, 1982, Braniff filed for Chapter 11.

One of the largest bankruptcies in history, Braniff's case can be called a classic Chapter 11 situation because the company simply ran out of cash. Its operations did not produce the revenues necessary to support its highly leveraged position. At that time Braniff employed over nine thousand people, and produced annual revenues of $1.5 billion. It owned sixty-two aircraft, plus spare engines and parts. These assets form the collateral for the $468 million in secured claims brought to the Court.

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[1]Wall Street Journal, January 17, 1983, p. 6.

3.2 THE PSA DEAL

The Braniff case is also interesting for the way in which it attempted reorganization. Nine months after grounding operations, Bankruptcy Judge John Flowers announced that a tentative arrangement had been worked out between Braniff and a West Coast airline, PSA. Under this arrangement, PSA would obtain title to all sixty-two of Braniff's airplanes, secured creditors would receive $250 million, unsecured creditors would receive ten cents on the dollar, and preferred and common stockholders would get absolutely nothing.[2] The entity that would remain under the Braniff name would employ about two hundred people and could anticipate annual revenues of $20 million. This deal failed a few months later for these reasons: For one, PSA was not able to win enough wage concessions from unions to make the new Dallas operation cost effective. But more importantly, this entire plan was put before Judge Flowers in no more than a two page memorandum.

Companies in Chapter 11 have long been recognized to have the right to continue to make operational decisions without formal Court approval. This would normally include leases and sales. For example, when White Motor Company was in Chapter 11, the Court permitted the sale of the bulk of White's truck-manufacturing division to Volvo.

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[2]Wall Street Journal, March 17, 1983, p. 3.

This sale was completed without official creditors' approval. PSA claimed that the deal with Braniff was merely a sale and lease, and not a complete reorganization, requiring detailed reports and creditor approval. Creditors and competing airlines were successful in challenging this deal in the Appeals Court.[3]

An issue involving the ownership of airport landing slots was also a factor in the failure of the PSA deal. Each airline is assigned landing slots at airports by the Civil Aeronautics Board. Braniff's slots were parcelled out to other companies when it ceased operations. PSA and Braniff contended that these assigned slots were assets of the corporation and could be assigned to PSA. This decision, originally in favor of PSA, was also overruled, and PSA gave up.[4]

3.3 THE HYATT PLAN

A second reorganization attempt, initiated by a pilots' group, stands a greater chance of success. Rather than divesting Braniff of all its flying assts, this arrangement provides for the taking over of flying operations by the Hyatt Hotel group. The blending of airline and hotel interests in the past has had mixed success, as Pan

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[3]Wall Street Journal, February 19, 1983, p. 6.

[4]Wall Street Journal, March 17, 1983, p. 2.

American Airlines could testify, but is certainly nothing new. Under the Hyatt plan, thirty of Braniff's 727-200's would be operational, and 2,500 of Braniff's former employees would be recalled to staff operations, using Braniff's former headquarters in Dallas.[5] This arrangement has the support of both creditors' groups and unions, who granted the wage concessions necessary to make operations competitive. American Airlines, who in part was responsible for Braniff's demise through aggressive competition, has even cooperated with the Hyatt plan by granting Braniff equal access to its Sabre reservation system. American had strongly objected to the PSA deal, and their support of the Hyatt plan has increased the probability of eventual acceptance. Getting Braniff airborne again will require the confidence of both consumers and travel agents, and it is thought that Hyatt's support will make this possible.

3.4 SUMMARY

As one of the Nation's leading passenger airlines, Braniff provided an important transportation service to the public prior to airline deregulation, as well as provided thousands of jobs. Its successful reorganization will restore millions of dollars in assets to productive

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[5]"The New Braniff: Hyatt Will Fly It," Air Transport World, vol 20: October 1983, p. 65.

use, and will provide continuing employment so necessary for a stable economy. Court sponsored reorganization is the best way to assure this process, and Braniff is correct to use this approach.

CHAPTER FOUR

MANVILLE CORPORATION

In the Braniff case, no one will deny that the airline is a company that belongs in Chapter 11. It was clear, in 1982, that Braniff could not meet its financial obligations, and Court action was necessary to protect creditors tor's interests. In the case of Manville Corp, formerly known as Johns-Manville, the issue is not at all so clear.

Although apparently solvent by the usual interpretation of that term, Manville was faced with potentially $2 billion worth of asbestos liability claims. When counted as a contingent liability against the firm's $1 billion in assets, these ongoing and potential lawsuits provoked Manville's management to file for Court protection under Chapter 11 on August 26, 1982. Bankruptcy Judge Burton R. Lifland ruled against the attempts by creditors and asbestos victims to deny Manville the use of Chapter 11 on bad-faith grounds. However, a controversy remains as to whether the Manville filing is effective management strategy, or a abuse of the system.

4.1 THE LIABILITY ISSUE

There are two main issues in the Manville case - the liability for injuries incurred by asbestos workers, and the operational health of this firm at the time of Chapter 11 filing. Neither are clear cut. As a long-time leading producer of asbestos, Manville supplied this product for countless government shipyard contracts for many years. Asbestos is now recognized as the causal agent in many forms of cancer and asbestosis, a chronic disabling lung disease, but it was once a popular construction material because of its fire-retardant properties. Current estimates of up to 48,000 workers now have injuries relating to Manville's product, and at least 20,000 have already filed suit. Manville was faced with an average of five hundred new suits each month, and its insurance carriers found legal challenges to their liabilities. Settlements for each individual lawsuit averaged $12,000 in 1982, and one worker succeeded in netting an award of $2.6 million.[1] State workmen's compensation covered most case initially, but proved to be wholly inadequate for the long-term injuries relating to caused by asbestos.

For years prior to Manville's 1982 filing, an attempt

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[1]Stephen Tarnoff, "Manville Considering Individual Settlements," Business Insurance, October 24, 1983, p. 3.

was made to have Congress acknowledge at least partial governmental responsibility as chief contractor for the shipyards and as a major employer of asbestos workers. One proposal in Congress would set a cut-off date after which no future liability cases would be accepted.[2] This would at least put a cap on the number of lawsuits, and thus make that issue more manageable. But a complicating factor is that asbestos-related injuries may take years to manifest. A worker may even be retired before developing asbestosis. Workers who develop cancer after the cut-off would have no redress, and this obvious disadvantage severely limits this proposal's chance of acceptance. Senator Gary Hart (D-Colo.) sponsored a proposal that would reform the current workmen's compensation system and provide government participation under a complicated arbitration formula.[3] The AFL-CIO, on the other hand, opposes any attempt to limit liability suits against asbestos manufacturers. The American Bar Association supports the position that the Federal government should accept some risk in the lawsuits when companies using asbestos materials were under Federal contracts.[4]

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[2]"Manville May Drive Congress to Action," Business Week, September 13, 1982, p. 34.

[3]Ibid., p. 35.

[4]Wall Street Journal, February 10, 1983, p. 6.

4.2 THE INSURANCE ISSUE

Another unresolved issue is -- which insurance policy covers the workers' injuries. Manville carried continuous insurance coverage throughout the years, but policies were written by various insurance companies at different times. Present insurance companies argue that the injury claims should be covered by the policy in effect when the exposure to asbestos took place. Previous carriers argue that the claims should be covered by the policy in effect when the worker became ill, possibly as much as twenty years later.

The U.S. Court of Appeals has not helped to clarify the issue, with three different courts handing down conflicting judgements. A case involving Eagle-Picher Industries, Inc., a Cincinatti-based manufacturer that used to produce asbestos, was appealed to the Supreme Court. However, the Supreme Court refused to hear this case. The High Court chose not to render a decision as to when insurer's liability is triggered, stating that the relevant liability law is already sufficiently settled.[5] As early as 1980, Manville sued Traveler's Insurance Co. and twenty-seven other insurers for reimbursement for defense and legal costs, which could be as much as $40,000 per case. Manville also requested $5 billion in damages for the stall

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[5]Paul G. Engle, "Manville's Bankrupt - But Not of Problems," Industry Week, April 4, 1983, p. 21.

in claims resolution. In the meantime, Travelers asked the California Supreme Court to administer a pool of funds from insurers to pay defense costs and current claims until the coverage question is resolved.[6]

4.3 THE ACCOUNTING ISSUE

Against this backdrop of asbestos litigation Manville claimed an accounting necessity to "book" contingent liabilities from these suits. Faced with liabilities of argueably $2 billion compared with equity of around $1 billion, Manville filed for Chapter 11 court protection, staying all suits and obligations until a reorganization is approved.

Since the specific insolvency test was deleted in the 1978 changes in the Bankruptcy Code, the courts have recognized the presumption that a company's filing is in good faith. Lawyers representing creditors and injured workers have claimed that this was an abuse of the system, arguing that Manville is a solvent entity with sufficient resources to meet its obligations for a long time, but they have not succeeded in removing Manville from Chapter 11. It has not been so much the changes brought about by the 1978 revisions that has allowed Manville to stay in Chapter 11, but more so the liberal interpretations by the bankruptcy judge as to what constitutes a good-faith filing.

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[6]Business Week, September 13, 1982, p. 35.

4.4 FINANCIAL CONDITION

Professor Edward I. Altman, a specialist in analyzing corporate bankruptcies, examined Manville's operational condition between 1972 and 1982, concluding that Manville's financial status had been deteriorating steadily over this period. This suggests that Manville may not have been the solvent entity that its critics claim. In 1981, Manville had revenues of $2.2 billion and net earnings of $60.3 million. In the year that Manville filed for Chapter 11 - 1982 - revenues decreased to $1.8 billion, producing a net loss of $97.6 million. Cash flow experts Robert Levine and Barre Littel argue that Manville was in trouble as early as 1979. That year, Manville earned $115 million on paper, but excess cash flow was actually negative.

Excess cash flow describes a cash accounting concept different from accrual accounting. Actual cash operating expenses are subtracted from actual cash revenues, with the depreciation added back, the result being excess cash flow. Normally this would mean that excess cash flow would be greater than book net income. However, this was a period of rising interest expenses, and curiously enough, increased cash dividends. In 1978, Manville paid dividends of $39 million. In 1980, excess cash flow was -$137 million. In 1981, although book earnings were over $60 million, excess cash flow was -$222 million. In spite of a worsening

cash position, cash dividends of over $70 million were paid to stockholders.[7]

In January of 1979, Manville bought Olinkraft, Inc., a forests products company for nearly $600 million, a figure almost fifteen times earnings. Of the purchase price, $300 million was paid in cash, with the remaining $300 million in convertible preferred stock. In its financial statements, Manville counted that preferred stock as equity - not debt, and showed a comfortable debt-to-equity ratio of one to two. But Manville had to make contributions to a sinking fund to convert that preferred stock, so its real effect on corporate cash is almost identical to debt. The debt-to-equity ratio becomes nearly one to one when that preferred stock is looked at this way. One can then conclude that Manville was in trouble operationally, regardless of the liability issue.[8]

The filing for Chapter 11 not only created a temporary immunity from lawsuits, but also produced a moratorium on hundreds of millions of dollars of notes and bonds. Manville's leading creditors were Prudential Insurance, $68 million; Morgan Guarantee Trust Co., $36 million; Bank of America, $20 million; Chemical Bank, $20 million; Citibank,

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[7]Barbara Rudolph, "Why Didn't the Creditors Notice?" Forbes, October 11, 1982, p. 98.

[8]Ibid.

$20 million; and Continental Illinois, $10 million.[9]

Professor Altman analyzed Manville's risk of bankruptcy using a formula called Zeta analysis. This technique identifies key financial ratios, primarily net cash flow to debt service, and compares them to historical ranges in bankruptcy filings. Altman combines five financial measures, each one objectively weighed to arrive at an overall credit score, which becomes the basis for estimating the financial viability of manufacturing firms.[10] His conclusion was that Manville was a marginal candidate for bankruptcy without its huge asbestos liabilities. With the contingent liabilities added in, Manville was a definate bankruptcy risk.

After filing for Chapter 11, Manville's stock dropped from $8 to $5 per share, but the corporation has been making grand attempts to operate business as usual and retain whatever consumer confidence is left. Although no longer in the asbestos business, Manville's building materials division has established an independent trust fund to honor liability claims regardless of the outcome of the bankruptcy proceedings.

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[9]Business Week, September 13, 1982, p. 35.

[10]Edwin I. Altman, "Exploring the Road to Bankruptcy," Journal of Business Strategy, April 1983, p. 37.

4.5 REORGANIZATION ATTEMPTS

Manville was originally given a deadline of November 1983 to propose a reorganization plan to the Court. Because of the complex liability issues involved, at least eight extensions have been granted, and the case is not as yet resolved. The plan proposed by Manville's management has some similiarity to Braniff's original plan. Two separate companies would be created. One company (M1) would have all the liability but few assets. The other company (M2) would contain operations, sending "all cash after operating expenses" back to the first to pay the claims. Liability awards would be similiar to workmen's compensation, with an average award around $15,000. By being able to estimate total liability more confidently, Manville could possibly use a technique called reverse insurance, whereby the total insurance claim, say $1 billion, would be paid by insurers, with Manville paying premiums of $200 million for five succeeding years.[11]

The lumping together of claims into a workmen's compensation type system is being resisted by lawyers for claimants and by trial lawyers associations. They claim that this system would deny an injured worker the right to a

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[11]Stephen Tarnoff, "Manville Offering Claimants Average of $15,000 Each," Business Insurance, November 7, 1983, p. 41.

jury trial. They compare the proposed average settlement of $15,000 with the multimillion dollar award obtained in just one case. Judge Lifland is reluctant to allow such a "hostile" plan gain approval, since it would be sure to encourage years of continuing lawsuits. Each filing extension provides Congress with the opportunity to enact legislation on the issues as well.

4.6 SUMMARY

Manville's success so far in using Chapter 11 as a method for holding off liability claims presents a dangerous precedent for other firms to follow. Any firm, faced with a damaging liability suit, could declare bankruptcy. This would strike a profound setback in consumer liability law. On the other hand, if Manville's situation can be isolated because of the huge number of lawsuits, Manville's precedent will not necessarily provide an open door for irresponsible industrial management. It also must be taken into acccount that Manville made an enormous contribution to the World War II effort. At that time it could not have been forseen that asbestos would harm so many workers. Congress should acknowledge at least some responsibility for the damages. It will also be up to Congress to determine a solvency test to insure that the Bankruptcy Court is not abused.

CHAPTER FIVE

CONTINENTAL AIRLINES

While the thrust of Manville's Chapter 11 filing is the asbestos liability issue, Continental Airlines has filed specifically for the purpose of lowering wage and labor costs. From a management point of view, this can be seen as merely survival by forcing a restructuring of costs that grew steadily during pre-deregulation days. From the union point of view, this can be seen as a breaking of the union by destroying its bargaining power instead of a cooperative scale-down of wages. Of interest here is the fact that the main tactic used is the abrogation of union contracts through the bankruptcy courts.

Prior to deregulation in 1978, increases in pilot, flight attendant, and machinist wages could be successfully passed on to customers. But with the post-deregulation scramble for passenger business and the fare-wars sparked by Pan Am's $99 tickets, Continental and the other high-cost trunk airlines began losing millions of dollars. Between June 1979 and June 1983, Continental alone lost $472 million. During this period pilots annual wages averaged $73,000. The base pay for flight attendants averaged

$28,000, and machinists annual wages averaged $33,000.[1]

5.1 CONTINENTAL'S MANAGEMENT

Although the current precedent for using Chapter 11 to abrogate union contracts was set by a relatively small New Jersey firm named Bildisco, the wholesale expansion of this tactic to restructure the airline industry's wage level is attributable to the management style of Continental's chairman, Mr. Francisco Lorenzo.

Mr. Lorenzo got his start in the airline industry by forming a financial advisory firm with a Harvard Business School classmate, Mr. Robert Carney. Primarily a financial team, in 1969 the pair formed Jet Capital Corp, and raised $1.5 million in a small public offering. In 1972, Jet Capital bought control of Texas International Airlines, a regional carrier precariously in debt. After winning CAB approval to introduce half-price, off-peak "peanut" fares, Mr Lorenzo restructured Texas International's debt and revamped the fleet. It earned a profit of $13 million in 1978.[2]

Ironically, it was an unsuccessful takeover bid for National Airlines that gave Lorenzo's airline the cash

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[1]"Continental Has a Union on the Run," Business Week, September 5, 1983, p. 34.

[2]Roy Rowan, "An Airline Boss Attacks Sky-High Wages," Fortune, January 9, 1984, p. 72.

it needed to expand. Pan American eventually won out in the aggressive bidding for National stock, but in the process Texas International earned a profit of $47 million from the sale of National stock. Texas International became Texas Air Corp, an airline holding company now in a position to branch out. In 1980, Mr Lorenzo launched his attack against unions by starting the nonunion New York Air. This airline was created to challenge Eastern's monopoly in the Boston-Washington corridor. It became profitable during 1983. In the meantime, Texas Air was fighting for control of Continental. It succeeded in June 1982. By January 1984, Jet Capital owned sixteen percent of Texas Air. Texas Air in turn owned ninety-one percent of Continental and sixty-four percent of New York Air.[3]

During that three year period when Texas Air was fighting for control of Continental, the latter's financial condition was deteriorating steadily. A chronic cash shortage required Continental to take drastic measures to maintain working capital. Between April 1982 and January 1984, Continental sold off $109 million in assets, raised $143 million through debt and equity financing, and accepted $80 million in cash infusions from Texas Air.[4]

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[3]Ibid.

[4]Ibid.

5.3 PRE-CHAPTER 11 ACTIONS

Upon taking control of Continental, Mr. Lorenzo immediately began to attack the high wage structure. Even though he had extracted $100 million worth of concessions from Continental's pilots, had laid off more than 3,500 employees and had trimmed operations by twelve percent, Lorenzo placed an ultimatum before the unions in September 1983 - either accept a new employee stock ownership plan or face bankruptcy. He asked for a voluntary reduction in labor costs of $150 million. In return he offered a twenty-five percent employee share of future profits, and an employee-elected director. The offer was sweetemed by a Texas Air offer of a thirty-five percent employee ownership position. The International Machinists Union struck, and the stock-sharing and wage reduction program was rejected.[5] On September 24, 1983, Continental filed for Chapter 11.

By preparing for the Chapter 11 filing in advance, Continental ceased operations for a mere three days before it began flying again. The company had at least $50 million in cash at the time of the filing, enough to hire strike-breaking pilots, machinists and ticket agents. Under the provisions of its Chapter 11 filing, Continental was able

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[5]Erwin J. Bulban, "Continental Regroups Under Chapter 11," Aviation Week and Space Tenhnology, October 10, 1983, p. 33.

to resume operations with several significant changes. Domestic service was reduced to twenty-five cities compared with seventy-eight prior to shutdown, with 118 daily departures instead of 540 previously, and 11.8 million available seat-miles instead of 42.6 million. The number of employees was reduced from 12,000 to 4,200, with recalled personnel accepting wage cuts of fifty percent. Executives and other management personnel salaries were reduced by fifteen percent, and office staff was cut sixty-five percent.[6]

The pilots that continued to fly through the strike accepted an increase in flying hours from fifty-four to eighty, and a cut in wages to $43,000. Flight attendants accepted a new $15,000 wage base. Mr. Lorenzo himself reduced his own compensation from $267,000 in 1982 to the same wage as pilots. He promised to stay at that wage until the airline becomes profitable.[7]

The success of these cost reduction techniques is being closely observed by airlines in similiar positions, namely Eastern and American. Mr. Lorenzo's ability to force unilateral concessions on the union has suddenly added new clout to airline management's bargaining position throughout the industry.

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[6]Ibid.

[7]"America'a Airlines - A New Chapter," Economist, October 1, 1983, p. 68.

5.4 THE BILDISCO PRECEDENT

As mentioned before, all this seems to have started with the Bildisco case. In 1980, Bildisco was a hundred person manufacturer and distributor of building supplies. It had only a few months before filing for Chapter 11 signed a labor contract for its thirty drivers with Teamsters Local 408 in New Jersey. Because of financial problems, Bildisco left the distribution side of its business. This firm retained only two employees doing Teamster-like work. The Bankruptcy Court gave Bildisco approval to abrogate the recently signed union contract, reducing its Teamster wages from $18 per hour to $12 per hour.[8]

Prior to the 1978 changes in the bankruptcy law, abrogation of labor contracts was allowed only if the employer proved that bankruptcy and dissolution were imminent if extraordinary relief was not available. The union position is well stated by Ken Nowak, Teamster Local 408 attorney:

> "We are not saying that bankruptcy courts can't abrogate labor contracts, but we are saying that Congress has provided all sorts of protection for labor contracts that companies are evidently circumventing through innovative uses of Chapter 11 Bankruptcy.[9]

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[8]"Bankruptcies That Slash Labor Costs," Industry Week, October 17, 1983, p. 19.

[9]Ibid., p. 10.

5.5 SUMMARY

Continental Airlines, like other large trunk airlines prior to deregulation, had allowed wages to climb to levels that became economically unjustifyable when competition hit the airlines. The winnowing process of free enterprise dictated that this airline either restructure its wage levels significantly, or face dissolution. Continental's bankruptcy would have a disasterous impact on the industry and on employment in general. It takes a heavy hand to beat back hard won union momentum in achieving increased wage levels for union members, and Chapter 11 has provided the clout for Continental's management to use to avoid dissolution. But it is the unilateral heavy-handedness that concerns people involved with labor-management issues. Once again Congessional action will be required to limit the right of employers to utilize Chapter 11 to abrogate union contracts.

Because of the Bankruptcy Court's liberal interpretation of the right of management to abrogate union contracts, Chapter 11 may be temporarily effective in restructuring the airline industry's wage scale. However, Congress has traditionally supported the collective bargaining process. Indeed, legislation has already been introduced to assure that collective bargaining is supported in the courts.

CHAPTER SIX

SUMMARY AND CONCLUSIONS

This is a time of transition for the entire bankruptcy court system. At the same time the jurisdiction of the bankruptcy judges is under challenge, the use of Chapter 11 in innovative ways is expanding. By using laws designed to protect creditor's interests, corporations have been able to forestall enormous liability suits, and force unilateral wage scales in the place of collectively bargained contracts. Is this creative management or is it an abuse of the system? Specialists in this area have voiced these comments:

> Ray Rodgers, director of Corporate Campaign Inc, a labor consulting firm: "In some respects, Frank Lorenzo is doing for management what unions should be doing for labor - thinking up new strategies to deal with labor-management problems. There are strategies that labor and public interest groups can use to counter abuse of bankruptcy proceedings."[1]

> Henry A. Duffy, president of the Airline Pilots Association: "If Continental is successful in imposing its wages and working conditions, that is going to be a role model for other airlines to follow. We are going to make Chapter 11 so difficult and so expensive that no

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[1]"Lorenzo Battles to Keep His Airline Aloft," Business Week, October 17, 1983, p. 42.

company can use it to slide out of its labor contracts so easily."[2]

Rep. George Miller (D-Calif.), chairman of the House Labor Standards Subcommittee: "Recent bankruptcy proceedings are undermining the foundation of labor-management relations. Legislation will be introduced to assure fairness in industrial relations."[3]

Earnest J. Nagy, chairman and CEO of Riblet Products Corp: "The airline industry is sick and has to do something, and if Chapter 11 is one of the vehicles get well again, then I'm all for it. I'm not anti-union, but if Continental can reorganize under Chapter 11 and cut down their fat and lower their wages, then it's a pretty good thing."[4]

Felix Rohatyn, head investment banker with Lazard Freres: "In a bankruptcy case, all major participants must make sacrifices for the company to survive. I would like to see a business-labor-government board that would look at such industrial problems as they evolve and develop proposals."[5]

Herman Glatt, chairman of the Business Bankruptcy Committee of the American Bar Association: "The entire thing is subject to mass confusion. The issue of union contracts has distracted many people from the more critical need of preserving working bankruptcy courts."[6]

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[2]James Ott, "Unions Attack Continental, Eastern Moves," Aviation Week and Space Technology, October 10, 1983, p. 12.

[3]Industry Week, October 17, 1983, p. 20.

[4]Ibid.

[5]Josh Martin, "The Various Uses of the Bankruptcy Laws," Financial World, December 31, 1983, p. 44.

[6]Ibid.

The changes to the Bankruptcy Code in 1978 appear to have created an open door to the use of Chapter 11 in innovative and controversial ways. But this is a temporary situation, with all the above issues before Congress. Eventually Congress will resolve the jurisdictional issue. Congress is also likely to limit the more controversial thrusts made by management in the use of Chapter 11. This will probably be resolved with a re-introduction of some form of a solvency test, as well as with legislation limiting the wholesale abrogation of union contracts. Possibly there will be mandated arbitration in future cases similiar to Continental.

These developments represent a growth spurt in the evolutionary development of bankruptcy law. It is also a period of crisis, but in that crisis, the issues are crystalizing, providing Congress with the opportunity to resolve them. The end result will be, no doubt, a maturation of bankruptcy law.

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