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Employee Interests in Bankrupcy: Lessons from Enron

Lorie Johnson
University of Georgia School of Law

Employee Interests in Bankruptcy: Lessons from Enron

Editor's Note: Assistant professor Lorie Johnson has conducted extensive research on the Enron debacle. She currently references the Enron case in her Bankruptcy and Corporate Finance courses and uses the school's new multi-media equipment and wireless Internet network to make the most current documents and findings available to her students.

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- Lorie Johnson

Enron employees lost over $1 billion in retirement savings when the company failed and filed for bankruptcy protection. Many of these employees also lost their jobs.

Enron employees were both visible and vocal about their losses, quickly obtaining the support of both the AFL-CIO and Jesse Jackson's Rainbow/Push Coalition in their fight to get some redress for their losses. Since Enron was current on its payroll at the time of the bankruptcy filing, employees' losses consisted of severance payments totaling $145 million and the losses associated with investments in Enron stock through their 401(k) accounts.

In a typical corporate bankruptcy, the court will appoint one committee to represent all unsecured creditors in negotiating a reorganization plan with the debtor. In the Enron case, the court initially appointed a 15-member committee, including an employee delegate, to represent all of Enron's unsecured creditors in negotiating with the company. In a corporate bankruptcy, the court may appoint a separate committee to represent the shareholders in negotiating with the debtor and unsecured creditors. The bankruptcy code also gives the court discretion to appoint additional committees if necessary to assure "adequate representation" of the parties in the bankruptcy case. To emerge from bankruptcy as a continuing business, the debtor has to obtain the support of any committees appointed. Courts rarely appoint more than one creditors' committee. Unless the bankrupt company is solvent, the court rarely appoints a shareholders' committee. Enron is clearly insolvent and no shareholders' committee has been appointed. Although several groups requested separate committees in the Enron bankruptcy, only the employees were successful in their request.

A class of claimants must show they are not "adequately represented" by the existing committee in order to obtain separate committee representation. Factors courts consider in assessing whether or not a group is adequately represented include the size and complexity of the case, the number and location of the creditors, the nature of the claims, and whether or not the claimants are likely to be treated differently than other creditors. The Enron employees' claims

under each of these factors are substantially similar to the other groups of trade creditors requesting committees - unless the court considers the employees' claims based on losses in their 401(k) accounts. Therefore, it seems likely Enron employees obtained separate committee representation based on this factor.

Enron employees had a significant portion of their 401(k) accounts invested in Enron stock. Even though they had at least 12 other investment options, including a money market fund, a bond fund, various equity funds, and a self-directed Schwab account, they had chosen to invest in Enron stock. While some employees undoubtedly felt pressured to make this choice, others admittedly chose to invest in the company's stock because they thought it was a good investment. They were not alone in making that assessment. Enron stock had significantly outperformed the market in 1998, 1999 and 2000. As late as a month before Enron's bankruptcy filing, two-thirds of the analysts following the stock rated it as a "strong buy" or "outperform" the market. In fact, many pension funds were also invested in Enron stock. Other public employee pension funds lost at least $3 billion in investments in Enron stock. While Enron employees/retirees suffered significant losses when Enron failed, other employees/retirees suffered similar losses based on the same fraudulent accounting and misleading statements by Enron's executives.

The Bankruptcy Code explicitly subordinates securities fraud claims. Claims based on securities fraud are not entitled to payment until all unsecured creditors are paid, unless the unsecured creditors agree to different treatment. This is where separate committee representation becomes significant. Claimants with a representative at the bargaining table do better than those who are unrepresented. One study of corporate reorganizations found that no reorganization plan was confirmed over active committee opposition. Consequently, having a separate committee gives Enron's employees substantial negotiating leverage with both the company and its other creditors. Other investors in Enron's stock have no voice in the bankruptcy proceeding. They are not creditors, so they are not entitled to representation on the unsecured creditors' committee. Since Enron is insolvent, they have no separate committee of their own.

Outside investors' securities fraud claims against Enron are clearly subordinated and last in line for payment. Enron employees, however, are arguing Enron's 401(k) administrators breached their fiduciary duty in continuing to offer Enron stock as an investment option and company officers breached their fiduciary duties by making false statements and failing to disclose the true condition of the company. This is an attempt to transform claims that would have securities fraud status in the hands of an Enron outsider into claims with unsecured creditor status in the bankruptcy proceeding. This moves Enron retirees/employees, who chose to invest in Enron stock, ahead of other employees/retirees who similarly chose to invest in Enron stock.

Rather than litigating the breach of fiduciary duty claims, Enron and its creditors may choose to settle and pay the claims through Enron's reorganization plan. If the employees had one vote on a 15-member committee, as was the case initially, employees would not have much bargaining power to extract a higher payment for their claims. But because they have a separate committee, they have greater bargaining power. Indeed, the fact the committee has already been successful in obtaining severance payments of $13,500 per employee reflects its substantial bargaining position. Since the legal basis for treating severance pay as an administrative expense entitled to immediate payment was extremely doubtful, this $13,500 reflects an early payment of an unsecured claim at a higher rate than most other unsecured creditors are likely to receive. Through their committee, Enron employees may also be successful in negotiating a settlement for losses in their 401(k) accounts, even though other investors who suffered similar losses will not recover anything from the company.

Enron employees had two types of claims against the company - claims based on severance pay entitled to higher priority and claims based on 401(k) stockholdings with lower priority. Claimants with claims of different priorities against a bankrupt corporation should not be given a separate committee because the committee gives them too much power to extract payment for their lower priority claims by demanding better treatment for their higher priority claims. While courts and trustees have broad discretion to appoint additional committees under the bankruptcy code, they should decline to exercise this discretion when the group requesting the committee has multiple claims with differing priorities against the debtor.

-Assistant Professor Lorie Johnson