Employment protection in reorganization proceedings – a comparative view

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One of the important causes of corporate insolvency is unsustainable labor costs. Corporations reach expensive labor agreements in times of prosperity, only to realize, in times of downturn, that they are unable to afford the agreed costs. General Motors, American Airlines and Bethlehem steel are but few examples of firms that entered into financial distress partly due to problematic labor agreements, and they filed for bankruptcy in an attempt to decrease their employment costs and to rehabilitate.

The intersection between bankruptcy and labor laws, however, raises difficulties. On the one hand, the rehabilitation of the business entity may require difficult employment measures to be taken. In order to decrease the debtor’s costs, employment contracts need to be terminated and working conditions modified. On the other hand, labor laws often limit such changes. Employees are sometimes protected by statute or by a collective bargaining agreement, and generally an employer cannot unilaterally override the protections and terminate or modify the contracts. So how such employment protections need to be treated during bankruptcy? Should labor law remain unchanged also when a firm undergoes insolvency proceedings, or should bankruptcy law override “regular” labor laws and facilitate corporate rehabilitation, perhaps at the expense of some of the debtor’s employees?

The paper examines this issue from a comparative perspective. It studies five different jurisdictions – Israel, United States, the Netherlands, France and Germany, and

looks into the bankruptcy modifications to labor laws in each of those systems. The first part of the paper reveals an interesting yet so far unexplored phenomenon. The United States, which generally has relatively weak employment protections, tends to keep the protections also during a bankruptcy process. Although bankruptcy laws in the United States make some changes in labor laws, by and large the debtor’s is subject to the same rules as the employer before him and rehabilitation does not serve as a justification for a unilateral modification of labor rights. On the other hand, European countries with relatively strong employment protections, like France, Germany or the Netherlands, change their labor practices within insolvency proceedings in order to promote the survival of businesses as going concerns. They limit employees’ rights when the employer files for bankruptcy, and allow for easier and faster dismissal procedures. Although no doubt the bankruptcy in those countries does not make the labor markets flexible or protection free, it does change the level of employment protection – in certain respects even brings it close to level in the United States.

This European approach seems contrary to what has become the “founding narrative” of bankruptcy law in the United States – the proceduralist view of bankruptcy. According to the procedural approach, bankruptcy law should mirror the non-bankruptcy legal entitlements. The legislator determines the creditors’ rights in general (the law outside bankruptcy), and unless some bankruptcy policy requires otherwise, bankruptcy law implements those rights within a bankruptcy process. In Europe, on the other hand, at least with regard to labor issues, bankruptcy law serves as a kind of a balancing system. Labor laws outside bankruptcy are highly inflexible, and the bankruptcy system somewhat

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3 See, Martha West II, at page 161 (“Congress rejected the Supreme Court’s attempt to reconcile the legal conflicts by elevating bankruptcy principles over labor law obligations.”); Miller et al. at page 495 (“Consequently, it is hard to conclude that the power of organized labor has substantially diminished in the chapter 11 context”); Cuevas at 199 (“Its [section 1113’s – o.k] policy of encouraging negotiation between a debtor and a union is consistent with both bankruptcy and labor law.”); Daniel Keating at page 548 (“...the NLRA provides that existing labor agreements can only be modified or terminated through a process involving notice and bargaining. This rule, in fact, is fairly similar to the result under the more elaborate standard set down in section 1113”)

4 Also see, Rojer Blanpain, Employees Rights in Bankruptcy – A Comparative Law Assessment (“Employees’ protection against dismissal is extremely limited in the context of bankruptcy...General bans on dismissal for specified categories of grounds for dismissal and dismissal situations play a role, at most, when the receiver is pursuing a strategy of selective dismissals.”)

5 This is also the way the federal bankruptcy code deals with labor rights. Although there are some bankruptcy modifications, an employer cannot expect to do better than it did before as a result of the filing.
modifies the rigid rules when the employer files a bankruptcy petition. This approach, especially when compared to the law in the United States, may seem somewhat surprising. Germany, France and the Netherlands are countries with a relatively high degree of employment protection. Labor unions enjoy considerable political powers, and they usually aim to strengthen employment rights. Thus, if a protectionist approach rightly captures the political and other considerations outside bankruptcy, why should there be a change inside bankruptcy? How come the unions allow (or as I argue – even support) the reduction of employment protections?

The second part of the paper aims to answer this puzzle. I argue that the employees’ interests change during a bankruptcy process. Outside bankruptcy high employment protection levels benefit the employees. Employees enjoy the job security the protections give, while the costs of the protections are shifted (at least in part) to the employer or to the general public. Inside bankruptcy, on the other hand, a high level of protection may be harmful to employees. Reduced employment costs may be essential to the continued operation of the firm, but rigid labor laws are liable to steer the firm towards liquidation. Employment protection might block the implementation of necessary operational measures, which can potentially benefit the majority of employees. Strategically then the employees have an interest to possess the power to waive some of their own protections in bankruptcy. The majority of employees need to decide if the proposed operational measures are to their advantage, and if so – to make the employment concessions necessary for the implementation of those measures.

The problem is that even when reorganization measures benefit the employees as a group, the dismissed individuals (a dissenting minority) may try to challenge them. Using their employment protections, the dismissed employees can argue the terminations are unlawful, or try to maximize the severance pay or damages they receive as a result. Such challenges can harm the employees’ group as a whole. They prolong the procedure of the terminations, render them more expensive, and hence impair the firm’s rehabilitation prospects. Ex-ante, therefore, behind a veil of ignorance where no employee knows if he will be the one dismissed or not, employees have an interest to limit the individual protections in bankruptcy. In case the majority of employees view the reorganization

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6 John Armour and Simon Deakin, Supra note 1.
measures as beneficial, the dismissed individuals’ ability to challenge the measures should be limited to the benefit of the group.

And indeed, the modifications to labor laws among the three European systems examined in the paper go along these lines. First, whereas outside bankruptcy employers need to justify the dismissals, inside bankruptcy the justification requirement is weakened or even eliminated. This means that when terminations take place as part of a bankruptcy process, the terminated employees’ ability to contest them is decreased. Second, the procedure for the terminations becomes easier. The pre-termination notice shortens, and the consultation requirements are modified to fit a bankruptcy process. Third, whereas outside bankruptcy terminations in connection to a sale of business (“transfer of business”) are strictly prohibited, inside a bankruptcy process they are allowed. An employer that sells its business inside bankruptcy may dismiss employees that the buyer does not seek to employ, and the buyer is not responsible for the employer’s pre-petition employment obligations. The paper shows that most of the changes that occur in bankruptcy are at the individual level. To the extent the works council has the right to be consulted or negotiated with outside bankruptcy, the council’s rights are preserved inside the bankruptcy procedure as well (albeit in a somewhat modified procedure).

Note that the argument here is of a positive nature. I do not argue that the bankruptcy modifications are desirable, and I make no claim as to their efficiency. Rather my aim is to characterize the modifications and explain why they occur in jurisdictions with high employment protection levels. I show that the employment protections given to the individual employees become problematic to the employees’ group in bankruptcy, because they can jeopardize reorganizations that benefit the employees as group. Thus, the same interest groups that champion the protections outside bankruptcy - the unions – have an interest to soften them up when the employer reaches insolvency.

After explaining the rationale for the bankruptcy modifications, the third part of the paper examines some of the problems they create. According to proceduralist bankruptcy theory, one of the main problems in changing substantive law in a bankruptcy process is forum shopping. The legal differences among the various collection proceedings incentivize the parties to choose the forum that maximizes their collection, and the perverse incentives result in a battle over which the proceedings will take place. The bankruptcy
modifications in labor law demonstrate this point. The paper in this context differentiates between two types of forum shopping: among different bankruptcy proceedings and between bankruptcy and non-bankruptcy forums.

The first type of forum shopping is relatively obvious in the Netherlands and in France. Both jurisdictions have several types of bankruptcy proceedings, and the labor law modifications are implemented in some of the proceedings but not in others. The paper shows that proceedings in which the modifications are implemented are significantly more popular than proceedings in which labor law remains unchanged. This occurs even when the alternative proceedings are better geared towards reorganization, and may improve the chances of rehabilitation. In the Netherlands, for example, the vast majority of firms choose an auction type of bankruptcy over a reorganizational type. According to empirical research conducted among small and medium firms, about 20% of the corporations that filed for bankruptcy mentioned employment benefits as part of the reasons for their procedural choice.

The second type of forum shopping is less prevalent. Although there are indications that it does exist, it seems that corporations do not tend to file for bankruptcy only to enjoy the labor law benefits. The reason for the infrequency of strategic bankruptcy filing is procedural. Bankruptcy proceedings that involve significant changes to labor laws usually mandate the appointment of a trustee (rather than a debtor in possession). The trustee replaces the incumbent management, and it is hard to imagine that management will be willing to sacrifice its control over the firm in order to gain employment flexibility. Management, therefore, has little interest to file for unneeded bankruptcies.

The appointment of a trustee, however, although it decreases forum shopping, also entails a price. Since the incumbent managers know that once a trustee is appointed they will lose control over the firm, they have an interest to delay the filing. Such delays decrease the firm’s value, because the firm fails to implement necessary reorganizational measures in time. By the time the firm files for bankruptcy its continuation as a going concern may no longer be a viable option, and more firms undergo liquidations. This effect may be detrimental to employees, and may even outweigh the benefits they gain from the labor law modifications.