

**Bankruptcy’s Section 1113—
Rejection of a Collective Bargaining Agreement:
The Court’s Diminution of Labor’s Prerogative
And Legal and Economic Arguments for its Reassertion**

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INTRODUCTION

Given the recent wave of bankruptcy filings of large corporations overburdened by legacy costs, it is timely to discuss and clarify § 1113's effect on the priority, rejection, and damages stemming from the rejection of a Collective Bargaining Agreement ("CBA"). Although CBAs are executory contracts,¹ § 1113 was enacted by Congress to stop the outright rejection of CBAs under § 365² of the 1978 Bankruptcy Code³ (the "Bankruptcy Code" or the "Code"). After twenty years of judicial construction, three questions remain in the interpretation of § 1113. First, several steps in the process for rejection have been interpreted to the debtor's favor. Second, § 1113's enactment has created confusion as to whether Congress intended the section to alter bankruptcy's priority scheme, with some courts interpreting the section to effectively raise CBA claims to the level of a "superpriority" status. Third, although § 1113 was meant to supersede and modify § 365 for CBAs, § 1113 fails to mention damages. Thus courts are in conflict as to whether they must deny damage claims outright or continue to treat the rejection of a CBA in the same manner as the rejection of any other executory contract.

Unfortunately for organized labor, § 1113 has not proven to be the panacea unions lobbied for. An empirical study examining rejections of CBAs during the ten years prior to and after the enactment of § 1113 demonstrates that judicial approval of CBA rejections merely

¹ An executory contract is "a contract under which the obligation 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." *See* Vern Countryman, *Executory Contracts in Bankruptcy: Part 1*, 57 MINN. L. REV. 439, 460 (1973). This interpretation has been widely held as the definition of an executory contract used in bankruptcy. *See, e.g.,* *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1045 (4th Cir. 1985) (adopting executory contracts definition propounded by Vern Countryman); *Terrell v. Albaugh (In re Terrell)*, 892 F.2d 469, 471 n.2 (6th Cir. 1989) (same). *See also* *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n.6 (1984) (citing legislative history to characterize executory contracts as contracts under which performance is due on both sides).

² Section 365, governing "executory contracts and unexpired leases," states in relevant part: "[T]he trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a).

³ 11 U.S.C. §§ 101 et seq.

declined from 67% to 58% during that period.⁴ It appears that the most significant change is simply that a debtor may no longer unilaterally reject the CBA, which thereby slows the debtor's ability to reject a CBA outright. However, court approved rejections are only slightly below the pre-1984 levels.

Why was labor unable to achieve a big win with § 1113? Bankruptcy and labor are both federal imperatives and § 1113 was an attempt to propel labor law to the forefront of the judicial decision-making process in bankruptcy. Unfortunately for labor, rejection of a CBA occurs during the bankruptcy proceeding, overseen by bankruptcy judges whose primary concern is with the orderly administration of the bankruptcy estate and not with federal labor law. A bankruptcy judge called to interpret a statute enacted to increase the prevalence of non-bankruptcy concepts in bankruptcy possesses a natural instinct, when faced with ambiguity, to resolve the issue in the statute towards a better alignment within the overall bankruptcy administrative scheme. This belittles the economic and congressionally determined significance given to labor. In order to overcome this (unconscious) discrimination and to halt bankruptcy's erosion of federal labor rights, two things must occur: economists and accountants must acknowledge labor's importance to corporations and Congress must revisit § 1113 to hand down a more forceful directive to reestablish the importance of CBAs.

In this paper, I introduce a new argument that eliminating a claim for breach of a labor contract will raise the ex ante cost of capital for a firm more than eliminating a different sort of claim would because labor is nondiversifiable. This has not been touched upon before and is a unique contribution to the literature. This paper begins with a brief history of the enactment of § 1113 and an analysis of the process for rejecting a CBA. I then discuss the priority issue, and

⁴ Christopher D. Cameron, *How 'Necessary' Became the Mother of Rejection: An Empirical Look at the Fate of Collective Bargaining Agreements on the Tenth Anniversary of Bankruptcy Code Section 1113*, 34 SANTA CLARA L. REV. 841, 892-93 (1994).

whether § 1113 modifies § 507's priority scheme. Next, I analyze the damage issue, and address whether damage claims arise from rejection. I will show how the majority of courts have resolved these key issues in a manner that 'smoothes' the bankruptcy process for the debtor, rather than for the benefit of labor as § 1113 was intended. I have endeavored to infuse into this discussion what I believe is the proper perspective: that of the bankruptcy judge's attempt to interpret what is essentially non-bankruptcy policy into the bankruptcy process. Finally, I conduct an economic analysis of the investment of 'human capital' as compared to an investment of 'financial capital' to show that labor's nondiversifiable character demands a higher default spread, and hence a cost of capital, than that given to creditors. I conclude with a discussion of the possibilities for recognizing labor's contribution to the firm on the balance sheet by modeling it as an intangible asset or capitalizing it in a method similar to that used by analysts capitalizing operating leases.

I.

THE HISTORY AND INTRODUCTION OF § 1113.

This section briefly outlines the immediate history surrounding the introduction of § 1113 into the Bankruptcy Code. Under pressure from labor unions, Congress reacted to the Supreme Court's decision in *NLRB v. Bildisco and Bildisco*⁵ by infusing the federal prerogative for labor into the Code.

Prior to 1984, courts consistently held that a CBA could be rejected as an executory contract under § 365 of the Code. In *Bildisco* the Supreme Court affirmed this right and attempted to lay down procedures for lower courts to follow in rejecting a CBA.

The *Bildisco* decision reaffirmed the debtor's right to reject a CBA as an executory

⁵ 465 U.S. 513.

contract in a Chapter 11 proceeding. The case is viewed as having two holdings. First, a unanimous Court held that rejection should be approved “if the debtor can show that the collective bargaining agreement burdens the estate, and that after careful scrutiny, the equities balance in favor of rejecting the labor contract.”⁶ Second, five justices upheld the ability of the debtor to unilaterally reject or modify a CBA subject to later court approval or denial.⁷

Just five months following the *Bildisco* decision, labor leaders successfully lobbied Congress to enact § 1113 of the Bankruptcy Code to preempt the Court’s ruling. Section 1113 outlays the procedural and substantive steps a company must follow in order to terminate⁸ or modify⁹ a CBA. In addition, § 1113(f) overruled *Bildisco*’s second holding which allowed unilateral rejection of a CBA subject to a later court determination.¹⁰ Moreover, § 1113(f) acted further to remove CBAs from the realm of § 365 by stating that “[n]o provision of this title shall be construed to permit a trustee to unilaterally terminate or alter any provisions of a collective bargaining agreement prior to compliance with the provisions of this section.”¹¹

Unfortunately for labor, § 1113 has caused confusion among the circuit courts called upon to interpret its provisions. In Part II, I show how this confusion has resulted in the courts whittling away at the Congressional grant given to labor. I hypothesize this diminution of § 1113 occurs as a result of bankruptcy judges remaining within the shelter of their institutional competence: delivering an efficient administration of the bankruptcy estate.

⁶ *Id.* at 526.

⁷ *Id.* at 534.

⁸ 11 U.S.C. § 1113(a)-(d).

⁹ *Id.* § 1113(e).

¹⁰ 465 U.S. at 534.

¹¹ 11 U.S.C. § 1113(f).

II.

THE SUBSEQUENT LEGAL DIMINUTION OF § 1113

There are three key areas wherein Bankruptcy Courts have worn away § 1113's edge. In Part II, I examine three steps of the Courts' nine-step procedure before approval of rejection of a collective bargaining agreement that have been interpreted in the debtor's favor. I follow this with a discussion of disputed issues that have been raised surrounding the administrative priority and damages of claims arising under a rejected CBA.

A. The Procedure to Reject a Collective Bargaining Agreement

Section 1113 lays out the exclusive procedures for modifying or rejecting a CBA. In essence, debtors must follow a nine-step process before a court ordered rejection of a CBA is approved.¹² Although this procedure begins “[s]ubsequent to filing a petition and prior to filing [the] application seeking rejection,”¹³ courts have set no minimum time frame for initiating this process. In fact, some courts have allowed the debtor to submit a proposal to the union representative simultaneously with the filing of the bankruptcy petition.¹⁴ A debtor may file the application for rejection immediately thereafter. Theoretically, this leaves only ten to fourteen days after the filing of the bankruptcy petition before the court holds a hearing on the application for rejection,¹⁵ leaving a minimal amount of time for a union to respond to the application.

¹² This nine-step process was first used in *In re American Provision Co.*, 44 B.R. 907 (Bankr. D. Minn. 1984).

¹³ 11 U.S.C. § 1113(b)(1).

¹⁴ See *In re Blue Diamond Coal Co.*, 131 B.R. 633, 641 (Bankr. E.D. Tenn. 1991) (“The debtor made its initial proposal to representatives of the Union as required under § 1113(b)(1) on the day it filed its Chapter 11 petition, May 17, 1991.”).

¹⁵ “Upon the filing of an application for rejection the court shall schedule a hearing to be held not later than fourteen days after the date of the filing of such application. All interested parties may appear and be heard at such hearing. Adequate notice shall be provided to such parties at least ten days before the date of such hearing.” 11 U.S.C. § 1113(d)(1). Although one court has held that making the proposal to reject then filing the motion for rejection on the same day as filing the bankruptcy petition technically meets § 1113's requirements, *In re U.S. Truck Co. Holdings, Inc.*, 2000 Bankr. LEXIS 1376 (Bankr. E.D. Mich. Sept. 29, 2000), held that “[a]buse of the time frame in

The nine-step test was elucidated in *In re American Provision Co.*¹⁶ The first five requirements must occur prior to filing the rejection motion but subsequent to filing the bankruptcy petition: (1) The debtor in possession must make a proposal to the union to modify the CBA.¹⁷ (2) This proposal must be based on the most complete and reliable information available at the time of the proposal.¹⁸ (3) The proposed modifications must be necessary to permit the reorganization of the debtor.¹⁹ (4) The proposed modifications must assure that all creditors, the debtor and all of the affected parties are treated fairly and equitably.²⁰ (5) The

submitting the motion for rejection may affect the requirement that bargaining be in ‘good faith.’” COLLIER ON BANKRUPTCY, ¶ 1113.06[1] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. 2005). In such cases, it may be better to use the § 1113(e) mechanism for interim modifications to the CBA. 11 U.S.C. § 1113(e).

¹⁶ 44 B.R. at 909. In each of these nine requirements, “the burden of proof is to be borne by the debtor with a preponderance of the evidence. The burden of going forward with the evidence can, however, shift to the union, particularly with respect to tests number 5, 7, and 8.” *In re Blue Diamond Coal Co.*, 131 B.R. at 643.

¹⁷ 11 U.S.C. § 1113(b)(1)(A). This requirement imposes no real burden on the debtor. It is important to note that the debtor may submit multiple proposals, consonant with the requirement to bargain in good faith. Moreover, a subsequent proposal may be considered by the court in approving the rejection of the CBA. In fact, “[n]owhere in the statute does it require that the employer’s best offer be made at the outset of the negotiations.” *In re Pierce Terminal Warehouse, Inc.*, 133 B.R. 639, 647 (Bankr. N.D. Iowa 1991). The statute simply requires that the employer prove that it made a proposal satisfying § 1113 before the court may authorize rejection of the CBA. *Id.* This interpretation provides the employer with opportunities to extract concessions from the union while bargaining by proffering a less than perfect offer.

¹⁸ *Id.* This step has been interpreted favorably to debtors. The union may not avoid rejection of the CBA if the proposal has no material inaccuracies. *See In re Indiana Grocery Co., Inc.*, 136 B.R. 182, 191 (Bankr. S.D. Ind. 1990) (Even though “some of the information on which the proposal was based was unreliable,” the court accepted that debtor had “used the most complete and reliable information and the best analysis it had available in formulating its proposal.”); *In re Salt Creek Freightways*, 47 B.R. 835, 839 (Bankr. D. Wyo. 1985) (“The requirement of § 1113(b)(1)(B) is that the debtor provide such relevant information to the Union as is necessary for the Union to evaluate the debtor’s proposal. It does not require . . . that the debtor also provide the Union, as part of its application to reject, with the written estimates necessary to evaluate the costs of the Union’s own counter-proposals.”). In order to be deemed as compliant, the debtor merely needs to conform with the requirement as best it can.

¹⁹ *Id.* *See infra* § 1.

²⁰ Section 1113(b)(1)(A) states that the debtor’s proposal must treat the “creditors, the debtor and all of the affected parties . . . fairly and equitably.” 11 U.S.C. § 1113(b)(1)(A). The purpose of this provision “is to spread the burden of saving the company to every constituency while ensuring that all sacrifice to a similar degree.” *Carey Transp.*, 816 F.2d at 90 (citing *In re Century Brass Products, Inc.*, 795 F.2d 265, 273 (2d Cir. 1986)). However, this does not require that the debtor to prove that others will shoulder cuts to the “same degree” as the union. *Id.* The statutory text regarding “fair and equitable” treatment both enhances and undermines Congress’ overall intent of using § 1113 to promote the union’s interests. Only debtors and creditors have seats at the proverbial “bargaining table” during a reorganization. This section illustrates Congress’ recognition that other stakeholders are affected by corporate reorganization and bankruptcy, in contrast to economists’ desire to limit concerns between contracting parties. *See infra* Part III. But at the same time, more equitable treatment among all affected parties stands in stark contrast to the private benefit lobbied for by labor.

debtor must provide to the union representatives such relevant information as is necessary to evaluate the proposal.²¹

The final four requirements relate to the negotiations between the debtor and the union representatives and must occur during the period after the submission of the proposal but before the date of the hearing on approval of the rejection of the CBA: (6) The debtor must meet at reasonable times with the union representatives.²² (7) The debtor must confer in good faith in attempting to reach mutually satisfactory modifications of the CBA during the meetings with union representatives.²³ (8) The union representative must have refused to accept the proposal without good cause.²⁴ (9) The balance of the equities must clearly favor rejection of the CBA.²⁵

If the court denies an application to reject the CBA, the employer must continue to comply with the terms of the CBA. However, there is a possibility for interim changes in a CBA. If the court does not rule within thirty days following the hearing, the employer may implement interim changes pending a ruling.²⁶ Alternatively, the court may authorize the trustee to

²¹ The § 1113(b)(1)(B) requirement that the debtor provide the union with “such relevant information as is necessary to evaluate the proposal” taken together with the § 1113(b)(1)(A) requirement that the proposal be “based on the most complete and reliable information” is a clear-cut provision that is easy for the debtor to accomplish.

²² *Id.* § 1113(b)(2). The requirement that the debtor and the union must meet at reasonable times is relatively straightforward. The purpose of this requirement, along with the requirement that the debtor supply the relevant information, is an attempt to encourage negotiations between the debtor and the union. *See Wheeling-Pittsburgh Steel Corp.*, 791 F.2d at 1093. The sufficiency of time spent negotiating is determined based on the circumstances of the particular case, and the urgency of the situation may be one factor in allowing for a shorter negotiation period. *See id.* at 1093-94. If the debtor and union fail to meet, this step provides an easy decision-making system for the court in its analysis of the application for rejection: if the failure to meet is due to the fault of the union, the court may utilize this step to determine that the union failed to reject the proposal for “good cause;” similarly, if the failure to meet is due to the fault of the debtor, a court could determine that the debtor did not confer in “good faith” with the union.

²³ Section 1113(b)(2) requires that the debtor must “confer [with the union] in good faith in attempting to reach mutually satisfactory modifications of such agreement.” 11 U.S.C. § 1113(b)(2). “Good faith” has been defined as “conduct indicating an honest purpose to arrive at an agreement as the result of the bargaining process.” *See In re Blue Diamond Coal Co.*, 131 B.R. 633, 646 (Bankr. D. Tenn. 1991). This does not require the debtor to meet with the union a specific number of times. Rather, the debtor need only establish that he has “seriously attempted to negotiate reasonable modifications in the collective bargaining agreement.” COLLIER ON BANKRUPTCY, *supra* note 15, ¶ 1113.06[5].

²⁴ *Id.* § 1113(c)(2). *See infra* § 2.

²⁵ *Id.* § 1113(c)(3). *See infra* § 3.

²⁶ *Id.* § 1113(d)(2).

implement interim changes in the CBA if the court finds it “essential to the continuation of the debtor’s business, or in order to avoid irreparable damage to the estate.”²⁷

Of these nine requirements, three have been heavily litigated and are discussed more fully below.²⁸

1. Step 3: The ‘Necessary’ Requirement

Step 3 requires that the debtor’s proposal must “provide[] for those *necessary* modifications in the employees benefits and protections that are *necessary* to permit the reorganization of the debtor.”²⁹ Case law interpreting this provision attempts to answer the questions of (1) “how necessary must the proposed modifications be,” and (2) “to what goal must those alterations be necessary?”³⁰ A circuit split currently exists between the Second and Tenth Circuits³¹ and the Third Circuit concerning the interpretation of “necessary” under both of these questions. The Third Circuit was the first to answer these questions and imposed more stringent standards on the debtor.

Regarding the question of “how necessary,” *Collier on Bankruptcy* notes that the terms of the proposal “must have a significant economic impact on the debtor’s operations” and otherwise non-economic factors will be held as not “necessary.”³² In *Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of America, AFL-CIO-CLC*, the Third Circuit held that “necessary” as used

²⁷ *Id.* § 1113(e).

²⁸ Not all courts follow this nine-part test. Judge P. Beatty, United States Bankruptcy Judge for the Southern District of New York, finds the test to be “talismanic” and instead prefers to consider only the three interdependent findings required by § 1113(c). See *In re Royal Composing Room, Inc.*, 62 B.R. 403, 406 (Bankr. D.N.Y. 1986), *aff’d*, 78 B.R. 671 (S.D.N.Y. 1987), *aff’d*, 848 F.2d 345 (2d Cir. 1988).

²⁹ 11 U.S.C. § 1113(b)(1)(A) (emphasis added).

³⁰ See COLLIER ON BANKRUPTCY, *supra* note 15, ¶ 1113.06[2] (citing *Truck Drivers Local 807 v. Carey Transp., Inc.*, 816 F.2d 82, 88-89 (2d Cir. 1987) (citing *Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of Am., AFL-CIO-CLC*, 791 F.2d 1074, 1088 (3d Cir. 1986); *In re Royal Composing Room, Inc.*, 62 Bankr. 403, 417-18 (Bankr. S.D.N.Y. 1986))).

³¹ The Tenth Circuit has followed the Second Circuit on each of the questions.

³² COLLIER ON BANKRUPTCY, *supra* note 15, ¶ 1113.06[2].

in § 1113(b)(1)(A) is synonymous with “essential” in § 1113(e), and must “be construed strictly to signify only modifications that the trustee is constrained to accept.”³³ This standard is especially strong, leaving the reorganizing debtor with very little ‘wiggle’ room. Stepping back from the issue to examine whether this standard fits with the purpose of bankruptcy and labor laws, the Third Circuit’s decision appears consonant with the importance given to labor but simultaneously diminishes the prospects that the reorganized debtor will be able to avoid future bankruptcies.

In *Truck Drivers Local 807 v. Carey Transp., Inc.*, the Second Circuit criticized the Third Circuit and held that the proposal should “contain [the] necessary, but not absolutely minimal, changes that will enable the debtor to complete the reorganization process successfully.”³⁴ This view is more harmonious with the efficient administration of bankruptcy and takes away negotiating power from the union, thereby making the debtor’s position stronger.

In answering the second question regarding ‘to what goal are those modifications necessary,’ the Third Circuit in *Wheeling-Pittsburgh* relied heavily on statements made by members of Congress.³⁵ Although the statutory language clearly states “necessary to permit the reorganization of the debtor,” the court interpreted this to refer only to the “shorter term goal of preventing the debtor’s liquidation” rather than on the “successful rehabilitation of the debtor [by] focus[ing] on the long-term economic health of the debtor.”³⁶ Again, the Third Circuit’s interpretation emphasizes the near-term goal of an immediate reorganization rather than the debtor’s long-term viability. This standard gives labor the importance that Congress intended.

³³ 791 F.2d 1074, 1088 (3d Cir. 1986).

³⁴ 816 F.2d 82, 90 (2d Cir. 1987). The Tenth Circuit adopted the analysis of the Second Circuit in *Sheet Metal Workers’ International Association, Local 9 v. Mile Hi Metal Systems, Inc. (In re Mile Hi Metal Systems, Inc.)*, 899 F.2d 887 (10th Cir. 1990).

³⁵ See *Wheeling-Pittsburgh*, 791 F.2d at 1087-89 (congressional statements regarding § 1113).

³⁶ *Id.* at 1088-89.

Unfortunately, while this standard may be an immediate victory for labor, it might lead to a short-lived triumph. In the long-run, it may be to labor's detriment if the debtor is repeatedly forced back into bankruptcy and possible liquidation due to its minimal bargaining position with labor. On the other hand, this standard maintains the balance between federal labor and bankruptcy laws as Congress intended when infusing § 1113 into the Bankruptcy Code..

In *Carey Transportation*, the Second Circuit again criticized the Third Circuit, this time based on the grounds that the standard articulated by the Third Circuit left no adequate distinction from § 1113(e)'s grant of interim relief.³⁷ The Second Circuit stated that the court should instead consider:

whether rejection would increase the likelihood of successful reorganization. A final reorganization plan, in turn, can be confirmed only if the court determines that neither liquidation nor a need for further reorganization is likely to follow. Thus, in virtually every case, it becomes impossible to weigh necessity as to reorganization without looking into the debtor's ultimate future and estimating what the debtor needs to attain financial health. . . . A debtor can live on water alone for a short time but over the long haul it needs food to sustain itself and retain its vigor.³⁸

The Tenth Circuit has also adopted this standard.³⁹ Although this standard may actually benefit labor under an interpretation that leans more toward the bankruptcy goal of reorganization rather than conforming to labor's immediate interests, this interpretation subsumes labor's interest to that of the debtor. Given that § 1113 was enacted to benefit labor, it is unlikely that Congress intended for its interpretation to be solely from the perspective of the debtor.

³⁷ 816 F.2d at 89.

³⁸ *Id.* at 89-90 (internal quotations and citations omitted).

³⁹ See *In re Mile Hi Metal*, 899 F.2d at 893.

2. Step 8: The Union’s Refusal Without ‘Good Cause’

If the debtor has fulfilled all of the preceding requirements to Step 8, the court must then determine whether the union “has refused to accept such proposal without good cause.”⁴⁰ Section 1113(c)(2) provides a low burden for the debtor if the debtor has thus far complied with § 1113, because § 1113 compliance “create[s] a prima facie case that the union does not have good cause to reject the proposal.”⁴¹

The union, on the other hand, faces a heavier burden. Because “[s]ection 1113(c)(2) requires only that the court find that the union ‘refused to accept’ the proposal—not that the union affirmatively rejected the employer’s proposal . . . a union cannot avoid rejection under section 1113 simply by failing to take a position on the employer’s proposal or refusing to bargain.”⁴² Furthermore, the “union must articulate and discuss in detail . . . its reasons for declining to accept the debtor’s proposal.”⁴³ If it has failed to do so, the union is deemed to have “perforce refused to accept the proposal without good cause under Code § 1113(c)(2).”⁴⁴

This judicial construction of § 1113 creates a formidable presumption in favor of the debtor’s position. If a debtor has complied with the prior requirements, the court generally assumes that the union’s rejection of the proposal is *de facto* without good cause. This diminishes the union’s bargaining power by requiring it to either accept any proposal that

⁴⁰ 11 U.S.C. § 1113(c)(2).

⁴¹ Tom A. Jerman & Robert E. Winter, *Who’s Flying This Plane? Collective Bargaining Agreement and Other Labor Issues*, 13 J. BANKR. L. & PRAC. 25, 34 (2004) (citing *In re Mile Hi Metal Systems, Inc.*, 67 B.R. 114, 118 (D. Colo. 1986), *vacated by* 899 F.2d 887 (10th Cir. 1990) (reasoning that “good cause” issue should not be reached unless it has been shown that debtor’s proposal meets all requirements of § 1113(b)(1)(A)); *In re Carey Transp., Inc.*, 50 B.R. 203, 212 (Bankr. S.D. N.Y. 1985), *aff’d*, 816 F.2d 82 (2d Cir. 1987) (Bankr. S.D.N.Y. 1985) (reasoning that union lacked “good cause” because proposed modifications were necessary, fair, and equitable)).

⁴² *Id.* at 34-35.

⁴³ *In re Royal Composing Room, Inc.*, 62 B.R. 403, 407 (Bankr. D.N.Y. 1986), *aff’d*, 78 B.R. 671 (S.D.N.Y. 1987), *aff’d*, 848 F.2d 345 (2d Cir. 1988).

⁴⁴ *Id.*

contains “necessary modifications” that are “fair and equitable”⁴⁵ to the *debtor*, or face outright rejection of its contract.

3. Step 9: The Balance of the Equities

Finally, Step 9 instructs that the court must determine that “the balance of the equities clearly favors rejection of such agreement.”⁴⁶ This requirement purportedly codifies the *Bildisco* standard, which “focus[ed] on the ultimate goal of Chapter 11 [to consider] only how the equities relate to the success of the reorganization.”⁴⁷ In *Carey Transportation*, the Second Circuit outlined six equitable considerations summarized from prior case law as follows: (1) the likelihood and consequences of liquidation if rejection is not permitted; (2) the likely reduction in the value of creditors’ claims if the bargaining agreement remains in force; (3) the likelihood and consequences of a strike if the bargaining agreement is voided; (4) the possibility and likely effect of any employee claims for breach of contract if rejection is approved; (5) the cost-spreading abilities of the various parties, taking into account the number of employees covered by the bargaining agreement and how various employees’ wages and benefits compare to those of others in the industry; and (6) the good or bad faith of the parties in dealing with the debtor’s financial dilemma.⁴⁸

These ‘equitable’ considerations are primarily from the debtor’s perspective and account minimally for labor’s interests. Factors one through four are exclusively related to the concerns of the debtor, while factors five and six account for both the union’s and the debtor’s interests.

⁴⁵ *In re Carey Transp., Inc.*, 50 B.R. at 212.

⁴⁶ 11 U.S.C. § 1113(c)(3).

⁴⁷ *Truck Drivers Local 807 v. Carey Transp., Inc.*, 816 F.2d 82, 92-93 (2d Cir. 1987) (internal citations omitted).

⁴⁸ *Id.* at 93. *See also Bildisco*, 465 U.S. at 525-26, *aff’g* 682 F.2d 72, 79-80 (3d Cir. 1982); *In re Brada Miller Freight System, Inc.*, 702 F.2d 890, 898-900 (11th Cir. 1983); *Shopmen’s Local Union No. 455 v. Kevin Steel Products, Inc.*, 519 F.2d 698, 707 (2d Cir. 1975).

To be truly ‘balanced,’ the bankruptcy court must assign equal weight to the union’s concerns. The current interpretation is a prime illustration of how bankruptcy judges construe the Code in a bankruptcy-centric manner to the detriment of the other federal imperatives that have been injected into the Code.

Once a debtor has satisfied the *American Provision Co.* nine-step procedure and received approval for rejection of the CBA, two further questions arise: first, courts have been uncertain of the priority given a CBA under § 1113; second, some have raised the question of whether the union actually has a claim for damages from a rejected CBA under § 1113. The fact that the latter issue is actually litigated is contradictory to labor law and past bankruptcy practices.

B. The Priority of Collective Bargaining Agreements Under § 1113

Sections 507(a)(1) and 503(b) of the Code govern the priority in which unsecured claims are distributed during a Chapter 11 Reorganization. The allowance of administrative expenses is determined in § 503 which states: “After notice and a hearing, there shall be allowed, administrative expenses . . . including—the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case.”⁴⁹ Section 507 then specifies that these claims are given first priority in distribution.⁵⁰

Circuit courts are currently split in their analysis of the priority status of a claim resulting from a CBA. Congress gave no clear signals in the text or the statutory history to guide the

⁴⁹ 11 U.S.C. § 503(b)(1)(A).

⁵⁰ *Id.* § 507(a)(2) (2005). This section was modified by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, 119 Stat. 23 (2005), which re-designated the old § 507(a)(1) as the current § 507(a)(2). Additionally, the Act inserted a new paragraph above the administrative expense claims to give “unsecured claims for domestic support obligations” first priority status under the new § 507(a)(1). Given the unlikelihood of litigation involving child support payments in a large Chapter 11 case, it suffices to say that despite the reordering, administrative expenses are still accorded first priority status in a corporate reorganization.

court's analysis of the priority a CBA receives in the distribution of the estate. The issue is whether the prohibition against unilateral modification of provisions of the CBA by an employer found in § 1113(f)⁵¹ preempts the priorities as set forth in § 507. The majority of courts, and the Second, Third, and Fourth Circuits, have reconciled §§ 507 and 1113(f) of the Code to establish that the Code's original priority ordering still applies.⁵² However, in *In Re Unimet Corp.*, the Sixth Circuit stated that § 1113 "unequivocally prohibits the employer from *unilaterally* modifying *any provision* of the collective bargaining agreement."⁵³ This implies that a CBA must be paid in full and that partial payment would be a prohibited modification of the CBA. Although the Sixth Circuit did not decide whether a payment under a CBA was an administrative expense, lower courts following the Sixth Circuit's rationale have created a "superpriority" status for CBA claims.⁵⁴

As the first circuit court to grapple with the priority issue of an assumed CBA, the Sixth Circuit, in *In Re Unimet*, handed down an opinion decidedly in favor of labor in its interpretation of § 1113. However, the Second, Third and Fourth Circuits, rather than recognizing the conflict between two federal prerogatives, have reconciled § 1113 with the rest of the Bankruptcy Code,

⁵¹ Section 1113(f) was added by the Bankruptcy Amendment and Federal Judgeship Act of 1984, Pub. L. 98-353, 98 Stat. 333, 390 (1984), to reverse the Supreme Court's decision in *Bildisco & Bildisco* to allow the trustee to unilaterally reject the CBA as an executory contract pursuant to § 365(a). This section imposes restrictions on how the debtor may deal with CBAs.

⁵² See *In re Roth American, Inc.*, 975 F.2d 949 (3d Cir. 1992) (holding that union's claims for vacation and severance pay were entitled to first priority as administrative expenses only to extent that benefits were earned by services rendered post-petition); *In re Ionosphere's Clubs, Inc.*, 22 F.3d 403 (2d Cir. 1994) (holding that claims by unions against Chapter 11 debtor for pre-petition vacation pay were not entitled to superpriority status equivalent at least to administrative expense, but instead, priority of vacation pay claims was governed by section providing third-priority status for vacation pay claims); *Adventure Resources, Inc. v. Holland*, 137 F.3d 786 (4th Cir. 1998) (holding that bankruptcy claim arising from breach of collective bargaining agreement may be accorded priority status only insofar as it fits into one of categories singled out for preferential treatment by priority statute).

⁵³ 842 F.2d 879, 884 (6th Cir. 1988) (emphasis in original).

⁵⁴ See, e.g., *In re Acorn Bldg. Components Inc.*, 170 B.R. 317 (E.D. Mi. 1994) (benefits must be paid at same priority of administrative expense claims); *Eagle Inc. v. Local 537 of United Ass'n*, 198 B.R. 637 (D. Mass. 1996) (§ 1113 trumps § 507 to create "super-priority" status for pre-petition claims under CBA); *In re Golden Distributors Ltd.*, 152 B.R. 35 (S.D.N.Y. 1992) (claims arising from CBA entitled to "super-priority" status); *In re Arlene's Sportswear Inc.*, 140 B.R. 25 (Bankr. D. Mass. 1992) (§ 1113(f) overrides priority provisions of § 507).

thereby removing any special status inherent in § 1113's treatment of CBAs.

The majority's construction, which gives a CBA assumed under § 1113 the same priority as any other executory contract assumed under § 365, is a practice that is inconsistent with and fails to recognize the importance Congress placed on collective bargaining agreements through federal labor law and § 1113 itself.

Furthermore, although § 1113 imposed a procedure for the rejection of a CBA,⁵⁵ this process has not dramatically reduced the percentage of court-approved rejections. This is a precarious position for labor because some courts now interpret § 1113 to dismiss damages claims altogether. Denial of the right to a claim for damages is not only counterintuitive, considering that § 1113 was designed as a special interest handout to labor, but also gives lesser treatment to a CBA than other executory contracts receive in bankruptcy.

C. Does Rejection of a CBA Create a Claim for Damages?

While most of the discussion has revolved around the issue of priority given to a CBA in bankruptcy after the enactment of § 1113, there is an unanswered issue with far reaching implications. Under § 1113, some courts find it unclear whether a union will possess a claim for damages after a court has approved rejection of its CBA. Prior to § 1113, the Bankruptcy Code treated the debtor's rejection of a CBA, an executory contract, as a breach prior to the date of the bankruptcy petition, leaving the non-breaching party with a general, unsecured claim for damages.⁵⁶ However, § 1113, which replaces § 365 for CBAs,⁵⁷ is silent as to whether this claim for damages still exists after the court-approved rejection of a CBA. Some courts interpret this lack of explicit rejection for damages to hold that no damage claim exists for the rejection of a

⁵⁵ *See supra* Part II.

⁵⁶ 11 U.S.C. §§ 365(g)(1), 502(g).

⁵⁷ *Id.* § 1113(a), (f).

CBA,⁵⁸ asserting that such a claim would defeat the purpose of § 1113.⁵⁹ Conversely, other courts hold that § 1113 was not meant to supplant § 365, but rather that the two sections must be read to supplement one another.⁶⁰

In *In re Blue Diamond Co.*, the court held that no claim for damages exists upon the rejection of a CBA because § 1113 “expressly eliminated collective bargaining agreements from the framework of § 365 . . . [and] § 502(g).”⁶¹ The *Blue Diamond* court recognized that prior to 1984, the rejection of a CBA fell under the provisions of §§ 365(g) and 502(g).⁶² The court, however, rejected the union’s claim for damages because it found no “statutory ambiguity” in § 1113.⁶³ Rather than finding ambiguity, the court instead stated that there was “merely the absence of any provision comparable to § 365(g) governing the effect of rejection of a CBA under § 1113; [t]herefore, reliance on § 1113’s legislative history would be inappropriate.”⁶⁴

Moreover, in recognizing that § 1113 created significant procedural hurdles for the debtor to overcome, the *Blue Diamond* court considered it “arguable that Congress intended that no claim for damages for rejection of a collective bargaining agreement would be allowed.”⁶⁵ Given that the rejection of a CBA can only occur if it is necessary for the reorganization of the company, the court speculated that damages for lost wages and benefits would lead to the failure of the Chapter 11 reorganization.⁶⁶ This is not completely true. Damages for rejection of a CBA would simply be added to the claims of other unsecured creditors, reducing the percentage paid

⁵⁸ See *In re Blue Diamond Coal Co.*, 147 B.R. 720, 729-30 (Bankr. E.D. Tenn. 1992) (holding that § 1113 takes CBAs out of ambit of § 365 and provides no equivalent of § 365(g)); *In re Armstrong Store Fixtures Corp.*, 139 B.R. 347, 350 (Bankr. W.D. Pa. 1992) (holding that § 1113 removes labor contracts from purview of § 365).

⁵⁹ See *Blue Diamond*, 147 B.R. at 732.

⁶⁰ See *In re Texas Sheet Metals, Inc.*, 90 B.R. 260, 264 (Bankr. S.D. Tex. 1988); *In re Indiana Grocery Co.*, 138 B.R. 40, 50 (Bankr. S.D. Ind. 1990); *In re Garofalo’s Finer Foods, Inc.*, 117 B.R. 363, 371 (Bankr. N.D. Ill. 1990).

⁶¹ 147 B.R. 720, 730 (Bankr. E.D. Tenn. 1992), *aff’d*, 160 B.R. 574 (E.D. Tenn. 1993).

⁶² *Id.* at 728.

⁶³ *Id.* at 731.

⁶⁴ *Id.*

⁶⁵ *Id.* at 732.

⁶⁶ *Id.*

to each claimant. However, the court decided to rely on the plain language of the statute to deny the union's claim for damages.⁶⁷

Alternatively, some courts have found that the failure to mention damages in § 1113 is itself an ambiguity, relying on techniques of statutory interpretation to adduce such a claim.⁶⁸ For example, the court in *In re Moline Corp.* opposed the argument made in *Blue Diamond*, asserting instead that the lack of damages in § 1113 evinces an example of legislative mistake:

While § 1113 deals extensively with the act of assuming or rejecting a collective bargaining agreement, it says nothing about the effect of assumption or rejection. . . . The court views the language in § 365(g) as a legislative gaffe, i.e., when Congress added § 1113 in 1984, it forgot to make conforming amendments to other provisions in the Bankruptcy Code, including § 365. [Therefore], if a collective bargaining agreement is rejected, both the damages caused by the rejection and any prepetition collective bargaining agreement claims are treated as prepetition claims entitled to that priority such prepetition claims would otherwise be entitled to.⁶⁹

Section 365(a) of the Bankruptcy Code provides that “the trustee, subject to the court’s approval, may assume or reject any executory contract.”⁷⁰ Section 365(g) provides that “the rejection of an executory contract . . . constitutes a breach of such contract . . . if such contract . . . has not been assumed under this section.”⁷¹ Some have argued that a rejection need not occur under § 365; rather, § 365(g) only requires that an “executory contract ‘has not been assumed under’ section 365.”⁷² Therefore, it purportedly follows that rejecting a CBA under § 1113 “qualifies as a contract that has not been assumed under section 365.”⁷³

⁶⁷ *Id.*

⁶⁸ See, e.g., Michael St. Patrick Baxter, *Is There a Claim for Damages From the Rejection of a Collective Bargaining Agreement Under Section 1113 of the Bankruptcy Code?*, 12 BANKR. DEV. J. 703 (1996).

⁶⁹ *In re Moline Corp.*, 144 B.R. 75, 79 (Bankr. N.D. Ill. 1992).

⁷⁰ 11 U.S.C. § 365(a).

⁷¹ *Id.* §365(g).

⁷² Baxter, *supra* note 68, at 717-18.

⁷³ *Id.* at 718.

III.

AN ECONOMIC ANALYSIS OF THE HUMAN CAPITAL CONTRIBUTION TO THE FIRM

Not only is there no reason to deny a claim for rejection or modification of a CBA, as others have observed, but such denial does particular harm here because labor is nondiversifiable, a point others have overlooked. As an intangible asset, accountants and economists find it hard to quantify the value of labor. Additionally, labor is not included in balance sheet calculations of assets and liabilities. The absence of labor on the balance sheet may be attributed to constitutional restraints on the ownership of labor⁷⁴ or to the nature of balance sheets themselves, which were designed primarily for the industrial era when property, plant, and equipment were the major components of corporate profits. Unlike labor, both physical and financial capital are readily quantifiable, may be contracted for, modeled, and reported with ease on the balance sheet. It is easy to understand how economists, in their efforts to explain the modern world, focus their models on easily quantifiable capital and often ignore greyer areas, such as the harder-to-quantify human capital. This leads to economists, accountants, and other commentators, in their dispensing with transaction costs to also disregard the human side of corporations.

Below, I expand upon an existing economic description of default spreads to show that eliminating a claim for breach of a labor contract will raise the ex ante cost of capital for a firm more than eliminating a purely financial claim because labor is nondiversifiable. It is surprising that this has been overlooked: once investments in human capital are analogized to investments in financial capital, it is straightforward that a risk-averse, nondiversified lender will charge more interest for any given risk of non-repayment than would a risk-neutral or diversified lender.

⁷⁴ “Neither slavery nor involuntary servitude, except as a punishment for crime whereof the party shall have been duly convicted, shall exist within the United States, or any place subject to their jurisdiction.” U.S. CONST. amend. XIII, § 1.

Following upon this discussion, I will examine two methods that attempt to quantify human capital on the balance sheet. First, is a regression method examining the economic performance of a corporation in order to quantify the value of the intangible human capital asset. Second, is a method to model labor on the balance sheet similar to the approach in which operating leases are capitalized by analysts examining financial statements. Because labor cannot be owned by the firm, it will be necessary to determine the relative priority of labor in the capital structure of the firm once it is recognized on the balance sheet.⁷⁵

A. Investments in Human Capital vs. Investments in Financial Capital

In a paper titled *A Normative Theory of Business Bankruptcy*, Professor Alan Schwartz of Yale Law School articulates a comprehensive model to show that “[a]n ex post efficient bankruptcy system . . . maximize[s] the payoffs that creditors receive from insolvent firms.”⁷⁶ Qualitatively, at the borrowing state, “a competitive credit market will reduce the amounts that lenders can require solvent firms to repay when the lenders’ expected insolvency payoffs increase. Thus, interest rates fall as the efficiency of the applicable bankruptcy system increases.”⁷⁷ By lowering the market interest rate, a firm can undertake a larger set of socially efficient projects.⁷⁸ While Schwartz’s goal is to show that efficient bankruptcy systems will lower borrowing costs, his analysis only accounts for financial capital and expressly ignores bankruptcy’s impact on labor and the communities of the bankrupt firm.⁷⁹ In the discussion below, however, I will demonstrate how Schwartz’s model may be modified to include an

⁷⁵ This has further implications regarding the ownership of the firm which are outside the scope of this paper.

⁷⁶ Alan Schwartz, *A Normative Theory of Business Bankruptcy* (2004), available at <http://law.bepress.com/alea/14th/art32>.

⁷⁷ *Id.* at 5.

⁷⁸ *Id.*

⁷⁹ *Id.* at 57-58.

individual's investment in human capital. The extended model includes the risk-averse nature of humans, the comparative difficulty in redeployment of human capital, as well as the non-diversifiable quality of human capital investment. This modified model will show that equivalent investments in human capital and financial capital yield different required default spreads above the risk free rate. I interpret the higher required default spread for human capital investment as evidence of the greater relative importance that should be given to labor in a bankruptcy proceeding.

1. The Credit Model: Equating Ex Post Recovery with Ex Ante Interest Rates⁸⁰

The model begins with six assumptions:

A1: The borrowing firm is run by an owner/manager.

A2: Creditors are imperfect monitors of payoff related actions that the firm takes after it borrows.

A3: Capital markets are competitive.

A4: Creditors can predict the mean of their payoffs in the default state.

A5: A "firm" is the project that it pursues.

A6: Creditors and the firm are risk neutral.⁸¹

I add one additional assumption to the model:

A7: Creditors are able to diversify their investments.⁸²

⁸⁰ See *Id.* at 9-12. For Schwartz's complete analysis on how bankruptcy influences the interest rate.

⁸¹ *Id.* at 9-10.

⁸² I attach importance to the fact that creditors are able to reduce their risk-aversion through diversification. In fact, diversification creates a fixed probability of success wherein "risk aversion becomes irrelevant." See Adler, Bankruptcy and Risk Allocation, 77 CORNELL L. REV. 439 (1992), 481. I discuss risk-aversion and diversification more fully in §§ 2,3 *infra*.

Schwartz notes in his paper that these assumptions allow the model to “capture[] the agency problem between the firm and its creditors [and] appl[y] to transactions between creditor professionals and corporate borrowers.”⁸³

The firm requires capital of I for a project which succeeds with probability p and earns net present value v (not including finance costs).⁸⁴ Let the recovery rate, X , be the distribution to creditors from an insolvent firm in bankruptcy after costs of administration with the assumption that creditors are able to easily redeploy the recovered capital into a new investment. The firm promises to repay F at the end of the project.

[Because] the credit market is competitive, F is the smallest sum that creditors can demand to fund the project. The risk free interest rate is assumed to be zero, so that a borrowing firm’s interest rate is a function only of the riskiness of its project and the properties of the bankruptcy system that is in place. Creditors in competitive markets earn zero pure profits, so creditors who lend I must expect to receive I in return.⁸⁵

This leads to Equation (1):

$$(1) \quad I = pF + (1 - p)X$$

Thus I is the expected value of the expected solvency and insolvency returns. It is assumed that $v > F > X$ so that a firm is solvent when successful and insolvent when not. Rearranging the formula, we see that Equation (1) implies that F is determined by the return the firm receives in bankruptcy:

$$(2) \quad F = \frac{I - X(1 - p)}{p}$$

If $p > 0$ (implying that there is a risk of default and that the firm is not riskless), F declines as the recovery rate, X , increases. This shows the intuition that “the more that creditors expect to

⁸³ Schwartz at 9-10.

⁸⁴ *Id.* at 10. Further, “ v is drawn from a positive, compact support $V_a \subset R_+$ by a cumulative distribution function $G_a(v)$. The expected value of a solvent firm is $v = \hat{v}_a \equiv \int_{V_a} v dG_a(v)$.”

⁸⁵ *Id.* at 11.

receive in the insolvency state, the less will creditors require the firm to repay in the solvency state.”⁸⁶ Therefore, the default spread on the firm’s effective interest rate as a function of default risk and recovery rate becomes:

$$(3) \quad r = \frac{F}{I} - 1$$

Thus, we see that the default probability and recovery rate affect interest rates—lowering the default probability or increasing the recovery rate will lower the interest rates that firms must pay to creditors.

2. Extending the Credit Model to Include Nondiversifiable Human Capital Investments

Firms and creditors do not operate in a vacuum; firms depend upon many other stakeholders for value creation. Chief among these stakeholders are employees, who invest their human capital in exchange for wages. There are two primary differences between investors of human capital and investors of financial capital. First, investments in financial capital are diversifiable, thereby lowering the risks of the investment portfolio. Second, I assume that financial investments are risk-neutral, partly due to their diversifiable nature and partly due to the easy redeployment of financial capital once it is recovered. On the contrary, human capital is neither diversifiable (we may ignore the fact that an individual may take on two or more jobs) nor easily redeployed.

Risk aversion is the reluctance of an investor to accept a bargain with an uncertain payoff rather than another bargain with a more certain, but possibly lower, expected payoff. For example, a person is given the choice between two scenarios, one certain and one not. In the uncertain scenario, the person has a 50% probability of receiving \$100 and a 50% chance of receiving \$0 for an expected value of \$50. A risk-averse person will be willing to accept less

⁸⁶ *Id.* at 11-12.

than \$50 in a certain investment. An investor willing to take only \$40 for the certain investment instead of the uncertain investment would be more risk-averse than an investor willing to take \$45 for the uncertain investment. Further, the more certainty a person has of receiving close to the \$50 expected value, the lower the discount they would take below that value. (i.e. the more risk-averse investor above may be willing to pay \$45 for 50% probabilities of receiving \$60 or \$40).

Diversifiability and risk aversion are sometimes conflated, but diversification has important implications for the observed differences in risk-aversion between investors in human capital and financial capital.⁸⁷ This can be seen through the examples above. Even though investors in human capital and financial capital may have the same initial level of risk-aversion, investors in financial capital are able to spread their risk through diversification achieving results more similar to the second example, whereas investors in human capital are unable to diversify, leaving them with the results of the first example.

Non-diversifiability and the ease of redeployment of recovered capital are important factors, particularly when tied in with the risk-averse nature of labor. In finance, there is a general axiom that we value a dollar lost more than we value a dollar gained, and that we place disproportionately more weight on greater losses than on smaller losses. Extending the discussion above, the differing risk averseness is explained by the different default experiences of labor and investors achieved through diversification. For example, if the default probability of new projects is 3% (ignoring recovery rate assumptions), creditors will experience a 100% chance of 3% default and adjust their models accordingly. However, a 3% default probability will be experienced by an individual employee as a 3% chance of 100% default. Thus, because

⁸⁷ A fuller discussion of diversification from the standpoint of portfolio theory is included in § 3 *infra*.

of the inability to diversify human capital investments, employees have the potential for far greater losses than investors of financial capital.

Furthermore, the recovery and redeployment of capital is experienced differently for human and financial capital. Financial capital is easily redeployed once recovered. In fact, there exists active trading of defaulted bonds by distressed debt hedge funds and other speculators wherein a creditor can recover part of its capital even before the ultimate judicial determination of the bankruptcy. On the other hand, there are high switching costs associated with human capital. Even ignoring the complicated and harder to measure switching costs due to human nature, such as job attachment, decreased labor mobility due to age, attachment to community or family in the area, or stigma due to being fired; “recovered” human capital is much more difficult to redeploy than financial capital.

An examination of generic human capital and firm-specific human capital will also show that labor rightly deserves special treatment in bankruptcy.⁸⁸ The value of an individual to a firm is a function of the individual’s generic and firm-specific human capital. If an individual has a high amount of firm-specific human capital and is fired or looks for another job because his employer is in trouble, his value to another employer will only be a function of his generic human capital. Thus, the recovery rate to investments in human capital is lowered dramatically for employees who possess a high amount of firm-specific human capital, or when an entire industry suffers a downturn so that employees must seek jobs outside the industry and their industry-specific capital is non-transferable.

⁸⁸ Here, I use generic human capital to refer to skills that are readily transferable to another job or industry, such as basic computer knowledge or management skills. I intend to denote firm-specific human capital as more specific to a particular firm or industry—such as a person’s understanding of a firm’s proprietary software, or a position on a particular assembly line, or an understanding of industry jargon.

Revisiting the model in Section 1 above, which shows the interest rate demanded by creditors of a firm, we can expand this model to apply to employees as creditors of human capital.

First, the assumptions are largely similar:

A1: The borrowing firm is run by an owner/manager.

A2: Employees are imperfect monitors of payoff related actions that the firm takes after it borrows.

A3: Labor markets are competitive.

A4: Employees can predict the mean of their payoffs in the default state.

A5: A “firm” is the project that it pursues.

A6: Labor is risk averse and the firm is risk neutral.

A7: Employees are unable to diversify their investments in human capital.

These assumptions presume that labor is separated from management, that there are agency costs associated with this separation, that labor markets are competitive so that firms must pay the market rate equivalent to the value of the firm-specific and generic human capital, that employees are risk-averse and that risk neutral employers can insure against the employees’ risk aversion, and that unlike creditors of financial capital, creditors of human capital are unable to diversify their investments.

Now in modified form, the firm requires a human capital investment of I_{HC} for a project which succeeds with probability p and earns net present value v . Let RA be the measure of employees risk aversion ($RA > 0$). Let the recovery rate, X , be the return to employees from an insolvent firm in bankruptcy after costs of administration with the assumption that the employees are able to redeploy their human capital investment into a new job. Let RC be the costs

associated with “redeploying” their human capital, such as switching costs, time required to find a new job, or costs of reeducation. Note that while financial investors experience an RC of effectively zero, from the discussion above we see that human capital RC is significantly greater than zero. The firm promises to repay F_{HC} at the end of the project. Since the labor market is competitive, F_{HC} is the smallest amount that employees can demand to work on the project. Assuming the risk free interest rate is zero, the rate demanded by employees is now a function of (a) the riskiness of the project, (b) the properties of the bankruptcy system, (c) the risk aversion of employees, and (d) the redeployment cost of human capital. Employees in competitive markets earn zero pure profits, so employees who lend an amount I_{HC} of their human capital must expect to receive a present value risk-weighted equivalent I_{HC} in return. Expanding on Equation (1) above, this leads to Equation (4):

$$(4) \quad I_{HC} = (p-RA)F_{HC} + (1-p-RA)(X_{HC}-RC)$$

Rearranging the formula, we see that Equation (4) implies that F_{HC} is determined by the return employees receive in bankruptcy as well as their risk aversion:

$$(5) \quad F_{HC} = \frac{I_{HC} - (X_{HC} - RC)(1 - p - RA)}{(p - RA)}$$

Since $p > 0$, F_{HC} declines again as the recovery rate, X , increases. However, the equation now includes variables RC and RA . Similar to creditors, the more employees expect to receive in the insolvency state, the less they will demand from the firm in the solvency state. However, unlike creditors, employees have RA and RC to contend with, which are not affected by the choice of bankruptcy system.

Assuming that I_{HC} of Equation (4) at the initial stage is equivalent to I from Equation (1), and that bankruptcy treats investments in human capital and financial capital similarly such that

X_{HC} from Equation (4) is to equal X from Equation (1), we see that the additions of RC and RA to the model make Equation (5) greater than the result in Equation (2). Thus we have:

$$(6) \quad F_{HC} > F$$

Therefore, the default spread over the risk free rate for human capital investments becomes:

$$(7) \quad r_{HC} = \frac{F_{HC}}{I} - 1, \text{ from (6) } r_{HC} > r$$

Thus, we see that the employees' risk aversion as well as employees' lower recovery rate due to slower redeployment of their human capital will increase the default spread needed by investors of human capital to compensate for similar levels of investment and recovery achieved by investors of financial capital.

3. Further Extending the Model: The Non-Diversifiability of Human Capital Investments

The intuition behind extending the model to include gains from diversification is a concept taught in most basic finance courses.⁸⁹ Conceptually, diversification lowers risk for two reasons. First, the more diversified a portfolio becomes, the less impact losses from a single investment will have on the portfolio. Second, diversification takes out the idiosyncratic risk of each individual investment, leaving the investor with only systematic market risk. Thus, investors of financial capital have the additional risk-reducing measure of diversification which investors of human capital cannot take advantage of.

This can be shown statistically. Risk and return of assets are measured by their variance and mean. Consider an investor of financial capital with a two-asset portfolio A and B . The assets have returns μ_A and μ_B , variance σ_A^2 and σ_B^2 , correlation ρ_{AB} . ($-1 \leq \rho \leq 1$), and weights w_A and w_B

⁸⁹ For a complete primer on diversification and risk, see ASWATH DAMODARAN, APPLIED CORPORATE FINANCE: A USER'S MANUAL, Ch. 3: *The Basics of Risk* (Wiley 2d ed. 2005).

respectively.⁹⁰ The return of the portfolio is the weighted average of the returns of the individual assets:

$$(8) \quad \mu_{PORT} = w_A \mu_A + w_B \mu_B$$

Note that in statistics, the variance of a portfolio is not the weighted average of the variance of the individual assets:

$$(9) \quad \sigma^2_{WEIGHTED} = w_A \sigma^2_A + w_B \sigma^2_B$$

Instead, the variance of the portfolio of assets *A* and *B* is given by:

$$(10) \quad \sigma^2_{PORT} = w_A^2 \sigma^2_A + w_B^2 \sigma^2_B + 2 w_A w_B \rho_{AB} \sigma_A \sigma_B$$

The benefits of diversification accrue for any correlation less than 1 (i.e., $\rho < 1$).⁹¹ Thus, while the return of a portfolio is the weighted value of the returns of the individual assets, the variance of the portfolio will be lower than the weighted average of the individual variances of the assets. Thus, diversification allows a financial investor to achieve the same portfolio returns, but with reduced risk.

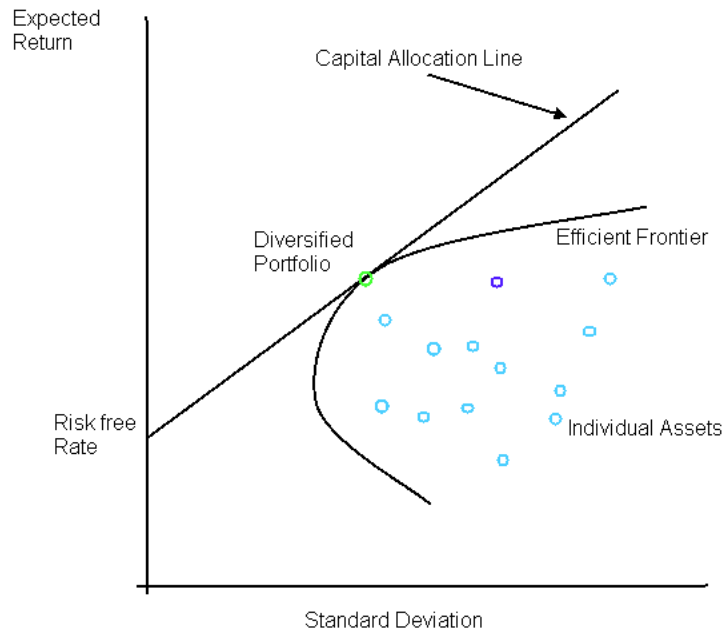
The rest is a simple application of modern portfolio theory.⁹² As seen in Figure 1 below, a diversified investor can diversify away risk yet receive the same return. In contrast, an individual employee cannot diversify away the risk of his human capital investment and is left holding a single, risky asset.

⁹⁰ $w_B = 1 - w_A$.

⁹¹ If $\rho < 1$, then $w_A^2 \sigma^2_A + w_B^2 \sigma^2_B + 2 w_A w_B \rho_{AB} \sigma_A \sigma_B < w_A^2 \sigma^2_A + w_B^2 \sigma^2_B$. For any values of w_A , w_B , σ^2_A , and σ^2_B . For example, assume $w_A = w_B = 0.5$, $\sigma^2_A = \sigma^2_B = 0.1$, and $\rho = 1$. Then $\sigma^2_{WEIGHTED} = (0.5 \times 0.1) + (0.5 \times 0.1) = 0.1$ and $\sigma^2_{PORT} = (0.5^2 \times 0.1) + (0.5^2 \times 0.1) + 2(0.5 \times 0.5 \times 1 \times \sqrt{0.1} \times \sqrt{0.1}) = 0.1$. But if $\rho = 0.5$, then the statistical variance of the portfolio drops to 0.075 while the weighted variance is still 0.1.

⁹² For the theory underlying modern portfolio theory, see generally, John Lintner, *The Valuation of Risky Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets*, 47 REVIEW OF ECONOMICS AND STATISTICS 13-39 (1965); Harry M. Markowitz, *Portfolio Selection*, 7 JOURNAL OF FINANCE 77-91 (1952); William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19 JOURNAL OF FINANCE 425-42 (1964); James Tobin, *Liquidity Preference As Behavior Towards Risk*, 25 REVIEW OF ECONOMIC STUDIES 65-86 (1958).

Figure 1: Benefits of Diversification⁹³



4. Implications of Extending the Credit Model to Human Capital Investment.

Many bankruptcy scholars currently lean towards the view that the purpose of bankruptcy law is to merely lower the cost of capital for a firm so that it can pursue more investment opportunities.⁹⁴ This view is short-sighted and ignores the relative risk borne by employees. There are a few ways to mitigate this risk held by employees.

One alternative would be for Congress to revisit and re-clarify its intention in § 1113 so that bankruptcy judges cannot interpret the section so easily towards benefiting debtors and creditors. As shown by the Schwartz model, bankruptcy law affects X , the recovery rate achieved by investors of human and financial capital. Strengthening § 1113 to benefit labor could increase the recovery rate to human capital (which will likely have a corresponding reduction in the recovery rate for financial capital). However, § 1113 can be manipulated so that financial

⁹³ *Id.*

⁹⁴ See Schwartz at 3. See also Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987).

investors and human capital investors experience the overall same rate of return, thus equating F and F_{HC} . Correspondingly, this change would cause default risk to be borne equally by investors of financial and human capital (i.e., $r = r_{HC}$).

B. Two Approaches to Model Labor's Contribution to the Balance Sheet .

Investments in Human Capital receive short thrift outside of the bankruptcy arena as well. Although human capital is the largest intangible asset of a corporation, accounting statements are outdated and do not reflect this reality. Priority within bankruptcy is roughly aligned with the capital structure found on a company's balance sheet with the varying degrees of debt contracts first in order and equity last. However, the accounting balance sheet does not accurately capture the value of intangible assets and has no means by which to measure the human capital value added by firm's employees. Although the nation has developed from agrarian roots to an industrial based economy, and finally to the present day service economy, accounting measurement standards have not kept up with the pace of change. Fifty years ago, the primary source of value creation came from property, plant, and equipment, as a reflection of the agrarian and industrial eras. In contrast, today, human capital has become the primary source of value creation for companies.⁹⁵ In fact, current human capital investment is significantly greater than historically, as "nearly 70% of all operating costs are ultimately attributable to people."⁹⁶ Other

⁹⁵ I refer to human capital as the "education, experience and abilities of an employee [that] have an economic value for employers and for the economy as a whole [and] like any other type of capital [it can] be invested in through education, training and enhanced benefits that will lead to an improvement in the quality and level of production." Forbes Media Company, Human Capital: Investopedia, <http://www.investopedia.com/terms/h/humancapital.asp>.

⁹⁶ Laurie Basie, Human Capital Advantage: Developing Metrics for the Knowledge Era, <http://www.linezine.com/4.2/articles/lbhca.htm>.

studies have found that 50% to 90% of value creation in firms today comes from intellectual capital, with the remaining 10% to 50% deriving from physical and financial capital.⁹⁷

However, accounting standards still rely on physical and financial assets as the measures of wealth creation. But measures such as return on assets and return on capital fail to recognize human capital unless it has already been converted into another intangible asset such as a patent, software, or copyright. As mentioned above, one primary reason for this is the fact the labor cannot be owned,⁹⁸ unlike property, plant, equipment, and other financial assets which can be readily contracted for, sold and exchanged. Furthermore:

[e]xpenditures associated with the development of people—education and training being perhaps the most prominent—are treated as costs even though, in actuality, these expenditures possess the attributes of an investment (an expenditure at one point in time that is made with the intention of generating an increase in capacity at some future point in time).⁹⁹

Although, technically, since “human capital cannot be owned, spending on the development of people does not meet the traditional accounting concept of an investment, since employers cannot control the asset, i.e., the people in whom an investment is being made.”¹⁰⁰

1. An “Economic Performance” Approach to Modeling Intangible Assets

Placing human capital onto the balance sheet has been raised from time and time in the accounting and economic literature.¹⁰¹ Historically, however, the attempt has failed “because it

⁹⁷ See JEREMY HOPE & TONY HOPE, *COMPETING IN THE THIRD WAVE: TEN KEY ISSUES THAT MANAGERS MUST FACE IN THE INFORMATION AGE* (Harvard Business School Press 1997).

⁹⁸ U.S. CONST. amend. XIII, § 1.

⁹⁹ Basie, *supra* note 94.

¹⁰⁰ *Id.*

¹⁰¹ See generally ERIC G. FLAMHOLTZ, *HUMAN RESOURCE ACCOUNTING* (Dickenson Publishing Company 1974); ROGER H. HERMANSON, *ACCOUNTING FOR HUMAN ASSETS* (Michigan State University 1964); RENSIS M. LIKERT, *THE HUMAN ORGANIZATION* (McGraw Hill 1967); R. Lee Brummet, et. al, *Human Resource Measurement—A Challenge for Accountants*, 45 *ACCOUNTING REVIEW* 217-24 (1968); James S. Hekimian & Curtis H. Jones, *Put People on Your Balance Sheet*, 43 *HARVARD BUSINESS REVIEW* 105-13 (1967).

proved impossible to secure agreement about the valuation models developed.”¹⁰² More recently, the Cap Gemini Ernst and Young Centre for Business Innovation has developed a Value Creation Index methodology which derives a “composite value creation score.”¹⁰³ Roslender summarizes the methodology as follows:

[It is] based on a model of value creation identified in the course of related consultancy and research activities. Nine categories on intangible value drivers are identified, including innovation, management capabilities, employee relations and process quality. Within each category several standard indicators have been developed, each designed to capture a different facet of value creation. These are aggregated by category, and using agreed weightings, translated into a composite score or index.¹⁰⁴

A more complete methodology has been developed by Baruch Lev of New York University and Feng Gu of Boston University.¹⁰⁵ Lev’s “methodology for measuring the value of intangible assets is based on the economic concept of ‘production function,’ where the firm’s economic performance is stipulated to be generated by the three major classes of inputs: physical, financial, and knowledge assets.”¹⁰⁶ Lev takes normalized historical earnings and future predicted earnings, adjusted for extraordinary and one-time items, to measure the economic performance of the enterprise.¹⁰⁷ He then defines economic performance as a function of the three classes of inputs, such that:

$$(11) \quad \textit{Economic Performance} = \alpha(\textit{Physical Assets}) + \beta(\textit{Financial Assets})$$

¹⁰² Robin Roslender & Robin Fincham, *Intellectual Capital: Who Counts, Controls*, 4 ACCOUNTING AND THE PUBLIC INTEREST 5 (2004).

¹⁰³ *Id.* at 7; Jonathan Low, *The Value Creation Index*, JOURNAL OF INTELLECTUAL CAPITAL 252-62 (2000); Cap Gemini, *Measuring the Future: The Value Creation Index* (2000), available at www.chi.cgey.com.

¹⁰⁴ *Id.*

¹⁰⁵ See generally FENG GU & BARUCH LEV, INTANGIBLE ASSETS: MEASUREMENT, DRIVERS, USEFULNESS (Working Paper 2001), available at www.baruch-lev.com. Lev and Gu’s measure of intangibles is much broader than this paper’s focus on human capital. It includes “new discoveries (drugs, software products, etc.), brands or unique organizational designs (e.g., Internet-based supply chains) [that] are by and large not traded in organized markets, and the property rights over these assets are not fully secured by the company, except for intellectual properties, such as patents and trademarks.” *Id.* at 2. Furthermore, the risk of intangible assets is typically greater than that of physical assets, which makes accountants reluctant to recognize intangibles in financial reports. *Id.* at 2-3.

¹⁰⁶ *Id.* at 3.

¹⁰⁷ *Id.* at 6.

$$+ \delta(\text{Intangible Assets})$$

where α , β and δ represent the contributions of a unit of asset to the enterprise performance.¹⁰⁸

Lev adjusts the balance sheet values of physical and financial assets to represent current market value. Then:

[t]he derivation of the value of the third performance driver— intangible capital—is . . . the solution to the above production function. . . . This is done by estimating the ‘normal rates of return’ on physical and financial assets—the α and β coefficients in the above production function—and subtracting from the estimated economic performance of the enterprise the contributions of physical and financial assets, namely the normal asset returns multiplied by the values of physical and financial assets. What remains from this subtraction is the contribution of intangible assets to the enterprise performance, which [Lev] define[s] as ‘intangibles-driven earnings.’¹⁰⁹

All that remains is to capitalize the expected stream of these intangibles-driven earnings (“IDE”) to yield an estimate of “intangible capital.”¹¹⁰

To test the validity of this measure, Lev and Gu ran several statistical tests on 2,000 companies from 1989 to 1999. They found correlations between stock returns and IDE ranging from 0.40 to 0.53, while the correlations were only 0.29 between stock returns and earnings and only 0.11 with reported cash flows.¹¹¹

Thus, intangible assets can be modeled and inserted onto the balance sheet. While Lev’s analysis is for “intangibles” as a class and does not identify any particular asset such as the Human Capital Asset, it still remains as the first step in greater recognition of human capital outside of bankruptcy. In fact, as the economy continues its trend towards more knowledge and service oriented, intangible assets will become increasingly more important as the significance of physical assets diminish.

¹⁰⁸ *Id.* at 3.

¹⁰⁹ *Id.* at 4. Lev estimates the economy-wide average contributions of physical and financial assets, α and β , to be 7% and 4.5%. *Id.* at 6.

¹¹⁰ *Id.* at 4.

¹¹¹ *Id.* at 17.

2. A More Focused Approach: Capitalizing Human Capital

In traditional accounting, human capital is not considered an asset and expenditures related to human capital are expensed immediately. The International Accounting Standards Board defines an asset as “a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.”¹¹² Human capital clearly falls within this definition, albeit with slightly more measurement difficulty than traditional assets. First, human capital is a resource controlled by the enterprise. It is important to note the difference between the words “controlled” and “owned.” As mentioned earlier, the Thirteenth Amendment bars the ownership of human capital by a firm. However, basic labor consists of an individual selling the use of his human capital to a firm in exchange for wages, and thus the firm effectively controls the human capital. Furthermore, the asset that exists originates from prior events, such as hiring the employee, training the employee, and even the employee’s prior pre-employment education. Finally, future economic benefits will flow to the firm as employees engage in their daily work.

Given that the control-ownership issue does not exist under the accepted accounting definition, the remaining issue is determining the length of time that future benefits will accrue. Employees typically have an at-will relationship with a firm. However, the technicality of this relationship does not reflect reality. Economists use the term ‘labor mobility,’ and often assume labor is freely mobile. However, labor is often very restricted due to an individual’s recognition of his firm-specific human capital, ties to family and/or the community, or other switching costs including pensions or bonus pools. Even though today’s employees may not spend forty years

¹¹² International Accounting Standards Board, *Elements 1: Asset Definition*, at 3 (2005), available at <http://www.iasb.org/NR/rdonlyres/1C268B9D-C477-4C0F-BA86-7C540ACA5E56/0/Dec050512ob02a.pdf>.

with the same company as prior generations did, we can use measures of turnover and tenure to estimate a predicted length of employment.

This concept is not new; there exists a decades-old body of literature proposing that human capital receive traditional accounting treatment and be recognized on the balance sheet.¹¹³ I posit that this theory did not gain traction in the 1970s because much value creation was still derived from physical assets. In contrast, today, more value creation is derived from the human capital investment and physical investments are becoming a smaller proportion of the overall firm value. This can be seen by the increase in average Market Price-to-Book ratio of public companies from near parity in 1950 to a 4.1:1 ratio in 2005.

The simplest form would be to recognize the human capital asset on the balance sheet in a similar method to the accounting treatment performed by financial analysts to recognize operating leases. All that is needed to recognize human capital on the balance sheet is the turnover and tenure for the firm's employees (or industry's employees), as well as the predicted wages over this period. Similar to capitalizing operating leases, an asset can be created by discounting the stream of wages over the predicted tenure of the employees and amortizing the asset over the same period. This is a simple model to place the human capital asset onto the balance sheet. However, in capitalizing operating leases, analysts also include a leasehold liability on the right hand side of the balance sheet. Since labor cannot be owned, an issue arises regarding how to account for this liability. Although the benefits of the asset will ultimately accrue to the equity owners (minus the current wages paid), the liability recognized for human capital should be a liability owed to labor itself. This has important implications for the capital

¹¹³ See generally Baruch Lev & Aba Schwartz, *On the Use of Economic Concept of Human Capital in Financial Statements*, ACCOUNTING REVIEW 103-12 (Jan. 1971); Eric G. Flamholtz, *A Model for Human Resource Valuation: A Stochastic Process with Service Rewards*, ACCOUNTING REVIEW 253-67 (Apr. 1971); Wayne J. Morse, *A Note on the Relationship Between Human Assets and Human Capital*, ACCOUNTING REVIEW 589-93 (July 1973).

structure of the firm, which would now also include labor rather than just equity investors and creditors.

CONCLUSION

Section 1113 lies at an important crossroad between two federal imperatives—judges must decide between a more orderly and efficient administration of the Bankruptcy Estate and the fair treatment of organized labor. Section 1113 carries large implications for debtors, organized labor, and the other unsecured and junior creditors in the debtor’s bankruptcy. The answers to what priority is given when the contract is assumed and whether damages arise from the rejection of a CBA will directly impact the bargaining process. Although these issues arise under bankruptcy law, bankruptcy judges should be mindful of their own (lack of) institutional competence in dealing with non-bankruptcy, labor related issues.

I have attempted to show through economics and accounting that labor merits special treatment in bankruptcy, and that barring a claim for breach of a labor contract will raise the ex ante cost of capital for a firm more than eliminating a different sort of claim would because labor is nondiversifiable. By extending a pre-existing economic analysis, we see that similar investments and recovery rates for human and financial capital yield a higher default risk for labor than for creditors. This is a reflection of the nondiversifiability of the individuals investment in human capital as well as the higher redeployment cost of human capital because an individual must seek reeducation and may conduct a lengthy job search before finding new employment. Furthermore, creditors have the opportunity to diversify their risk in a well-balanced portfolio—an opportunity which does not exist for individuals. Congress has the ability to equalize the default risk of human capital to that of financial capital by modifying the recovery

rates that investors in human and financial capital each receive in bankruptcy. If Congress still believes in the prerogative of labor, § 1113 will be the appropriate vehicle to achieve this goal.

Additionally, the accounting balance sheet fails to capture the reality of the marketplace outside of bankruptcy. The disparity between accounting and reality continues to widen as we develop from an industrial economy to a knowledge-based economy where wealth creation derives largely from the efforts of human capital. Recognition of the assets created by human capital investment has significant implications for the capital structure of corporations and further acknowledges the labor's importance in creating value in today's economy.