Good Intentions, Bad Economics: Retiree Insurance Benefits in Bankruptcy

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Good Intentions, Bad Economics: Retiree Insurance Benefits in Bankruptcy

Dan Keating*

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I. INTRODUCTION

One of the emerging corporate problems of the 1980s, retiree insurance benefits, has met face to face with an increasingly common corporate solution, Chapter 11 reorganization. The intersection of these two

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phenomena first gained national attention with the July 1986 bankruptcy filing of the LTV Steel Corporation. Immediately after seeking bankruptcy court protection, LTV informed its 68,000 retirees that the company temporarily would cease to pay the medical and life insurance benefits that it had promised these former workers when they retired.

Prompted by tragic stories of LTV retirees and their spouses who were forced to postpone critical medical treatment, Congress enacted a temporary bill that mandated continuation of payments to retirees during LTV's reorganization. Even before Congress passed that measure, union workers staged a labor strike at one of LTV's major steel plants to protest the retiree benefits cutoff. LTV's management responded to the strike by obtaining an order from the bankruptcy court allowing the company to resume benefits during the pendency of the Chapter 11 bankruptcy.

Although the immediate LTV crisis had passed, Congress eventually enacted permanent legislation intended to respond on a broader scale to the problem of retiree insurance benefits in Chapter 11 reorganizations. On June 16, 1988, President Reagan signed into law the new legislation, which gives a special priority status to retiree medical and life insurance benefits in Chapter 11 reorganization cases. Most of this legislation is contained in a new provision to the United States Bankruptcy Code, section 1114.

Undoubtedly Congress believes that the nation's retirees can feel secure now that section 1114 is part of the Bankruptcy Code. Unfortu-


2. LTV's communication to its retirees took the form of a letter dated July 17, 1986. For a copy of that letter, see Commercial Law Hearing, supra note 1, at 149.


4. For a copy of LTV's application to the bankruptcy court for permission to resume payments to retirees, as well as the order that allowed LTV to resume such payments, see Commercial Law Hearing, supra note 1, at 154-67.

5. See infra text accompanying notes 79-138.


8. See, e.g., 134 CONG. REC. S9236-27 (daily ed. May 26, 1988) (statement of Sen. Howell T. Heflin) (remarking that "I am proud to have been part of an effort that will provide my fellow Alabamians and other retirees across this Nation with a greater sense of security—that our Nation's tremendous health care resources will be available to them in times of need").
nately, section 1114 does little to increase the likelihood that retirees will receive their promised health and life insurance benefits. Because section 1114 applies only to Chapter 11 cases, the new legislation will affect only a small percentage of cases in which companies become insolvent. Although retirees now will receive a special priority for their benefits claims in Chapter 11 cases, they will have no similar preferred position in Chapter 7 liquidation cases or in nonbankruptcy dissolutions.

More significantly, section 1114 may make it less likely that companies with significant retiree benefits liabilities will be able to reorganize successfully. If retirees receive a greater relative entitlement in a Chapter 11 case than in a Chapter 7 case, other unsecured creditors will see their recovery in a Chapter 11 case reduced. Thus, these nonretiree unsecured creditors may have an incentive to block a company's Chapter 11 reorganization plan even when that company's going-concern value would be realized best in the Chapter 11 forum. This rearrangement of nonbankruptcy entitlements, even though for the benefit of a sympathy-evoking class like retirees, undermines two of the most fundamental reorganization goals: equality of distribution and preservation of going-concern value.

Probably the greatest weakness of the new retiree benefits legislation is that it fails to address the real problem behind crises like that in the LTV reorganization: the failure to prefund the corporate promise to provide insurance benefits to retirees. If a company has not set aside assets to cover its promise to retirees, a mere change in the Bankruptcy Code cannot overcome that void. The new benefits legislation is not broad enough to give any true protection to retirees, yet the legislation alters the nature of the Chapter 11 bargaining process significantly enough to make a reorganization less likely for any company with large retiree benefits liabilities.

11. 11 U.S.C. § 1114(e)(2) (1988) (providing that “[a]ny payment for retiree benefits required to be made before a plan confirmed under section 1129 of this title is effective has the status of an allowed administrative expense as provided in section 503 of this title”).
12. Id. § 103(f) (noting that Chapter 11 provisions apply only to cases brought under that chapter).
13. See infra text accompanying notes 158-79.
14. Id.
15. See infra notes 186 & 188.
This Article explores the problem of retiree insurance benefits. Part II addresses what they are, when they vest, how they are funded, and how they differ from pension benefits. Part III of the Article discusses the treatment of retiree benefits in bankruptcy before the enactment of section 1114. Part IV then describes in detail the specific operation of section 1114 and notes its significant ambiguities. In Part V the Article shows why section 1114, though well intentioned, is a dangerous and counterproductive statute that will increase significantly the transactions costs in Chapter 11 negotiations and thereby decrease the likelihood of successful reorganizations. Rather than giving retirees increased protection for their nonpension benefits, section 1114 merely damages an already fragile reorganization process. Finally, the Article will propose that the best approach to the retiree benefits crisis is an ERISA-type prefunding requirement.

II. RETIREE INSURANCE BENEFITS

A. PREVALENCE OF RETIREE INSURANCE

Probably the greatest single expense facing retired persons is the cost of their medical care.\(^\text{16}\) Even those workers whose pension benefits vest fully before age sixty-five may choose not to retire early because a large price tag attaches to medical coverage for older policy holders.\(^\text{17}\) Many companies, in an effort to encourage early retirement, have included provisions for continued health and life insurance in their retirement packages.\(^\text{18}\)

The increase in employer-sponsored retiree health benefits is a tacit acknowledgment by the business world that Medicare's gaps are often more significant than its coverage. For example, because of an increase in early retirement programs, nearly forty percent of all current retirees are not covered by Medicare.\(^\text{19}\) Those retirees who have reached

16. Retirees who are over 65 and covered by Medicare but not by an employer-sponsored health plan spend up to one-third of their income on additional coverage and out-of-pocket medical expenses. See Retiree Health Benefits Hearings, supra note 10, at 94.

17. Retired couples between the ages of 62 and 64 who are not covered by either Medicare or by an employer-sponsored health plan spend an average of 56% of their Social Security benefits to pay for their medical premiums. Id. at 97.


19. LTV Hearing, supra note 3, at 7 (statement of Lynn Williams, international president, United Steelworkers of America).
the minimum age for coverage often need supplemental insurance to meet the increasingly large deductibles and copayments that Medicare requires.20

Although retiree insurance benefits were provided initially by only the largest firms, such benefits are becoming more common in medium-sized and smaller companies. More than eighty percent of the employees in large companies have been promised some form of postretirement health coverage. Half of the employees in medium-sized firms can expect medical insurance benefits when they retire.21 Nearly seven million current retirees and their dependents rely on employer-sponsored health insurance,22 and that number is expected to double in the next ten years.23

B. Vesting: Timing and Contractual Existence

In the last few years, a number of retirees have been shocked to discover that the postemployment insurance benefits they received from their former companies could be taken away from them without reason or warning.24 Such retirees have challenged their former employers in court on this issue with mixed results. When courts have found that the insurance benefits were vested, they have held that the retirees were entitled to recover from the employer the present value of that benefit.25 When courts have determined that such benefits were not vested, however, the retirees have been left with no recourse.26

Although pension benefits and welfare benefits seem very much alike, the rules that govern them are quite different. The requirements for vesting of pensions are both highly regulated and very complicated due to the advent of ERISA.27 Because ERISA’s vesting requirements

21. Id. at 98.
22. Id. at 94.
25. See, e.g., Weimer v. Kurz-Kasch, 773 F.2d 669 (6th Cir. 1985); see also Bower v. Bunker Hill Co., 725 F.2d 1211 (9th Cir. 1984).
do not encompass retiree insurance benefits, the law concerning vesting of these nonpension benefits has been more fluid and much less certain than comparable law covering pensions. One major difference between the vesting of these two types of benefits is that the worker has no entitlement to retiree insurance premiums until the actual point of retirement. By contrast, ERISA mandates that after a minimum number of years on the job with the same employer, the employee becomes entitled to the pension funds that the employer has accrued on the employee's behalf. Thus, if an employee terminates employment prior to retirement, she is entitled to a portion of her pension benefits but none of her retiree health insurance. The more fundamental distinction, however, between pension vesting and retiree insurance vesting goes to the character and existence of the promise itself. Under ERISA regulations, a retiree who receives an employer-sponsored pension could not find that her employer suddenly had terminated her pension. Depending, however, on the terms of and the circumstances surrounding a retiree insurance program, that same employer may have the legal right


The term "accrued benefits" [in ERISA] refers to pension or retirement benefits and is not intended to apply to certain ancillary benefits, such as medical insurance or life insurance, which are sometimes provided for employees in conjunction with a pension plan, and are sometimes provided separately. To require the vesting of these ancillary benefits would seriously complicate the administration and increase the cost of plans whose primary function is to provide retirement income.


29. See 29 U.S.C. § 1051(1) (1982 & Supp. V 1987); see also International Ass'n of Bridge, Structural and Ornamental Iron Workers Local No. 111 v. Douglas, 646 F.2d 1211, 1215 (7th Cir.), cert. denied, 454 U.S. 866 (1981) (stating that "welfare benefits do not become vested until a claim arises that is payable under the Plan; these benefits are contractual rights subject to amendment by parties to the Agreement").


31. Since Congress passed the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), Pub. L. No. 99-272, 100 Stat. 222 (codified in scattered titles of U.S.C.), workers who terminate their job with an employer before retirement do have some protection with respect to their employer-sponsored group health insurance plan. COBRA enables employees who lose their jobs or retire to purchase health coverage at the group rate for at least 18 months following termination of their employment. See id. § 10001(k)(2)(B)(i)(I), 100 Stat. at 224 (codified at 26 U.S.C. § 162(h)(3)(B)(i)(I) (Supp. V 1987)).

32. In addition to mandating certain vesting requirements, ERISA includes plan termination insurance requirements. See 29 U.S.C. § 1321(a)(1) (1982 & Supp. V 1987). Thus, even if an employer fails properly to fund its employees' pensions, the workers will be protected through the federal Pension Benefit Guarantee Corporation (PBGC). The PBGC protects the retirement income of more than 38 million workers and retirees in more than 112,000 private sector pension plans. See LTV Hearing, supra note 5, at 56 (testimony of Kathleen P. Utgoff, executive director, PBGC).
to cease paying insurance premiums on behalf of retirees.\textsuperscript{33}

The leading opinions in the area of retiree insurance vesting, \textit{United Automobile Workers v. Yard-Man, Inc.}\textsuperscript{34} and \textit{In re White Farm Equipment Co.}\textsuperscript{35} are both from the Sixth Circuit. Together these two cases allow employers to terminate retiree insurance programs if the documents that create the plan unambiguously reserve such a right.\textsuperscript{36} Any case in this area necessarily will be very fact-specific, even when the employer has reserved a right of termination in a written plan document. The \textit{Yard-Man} and \textit{White Farm} courts held that oral promises made to retirees as well as surrounding circumstances creating an obligation on the part of an employer may remove a right to termination that the employer had reserved in writing.\textsuperscript{37}

The vesting question is critical in the context of section 1114 because the new Bankruptcy Code section might not apply if a retiree benefits program is terminable at will under state law.\textsuperscript{38} Arguably, the language of section 1114(e)(1) which states that the debtor-in-possess-

\textsuperscript{33} See, e.g., \textit{In re White Farm Equip. Co.}, 788 F.2d 1186 (6th Cir. 1986); see also Turner v. Local 302, Int'l Bhd. of Teamsters, 604 F.2d 1219 (9th Cir. 1979).
\textsuperscript{35} 788 F.2d 1186 (6th Cir. 1986).
\textsuperscript{36} In \textit{Yard-Man} the court held that the employer unlawfully terminated the health and life insurance benefits of its retirees upon the expiration of the collective bargaining agreement. \textit{Yard-Man}, 716 F.2d at 1482-83. Although the court in \textit{Yard-Man} held for the retirees, the opinion emphasized that it was the intent of the parties in the collective bargaining agreement that led to this conclusion. \textit{Id.} at 1479-80. The \textit{Yard-Man} opinion also created a presumption in favor of vesting, absent language to the contrary: "retiree benefits are in a sense 'status' benefits which, as such, carry with them an inference that they continue so long as the prerequisite status requirement is maintained." \textit{Id.} at 1482.

The \textit{White Farm} case, unlike \textit{Yard-Man}, involved retiree benefits that did not find their source in a collective bargaining agreement. After \textit{White Farm} filed a petition under Chapter 11 of the Bankruptcy Code, it continued to fund retirement benefits. After a few months, however, the company notified its retirees that the plan would be discontinued. When former employees and their spouses sued for reinstatement of benefits, the bankruptcy court upheld the employer's right to terminate the plan because language in the summary booklets describing the plan gave the employer an explicit right to discontinue the plan. \textit{In re White Farm Equip. Co.}, 23 Bankr. 85 (Bankr. N.D. Ohio 1982), rev'd, 42 Bankr. 1005 (N.D. Ohio 1984), rev'd, 788 F.2d 1186 (6th Cir. 1986). After the district court reversed the bankruptcy court, the Sixth Circuit reversed the district court and remanded the case to the bankruptcy judge. The Sixth Circuit held that parties may reserve a right to terminate or modify welfare benefits plans and that "the legislature, rather than the courts, should determine whether mandatory vesting of retiree welfare benefits is appropriate." \textit{White Farm}, 788 F.2d at 1193.

\textsuperscript{37} See \textit{Yard-Man}, 716 F.2d at 1479-80 (in interpreting the contract, courts must look to the context in which specific language arose); see also \textit{White Farm}, 788 F.2d at 1193 (in determining whether vesting of retiree benefits was intended, courts may look to surrounding circumstances in order to draw inferences or make presumptions on issue of terminability).

\textsuperscript{38} \textit{Retiree Health Benefits Hearings}, supra note 10, at 62 (statement of Douglas G. Baird) (noting that prior to the enactment of § 1114, if the employer had a contractual right to terminate benefits under state law, the employer would have the same right in bankruptcy).
sion "shall timely pay and shall not modify any retiree benefits" requires companies in Chapter 11 to continue retiree insurance benefits payments whether or not those benefits were vested under state law. Nevertheless, the resolution of the vesting issue under state contract law may determine whether the retiree has an unsecured claim in bankruptcy subject to special elevation in status under section 1114, or simply no claim at all.

C. The Funding Void

Even if retirees can prove that their insurance benefits are vested, they cannot be certain that they will continue to receive them. Without adequate prefunding, an unambiguously vested retiree insurance program remains a promise whose worth is a function of the financial health of the company that has made it. Just as with vesting, the vast difference between corporations’ funding of pensions and their funding of retiree insurance is primarily a product of ERISA. With pensions, ERISA mandates certain minimum funding levels so that even when a company becomes insolvent, its pension obligations will be met. Because ERISA’s funding requirements do not apply to retiree insurance benefits, virtually all companies that provide these benefits treat the cost of such programs as an annual expense. There has been little incentive for companies to prefund nonpension benefits for retirees, especially because the Deficit Reduction Act of 1984 removed the tax benefits of such prefunding.

The failure of businesses to prefund vested retiree insurance benefits may lead to a major financial crisis, with some estimates of total unfunded retiree medical liabilities approaching two trillion dollars.

40. See 29 U.S.C. §§ 1081-1086 (1982 & Supp. V 1987) (describing ERISA minimum funding requirements). Even when a company fails to comply with the minimum funding requirements, the PBGC will ensure that retirees receive their promised pensions. See supra note 32. When LTV filed bankruptcy, for example, the company had underfunded its pension plan by about $1.7 billion. See LTV Hearing, supra note 3, at 59 (testimony of Kathleen P. Utgoff, executive director, PBGC).
41. About 95% of businesses that provide retiree medical benefits pay as they go. See Searfoss & Erickson, The Big Unfunded Liability: Postretirement Healthcare Benefits, 166 J. Acct. 28, 30 (1988).
42. See Retiree Health Benefits Hearings, supra note 10, at 110 (asserting that almost no employers currently prefund retiree insurance benefits; the passage of the Deficit Reduction Act of 1984 largely eliminated tax-favored funding options); see also Searfoss & Erickson, supra note 41, at 29 (alleging that one reason companies do not prefund retiree medical benefits is that payments to prefund such plans are not tax deductible, unlike excess contributions to a pension trust).
43. See Oversight Subcommittee Turns Spotlight on Retiree Health Plans, 40 Tax Notes 1225 (1988); see also Melbinger, supra note 1, at 650 (estimating unfunded retiree benefits liabilities for Fortune 500 companies alone at $2 trillion, even though the assets of those same companies are valued at only $1.3 trillion).
For some industrial companies, the present value of promised retiree medical benefits may exceed the net worth of the company.44 Several factors have contributed to the massive liability represented by unfunded retiree benefits at many large businesses. First, annual increases in the cost of health care consistently have outstripped the national inflation rate.45 Second, employees retire earlier and live longer than in the past, a dual-edged increase in the length of time during which the retirees will collect insurance benefits.46 Finally, in many manufacturing industries the competition of imported products has led to a decline in the number of active workers; in some companies the number of retirees is twice the number of current employees.47

One development that may change the way companies treat retiree insurance costs is the proposal by the Financial Accounting Standards Board (FASB) to force companies to recognize the total present value of accrued nonpension retiree benefits on their balance sheets.48 Previously, businesses could treat the cost of retiree medical benefits as an annual expense.49 Enactment of the new FASB proposal, which would be phased in over a five-year period, is likely to prompt diverse reactions from the corporate world. Some companies may respond to the change by an investigation into the practicability of prefunding benefits.50 Other businesses may discontinue such benefits in the future ex-

45. In fact, health care costs have risen three times faster than the consumer price index over the last 20 years. See Corporate Retiree Health Benefits: Here Today, Gone Tomorrow: Hearing Before the House Select Comm. on Aging, 98th Cong., 2d Sess. 99 (1984); see also Liebtag, Health Benefits for Retirees, 164 J. Acct. 100, 101 (1987) (noting that in the early 1980s, health benefits expenses increased as much as 16% annually).
46. See Searfoss & Erickson, supra note 41, at 30 (stating that the over-65 population is expected to have increased by 63% by the year 2020); see also Retiree Benefits Protection Act of 1987: Hearing on H.R. 2969 Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary, 100th Cong., 1st Sess. 202 (1987) [hereinafter Protection Act Hearing] (statement of Joseph Patchan, Esq. and Susan B. Collins, Esq.).
47. See Searfoss & Erickson, supra note 41, at 32.
48. See generally id. at 30-39 (explaining the FASB proposal). If the FASB exposure draft is adopted, it probably will become effective for fiscal years beginning after December 15, 1991. Companies’ unrecorded liabilities for retiree benefits will be included on balance sheets under this proposal. Recognizing these estimated future liabilities will reduce net income and even may cause some companies to violate existing loan covenants. See Cooper & LyBrand, Accounting for Retiree Health Benefits: Addressing the Broader Business Issues 1 (Mar. 1989).
49. See supra text accompanying notes 41-42. Although businesses have not yet been forced to recognize their unfunded retiree benefits obligations as a balance sheet liability, since 1984 the FASB has required that companies disclose in financial statement footnotes the costs of life insurance for retirees and the costs of health care for retirees, surviving spouses, and dependents. Disclosure of Postretirement Health Care and Life Insurance Benefits, Statement of Financial Accounting Standards No. 81, § 6-7 (Fin. Accounting Standards Bd. 1984).
50. See Retiree Health Benefits Hearings, supra note 10, at 110 (stating that employer interest in prefunding is increasing with the threat of the new FASB proposal).
cept for retirees whose rights have vested already.\textsuperscript{51}

With or without passage of the FASB proposal, the problem of unfunded retiree insurance benefits will become more severe in the next several years. For many businesses that are faced with the prospect of paying for promises they can no longer keep, a bankruptcy filing may prove to be the only viable option.

III. Retiree Benefits in Bankruptcy Before Section 1114

A discussion of the status of retiree benefits in Chapter 11 cases prior to the enactment of section 1114 is complicated by at least two factors. First, courts have distinguished between retirees whose postemployment insurance benefits were included in a collective bargaining agreement and retirees whose benefits were not part of a union contract.\textsuperscript{52} Many companies in Chapter 11 will have retirees in both categories.\textsuperscript{53} Second, to the extent that retirees' benefits were part of a collective bargaining agreement, the treatment of those benefits in Chapter 11 cases was affected by the enactment in 1984 of Bankruptcy Code section 1113.\textsuperscript{54} That section restricts the ability of a company in Chapter 11 to reject a collective bargaining agreement.\textsuperscript{55}

A. Salaried Retirees

Before the enactment of section 1114, retirees whose benefits were not part of a collective bargaining agreement had no special priority to a company's assets in a Chapter 11 reorganization. If they could show that their benefits were vested, these retirees were eligible to file a claim in the bankruptcy.\textsuperscript{56} Because any retiree entitlement to unpaid past and future benefits was based on a breach of contract, it was an unsecured claim.\textsuperscript{57} In other words, salaried retirees would not receive any of their nonpension benefits until debts of secured creditors and

\begin{itemize}
\item \textsuperscript{51} \textit{Id.} at 111 (stating that new regulations that make providing retiree benefits more burdensome would encourage some employers who currently offer such benefits to terminate them).
\item \textsuperscript{52} \textit{See infra} text accompanying notes 56-74.
\item \textsuperscript{53} \textit{See, e.g., In re McLouth Steel Corp.}, 23 Bankr. 167 (Bankr. E.D. Mich. 1982) (deciding that nonunion retirees were not denied equal protection by a Chapter 11 debtor continuing to pay union retirees medical benefits while refusing those same benefits to nonunion retirees). The LTV case involved both union and nonunion retirees. \textit{See Commercial Law Hearing, supra} note 1, at 47 (statement of Herbert P. Minkel, Jr.).
\item \textsuperscript{54} 11 U.S.C. § 1113 (1988); \textit{see infra} text accompanying notes 139-50.
\item \textsuperscript{55} \textit{See} 11 U.S.C. § 1113 (1988).
\item \textsuperscript{56} A "claim" under the Bankruptcy Code is defined to include a "right to payment." \textit{Id.} § 101(4)(A). Whether a right to payment exists will be a function of nonbankruptcy law. \textit{See supra} note 38; \textit{infra} note 155.
\item \textsuperscript{57} \textit{See Retiree Health Benefits Hearings, supra} note 10, at 64 (statement of Douglas G. Baird).
\end{itemize}
priority claimants were satisfied.  

Bankruptcy law dictated that prepetition unsecured creditors, such as these retirees, not receive any distribution during the pendency of the case.  
Thus, although the retirees' nonbankruptcy entitlement to nonpension benefits was to a stream of future payments, the claim of each retiree in bankruptcy had to be reduced to a single figure. Each nonunion retiree's bankruptcy claim would be an actuarially determined lump sum representing the discounted present value of the retiree's promised future benefits.  
A salaried retiree's return from the estate of a Chapter 11 debtor would be a function of how much value the Chapter 11 plan provided for unsecured creditors or, if the company was liquidated, how much money was left after the secured and priority claimants were paid.

B. Union Retirees

Even before the passage of section 1113, retirees whose benefits were part of a union contract with the company were probably in a better position than their salaried counterparts.  
Employees protected by a union contract faced the risk that the Chapter 11 company might reject unilaterally its collective bargaining agreement and thus transform the union retiree's nonpension entitlements into a general unsecured claim.  
Such a decision by the struggling company would be ill-

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68. Section 507 of the Bankruptcy Code sets forth a list of expenses and claims in bankruptcy that are given priority. See 11 U.S.C. § 507 (1988). In a Chapter 7 liquidation, the § 507 priority scheme is incorporated into that chapter's distribution provision. Id. § 726(a)(1). Ironically, the Bankruptcy Code nowhere says explicitly that secured claims must be paid before the so-called "priority" claims of § 507, although the common law of bankruptcy is clear that secured creditors can enforce their liens in full before priority and general unsecured creditors get paid. See Butner v. United States, 440 U.S. 48, 54-57 (1979) (looking to state-law entitlements to determine property rights in bankruptcy).

69. See Commercial Law Hearing, supra note 1, at 52 (statement of Herbert P. Minkel, Jr. and Prof. Lawrence P. King) (stating that "[t]he most difficult thing for managers of a debtor corporation to rationalize and accept is the fact that claims arising prior to the filing of the bankruptcy petition are prepetition claims and may not be paid without an order of the court").

70. See Page, supra note 23, at 501 (stating that under contract law, an employer's failure to provide vested retiree benefits may result in a judgment equal to the total present value of retirement benefits); see also Protection Act Hearing, supra note 46, at 164-65 (testimony of Nathan B. Feinstein) (making the point that funding LTV retiree benefits in a Chapter 11 plan would mean accounting for discounted present value of such future benefits as part of the plan); cf. Levy v. Lewis, 635 F.2d 960, 969 (2d Cir. 1980) (Mansfield, J., concurring) (indicating that "[t]o the extent that appellant proved a claim to future insurance benefits under the plan, the claim presumably would be allowed in an amount based upon the cost of substitute health and welfare insurance policies for the balance of the retirees' life expectancies").

61. See infra text accompanying notes 62-63.

62. In NLRB v. Bildisco & Bildisco, 465 U.S. 513 (1984), the Supreme Court upheld the ability of an employer to reject a collective bargaining agreement entered into prepetition. The Court held by a 5-4 majority that the debtor had not committed an unfair labor practice when it
advised in many cases, however, given the labor problems that inevit-ably would follow. In one presection 1113 case, the bankruptcy court al-
lowed the debtor-in-possession to continue retiree benefits payments to
union retirees as provided in the union contract even though the com-
pany refused to pay those same vested benefits to salaried retirees.3

The enactment of section 1113 made it more difficult for a Chapter
11 company to reject a collective bargaining agreement and therefore
made the difference between union and nonunion retirees more pro-
nounced. Under section 1113, management must make an offer to the
union to modify the contract before it seeks outright rejection.4 The
bankruptcy court may approve a rejection of the collective bargaining
agreement only after such a proposal has been made, the union has
failed to accept it “without good cause,” and “the balance of the equi-
ties clearly favors rejection of such agreement.”5

Under at least one interpretation of section 1113, section 1114
would offer no independent benefits to union employees. LTV’s attor-
neys, however, did not choose this interpretation. When LTV Steel filed
for Chapter 11, its lawyers did not believe that section 1113 prohibited
the cessation of retiree medical and life insurance payments that were
part of a collective bargaining agreement6 even though section 1113
says that a debtor-in-possession is not permitted to “unilaterally termi-
nate or alter any provisions of a collective bargaining agreement” before
complying with the requirements of that section.7 LTV’s argument was
that section 1113 protected only current employees, not retirees.8 This
logic had been accepted by one bankruptcy court, in In re Unimet
Corp.,9 a year before LTV had filed. According to the Unimet reason-
ing, the basis for distinguishing between retirees and current employees
in section 1113 could be found in Allied Chemical & Alkali Workers of
America v. Pittsburgh Plate Glass Co.10 In that 1971 decision, the Su-

unilaterally abrogated the union contract. Id. at 527-34. A Chapter 11 company’s ability to reject
executory contracts generally stems from 11 U.S.C. § 365(a) (1988), which provides that “the trust-
te or [debtors-in-possession, subject to the court’s approval, may assume or reject any executory
contract of unexpired lease of the debtor.”

65. Id. § 1113(c).
66. See Commercial Law Hearing, supra note 1, at 104 (statement of LTV Corp.).
68. See Commercial Law Hearing, supra note 1, at 107 (statement of LTV Corp.).
69. No. 685-00240, slip op. (Bankr. N.D. Ohio Sept. 27, 1985). The bankruptcy court’s deci-
sion in Unimet ultimately was reversed in In re Unimet Corp., 842 F.2d 879 (6th Cir. 1988). The
Sixth Circuit held that § 1113(f)'s language prohibiting unilateral termination or alteration of “any
provisions of a collective bargaining agreement” did apply to provisions that benefited retirees. Id.
at 884.
70. 404 U.S. 157 (1971).
Supreme Court held that an employer's mid-term unilateral modification of retirees' benefits did not constitute an unfair labor practice because the retirees were not "employees" for the purposes of section 8 of the National Labor Relations Act. From this Supreme Court case, the bankruptcy court in *Unimet* concluded that section 1113 was not intended by Congress to protect retirees. The logic, in short, was that section 1113 was designed to protect employees; retirees are not employees; thus, section 1113 does not prevent the company from terminating retiree benefits, even if those benefits are included in a collective bargaining agreement.

Although LTV could point to the decision in *Unimet* as precedent for its interpretation of section 1113, the case law at the time of LTV's filing was less than clear. About a month prior to LTV's bankruptcy petition, in *In re Century Brass Products*, the Second Circuit held that retirees entitled to collectively bargained-for benefits should be characterized as "employees" for purposes of applying section 1113. If the Second Circuit was correct in *Century Brass*, section 1113 alone should have prevented LTV's unilateral termination of benefits. If LTV's actions were nothing more than a wrongful interpretation of section 1113, then the independent benefit of section 1114 for union retirees is dubious.

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71. See id. at 172. The Court noted that preservation of retiree benefits did not vitally affect active employees, and that because retired workers had ceased doing work for hire, they could not be construed as the type of "employee" within the meaning of the NLRA's collective bargaining obligations. See id.


73. 795 F.2d 265 (2d Cir. 1986).

74. See id. at 274-75. Specifically, the court in *Century Brass* held that when an employer files a Chapter 11 case, the rights of retired workers "vitaly affect" the rights of current employees within the meaning of *Pittsburgh Plate Glass* and therefore the retirees should be construed as "employees" for purposes of the NLRA's collective bargaining obligations. The court said that a refusal of the union to negotiate a reduction in retiree benefits could "vitaly affect" current workers in at least two ways: (1) current workers would have to bear a much larger cost of the reorganization because of the high cost of retirement benefits; and (2) if the retirement benefits could not be renegotiated, the company's reorganization could fail, leading to closure of the business and loss of current jobs. See id. at 274. The court in *Century Brass* also acknowledged the inherent conflict of interest between current employees and retirees with respect to the employer's reorganization. That conflict of interest stems from the limited resources available to the reorganizing company: any dollar applied toward promised retiree benefits is potentially one less dollar available for current workers' salaries. Accordingly, the Second Circuit held that when a bankruptcy court determines that there is a conflict of interest between current workers and retirees, a separate representative for retirees should be appointed by the judge. See id. at 275. Similarly, section 1114 empowers the court to appoint a separate representative for retirees when the court finds, after notice and a hearing, that the union is not an appropriate representative for the retirees. See 11 U.S.C. § 1114(c)(1) (1986).
C. The Stopgap Legislation

Although the public outcry over LTV’s cessation of benefits caused Congress to move quickly, a labor strike at one of LTV’s plants prompted the company to resume paying retiree benefits. Nevertheless, Congress passed a temporary measure designed to prevent a recurrence of the LTV situation while legislators worked on designing a more permanent solution. The stopgap legislation, much simpler than its permanent successor, provided that a company which files a Chapter 11 case after October 2, 1986, must continue to pay retirees any benefits that were promised prepetition. The temporary legislation produced only one litigated case which held that, notwithstanding the law, retiree benefits could not be paid if those payments would reduce the collateral of secured creditors.

IV. The Substance of Section 1114

A. Scope of Coverage

Section 1114 applies to Chapter 11 reorganization attempts, not to Chapter 7 liquidations. Under section 1114, no claim for retiree benefits is limited by section 502(b)(7) of the Bankruptcy Code, which restricts the amount of an employee’s claim arising from the termination of an employment contract. Although section 1114 took effect immediately upon enactment, it applies only to cases filed after the date of enactment. For pending Chapter 11 cases, the stopgap legislation was amended concurrently with section 1114 to give retirees of those companies essentially the same protections granted by section 1114.

75. Commercial Law Hearing, supra note 1, at 158 (containing LTV Corp.’s application to pay retiree benefits during the pendency of the Chapter 11 case).
76. See supra note 3 and accompanying text.
80. Id. § 1114(j).
81. Id. § 502(b)(7). Section 502(b)(7) provides that if an employee makes a claim for damages resulting from the termination of an employment contract, the claim is limited to the compensation provided by that contract for one year following the earlier of the date of the employer’s petition or the date on which the employer directed the employee to terminate or the employee did terminate performance under the contract. Id. The employee may collect, in addition, any unpaid compensation due under the contract at the earlier of the above two dates. Id.
83. Id. § 1106 note. The main difference between Chapter 11 cases covered by § 1114 and cases that were pending at the time of § 1114’s enactment is that in the latter set of cases, the statute expressly incorporates the modification standard of § 1113(b)(1)(A) as the standard to be used for modification of retiree benefits. For cases that are covered by § 1114, the modification standard is virtually identical to that given under § 1113, with the exception that the § 1114 modification standard twice uses the phrase “necessary to permit the reorganization of the debtor,” id.
Not all retirees are eligible for the benefits of section 1114. If a retiree had a gross income of 250,000 dollars or more in the year preceding the filing of the petition, the protections of section 1114 generally would not apply. Such upper-income retirees can avail themselves of the provisions of section 1114 only if they can demonstrate that they are unable to obtain for themselves and their dependents insurance comparable to that offered by the company on the day before it filed for relief under Chapter 11.

B. Limits on Debtor's Ability to Modify Benefits

The thrust of section 1114 is that the debtor "shall timely pay and shall not modify any retiree benefits" unless one of two conditions is met. The debtor can modify the benefits if there is a consensual arrangement regarding modification between the debtor and the retirees' authorized representative. Absent such a consensual arrangement, a modification will be approved only if the debtor makes a proposal that is rejected by the retirees' representative without good cause and the court determines that the proposed modification is necessary to permit the reorganization of the debtor, assures that all affected parties are treated fairly and equitably, and is clearly favored by the balance of the equities. This three-pronged standard for nonconsensual modification of retiree benefits is intended by Congress to be identical to the standard currently governing rejection by Chapter 11 debtors of collective bargaining agreements under section 1113. The Senate Judiciary Committee believed that it was important to use a familiar standard. Senator Howard M. Metzenbaum's comments on the final bill indicated that the phrase "necessary for the reorganization of the debtor" should be given the Third Circuit's interpretation. In *Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of America* the Third Circuit de-
determined from legislators' remarks that a proposal to modify a labor contract is "necessary to permit a reorganization" when it is essential to the "goal of preventing a debtor's liquidation." Senator Metzenbaum added that the modifications ordered under the new legislation should be "only those necessary to avoid liquidation."

Section 1114 provides alternative procedures for the appointment of the retirees' authorized representative, depending on the status of the retirees. For retirees whose benefits are covered by a collective bargaining agreement, the labor organization that signed the agreement acts as authorized representative unless that organization decides not to serve or the court determines that different representation is appropriate. When a labor organization is not the retirees' representative, the court will appoint a committee of retired employees to serve as representative for the retirees. If retirees' benefits are not covered by a collective bargaining agreement, the court, after notice and a hearing, similarly will appoint a committee of the debtor's retirees if the debtor seeks to modify or not to pay retiree benefits. Such a committee of retired persons is granted all of the rights and duties of other creditors' committees and has the power to enforce the rights of retirees with respect to health and insurance benefits that the debtor seeks to modify.

For a nonemergency motion to modify benefits, the bankruptcy court must set a hearing for no later than fourteen days following the filing of the application. The court must then rule on the motion within ninety days following the hearing. Section 1114, however, also permits the court to allow "interim modifications" of retirees' benefits

92. Id. at 1089.
95. Id. § 1114(c)(2).
96. Id. § 1114(d).
97. Id. § 1114(b)(2). Section 1103 of the Bankruptcy Code enumerates the powers and duties of a creditors' committee. Id. § 1103. These include the ability to employ professionals, consult with the debtor concerning the administration of the case, investigate the acts and financial condition of the debtor, participate in the formulation of a plan, request the appointment of a trustee or examiner, and perform "such other services as are in the interest of those represented." Id.
98. Id. § 1114(k)(1). The court is allowed a seven-day extension of this fourteen-day period for commencing of the hearing "where the circumstances of the case, and the interests of justice require such extension, or for additional periods of time to which the trustee and the authorized representative agree." Id.
99. Id. § 1114(k)(2). The court may extend this 90-day time period "in the interests of justice" if the debtor-in-possession and the authorized representative of the retirees agree. Id. If the court fails to rule on an application for modification of benefits within 90 days of the commencement of the hearing, or within the additional time period set by the court with the agreement of the two sides, then the debtor may implement the proposed modifications pending the ruling of the court on the original application. Id.
after notice and a hearing if such modifications are essential to the con-
tinuation of the debtor's business or to avoid irreparable harm to the
estate.\textsuperscript{100}

One of the main themes of the new legislation is that retiree bene-
fits should be modified in a Chapter 11 case only to the extent nec-
essary to avoid a liquidation of the debtor.\textsuperscript{101} Because a debtor's financial
condition may change substantially during the pendency of a Chapter
11 case, section 1114 provides that neither the debtor nor the retirees' 
authorized representative is precluded from making more than one 
motion for a modification of benefits.\textsuperscript{102} Therefore, if the debtor finds that 
after initial reductions in retirees' benefits levels, the company still
risks liquidation, it may apply to the court for further reductions.\textsuperscript{103}
Similarly, if a struggling debtor improves the company's finances during 
the Chapter 11 case, the retirees' representative may argue that earlier 
reductions in benefits levels are no longer necessary for the debtor to 
reorganize successfully.\textsuperscript{104}

In the same legislation that created the new section 1114, Congress
significantly amended section 1129, which lists the prerequisites for
confirmation of a Chapter 11 plan.\textsuperscript{105} Whereas section 1114 requires
that retiree benefits must continue at their full level absent formal
modification during the Chapter 11 case, the amendment to section
1129 provides that continuation of retiree benefits in the plan itself is
an independent prerequisite for plan confirmation.\textsuperscript{106} New subsection
(13) of section 1129(a) says that the Chapter 11 plan must provide for
the continuation "of all retiree benefits [at their modified levels] . . . 
for the duration of the period that the debtor has obligated itself to
provide such benefits."\textsuperscript{107} Thus, if the retirees' benefits had been modi-
cified during the Chapter 11 case to sixty percent of their original level,}

\textsuperscript{100} Id. § 1114(b)(1). The hearing for interim modifications shall be scheduled "in accor-
dance with the needs of the trustee" and implementation of such interim changes "does not render
the motion for modification moot." Id. § 1114(b)(2)-(3).

\textsuperscript{101} See, e.g., id. § 1114(f)(1)(A) (allowing only "those necessary modifications in the retiree
benefits that are necessary to permit the reorganization of the debtor"); id. § 1114(g)(3) (providing
that "such modification is necessary to permit the reorganization of the debtor"); see also supra
text accompanying notes 89-92 (concluding that under the new legislation, modifications ordered
should be "only those necessary to avoid a liquidation").

\textsuperscript{102} 11 U.S.C. § 1114(g) (1988).

\textsuperscript{103} Id. (stating that the trustee is not precluded "from making more than one motion for a
modification order governed by this subsection").

\textsuperscript{104} Id. (allowing the authorized representative of the retirees to apply to the court for an
order increasing those benefits modified by a court order or an agreement by the retirees, which
order shall be granted if the increase in retiree benefits sought is necessary to permit reorganiza-
tion, fair to all affected parties, and favored by the balance of the equities).

\textsuperscript{105} Id. § 1129(a)(13).

\textsuperscript{106} Id. § 1129(a)(13).

\textsuperscript{107} Id.
then the plan must provide for the continued payment to retirees at the sixty percent level. The right to the remaining forty percent of the benefits payments would be treated in the plan like general unsecured claims.\textsuperscript{108}

C. Elevation of Retiree Claims to Priority Status

One of the most significant features of the new statute is that it raises to the level of an administrative expense priority any payment for retiree benefits "required to be made before a plan confirmed . . . is effective."\textsuperscript{109} This feature means that retiree insurance benefits which come due between the filing of the petition and confirmation of the plan are subordinate only to the claims of secured creditors.\textsuperscript{110} The new administrative priority of retiree claims is extremely significant for lenders that extend prepetition unsecured credit to companies that have large retiree insurance liabilities. These lenders now must face the prospect of having their loans subordinated in Chapter 11 to the retirees' claim for benefits.\textsuperscript{111}

It is not clear from the language of section 1114 what portion of the debtor's obligation to its retirees merits the administrative expense priority. The ambiguity on this point may be illustrated with the following hypothetical. A company in Chapter 11 bankruptcy, following proper modification of its retirees' benefits during the pendency of the case, ultimately has its plan confirmed. The total present value of retirees' future benefits was one hundred million dollars when the case began. The retirees' benefits level was modified during the pendency of the case to seventy-five percent of its original amount, and later, this level of benefits is agreed to in the proposed plan. Under the plan the general unsecured creditors are to be paid fifty cents on the dollar for their claims. The legislative history of section 1114 makes it clear that the retirees would be entitled to 12.5 million dollars for the 25 million dollars worth of benefits that they lost through the modification.\textsuperscript{112} The fact that the retirees already will receive seventy-five cents on the dol-

\begin{footnotes}
\footnote{108. The legislative history of the Retiree Benefits Bankruptcy Protection Act of 1988 makes it clear that any amounts paid to the retirees as part of the plan or during the pendency of the case cannot be subtracted from the amount to which the retirees are entitled as unsecured creditors. See infra text accompanying notes 112-14. This concept was codified at 11 U.S.C. § 1114(i) (1988).}
\footnote{109. 11 U.S.C. § 1114(e)(2) (1988).}
\footnote{110. Cf. supra note 78 and accompanying text.}
\footnote{111. See Protection Act Hearing, supra note 46, at 85 (testimony of Prof. Lawrence King) (contending that lenders are averse to extending credit prebankruptcy if they know that the borrower is subject to a large claim for retiree medical benefits).}
\footnote{112. See S. REP. No. 119, 100th Cong., 1st Sess. 6 n.2 (1987) (illustrating an example of the calculation contemplated by § 1114(i)).}
\end{footnotes}
lar for their benefits does not enable other creditors to "credit" those seventy-five percent payments to the retirees' 25 million dollars general unsecured portion of their claim. Thus, other unsecured creditors may not reduce the retirees' return on that 25 million dollars below the fifty percent level that other general unsecured creditors receive.

This example illustrates the ambiguity of the "administrative expense" character of the retirees' entitlements. If the estate kept current on its seventy-five percent payments during the pendency of the case, the retirees' claim to future seventy-five percent payments as part of the plan cannot be called an "administrative expense," because there is no longer any estate to administer following confirmation of the plan. At the point of confirmation, the retirees' claim to seventy-five percent payments in the future is merely the contractual obligation of the newly reorganized company. General contract law, not the Bankruptcy Code, governs the retirees' rights to those payments in the future.113

The case would be different, however, if the retirees had not received all the agreed-upon seventy-five percent level of benefits during the pendency of the Chapter 11 case. In this latter example, the difference between what the retirees were supposed to have received under the modified benefits plan, and what the retirees actually did receive in benefits payments during the pendency of the case, would seem to qualify as an administrative expense for purposes of classification in the plan. If, in the hypothetical situation, the case lasted two years, the unmodified value of retiree benefits during these two years was four million dollars, and the seventy-five percent modification was agreed upon immediately after the Chapter 11 case was filed, the retirees' administrative expense entitlement for the two years would be three million dollars. If, during those two years, the retirees collectively received from the debtor just two million dollars in benefits rather than the three million dollars to which they were entitled following modification, then the retirees would appear to have an "administrative expense" claim for one million dollars at the point of confirmation of the plan. The retirees also would have a general unsecured claim for one million dollars, the amount by which the twenty-five percent modification reduced their one hundred percent entitlement of four million dollars. The one million dollar administrative expense claim would represent a payment that was "required to be made before a plan confirmed under section 1129 of this title is effective," the touchstone for qualifying as

113. Once a plan is confirmed, § 1141 of the Bankruptcy Code vests in the debtor all of the property of the estate free and clear of all claims and interests of creditors except those provided in the plan. See 11 U.S.C. § 1141(c) (1988). Section 1141 also provides that the provisions of a confirmed plan bind both the debtor and the parties entitled to property under the plan. See id. § 1141(a).
an administrative expense under section 1114(e)(2).\textsuperscript{114}

The situation in which the case converts to a Chapter 7 liquidation before any plan is confirmed poses the issue of what portion of the retirees' past or future benefits claim qualifies as an administrative expense in the Chapter 7 case. It is not clear whether the administrative expense classification applies only to the amount that should have been paid during the Chapter 11 but was not, or to the full discounted present value of the insurance benefits for the rest of the retirees' lives. The general rule in converted cases, that administrative expenses of the Chapter 11 case are paid only after administrative expenses of the Chapter 7 case are paid, applies to retirees' claims.\textsuperscript{115} If Congress had wanted to give retiree benefits a special priority in all bankruptcy cases, then it could have added a provision to section 507 of the Bankruptcy Code, which governs priorities in Chapters 11 and 7.\textsuperscript{116} The sections of Chapter 11 of the Bankruptcy Code, such as new section 1114, apply only in Chapter 11 cases.\textsuperscript{117} Nevertheless, an administrative claimant in a converted Chapter 11 case still comes ahead of general unsecured creditors in the Chapter 7 liquidation;\textsuperscript{118} thus, it is useful to know what priority the retirees can bring into the Chapter 7 case.

As mentioned earlier, section 1114(e)(2) provides that the category of retiree benefits claims entitled to administrative expense status includes payments "required to be made before a plan confirmed . . . is effective."\textsuperscript{119} If, as in the majority of Chapter 11 filings,\textsuperscript{120} no plan is ever confirmed, the status of the retirees' claims is uncertain. An example illustrates the problem. A company with significant retiree benefits obligations files a Chapter 11 case, has its retiree benefits modified during the pendency of the case to seventy-five percent of their original level, and then converts the case to a Chapter 7 one year after filing. During the one-year pendency of the Chapter 11 case, the retirees are paid just sixty percent of their medical benefits rather than the seventy-five percent to which they were entitled following proper modification. When the case is converted, one possible reading of section 1114(e)(2) gives the retirees in the Chapter 7 case an administrative expense priority for only the fifteen percent of benefits that they did
not receive during the one-year pendency of the Chapter 11. Under this view, the rest of the retirees' entitlement in the Chapter 7 case, namely the twenty-five percent reduction of their benefits during the Chapter 11 and the full discounted present value of all their future medical benefits, would be treated as a general unsecured claim. The attorney for the retirees probably would argue for a second interpretation of the administrative expense priority that attaches to retiree benefits under section 1114. Under this view, the retirees' administrative expense claim following conversion of the case to Chapter 7 would consist of the discounted present value of these benefits at the level to which they were modified during the pendency of the Chapter 11 case. Thus, if the present value of retirees' future benefits at an unmodified level was one hundred million dollars when the case began and there was a modification during the Chapter 11 to a seventy-five percent level, the retirees' administrative claim in the Chapter 7 case would be seventy-five million dollars, less any amounts that actually were paid to retirees during the Chapter 11 case.

The language and legislative history of section 1114 provide little guidance on which of the two alternative interpretations should be followed in the common situation when a Chapter 11 case converts to a Chapter 7 case. The broader interpretation of administrative expense that would be sought by the retirees has at least two arguments in its favor. First, the language of section 1114 says that an administrative expense priority attaches to "[a]ny payment . . . required to be made before a plan confirmed under section 1129 of this title is effective." If a plan is never confirmed and therefore is never "effective," the literal language suggests that "any payment" would encompass all future payments required to be made to retirees. The only event in section 1114 that would limit the amount of retiree payments which qualify for administrative status, the confirmation of a plan, will never occur once there is a conversion to a Chapter 7. Congress could have eliminated this argument if it had added to the phrase "before a plan confirmed . . . is effective" the words "or the case is converted or dismissed." Second, the retirees' argument for administrative expense priority is bolstered by the general principle in bankruptcy that claims which are not yet due and owing to the debtor are accelerated once the debtor

122. Interestingly enough, Congress did provide for the possibility of dismissal, although not conversion, in the conforming amendments that it made to the stopgap legislation as part of the bill that was signed into law by President Ronald Reagan. For cases that were pending at the time of the enactment of § 1114 and therefore covered by the stopgap legislation, the amendment to the stopgap legislation provides that the trustee "shall pay" benefits until "the dismissal of the case involved" or "the effective date of a plan confirmed under section 1129." See id. § 1106 note.
files a bankruptcy petition. Thus, even though the retirees were entitled to a stream of future payments outside of bankruptcy, each retiree’s claim in bankruptcy would be for the discounted present value of that stream. When the case converts, then the retirees could argue that it is this full lump sum, and not just the insurance premiums which were due during the Chapter 11 proceeding, that constitutes the retirees’ administrative claim in the converted case.

It is troublesome, however, to give retirees a larger administrative claim than they were owed at the modified level during the pendency of the Chapter 11, because such a windfall would operate in an arbitrary fashion. The following example illustrates the arbitrary application of the broad reading of the administrative expense priority. A company with assets of one hundred million dollars has obligations to retirees for future nonpension benefits totaling one hundred million dollars in present value terms. This company owes two hundred million dollars to nonretiree unsecured creditors. If the company filed a Chapter 7 case first, without ever trying to sustain a Chapter 11 reorganization, both the retirees and the other unsecured creditors would receive thirty-three cents on the dollar. The same company might, however, attempt a Chapter 11 reorganization even though the prospect did not appear encouraging. If the company struggled along for three months in Chapter 11 and then decided to convert to Chapter 7 without any attempt to modify retiree benefits, the retirees, under the reading of section 1114 that is more favorable to them, would be entitled to one hundred cents on the dollar, and the other unsecured creditors would receive nothing. This polar difference in bankruptcy distribution

123. See S. REP. No. 989, 95th Cong., 2d Sess. 62-65 (1978) (stating that § 502 of the Bankruptcy Code retains the traditional rule that bankruptcy accelerates the principal amount of all claims against the debtor).

124. See supra note 60.

125. Even following the enactment of § 1114, retirees’ claims for benefits in a straight Chapter 7 case would be unsecured. See supra text accompanying notes 56-58. Thus, under § 726(2) of the Bankruptcy Code, the retirees would share pro rata with the other unsecured creditors. See 11 U.S.C. § 726(2) (1988).

126. Section 1112(a) of the Bankruptcy Code gives the debtor the right to convert a Chapter 11 case into a Chapter 7 case unless the debtor is no longer in possession, the original Chapter 11 case was an involuntary one, or the case was in Chapter 11 because of a conversion motion that was not the debtor’s. See 11 U.S.C. § 1112(a) (1988).

127. Under the proretiree reading of § 1114(e)(2), once the company filed Chapter 11, the administrative expense priority would attach to the retirees’ claim for promised future benefits. Id. § 1114(e)(2). Because after conversion to Chapter 7 a Chapter 11 plan would neither be “confirmed under section 1129” nor “effective,” then “[a]ny payment . . . required to be made” would be all payments required to be made to retirees. See id. Thus, the retirees’ § 503 claim in Chapter 7 would be for the full $100 million present value of their promised future benefits. Under § 726 that administrative expense would have to be paid in full before general unsecured creditors received anything. See id. § 726. The nonretiree unsecured creditors would, under that reading of §
from the straight Chapter 7 case would result only because in the latter case the hypothetical company decided to give Chapter 11 an ill-fated try. Under a narrower reading of the retirees' administrative status, the result in the preceding “quick conversion” example would give retirees in the Chapter 7 case a priority only to any benefits payments that were due to them during the three-month Chapter 11 period but never paid. For the majority of their claim, the present value of all future entitlements, the retirees would be treated on a par with the other unsecured creditors in the distribution of the debtor's limited pool of assets.

This more limited reading of retirees' administrative status seems more consistent with congressional intent. Based on the legislative history of section 1114, it is probably fair to say that Congress did not give much thought to what should happen to retirees' claims when a Chapter 11 case is converted to a Chapter 7. Nevertheless, by placing the priority provision in Chapter 11 of the Bankruptcy Code rather than in the Code's general priority provision, section 507, Congress made an implicit judgment not to give retirees a special priority in the pure Chapter 7 case. Therefore, adopting a construction of section 1114 that limits the priority that retirees receive in cases converted to Chapter 7 seems consistent with the location in the Bankruptcy Code where Congress chose to place the source of retirees' new elevated status.

D. The Problem of “Pipeline Claims”

A Chapter 11 filing brings another financial difficulty to retirees: the so-called “pipeline claims.” Pipeline claims occur when medical services are performed prepetition for retirees of a self-insured company, but the company does not receive the bill from the service provider until postpetition. Without legislation covering this situation, the bankrupt company can relegate the claim of the health care provider to prepetition unsecured status. The provider, in turn, then could look to the retiree to pay, because such providers typically have a contractual right of reimbursement against the retiree when the self-insuring

1114(e)(2), not receive a penny in the Chapter 7 distribution.
128. See supra text accompanying notes 120 & 121.
129. Id.
130. But see supra note 122 and accompanying text.
132. Because the services giving rise to the claim arose prepetition rather than postpetition, the provider would not be eligible for § 503 administrative claim status, which attaches only to the costs of preserving the postpetition bankruptcy estate. See 11 U.S.C. § 503(b)(1)(A) (1988).
company fails to pay.\textsuperscript{138}

To prevent retirees from being saddled with these prepetition claims, an amendment to the stopgap legislation provided that the debtor “shall pay” such claims of health care providers if the provider can demonstrate to the bankruptcy court that it has a contractual right of reimbursement against the retiree to whom it provided prepetition services.\textsuperscript{134} The legislative history to this provision makes it clear that once the provider demonstrates a right of reversal, the debtor “must immediately pay the full amount owed to the administrator or health care provider without waiting for confirmation of a plan of reorganization.”\textsuperscript{135} If the court finds no right of contractual reversal, the pipeline claims of the health care provider are treated like general unsecured claims.\textsuperscript{136}

One problem with this provision is that, although it addresses the timing of payment to health care providers for such prepetition claims, it does not appear to assign to such claims a specific priority among claimants generally. These claims might be treated simply like unsecured claims that are paid out early in the case by the debtor, with the possibility that the provider later may have to reimburse the estate if other unsecured claims are not paid in full. Another possibility is that these claims might have a status just below secured claims, to be paid ahead of any other unsecured priority claims, including administrative expenses.\textsuperscript{137} Alternatively, these claims might have a status equal to, but not greater than, other administrative expenses. In this case, the recipient of these early payments may have a later obligation to the estate if other administrative claimants are not paid in full. Neither the statute nor the legislative history offers much help on this issue, which can loom very large. In \textit{LTV}, for example, these prepetition pipeline claims totaled thirty-five million dollars.\textsuperscript{138}

\begin{itemize}
  \item \textsuperscript{133} See \textit{Protection Act Hearing}, supra note 46, at 192 (statement of Joseph Patchan, Esq. & Susan B. Collins, Esq.).
  \item \textsuperscript{134} See 11 U.S.C. § 1106 note (1988). Although § 1114 itself does not address the issue of “pipeline claims,” the amendment to the stopgap legislation carries forward to new Chapter 11 cases the treatment given to “pipeline claims” in the stopgap legislation. See id.
  \item \textsuperscript{136} Id.
  \item \textsuperscript{137} For examples of two other instances in the Bankruptcy Code in which certain creditors are given “superpriorities” that come ahead of even administrative claims under § 503, see 11 U.S.C. § 364(c)(1) (1988) (stating that when the trustee is otherwise unable to obtain postpetition unsecured credit, the court may grant such postpetition lender a priority greater than § 503 status); id. § 507(b) (stating that when a secured creditor’s “adequate protection” subsequently proves to be inadequate, the secured creditor is entitled to superpriority for the amount of deficiency).
\end{itemize}
Section 1114 gives the same special status to retiree benefits that are not covered by a collective bargaining agreement as it gives to those benefits that do find their source in a union contract. The only difference in section 1114's treatment of union as contrasted with salaried retirees is the method of determining who shall be the retirees' authorized representative in the Chapter 11 proceeding. Section 1113, on the other hand, is relevant only to retiree benefits derived from a collective bargaining agreement. Section 1114 thus intersects with section 1113 in the case in which the Chapter 11 debtor wishes to reject a collective bargaining agreement that includes a provision for retiree benefits.

The following example illustrates the problems that can arise when these provisions intersect. A debtor in a Chapter 11 case wants to modify its collective bargaining agreement by cutting current workers' wages by thirty percent. The debtor does not propose any modification of the benefits paid to retirees pursuant to the same union contract. In this example the debtor would not have to contend with the modification requirements of section 1114, but would have to show, pursuant to section 1113, that the proposal treats all creditors "fairly and equitably." Even though section 1114 would not apply directly, the debtor might argue that keeping the retirees' benefits intact while cutting current workers' wages is "fair and equitable" because section 1114 shows a congressional intent to give favored status in bankruptcy to retiree interests. The problem with this argument is that it tries to compare fundamentally distinct entitlements. Retirees who are owed future benefits can be characterized rightly as pure "creditors," because they already have given to the company the consideration necessary to support the company's promise to provide those benefits. Current workers, on the other hand, are "employees," because they have only a promise to receive compensation in the future.

139. See 11 U.S.C. § 1114(b)(1) (1988) (providing that "authorized representative" shall be defined in subsection (c) for persons receiving benefits covered by a collective bargaining agreement and in subsection (d) for persons receiving benefits not covered by such an agreement).
140. See id. § 1114(c), (d); see also supra text accompanying notes 94-97.
141. See supra text accompanying notes 61-74.
142. Congress was aware of such an intersection, but expressly made no judgment whether a trustee could seek modification of retiree medical benefits under § 1114 without first complying with § 1113 when appropriate. See S. Rep. No. 119, 100th Cong., 1st Sess. 4 (1987).
143. 11 U.S.C. § 1113(b)(1)(A), (c)(1) (1988) (asserting that before seeking an application to reject a collective bargaining agreement, the debtor-in-possession first must make a proposal treating "all of the affected parties . . . fairly and equitably").
144. The Bankruptcy Code defines "creditor" as an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." Id. § 101(9)(A). "Claim" includes a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." Id. § 101(4)(A).
the other hand, are not pure "creditors" with respect to their future wages under a union contract because a prerequisite to the workers receiving the agreed-upon wage is performing the appropriate labor.\textsuperscript{145} Thus, current workers could argue that the debtor could not use section 1114 to defend such a proposal, because section 1114 showed only that Congress intended to prefer retirees over other true unsecured creditors and not necessarily over present employees.

In a variation of the hypothetical example, the employer in Chapter 11 proposes instead, pursuant to section 1113, that current workers' wages be cut by only twenty percent and that retirees' nonpension benefits also be cut by twenty percent. The collective bargaining unit accepts this proposal and the formal contract rejection procedures under section 1113 never come into play.\textsuperscript{146} This poses the issue of whether the debtor and the collective bargaining unit may point to section 1113 and claim that the retirees are bound by the new arrangement.

Even before the enactment of section 1114, the retirees' rights probably could not be diminished in this manner. Prior to section 1114, the \textit{Century Brass} court held that when a conflict of interest could be shown between the interests of current employees and former workers, retirees were entitled to have an authorized representative appointed before any of their rights could be bargained away in a section 1113 setting.\textsuperscript{147} Today section 1114 provides for a similar mechanism; it mandates the appointment of a representative for retirees, separate from the labor union, when a party in interest can show that independent representation of retirees is appropriate.\textsuperscript{148} Furthermore, sec-

\textsuperscript{145} To the extent that current workers have performed services prepetition for which they were never paid, then those workers would be "pure creditors" for the amount of prepetition salary owed. Union workers' entitlements to future salary, however, would be part of their executory contract with the debtor. Executory contracts are covered generally by 11 U.S.C. § 365 (1988), although collective bargaining agreements are a special form of executory contract provided for in § 1113. The classic definition of an executory contract is "a contract under which the obligations 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." Countryman, \textit{Executory Contracts in Bankruptcy: Part I}, 57 MINN. L. REV. 439, 460 (1973). Because retirees have performed their obligations fully, their right to such benefits is not governed by § 365. At least one commentator has confused the difference between the rights of current workers to their future salaries and the rights of retirees to future retiree benefits. See McNeil, \textit{The Failure of Free Contract in the Context of Employer-Sponsored Retiree Welfare Benefits: Moving Towards a Solution}, 25 HARV. J. ON LEGIS. 213, 236 (1988) (concluding erroneously that vested nonunion retiree benefits are governed by § 365).

\textsuperscript{146} Section 1113(c)(1) makes it a prerequisite to a debtor's ability to reject a collective bargaining agreement that such debtor first make a proposal to the authorized representative of the employees that is necessary to permit the reorganization of the debtor, and assures that all creditors, the debtor, and all of the affected parties are treated fairly and equitably. See 11 U.S.C. § 1113(b)(1)(A), (c)(1) (1988).

\textsuperscript{147} See supra text accompanying notes 73 & 74.

\textsuperscript{148} See supra text accompanying notes 94-97.
tion 1113 implicitly allows the extrajudicial deal struck in the above example between the debtor and the collective bargaining unit, but section 1114 does not because the arrangement agreed to by the debtor and the union attempts to modify retiree benefits without complying with the requirements of section 1114. In short, no party can modify retiree benefits in a Chapter 11 case without having to contend with the provisions of section 1114.149

In a final variation of the hypothetical, the debtor makes the same twenty-twenty reduction proposal, but the labor union rejects it. The debtor would like to avoid section 1114 completely and successfully reject the collective bargaining agreement simply by meeting the section 1113 test of “fair to all parties,” “necessary for a successful reorganization,” and “favored by the balance of the equities.” The debtor may achieve this result but may not avoid section 1114. The debtor could never modify or reject its obligation to provide retiree benefits without first complying with section 1114. On the other hand, if the bankruptcy judge believed that the proposed package of reductions was, under section 1113, “fair,” “necessary,” and “equitable,” then the very same judge probably would allow the retiree benefits reduction. The section 1114 test for modification of retiree benefits is, after all, essentially the test contained in section 1113 for rejection of a collective bargaining agreement.

In practice, section 1114 will not change section 1113 negotiations beyond the change already created by Century Brass. Because the tests of sections 1114 and 1113 are so similar, the main effect of section 1114 on section 1113 is to codify the holding of Century Brass that when a collective bargaining agreement provides for retiree benefits, the debtor and the labor union lack the ability to bargain for reduction of those retiree rights without the independent representation of retiree interests.150

149. Section 1114(e)(1) makes it clear that notwithstanding any other provision of the Bankruptcy Code, the debtor-in-possession or trustee “shall timely pay and shall not modify any retiree benefits” unless they comply with the modification procedures set down in § 1114. 11 U.S.C. § 1114(e)(1) (1988). If it is clear that the debtor must reduce operating expenses to avoid a liquidation, § 1114 does not answer how much of the reduction should come from current workers’ wages and how much should come from the benefits of retirees. Perhaps the language in § 1114(f)(1)(A) that “all of the affected parties are treated fairly and equitably” would mandate a pro rata reduction as suggested in the text example, in which both union wages and retiree benefits were cut by 20%.

150. See supra notes 73, 74, and accompanying text.
V. THE PROBLEMS WITH SECTION 1114

A. Undermining the Purposes of Chapter 11

In order to understand the fundamental flaws of section 1114, it is useful to explore first the policies behind Chapter 11 of the Bankruptcy Code. One of the chief purposes of Chapter 11 is to preserve the going-concern value of businesses that are worth more intact than liquidated.151 Chapter 11 provides a forum for resolution of competing, conflicting claims to a debtor’s assets. During the process, individual creditors are prohibited from collection actions that would otherwise be allowed.152 In Chapter 11 the creditors as a group, most often in conjunction with the debtor’s current management, can decide in a controlled setting what is the optimal use of a debtor’s assets.153 The ultimate goal in Chapter 11 is to use the company’s assets in a way that increases the size of the overall pie;154 the relative size of the pieces, for the most part, has been fixed already by the state-law bargains struck between the debtor and each individual creditor prebankruptcy.155

The problem with section 1114 is that it creates a set of Chapter 11-only priorities, a significant new source of transactions costs that may force a case out of Chapter 11 even when the Chapter 11 forum would provide the best vehicle for optimizing the total pool of assets available for all creditors.156 These transactions costs arise because what is typically a two-party bargaining process over allocation of a firm’s going-concern surplus is transformed into a more cumbersome three-party negotiation. Moreover, the reordering of creditor priorities mandated by section 1114 will create two sets of perverse incentives. First, nonretiree unsecured creditors will have an incentive to see the debtor company in Chapter 7 rather than in Chapter 11, even when Chapter 11 would provide the most efficient forum for deployment of the debtor’s

151. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 220 (1977) (stating that the premise of business reorganization is that a company’s assets are worth more as a going concern than they are if sold for scrap); see also In re Kleinsasser, 12 Bankr. 452, 455 (Bankr. D.S.D. 1981) (contending that “it was the intent of Congress . . . . that a debtor be given one meaningful opportunity to rehabilitate”).

152. The Bankruptcy Code’s automatic stay provision, 11 U.S.C. § 362 (1988), prohibits any act to collect a prepetition debt once a bankruptcy petition is filed. See Kleinsasser, 12 Bankr. at 455 (stating that the automatic stay “provides a debtor a breathing spell from his creditors to attempt a reorganization”).


154. See Baird & Jackson, supra note 10, at 118 (suggesting that a goal of bankruptcy is to deploy the company’s assets as a single owner would).

155. See Butner v. United States, 440 U.S. 48, 54-56 (1979) (stating that absent federal policy to the contrary, property rights in bankruptcy are defined by state law); see also Eisenberg, Bankruptcy Law in Perspective, 28 UCLA L. Rev. 963, 955-59 (1981).

156. See infra text accompanying notes 158-79.
assets. By the same token, a Chapter 11-only priority will give retirees an incentive to keep a company in Chapter 11 even when the retirees know that the assets of the business would be worth more if the company were liquidated under Chapter 7.157

B. Creation of New Transactions Costs

The following hypothetical example demonstrates how section 1114 creates new transactions costs in Chapter 11 cases involving companies with retiree benefits liabilities. A company is worth four hundred million dollars as a going concern and three hundred million dollars if liquidated in Chapter 7. The firm has outstanding one hundred million dollars of secured debt, three hundred million dollars worth of nonretiree unsecured debt, and vested retiree medical obligations with a discounted present value of two hundred million dollars. The company also has stockholders, and many of these equity holders are current managers of the business. This business decides to file a Chapter 11 case when it is unable to meet its debt obligations and its creditors begin individual collection actions. In a presection 1114 world most of the bargaining in the typical Chapter 11 case will focus on how to allocate among the various classes of creditors the “going-concern surplus” to be gained by use of the Chapter 11 forum.158 In this example, the going-concern surplus is one hundred million dollars—the difference between the four hundred million dollars that the company is worth in Chapter 11 and the three hundred million dollars that it is worth in a Chapter 7 liquidation. Because the secured creditors in the example will be paid in full regardless of whether the company reorganizes or liquidates, they will not be concerned with allocation of the going-concern surplus.

157. The retirees' ability to keep a company in Chapter 11 against the wishes of other claimants would seem to be much weaker than the ability of nonretiree creditors to block a Chapter 11 plan that did not provide them with payments at least equal to those under a Chapter 7 liquidation. Section 1112 of the Bankruptcy Code, which governs conversion of a case from Chapter 11 to Chapter 7, provides that on request of a party in interest, the court may convert a case for “cause,” including, among other things, “continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation.” 11 U.S.C. § 1112(b)(1) (1988). If this or any other showing that merited a conversion can be made, the retirees would be statutorily powerless to prevent the conversion even though the retirees themselves, with their § 1114 priority, would be much better off in the Chapter 11 forum. On the other hand, disgruntled nonretiree unsecured creditors who wish to see a case in Chapter 7 have the statutory ability to block a Chapter 11 plan if they will not receive under the plan at least what they would obtain in a Chapter 7 liquidation of the same company. The ability of individual creditors to insist on receiving in a Chapter 11 plan at least what they would get in a liquidation of the same company is assured by application of the “best interests of creditors” test, prescribed by § 1129(a)(7).

158. But see LoPucki, supra note 120, at 100-01 (contending that empirical research on Chapter 11 debtors suggests that the size of the debtor, not the success of creditor bargaining, is more likely to determine success in Chapter 11). See generally Baird & Jackson, Bargaining After the Fall and the Contours of the Absolute Priority Rule, 55 U. Chi. L. Rev. 738 (1988).
Thus, the two classes that will bargain over the surplus will be the residual claimants, the class consisting of all unsecured creditors including retirees, and the equity holders.

Each of the two sides in this bargaining over allocation of the one hundred million dollar going-concern surplus has some leverage over the other. The unsecured creditors have on their side the “absolute priority rule” of section 1129 of the Bankruptcy Code. That rule says that no class of unsecured claimants can be forced to accept a Chapter 11 plan that gives them less than a full payout unless all junior classes of claimants receive nothing. Thus, any plan proposed by the current managers that gives the stockholders any value at all can be blocked statutorily by the “no” votes of the unsecured class of claimants. The absolute priority rule would appear to give the residual claimants, here the unsecured creditors, the right to insist on all of the going-concern surplus. That result almost never will be reached in practice, however, because the junior claimants, in this case the equity holders, have at

159. The “residual” claimants in any Chapter 11 case will be those whose claims are at the margin—that is, those claimants who stand to win or lose depending on the fortunes of the firm. In a solvent firm, the residual owners will be the shareholders. In a firm that is insolvent, the residual owners typically will be the unsecured creditors. See Baird & Jackson, supra note 158, at 761-62.

160. As noted above, retirees are nothing more than unsecured creditors with respect to their benefits claims. See supra text accompanying notes 56-60. It is conceivable that even in a presection 1114 case, retirees may have been classified separately in a plan from the other unsecured creditors. See 11 U.S.C. § 1122(a) (1988) (indicating that a plan may place a claim in a particular class only if such claim is “substantially similar” to the other claims of such class). Because of the requirements of § 1129(b)(1), that a plan be “fair and equitable” and not “discriminate unfairly,” however, it is unlikely that the other unsecured creditors would have had to accept a plan that paid the retirees a greater percentage of their claim than the other unsecured creditors would receive under the plan. Furthermore, if a plan were to propose such favored treatment for the retirees in a presection 1114 setting, the nonretiree unsecured creditors could have invoked the “best interests of creditors” test, see supra note 157, and prevented confirmation of that plan as long as the extent of the retirees' favored treatment exceeded the going-concern surplus of the company.


162. One of the 13 prerequisites to the confirmation of a plan under § 1129(a) is that each class of “impaired” claims has accepted the plan. Id. § 1129(a)(8). In the example, the nonretiree unsecured creditors would be “impaired” under § 1124 because their nonbankruptcy entitlements would be altered by the plan. See id. § 1124. “Acceptance” of a plan by a class of creditors requires an affirmative vote by at least two-thirds in amount and one-half in number of the allowed claims of such class held by creditors. Id. § 1126(c).

Even if a class of claims votes against a plan, the plan still can be confirmed under § 1129(h), the “cramdown” procedures of the Bankruptcy Code. Id. § 1129(b). For a plan to be crammed down over the dissenting votes of a class of creditors, however, § 1129(b) requires that a number of conditions be met. First, all of the other 12 requirements for the confirmation of a plan in § 1129(a) must be satisfied, including the “best interests” test discussed above. See supra note 157. Furthermore, § 1129(b)(2)(B) says that no plan can be confirmed over the “no” vote of a dissenting class unless the plan provides for that class to be paid in full or no junior class receives anything. 11 U.S.C. § 1129(b)(2)(B) (1988). This provision is the “absolute priority rule,” discussed above. See supra text accompanying notes 161-65.
least two sources of leverage. First, all holders of interests in the debtor are given the procedural right in Chapter 11 to force a judicial valuation of the company in bankruptcy. Such a valuation is costly and time-consuming and reduces the going-concern surplus that otherwise would be available to the creditor group. Second, many of the large equity holders will be senior managers who have company-specific skills that contribute to the very existence of a going-concern surplus. If the residual claimants try to shut out the equity holders from any participation in the reorganized firm, these stockholder-managers can threaten to take their skills elsewhere and thereby deplete a significant part of the going-concern surplus.

If there is a going-concern value to be preserved, the debtor would benefit by having these two sets of claimants strike a bargain. In a world of perfect information and zero transactions costs, the residual claimants and the junior creditors should come to a surplus allocation agreement in any case in which the company is worth more in a Chapter 11 reorganization than in a Chapter 7 liquidation. In such a world, the question would never be whether the company would have its Chapter 11 plan confirmed, but rather how much of the surplus gained in the Chapter 11 forum would go to the residual claimants and how much would accrue to the junior owners.

In the real world of bankruptcy, however, information is often scant, and transactions costs are staggering. The cost of such bargaining over allocation of the going-concern surplus can be very high indeed. In a Chapter 11 negotiation, timing is often of the essence, and

163. The ability of a dissenting class of creditors to force a judicial valuation derives from a number of different sources. First, application of the "best interests" test, see supra note 157, requires that the court engage in a liquidation appraisal. Second, the requirement for cramdown that the plan be "fair and equitable," 11 U.S.C. § 1129(b)(1) (1988), with respect to each dissenting class of claimant also may require a valuation. The "fair and equitable" test is thought to imply a requirement that no class receive more than 100% of its claims. Thus, if claimants receive stock in the reorganized company as part of the plan, the court may need to value the stock in order to ensure that no claimant is being overcompensated for its claim. See Broude, Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative, 39 Bus. Law. 441 (1984).

164. Broude, supra note 163, at 453 (stating that the threat of forcing a valuation "furnishes a reason to give something to old equity, enough to gain its consent and avoid cramdown").

165. R. BAIRD & T. JACKSON, CASES, PROBLEMS AND MATERIALS ON BANKRUPTCY 616 (1985) (stating that when impaired general creditors agree to a plan of reorganization that allows shareholder participation, they are recognizing in part the value of shareholders' participation as managers in the reorganizing company).

166. This conclusion follows from the Coase Theorem. See Coase, The Problem of Social Cost, 3 J.L. & Econ. 1, 2-15 (1960) (contending that in a world with zero transactions cost, original entitlements will not affect how assets are deployed, because assets will be applied to their highest-valued use).

167. The administrative costs of a typical Chapter 11 reorganization in which a creditors' committee is appointed have been estimated at $100,000. See Baird, The Uneasy Case for Corporate Reorganizations, 15 J. Legis. Stud. 127, 135 n.13 (1986).
prolonged negotiations reduce the chance of a successful agreement. If the going-concern surplus is not significant, or if the bargaining parties have different perceptions of the size of such surplus, no bargain may be reached, and the company may liquidate in Chapter 7. In short, Chapter 11 negotiations are delicate processes that take place in the shadow of that statute's procedural rules. If negotiations break down and the statutory rules actually are invoked, the game may be lost already.

The enactment of section 1114 complicates these delicate Chapter 11 negotiation processes and exacerbates the problem of transactions costs. In the same example of a company with a one hundred million dollar going-concern surplus, the secured creditors once again will not be players in negotiations over the going-concern premium. And, once again, the equity holders will have two sources of leverage to make a claim for their share of the one hundred million dollar surplus. Because section 1114 creates a new priority for retirees in Chapter 11, the statute adds a distinct third party, the retirees, to the reorganization negotiations. No longer are the retirees and the other unsecured creditors in an identical priority position. With the creation of a Chapter 11-only priority, section 1114 introduces a completely separate, and arguably more complex, form of bargaining over the allocation of any going-concern surplus that may exist in the Chapter 11 forum.

This new form of bargaining is more complex not only because there are three sets of players instead of two, but also because the retirees' new-found priority may be reduced in part, either voluntarily or through court-ordered modifications. Unlike the secured creditors, who are indifferent to a threat of conversion to a Chapter 7 case, the retirees may be willing to sacrifice some of their preferred position in a Chapter 11 in order to avoid the possibility of a Chapter 7.

Each set of players in this new form of bargaining, the retirees and the nonretiree unsecured creditors, has its own unique leverage. Chap-

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168. See Broude, supra note 163, at 441 (stating that “in an arena where timing is often more important than the ideal result, the delay caused by invocation of the cramdown power is likely to result in harm to all”).

169. See Roe, Bankruptcy and Debt: A New Model for Corporate Reorganization, 83 COLUM. L. REV. 527, 540 (1983) (noting that because senior classes can give up value to junior classes, juniors are inclined to demand even more, thus increasing “the tension created by the uncertainty of value”).

170. See D. Baird & T. Jackson, supra note 165, at 616 (observing that “[p]arties always negotiate against a background of legal rules, in bankruptcy or out”).

171. See id. at 617 (stating that “the whole structure of Chapter 11 is designed to ensure that parties bargain with one another and that there is not a full-blown valuation”). See generally E. Warren & J. Westbrook, The Law of Debtors and Creditors: Text, Cases and Problems (1986) (discussing the fact that judicial valuation is a very expensive activity that the drafters of the Code sought to avoid if at all possible).
ter 11’s “best interest of creditors” test provides the leverage that the nonretiree unsecured creditors enjoy;172 no creditor can be forced to accept a plan of reorganization that provides the creditor with less than it would receive in a liquidation.173 Because the nonretiree unsecured creditor is on equal footing with retirees in a Chapter 7 but not in a Chapter 11, it will be difficult for a Chapter 11 plan that provides for continued retiree benefits to meet the “best interests” test, unless the going-concern surplus is so large that it exceeds the present value of the retiree benefits. The chief leverage that retirees enjoy in bargaining for a bigger piece of any going-concern surplus is section 1114 itself. That statute says in subsection (g) that no party can force any reduction in retiree benefits except to the extent that such modification is “necessary to permit the reorganization of the debtor . . . .”174 Thus, retirees can contend in their bargaining with other unsecured creditors that the retirees need not accept any reduction in benefits greater than that specified by the statutory standard.

The question then becomes how much reduction in benefits nonretiree unsecured creditors can insist to the court is “necessary to permit a reorganization.” One possible reading of the modification standard of section 1114(g) starts with the presumption that Congress intended the retirees to be paid in full for their benefits before general unsecured creditors receive a penny because Congress elevated retirees’ claims to the level of administrative expenses. Under this approach, the judge would refuse to modify retirees’ benefits until the point when the continued payment of full benefits to the retirees made it impossible for the company to secure any postpetition credit and to realize any cash flow.

On the other hand, the judge making this decision cannot ignore the power that the “best interests” test bestows upon nonretiree unsecured creditors. Section 1114 does not change the fact that disgruntled unsecured creditors in a Chapter 11 always have the ability to block a plan of reorganization unless they receive at least as much in the plan as they would receive in a liquidation of the business.175 Be-

172. See supra note 157.
173. Id.
175. See supra note 157. Note that for purposes of the “best interests” test, the analysis of how much unsecured creditors would receive in a Chapter 7 liquidation must take account of the fact that a conversion to Chapter 7 typically would bring an increase in the amount of unsecured claims, thereby reducing the return of unsecured creditors. See Broude, supra note 163, at 449. For example, secured creditors are likely to receive less in a Chapter 7 foreclosure on their collateral than they would in a Chapter 11 plan. Id. Furthermore, leases that are assumed by the debtor in Chapter 11 may be rejected in Chapter 7, leading to an unsecured damages claim by the other party. Id. To the extent that the judge accounts for this probable increase in the amount of un-
cause unsecured creditors will be treated on a par with retirees in a
Chapter 7 liquidation, it is unlikely that a Chapter 11 plan which pro-
vides for continued payment of retiree benefits will give general un-
secured creditors as much as they would receive in a Chapter 7
liquidation. The ability of unsecured creditors to block a plan of reor-
ganization under certain circumstances may define the phrase “neces-
sary to permit a reorganization” under section 1114(g). In other words,
a judge may say that retiree benefits must be modified only to a level
which would ensure that unsecured creditors receive as much in the
plan as they would in a liquidation, thus stripping them of their ability
to block the confirmation of a plan.

If a judge had accurate information about the value of the business
as a going concern versus its liquidation value, the judge’s use of the
above standard to determine section 1114(g) modifications would en-
sure that disgruntled unsecured creditors could not force any ill-advised
Chapter 7 liquidations. It is doubtful that any judge will have such in-
formation. More likely, the judge will be forced to endure a parade of
valuation experts whose conclusions about the company’s projected
worth will coincide with the interests of those who employ them. No
matter what the judge decides, needless expense and litigation will have
been created by the injection of just another piece of special interest
legislation into the Bankruptcy Code.

The relatively few successful Chapter 11 cases typically result from
skillful negotiations in which the players’ common interests in a suc-
cessful reorganization predominate over their conflicts of interest.
Even if both the retirees and the unsecured creditors agreed on the size
of the Chapter 11 surplus, each side would wish to bargain for itself a
relatively larger portion of that surplus. In the presection 1114 world
where retirees had the same position in a Chapter 11 case as other un-
secured creditors, there was no need for this additional source of strate-

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176. See infra text accompanying notes 180-87.
177. Cf. Commercial Law Hearing, supra note 1, at 64 (stating that during the Chapter 11
case in In re White Farm Equip. Co., 788 F.2d 1186 (6th Cir. 1986), the creditors’ committee,
union, and debtor hired three actuarial firms whose estimates of the present value of retirees’
vested medical benefits varied as much as five-fold).
178. See Protection Act Hearing, supra note 46, at 85 (statement of Prof. Lawrence King)
(noting that “[t]he more that priorities are included in the Code and the more that special groups
are placed ahead of other groups, the more difficult it becomes for a company in financial difficulty
to get the necessary finances to work out its problems”).
179. Cf. Broude, supra note 163, at 441 (stating that “the risks of failure to reach a settle-
ment are so great, and the possible negative impact of the imposition of the cramdown powers so
significant, that the cramdown power is used more as a threat than as a club actually employed in
confirming a plan of reorganization”).
gic game-playing that will be inherent in a system that creates a new dissimilarity of interests between the two sides.

C. The Problem of Perverse Incentives

In addition to creating the new transactions costs described above, the enactment of section 1114 gives certain Chapter 11 players incentives that are contrary to the underlying goals of the reorganization process. First, section 1114 changes the incentives of the nonretiree unsecured creditors. In a presection 1114 setting, these creditors would have an incentive, once their debtor filed a Chapter 11 petition, to see the debtor reorganize as long as they thought that the company would be worth more as a reorganized going concern than it would be worth liquidated under Chapter 7. With the enactment of section 1114, however, the nonretiree creditors’ desire to see the company in a Chapter 11 will not be necessarily a function of whether they believe that the company would be worth more in a Chapter 11 than in a Chapter 7. Instead, the desire of nonretiree unsecured creditors to see the company reorganize will be influenced by how much their retiree counterparts are willing to reduce their insurance benefits.

The facts of the previous hypothetical illuminate this point. A debtor company in Chapter 11 is worth four hundred million dollars as a going concern and three hundred million dollars if liquidated in a Chapter 7 case; the debtor has one hundred million dollars of secured

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180. This conclusion assumes that the unsecured claimants as a group would reap the benefits of at least part of the going-concern surplus. Because the unsecured claimants are the residual claimants in the hypothetical, this result seems probable. See supra note 159.

It also should be noted that unsecured trade creditors who continue to do business with the Chapter 11 debtor may have incentives to keep the debtor in Chapter 11 whether or not the debtor is worth more in Chapter 11 than in Chapter 7. These trade creditors may believe they are better off with the profits they will make through continued business with the debtor while it is in Chapter 11, even if they believe that the debtor in fact has no going-concern surplus and is probably worth more liquidated in a Chapter 7 case.

181. The examples so far have assumed that Chapter 11 is the best vehicle for preserving the going-concern value of a firm in bankruptcy. There is, however, no statutory reason why, following a conversion of the case to Chapter 7, some or all of the company’s going-concern value cannot be preserved. In other words, it is technically possible in a Chapter 7 liquidation to have the company sold intact with the proceeds of the sale constituting the Chapter 7 estate against which the debtor’s creditors will satisfy their claims. One of the duties of the Chapter 7 trustee is to “collect and reduce to money” the property of the estate, See 11 U.S.C. § 704(1) (1988), but nothing in the Bankruptcy Code mandates that the trustee sell the property of the estate on a piecemeal basis. In fact, § 721 contemplates that the trustee may continue the operation of the business for a limited period in Chapter 7 “if such operation is in the best interest of the estate and consistent with the orderly liquidation of the estate.” Id. § 721.

If going-concern values could be realized just as efficiently in a Chapter 7 as in a Chapter 11, one reason why most reorganizing companies still would choose the Chapter 11 forum is because in Chapter 11 the presumption of the Bankruptcy Code is that current management remains in place. See id. § 1107 (providing that the debtor-in-possession shall have all of the rights and duties of a
debt, three hundred million dollars of nonretiree unsecured debt, two hundred million dollars of retiree obligations, and a class of stockholders. With or without section 1114, the secured creditors would receive their one hundred million dollars off the top, whether or not there was a successful plan of reorganization. In a presection 1114 world, both retiree and nonretiree unsecured creditors would bargain with the shareholders over allocation of the one hundred million dollar going-concern surplus available through the Chapter 11 forum. Even if the shareholders managed to bargain for a full fifty percent of that surplus, leaving fifty million dollars for the residual claimants, the nonretiree unsecured creditors would still have an incentive to see the company reorganize in Chapter 11 rather than liquidate in Chapter 7. The nonretiree unsecured creditors would prefer such a result because with a fifty-fifty split of the Chapter 11 surplus, they still would receive ten cents more on the dollar in a Chapter 11 reorganization than they would in a Chapter 7 liquidation.182

The enactment of section 1114 created a new state of affairs. The previous hypothetical with the same debtor and creditors illustrates the problem. For this example the level of retiree insurance benefits is not

182. In a Chapter 7 case the nonretiree unsecured creditors would receive 40 cents on the dollar ($300 million minus $100 million for secured creditors equals $200 million to be divided among the holders of the $500 million total of unsecured claims). In Chapter 11 the unsecured creditors would receive 50 cents on the dollar ($400 million minus $100 million for secured creditors minus $50 million for equity equals $250 million to be split among $500 million worth of unsecured claims). The bargaining costs between the residual claimants and the shareholders would reduce the Chapter 11 premium by that amount, but would not make Chapter 7 the preferred choice unless the transactions costs in the Chapter 11 exceeded the amount of the going-concern surplus, $100 million.

The above figures assume that courts would accept the more limited reading of retirees' administrative status under § 1114(e)(2). See supra text accompanying notes 125-30.
reduced during the pendency of the Chapter 11. After four months, the
debtor-in-possession proposes a plan of reorganization. The plan pro-
vides that secured creditors will be paid in full at a total cost of one
hundred million dollars, retiree insurance benefits will continue to be
paid in full at a total discounted present cost of two hundred million
dollars, nonretiree unsecured creditors will receive thirty cents on the
dollar in cash, and equity holders will receive stock in the new company
with a total present value of ten million dollars. Even if the nonretiree
unsecured creditors had accurate information and knew that the debtor
would be worth four hundred million dollars as a going-concern and
three hundred million dollars if liquidated piecemeal, that class of un-
secured creditors would block the plan and insist on some portion of
the going-concern surplus.\textsuperscript{183} They would have the incentive to block
the plan because in a Chapter 7 case the retirees and the unsecured
creditors each would receive forty cents on the dollar,\textsuperscript{184} which is
greater than the thirty percent return that the Chapter 11 plan pro-
provided for the nonretiree unsecured creditors.

Only if the retirees in the above example are willing to accept a
reduction in their medical benefits, or the court forces such a reduction,
will the other unsecured creditors have an incentive to see the debtor
reorganize in the Chapter 11 case. Both statutory routes to modification
of retiree benefits will involve some form of transactions costs, either
through bargaining or judicial valuation.\textsuperscript{185} Although the nonretirees' pervers
incentive to see a company in Chapter 7 may in some cases be
overcome, section 1114 will have done its damage already by creating a
baseline of Chapter 11 entitlements in which nonretiree unsecured
creditors may be better off in a Chapter 7 even if the company as a unit
is more valuable in a Chapter 11 setting.

Section 1114 also changes the incentives of retirees. A new hypo-
thetical illustrates this change in incentive. A company, for whatever
reason, simply has no going-concern surplus;\textsuperscript{186} it is worth five hundred

\textsuperscript{183} The nonretiree unsecured creditors would have the ability to block the plan by voting
against it because each of these creditors would not be receiving as much in the plan as each would
receive in a Chapter 7 liquidation of the debtor. \textit{See supra} note 157.

\textsuperscript{184} The calculation would be as follows. The Chapter 7 liquidation would yield a total of
$300 million. The secured creditors would receive $100 million of that total, leaving $200 million
for the retirees and the other unsecured creditors. Because these claims together total $500 million
($200 million for retirees and $300 million for other unsecureds), the $200 million would be enough
to pay 40\% of those claims.

\textsuperscript{185} \textit{See supra} text accompanying notes 158-79.

\textsuperscript{186} The purpose of Chapter 11 is not necessarily to see every business reorganized. Rather,
it aims to reorganize companies that in fact have going-concern value worth preserving. \textit{See} Baird
& Jackson, \textit{supra} note 10, at 109 (stating that the "firm should be kept intact only if it has more
value as a going concern than liquidated"); see also 11 U.S.C. \textsection{} 1129(a)(11) (1988) (providing that
one prerequisite to confirmation of a plan is that the company is capable of preservation as a going
million dollars if liquidated piecemeal in a Chapter 7 case but is worth only three hundred million dollars as a going concern. The members of the company’s management, in a desperate attempt to keep their jobs, file a Chapter 11 petition for reorganization. Secured creditors are owed one hundred million dollars, nonretiree unsecured creditors are owed three hundred million dollars, and retirees have been promised future benefits with a discounted present value of two hundred million dollars. There is also a class of stockholders. In this example, the retirees will want the case to stay in Chapter 11 as long as possible even if their accountant tells them the stark facts about the company’s lack of a going-concern surplus. As long as the company is in Chapter 11, the retirees will receive a preferred position compared with other unsecured creditors. Once the case is converted to a Chapter 7, however, the retirees lose that priority and share pro rata with the rest of the unsecured creditors. Thus, section 1114 sets up a situation in which the retirees will have a perverse incentive to “bleed away” the assets of the estate to the detriment of the creditor group even in such an admittedly fruitless Chapter 11 effort.

D. Objections to “Bankruptcy-Only” Priorities

In addition to preservation of going-concern value, another fundamental goal of bankruptcy is “equality of treatment.” Unlike most state-law systems, in which the spoils go to the swiftest creditor, the bankruptcy forum treats like creditors alike. The base line for determining which creditors are “like” for purposes of bankruptcy distribution is the creditors’ relative positions under state law. In other words, because a fully perfected secured creditor will get paid before a general unsecured creditor under state law, the same result generally occurs in bankruptcy. Similarly, subordinated creditors under state law do not collect their claims in bankruptcy until unsubordinated creditors have been paid.

There are some exceptions to the above principle. Section 507 contains a number of categories of claimants whose rights are greater in bankruptcy than they are outside bankruptcy. Most of these priori-
ties, however, are limited to fairly modest dollar amounts.\textsuperscript{191} Even then, many critics argue that a proliferation of such special priorities in bankruptcy tends to thwart the effectiveness of the bankruptcy process.\textsuperscript{192}

Giving certain classes of creditors priorities in bankruptcy that they do not enjoy outside bankruptcy tends to have at least two detrimental consequences. First, it may give that class of creditors an incentive to see its debtor in bankruptcy even when the company's problems could be resolved more readily and cheaply outside bankruptcy.\textsuperscript{193} Second, the existence of a special priority in bankruptcy, particularly one attaching to a very large claim, may make it more expensive for the debtor to obtain credit.\textsuperscript{194}

Some general observations about the role of the bankruptcy process demonstrate the underpinnings of the first problem. Bankruptcy is a costly procedural mechanism that should be used only in a case in which creditors of the debtor cannot come to a consensual agreement. One of the chief advantages that bankruptcy has over out-of-court workouts is its coercive process. Unlike nonbankruptcy composition agreements among creditors, bankruptcy is a collective proceeding in which no creditor may choose to opt out. Notwithstanding this advantage to the bankruptcy process, many companies could be reorganized at less expense without court intervention. The first problem with section 1114 is that it makes an out-of-court reorganization much more unlikely because any proposed reduction in retiree benefits would prompt retirees to force the company into Chapter 11, where retirees would enjoy the priority position that they lack outside bankruptcy.

The second problem created by a significant bankruptcy-only priority such as that conferred by section 1114 is the debtor's reduced access to credit markets. Any lenders that consider extending credit to a company with large retiree insurance obligations will have to factor into their interest rate the reduced return they will receive in bankruptcy due to the subordination of their claim to that of the retirees. The disincentive for creditors to lend created by section 1114 will loom largest

\textsuperscript{191} See, e.g., id. § 507(3)(B) (providing that special priority for prepetition wage claims is limited to $2000 for each individual).
\textsuperscript{192} See Protection Act Hearing, supra note 46, at 160 (testimony of Nathan B. Feinstein) (indicating that “experience in Europe and elsewhere has been that engrafting welfare priorities into the reorganization process has destroyed the process”).
\textsuperscript{193} See Butner v. United States, 440 U.S. 48, 55 (1979) (asserting that an important reason for uniform treatment of property interests inside and outside bankruptcy is to discourage forum shopping).
\textsuperscript{194} See Protection Act Hearing, supra note 46, at 85 (testimony of Prof. Lawrence P. King) (suggesting that in prebankruptcy workouts, lenders will be more likely to forgo payments owed if they can be assured of receiving a reasonable return if the debtor goes into Chapter 11); see also id. at 122-23 (testimony of William J. Perlstein) (stating that postpetition unsecured credit is unlikely if the Chapter 11 debtor is saddled with significant retiree benefits obligations).
at the very time when the debtor needs credit the most. Section 1114 will cause the financially struggling debtor, desperately in need of a cash infusion, to pay the largest premium for a loan, because the likelihood of a lender facing the retirees’ bankruptcy priority will be greatest with just such a borrower.

A final troubling aspect to the administrative expense priority given to retiree benefits in Chapter 11 cases is that there is nothing about a retiree insurance expense that gives it the character of a traditional administrative expense. The first priority accorded to administrative expenses is reserved generally for those creditors who have added value to the debtor’s estate. Administrative priority status attaches, for example, to the rendering of postpetition services or the extension of postpetition credit. While retirees at one time gave value to the company for which they worked, that is true of all prepetition unsecured creditors, none of whom qualify for an administrative expense priority.

VI. NONBANKRUPTCY SOLUTIONS

There are a number of possible ways to address the problems that Congress purported to alleviate with the enactment of section 1114. One possible approach would attach a federally created lien to the assets of a company, both inside and outside bankruptcy, equal to the amount of retiree insurance obligations owed by the company. This method of giving retirees a priority over other creditors would be superior to section 1114 because it would remove two types of perverse incentives created by the operation of section 1114. First, other unsecured creditors would not wish to force the company into Chapter 7 in any case in which these creditors believed that the most efficient use of the debtor’s assets could be made in the Chapter 11 forum. Second, retirees would not have a perverse incentive to force their former company into Chapter 11 in a case when an out-of-court workout would be the


197. See supra text accompanying notes 189-92. But see Commercial Law Hearing, supra note 1, at 80 (testimony of Prof. Vern Countryman) (suggesting special treatment for retiree benefits might be appropriate because current workers may be agreeing to work in part because retirees are being paid benefits).

198. Cf. 29 U.S.C. §§ 206, 207, 215(a)(2) (1982 & Supp. V 1987) (providing that the Secretary of Labor has the ability to enjoin companies that fail to pay minimum wage from placing goods into commerce, effectively giving workers a “lien” on goods for the amount of minimum wage owed).

199. See supra text accompanying notes 180-85.
best way to reorganize the business. The federal statutory lien approach is not without its drawbacks. Such a lien would have a detrimental effect on the availability of credit for companies whose retiree benefits liabilities are substantial. If section 1114 causes lenders to charge a premium for loans to businesses that have large retiree liabilities, a retiree benefits lien that operated in all cases would make such a premium that much greater. In many cases, the existence of such a federal lien would discourage the extension of all credit.

Another possible approach to the retiree benefits dilemma is a congressional mandate that companies must prefund retiree benefits programs, as under ERISA. The drawback to this method is that many employers would discontinue providing the benefit if such a program meant that they would be forced to prefund it. Furthermore, those companies that did retain their programs probably would have to pay lower salaries once they recognized the true cost of this form of deferred compensation. Finally, the administration and enforcement of federally mandated prefunding would entail new costs, a lesson this country has learned since the advent of ERISA. Notwithstanding all of these costs, an ERISA-type mechanism is probably the only realistic way to address the true underlying cause of the retiree benefits crisis: lack of funding. Although regulation of retiree benefits prefunding would be a more expensive prospect for the federal government than the new bankruptcy legislation, Congress could take advantage of the ERISA structure that is already in place as the vehicle for ensuring employer compliance.

Certainly many companies would respond to a prefunding requirement by dropping retiree medical programs altogether. With the advent, however, of the FASB proposal for forcing companies to show retiree benefits liabilities on the balance sheet, those companies that do not have a serious commitment to retiree insurance benefits most likely will phase out such programs in any event. Furthermore, even if some businesses discontinue postemployment benefits as a result of such funding requirements, there is some benefit to forcing a company's hand on the retirement insurance issue.

If employers are required to back up their retirement benefits promises with funds earmarked for that purpose, those workers who are

200. See supra text accompanying notes 186 & 187.
201. See supra note 51 and accompanying text.
202. See, e.g., LTV Hearing, supra note 3, at 64-67 (letter from Kathleen P. Utgoff, executive director, PBGC) (describing how PBGC is required to assume responsibility for guaranteed benefits that the promising company underfunds).
203. See supra text accompanying notes 48-51.
204. See supra note 51 and accompanying text.
promised such benefits can be certain that the money will be available to pay for the benefits when the workers retire. Employees who work for companies that no longer offer such benefits to retirees can plan their lives accordingly. For example, when these noncovered employees consider the option of early retirement, they can evaluate realistically whether the cost of pre-Medicare health coverage will make such a decision financially ill-advised.

The real tragedy of the current state of affairs is the surprise factor. The typical retiree who has been promised insurance benefits simply does not consider that the promise is contingent on the employer’s continued financial health. \(^{205}\) Because the retiree has not considered the potential frailty of the promise, he has not accounted, financially or emotionally, for the possibility that the promise will be broken. If a prefunding requirement means that fewer employers will make a retiree insurance commitment, at least those companies making such commitments will set aside the funds to meet those obligations as they come due.

A newly enacted prefunding requirement would be too late for current retirees; their hope of receiving retiree benefits rests on the continued financial health of their former employer. The retiree would want the former employer to have open to it all possible avenues, both bankruptcy and nonbankruptcy, for working through its financial difficulties. A repeal of section 1114 would give these retirees greater assurance that the party who promised them their retirement insurance benefits would be ultimately in the best possible position to keep that promise.

**VII. Conclusion**

Section 1114 of the Bankruptcy Code was enacted by Congress as a well-intentioned response to the crisis created for retirees when LTV filed Chapter 11 and ceased paying retiree insurance premiums. Unfortunately, the new bankruptcy provision is of dubious value to retirees. Because Congress gave retirees a priority that attaches solely in a Chapter 11 case, the retirees have no special protection either in a Chapter 7 liquidation or in a liquidation under state law.

Besides failing to give retirees any meaningful protection for their postemployment insurance benefits, section 1114 creates an incentive for other unsecured creditors to force a business to liquidate under Chapter 7 even when the assets of the business would be deployed most effectively in the Chapter 11 forum. Furthermore, the new Bankruptcy Code section gives retirees a reason to want their former employer in

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205. See, e.g., Retiree Health Benefits Hearings, supra note 10, at 8-11 (providing the testimony of retirees whose medical insurance was discontinued suddenly).
Chapter 11 even when the problems of the business could be resolved best outside the bankruptcy reorganization process. Finally, the new Bankruptcy Code section creates a significant additional source of transactions costs in a Chapter 11 case that could prevent the successful reorganization of companies that have a going-concern value worth preserving.

The crisis surrounding retiree insurance benefits can be resolved only with an approach that addresses the true underlying cause: lack of prefunding. An ERISA-type prefunding requirement, despite its costs, would give security for employees whose companies continued to offer retiree insurance benefits. Furthermore, employees whose companies chose to discontinue retiree insurance programs at least could plan for their future with a realistic set of expectations concerning their postemployment entitlements.