

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.



“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.”

- 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

Faculty Accomplishments

Callaway Chair Emeritus Verner Chaffin (back, l.) and Dean David Shipley (back, r.) with Ethel Chaffin (front, l.) and Sarajane Love at a private dinner celebrating the naming of Love to the Chaffin Professorship of Fiduciary Law.

Love Appointed to Chaffin Professorship

Sarajane Love will be the first holder of the Verner F. Chaffin Professorship of Fiduciary Law.

A UGA law faculty member since 1984, Love specializes in trusts and estates and also teaches courses on federal pension regulation and women and the law. Her recent scholarship includes two books, *Redfearn's Wills and Administration in Georgia* and *Comparative Treatment Edition of Redfearn's Wills and Administration in Georgia*.

Before teaching at Rutgers Camden University School of Law and Tulane University, she served as law clerk to the late Judge Lewis R. Morgan of the Fifth Circuit (now 11th) U.S. Court of Appeals.

Love graduated first in her class from the UGA School of Law in 1973 and earned her bachelor's degree from Emory University. She is the third woman to hold an endowed position at the law school.

Dean David Shipley says Love is the perfect person to be the inaugural holder of the Chaffin professorship. "Sarajane's growing reputation in the area of fiduciary law makes her an ideal candidate for this position. There is no doubt that she will set a high standard for future holders of the Chaffin professorship."

This professorship was solely established by Ethel Chaffin to honor her husband Verner

Chaffin, Callaway Chair Emeritus, who taught at the law school from 1957 to 1989. Chaffin had a very distinguished career at the university. To this day, he remains involved with the law school and the broader legal community, including the State Bar of Georgia.

"We are grateful for this donation from Ethel Chaffin," Shipley said. "Privately-funded chairs and professorships enable the School of Law to attract and retain some of the nation's best scholars and teachers for our students."

Larson to Hold Talmadge Chair

The recipient of the 1998 Pulitzer Prize in History, Edward Larson was recently named to the Herman E. Talmadge Chair of Law.

Specializing in the law of biotechnology and health care, Larson joined the university in 1987. At the School of Law, he teaches courses on health care financing and science law in addition to property law. Along with several law review articles published this year on the topics of disability rights and constitutional law, his recent scholarship includes the books *Summer for the Gods: The Scopes Trial and America's Continuing Debate Over Science and Religion* and *Evolution's Workshop: God and Science in the Galapagos Islands*.

He earned his law degree from Harvard University and his Ph.D. in the History of Science from the University of Wisconsin-Madison.

Larson holds a joint appointment at the law school and the history department, where he currently serves as department chair. He is one of only two UGA professors to occupy two endowed positions simultaneously. He is also the Richard B. Russell Professor of American History.

Dean David Shipley said he was pleased to be able to appoint Larson to this prestigious chair. "To have someone with Larson's national and international reputation at our school is essential to maintain our position as one of the top public law schools in the nation," he said.

The Talmadge Chair was established in 1979. It honors the late Herman E. Talmadge, who served as both Georgia governor and U.S. senator. He was a 1936 graduate of the School of Law.

Johnson Selected as Lilly Teaching Fellow

Assistant Professor Lorie Johnson has been selected as a 2002-03 UGA Lilly Teaching Fellow. She is one of 10 UGA assistant professors chosen from 44 nominees.

The goal of the Lilly program is to allow assistant professors to strengthen their teaching skills, develop their ability to appropriately balance teaching with the research and service roles mandated by the university, share their ideas with colleagues from other disciplines, and complete an instructional project designed to enhance courses and teaching methods in their academic department.

Johnson's instructional project is to develop a business negotiation course that will allow students to integrate the principles of business organization law and business finance with experience negotiating and drafting the basic documents they will encounter in the business world. She hopes this course will eventually be offered as a joint J.D./M.B.A. course.



Rees Retires – Mostly, Anyway

One of the School of Law's longest-serving faculty members, Law School Association Professor John Rees Jr., retired in June 2002.

However, he will continue to teach two courses, Conflict of Laws and Federal Courts, each year.

Rees began teaching at Georgia Law on September 1, 1959, and served as assistant dean from 1964 to 1969. He was the law school's senior professor in the areas of civil procedure, federal courts and conflict of laws. He led the facilities committee that oversaw design and construction of the Hirsch Hall expansion, dedicated in 1967. In 1991, Rees was appointed as the Law School Association Professor.

His scholarship includes participation in a forum on conflict of laws at Mercer University. The transcript of the forum was published in the *Mercer Law Review* (1997). In the past, students have also honored him with the Faculty Book Award for Teaching Excellence.

In addition to his role as professor and active faculty member of 42 years, Rees is a major benefactor. He has generously endowed the John B. Rees Jr. Law Library Book Fund to help maintain the law library's collection. In 1997, his outstanding service to the School of Law was recognized by the Law School Association, when it presented him with the Distinguished Service Scroll Award, the highest honor bestowed by the organization.

Rees earned his undergraduate degree from Hobart College and his law degree from the University of Virginia, where he served on the editorial board of the *Virginia Law Review*. He is a member of the State Bar of Georgia and the Virginia and Washington, D.C., bars. In 1965, he served as technical advisor to the committee of the Georgia House which drafted the Georgia Civil Practice Act, based on the Federal Rules of Civil Procedure.

White Appointed Faculty Mentor in UGA Foundation Fellows Program

Hosch Professor Rebecca White has been selected as a senior faculty fellow in the university's premier undergraduate scholarship program, Foundation Fellows.

This summer she began a four-year term, serving as a mentor and role model to the students in the fellowship. She joins a group of 11 other UGA senior faculty fellows who represent a range of academic disciplines from the humanities to the sciences.

Steven Elliott-Gower, associate director of the Honors and Foundation Fellows programs said the senior faculty fellows come from a variety of disciplines to meet the needs of the program's students. "They are chosen on the basis of their nationally recognized scholarship and their demonstrated interest in undergraduate education," he said.

Senior faculty fellows are assigned four to eight students and generally meet with them as a group once a semester, then follow up with individual contacts.

White and two other new appointees succeed Talmadge Chair and Russell Professor Ed Larson, Betty Jean Craige and Tom Polk, who have served as senior faculty fellows since the mid-1990s.

-Steven Elliott-Gower



Hellerstein Lends Expertise to All Three Major World Organizations on Taxation

This past year, Shackelford Professor of Taxation Law Walter Hellerstein completed the circle of consulting the top three world organizations involved in international commerce on e-commerce tax issues. In the spring of 2002, he spoke to the World Trade Organization in Geneva regarding revenue implications of e-commerce for development.

Hellerstein has also consulted the United Nations' Ad Hoc Group of Experts on International Cooperation in Tax Matters to which he presented papers in Montreal, Canada, and Geneva, Switzerland. In addition, he is continuing his work with the Organization for Economic Cooperation and Development in Paris, France, where he serves as a consultant to the OECD's Working Party on Consumption Taxation and as an appointed member of the OECD's Technical Advisory Group on Consumption Taxes.

Professors Join Forces to Recognize Students

Shackelford Professor Walter Hellerstein, Associate Professor Larry Blount and Professor Camilla Watson joined forces to personally fund the John C. O'Byrne Excellence in Taxation Award this past spring. This award will be presented annually to a high achiever in one of the school's tax law courses.

Registrar Marc Galvin said it was very gracious of these three professors to honor outstanding students and the memory of John C. O'Byrne. This award replaces the Georgia Federal Tax Award for Excellence in Tax Law.

Going Live

Callaway Professor Ron Carlson ventured into uncharted territory in April 2001 when he premiered UGA's first live national continuing legal education course via the Internet. Attorneys across the nation logged onto Carlson's webcast to earn CLE credit, while others gathered at sites as far away as California to view and to call in. Carlson presented analysis on the topic of jury summation after two of his third-year students, Mark Mitchell (J.D. '01) and Paul Rosenthal (J.D. '01), gave hypothetical closing arguments. The course was broadcast from UGA's Grady College of Journalism and Mass Communications.

Ironically, Carlson jokes, while he's not on the cutting edge of technology himself, he is helping out the lawyers who are. He presented another webcast CLE program, this time for Georgia ICLE, in December 2002.
-Kathy Pharr/Ron Carlson

The U.S. Supreme Court Hears the Mickey Mouse Case

Editor's Note: Brock Professor Ray Patterson consulted and advised the counsel for Eldred and was present for the arguments before the U.S. Supreme Court. Patterson's expertise in the area of copyright is well known. He recently co-authored an article on copyright in 1791, as the constitutional framers understood it, with the University of Houston Law Center's Professor Craig Joyce. Another newly authored work is "The DMCA: A Modern Version of the Licensing Act of 1662" in the Journal of Intellectual Property Law (2002).



The case of *Eldred v. Ashcroft*, argued before the U. S. Supreme Court on October 9, 2002, is the most important copyright case since 1834, when the court decided its first, *Wheaton v. Peters*. In *Wheaton*, the court ruled that under the Copyright Clause of the U.S. Constitution only Congress can grant copyright for published works. In *Eldred*, the court will decide the scope of Congress' copyright power. May Congress grant, in the words of the Copyright Clause, copyright only for a "limited time[]" or may Congress extend the time already granted for existing copyrights? This is what Congress did in the Copyright Term Extension Act (CTEA), extending the term for all copyrights, present and future, for 20 years.

The CTEA is commonly referred to as the Mickey Mouse Copyright Protection Act, because the Disney Company was shortly destined to lose the copyright of its favorite child and allegedly carried favor with members of Congress to rescue Mickey from the horrible fate of falling into the public domain where he would be unprotected from mouse molesters. (This may be true, since members of Congress are known to suffer from a congenital defect known as "the 30-pieces-of-silver syndrome.")

But even if the motive for the CTEA is tainted, Congress did enact it, and the court must decide the case on its merits. No one, other than copyright holders, contends the statute is sound policy but the issue is con-

gressional power. The problem the court faces in limiting that power is that in the past Congress, long before Mickey Mouse, had extended copyright terms, and, indeed, it did so in the 1976 Copyright Act. The court's problem is that if the CTEA is unconstitutional, the ruling might be precedent for holding the 1976 Act unconstitutional.

Fortunately, there are sound reasons for saying the unconstitutionality of the CTEA is not precedent for the unconstitutionality of the 1976 Act. First, all extensions of copyrights in the past have been made as part of a general revision of the copyright statute. The CTEA is the first independent statute to extend copyright terms. The importance of this point is that none of the prior extensions resulted in freezing the public domain, which the CTEA did as of its effective date. Under that statute, no copyrighted work will go into the public domain for 20 years. And, of course, if the CTEA is constitutional, Congress can repeat the scenario in 20 years and, given the unlikelihood of a cure for the 30-pieces-of-silver-syndrome, will probably do so.

This result could be viewed as merely an unfortunate consequence of bad policy, except for one thing: The Copyright Clause of the U.S. Constitution requires that copyright protect the public domain by limiting copyright protection to new (and original) works for a limited time. The first condition means that copyright cannot be used

to capture works in the public domain, the second that all copyrighted works will go into the public domain.

In addition, the extension of copyright terms as part of a general revision of the copyright statute has generally been made as a matter of equity to avoid penalizing authors who would otherwise not have the benefit of the change in the law. These extensions can thus be viewed as an exercise of equitable power by Congress under the Copyright Clause. The CTEA is clearly an exercise and, arguably, an abuse of its legal power.

Finally, it should be noted that none of the prior extensions of the copyright term resulted in freezing the public domain, as does the CTEA. Prior to the 1976 Act, copyright was granted for two terms, and, to obtain the benefit of the second term, the copyright holder had to renew the copyright. Statistics show that only a small percentage of copyright holders in fact renewed their copyrights, which meant the impact of the extensions on the public domain was slight.

The ultimate point is the Copyright Clause is a limitation on as well as a grant of constitutional power. When Congress exceeds those limits, courts should so hold. One of the surprising things about *Eldred* is it is the first case ever to challenge the constitutionality of a copyright statute - a remarkable fact in view of the dozens and dozens of copyright statutes Congress has passed in over 200 years (since 1790) - and courts are not used to questioning Congress' copyright power. Thus, it may be well to note that just as Congress is bound by the Copyright Clause in enacting copyright statutes, courts should be bound by the clause in interpreting those statutes.

One final point, Mickey's emancipation does not mean Disney can no longer claim to be Mickey's progenitor and, arguably, at the age of 70 or so years, Mickey is entitled to emancipation. Otherwise, Disney might be charged with violation of the laws against animal cruelty.

*-Brock Professor of Professional Responsibility
Ray Patterson*