Delta and Northwest: U.S. Airline Bankruptcies Focus On Labor

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Since the deregulation of the U.S. airline industry in 1982, the large pre-deregulation carriers, referred to as “legacy carriers,” have struggled to remain profitable in an increasingly competitive marketplace. In recent years, competitive pressures have contributed to all but one of these legacy carriers filing for bankruptcy protection, some more than once, or going out of business. On September 14, 2005, two additional legacy carriers filed for reorganization under chapter 11 of the U.S. Bankruptcy Code – Delta Air Lines, Inc. (Delta) and Northwest Airlines (Northwest) – each seeking bankruptcy court protection to implement measures they believe will lead to lower overall costs and increased revenues. Although these cases were filed only recently, an issue of intense interest has been whether the debtors would achieve consensually what they characterized as critical labor cost savings, or whether they would use Section 1113 of the Bankruptcy Code to reject their collective bargaining agreements (CBAs) – a step that no major airline has yet been forced to take.

The Chapter 11 Filings

The early emphasis on labor issues is best understood against the backdrop of the factors underlying these chapter 11 filings. In papers filed at the outset of their bankruptcy cases, both airlines noted that the economic model of the U.S. airline industry has fundamentally changed, largely as a result of the proliferation of “low-cost carriers” (LCCs), such as JetBlue Airways, Southwest Airlines and America West. The market share of LCCs has tripled from 1990 to 2005, encroaching into revenue streams that historically belonged to legacy carriers. Both Delta and Northwest stated that LCCs have a sizable cost advantage over legacy carriers because, among other things, LCCs have much lower labor and operating costs. In addition, unlike legacy carriers, LCCs have never provided defined-benefit pension plans (Pension Plans) to their employees, instead opting for lower-cost defined contribution plans. Both airlines characterized the compensation of their unionized pilots as among the highest in the industry.

Delta and Northwest also observed that the revenue environment in the industry generally had been changed by the decrease in high-yield business travel and the growth of the Internet as a distribution outlet for tickets – two factors that challenged the industry’s historic pricing models, increased price transparency and reduced ticket prices generally. Although LCCs, given their cost advantages, have been able to remain profitable notwithstanding lower ticket prices, Delta and Northwest stated that they have been unable to reduce costs sufficiently to meet these reduced prices without suffering operating losses.

Both airlines stated that these pressures were exacerbated by recent rising oil prices, which had dramatically affected fuel costs. Whereas in the past legacy carriers could increase fares to compensate for increased expenses due to fuel and labor costs, today legacy carriers are forced to match the fares set by LCCs. The twin pressures of declining prices and increasing costs eroded the airlines’ cash positions and required them to incur additional debt.

Faced with these pressures, both airlines had attempted prior to bankruptcy to cut non-labor costs and to negotiate concessions from their unions; however, these and other measures had been insufficient to return them to profitability. Their heavy debt burden as a result of recent losses, and their large unfunded pension liabilities, had resulted in a liquidity threat. On filing, both airlines stated that billions of dollars in cost savings and revenue improvements would be necessary to reorganize successfully.

Rejection of Collective Bargaining Agreements

As their filings make clear, a key area in which Delta and Northwest seek to use the Bankruptcy Code to achieve their goal of significant cost savings is the modification or rejection of existing CBAs with their unionized employees.

To that end, shortly after their chapter 11 filings, both Delta and Northwest filed an application (Application) to reject their respective CBAs with the Air Line Pilots Association (ALPA) pursuant to Section 1113 of the Bankruptcy Code.

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1 Among the large pre-deregulation carriers, Pan Am, TWA, Eastern and Braniff are no longer in business; the carriers still operating are American, United, Continental, US Airways, Delta and Northwest. Only American has not sought bankruptcy protection.

2 For example, LCC fleets are typically composed of fewer types of aircraft than those of legacy carriers, leading to cost savings on pilot training, maintenance and parts.

3 The U.S. Supreme Court has described the differences between a defined benefit plan and a contribution plan:

A defined benefit plan is one that promises to pay employees, upon retirement, a fixed benefit under a formula that takes into account factors such as final salary and years of service with the employer. See 29 U.S.C. §1321. It is distinguished from a ‘defined contribution’ plan (also known as an ‘individual account’ plan), under which the employer typically contributes a percentage of the employee’s compensation to the account upon retirement.

4 Delta stated that it would need an additional $3 billion in annual cost reductions and revenue improvements to be realized by the end of 2007. Northwest stated it would require $1.4 billion in labor cost savings.

5 On November 1, 2005, Delta filed its Motion to Reject ALPA Collective Bargaining Agreement. On October 12, 2005, Northwest filed Northwest’s Application to Reject Collective Bargaining Agreements Pursuant to 11 U.S.C. § 1113(c). In its Application, Northwest seeks to reject “nine (9) CBAs” between Northwest and the six unions...that represent the vast majority of Northwest’s employees,” including its CBA with ALPA. Northwest Application, p. 2.
Section 1113 provides the exclusive means for a debtor, other than a railroad, to reject a CBA, and seeks to reconcile the Bankruptcy Code policy of fostering rehabilitation of debtors with the U.S. labor law policy of protecting employee rights through collective bargaining. In striking this balance, Section 1113 is designed to encourage negotiations between a debtor and its unions. Thus, a debtor may not unilaterally terminate a CBA without meeting the requirements of Section 1113 and is bound to the terms of an existing CBA unless the court grants an application for rejection or interim relief.

Section 1113(b)(1) imposes specific obligations on a debtor seeking rejection or modification to:

“(A) make a proposal to the authorized representative of the employees covered by such agreement, based on the most complete and reliable information available at the time of such proposal, which provides for those necessary modifications in the employees benefits and protections that are 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; and

(B) provide … the representative of the employees with such relevant information as is necessary to evaluate the proposal.”

Section 1113(c) provides that the court may approve an application to reject a CBA “only if the court finds that—

(1) the [debtor] has, prior to the hearing, made a proposal that fulfills the requirements of subsection (b)(1);

(2) the authorized representative of the employees has refused to accept such proposal without good cause; and

(3) the balance of equities clearly favors rejection of such agreement.”

**Delta’s Negotiations with ALPA**

 Shortly before its bankruptcy filing, Delta made a proposal to ALPA for a $325 million reduction in annual pilot labor costs, which Delta advised ALPA was its proposal pursuant to Section 1113. The proposal included a 19.5% cut in pilot wages and a “hard” freeze on the accrual of further benefits in the pilots’ Pension Plan (meaning that not only would no further service credits be accumulated, but also no future increased earnings would be used in calculating pension benefits); these concessions were to be offset in part by an enhanced employee profit-sharing plan.

In its Application, Delta argued that the proposal meets the requirements of Section 1113 because the full $325 million in cost savings is necessary to reorganize successfully, and the union employees are being asked to bear only their proportionate share of the burden of the debtors’ stakeholders.

ALPA objected to the Application, arguing that the Delta proposal failed to comply with Section 1113 and was not fair and equitable, in that pilots were being asked to sacrifice disproportionately and Delta had not shown that the full $325 million in pilot cuts was required to return Delta to profitability. ALPA pointed out that the pilots would likely suffer enormous losses in the reorganization from layoffs and the likely termination of the Pension Plans as a result of Delta’s continued failure to make pension contributions – losses it said were not accounted for in the Delta proposal. ALPA had made a counterproposal to provide an average annual cost savings of approximately $90.7 million over four years, including a reduction in pilot pay by 9% commencing December 1, 2005 and moving to 5% by January 2007, and a “hard freeze” for the Pension Plan; it further required that any reorganization plan provide equity, security or other consideration for the pilots’ pre- and post-petition concessions. ALPA announced that the pilots were prepared to strike if the CBA was rejected, a move Delta characterized in public filings as tantamount to a “murder-suicide” because it would put the airline out of business. Moreover, Delta said such a strike was enjoined under the Railway Labor Act, a position the union rejected.

In December, before the court was scheduled to rule on the Application, ALPA reached an interim agreement with Delta providing for annualized pilot cost reductions of $143 million, including a 14% pay cut. The agreement, which provided some relief for Delta’s immediate cash needs, was approved by the court on December 13, 2005. Under the agreement, the parties will attempt to reach a comprehensive agreement by March and, failing agreement, will submit the Section 1113 rejection decision to binding arbitration.

**Northwest’s Negotiations With ALPA**

Northwest’s Application included a proposal to ALPA for annual pilot labor cost savings of $361 million, including an average base pay reduction of 28.4%. As in Delta, Northwest argued that these cuts were necessary to avoid liquidation, and did not impose an unfair burden on the pilots. ALPA countered that Northwest’s demands did not meet Section 1113 because they were overreaching and unfairly burdensome; its pilots stated they were prepared to strike. In early November 2005, ALPA and Northwest reached an interim agreement for an annual concession of $215 million, and adjourned the hearing on the Application pending further negotiations. Separately, ALPA and Northwest agreed that the Northwest Pension Plan would be frozen as of February 1, 2006, and that the parties will agree upon the terms of a contribution plan. ALPA subsequently proposed to increase the amount of concessions to $244 million, including a 20% wage cut, and demanded various benefits including an improved profit sharing plan and equity in the reorganized company, although a comprehensive agreement has not yet been reached. Although a hearing on Northwest’s Application commenced on January 17, 2006, the parties made clear that they were continuing to negotiate and were not seeking an immediate ruling.

**Conclusion**

These negotiations illustrate the purpose – and the tensions – underlying Section 1113. Both the airlines and the unions have emphasized that they favor a negotiated resolution; the alternative is a high stakes gamble in which both sides stand to lose. Whether such a resolution is possible, and, if achieved, whether it will be sufficient to enable these legacy carriers to compete successfully in the marketplace, are issues that will continue to be of interest in the weeks and months ahead.

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7 11 U.S.C. §1113(c).
8 Although ALPA valued the proposal at $294 million, Northwest valued the proposal at $244 million, exclusive of changes to retiree benefits and scope changes – items that were excluded from Northwest’s initial proposal.
9 As of the commencement of the hearing, Northwest had reached agreements with four of the six unions against which relief was sought in the Application. Thus, the hearing proceeded only with respect to ALPA and the Professional Flight Attendants Association.