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IN THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

In Re:	Chapter 11
NORTHWEST AIRLINES CORPORATION, *et al.*,	Case No. 05-17930 (ALG) (Jointly Administered)
Debtors.	

SUPPLEMENTAL MEMORANDUM OF LAW OF THE INTERNATIONAL ASSOCIATION OF MACHINISTS AND AEROSPACE WORKERS' AND ASSOCIATION OF FLIGHT ATTENDANTS IN SUPPORT OF JOINT MOTION FOR ALLOWANCE OF CLAIMS NO. 4851 AND 8964

The International Association of Machinists and Aerospace Workers, AFL-CIO (the "IAM"), by and through its counsel, Lowenstein Sandler PC, the International Brotherhood of Teamsters (the "IBT"), by and through its counsel Bradley T. Raymond, PC, and the Association of Flight Attendants-CWA (the "AFA"), by and through its undersigned counsel, Guerrieri, Edmond, Clayman & Bartos, PC, submit this supplemental Memorandum of Law in support of the Joint Motion of the Debtors, the IAM, the IBT, and the AFA for allowance of Claim No. 4851 (the "IBT Claim") and Claim No. 8964 (the "IAM Claim") (collectively, the "Union Judgment Claims"), and respectfully represent as follows:

PRELIMINARY STATEMENT

The Union Judgment Claims should be allowed as general unsecured claims against the Debtors. The claims are based on the Debtors' breach of valid contracts requiring them to re-pay the value of hundreds of millions of dollars of wage and benefit concessions granted by the airline's IAM-represented employees and flight attendants in 1993 by re-purchasing preferred stock issued to those employees in accordance with a contractual put right. The contracts gave rise to a debt obligation on the part of Northwest to pay a fixed amount to the employees based on the actual value of savings realized by the airline from the employees' concessions. When the Debtors failed to honor the put right and repay the loan from their employees, the two unions sued and, following hotly-contested proceedings, obtained money judgments from the Supreme Court of the State of New York. The unions subsequently filed proofs of claim (nos. 4851 and 8964) with this Court in the amount of the judgments, plus interest.

Because the judgments are entitled to *res judicata* effect in this Court, the Union Judgment Claims should be allowed under section 502 of the Bankruptcy Code. Even if the judgments are not binding, the claims should still be allowed, given the absence of any evidence challenging the validity of the claims. Indeed, it is telling that the Debtors, rather than contest the claims, have decided in the exercise of their business

judgment to advocate for their allowance. There also is no basis for subordinating the Union Judgment Claims under section 510(b) of the Code. Section 510(b) is inapplicable because the Union Judgment Claims are based on *bona fide* debts incurred by the Debtors, rather than compensation for lost equity investments.

The Court should also consider the effect that disallowance or subordination of the Union Judgment Claims is likely to have on an already demoralized work force. The Court is intimately familiar with the past discord among labor and management at Northwest Airlines, as well as the tremendous sacrifices unionized employees have already made as part of the current restructuring. Depriving the IAM-represented employees and flight attendants of their legitimate status as creditors entitled to payment for the *de facto* loans they extended to the airline to get it through past hard times -- and putting them behind "creditors" who purchased unsecured claims at a discount in order to turn a quick buck -- would pile indignity on top of inequity. The Debtors recognize this, which is why they have submitted this joint motion with the unions.

For the foregoing reasons, the IAM, the IBT, and AFA respectfully request that the Court allow the Union Judgment Claims in full as general unsecured claims.

BACKGROUND

A. The Claimants

The claims at issue in this motion arise from the Debtors' contractual obligation to repay wage and benefit concessions agreed to in 1993 by two groups of unionized employees. The first group consists of employees represented by Air Transport District Lodge 143 of the IAM ("District Lodge 143"), who work in the following employee classifications: Equipment Service Employees; Stock Clerks; Clerical, Office Fleet and Passenger Service; Plant Protection; Flight Simulator

Technicians; and Mechanics and Related Employees (the "IAM Group"). The airline's flight attendants form the second group (the "AFA Group"). At the time the relevant concessions were agreed to, the International Brotherhood of Teamsters (the "IBT") served as the flight attendants' certified collective bargaining representative, a function now served by the AFA. At all relevant times, the terms and conditions of employment for the IAM Group and the AFA Group were governed by collective bargaining agreements negotiated with the Debtors pursuant to the Railway Labor Act.

B. The Basis for the Union Judgment Claims.

1. The Debtors' Concession Repayment Obligation.

In 1992, Northwest Airlines was experiencing serious financial difficulties that threatened to force the airline into bankruptcy. Management asked its unions to "do their part" to return the airline to solvency by agreeing to hundreds of millions of dollars of wage and benefit concessions. Months of intensive negotiations ensued. (Declaration of Thomas Roth ("Roth Decl."), ¶ 3).

Believing very strongly that the airline's financial problems flowed from poor management decisions and costly deals struck with past investors, none of the unions were willing to give the concessions requested by Northwest for free. Some unionized groups -- led by the pilots ("ALPA") -- demanded to be treated like investors, *i.e.*, by acquiring an equity interest in the airline in exchange for agreed-upon concessions. ALPA focused its demands on maximizing an ownership interest in the airline. (Roth Decl., ¶ 4).

The IAM and the flight attendants, who at the time were represented by the IBT (and now are represented by the AFA), ultimately took a different tack. Both groups were among the lowest-paid employees at the airline, and their members lived paycheck-to-paycheck. For example, the pilots' average total compensation in 1992 exceeded $157,000, as compared to $43,000 for the IAM Group. (Roth Decl., ¶ 5). The

pilots' much greater average disposable income gave them the luxury of sharing as equity investors in the upside potential of a restructured Northwest Airlines, as well as the financial wherewithal to absorb the risks of such an investment. Neither the IAM-represented employees nor the flight attendants could afford that luxury. Moreover, feedback obtained from the IAM's members during negotiations revealed a conspicuous lack of appetite among them for obtaining an equity interest in their employer. (*Id*.)

Consequently, the IAM and the IBT eschewed investor status and instead reluctantly agreed to make a loan to the airline. The IAM and IBT would provide concessions to the airline, so long as Northwest agreed to pay the money back at a future date. Northwest agreed to the repayment obligation but, for tax reasons, refused to structure the transaction in the form of a traditional debt instrument. Instead, the IAM and the IBT agreed to accept Series C preferred stock with a mandatory put right after ten years. In other words, the airline had to buy the preferred stock back from the IAM and the IBT after ten years at a price which corresponded directly to the value of savings realized by the airline from the concessions provided by these two unions. In substance, the preferred stock provided collateral for Northwest's obligation to pay back the money loaned by the IAM and the IBT through the concessions they agreed to. (Roth Decl., ¶ 6).

Under the terms of the deal struck in 1993, the value of the concessions provided just by the IAM-represented employees totaled approximately $340 million over three years. Northwest's repayment obligation was set forth in an Equity Letter Agreement dated August 1, 1993 (the "Agreement") among Wings Holdings Inc. (Northwest's holding company), Northwest Airlines, Inc. (the operating airline) and the IAM.[1] (Roth Decl., Ex. A). Under the Agreement, Wings Holdings issued to trusts

[1] The IBT entered into a virtually identical agreement with Wings Holdings and Northwest on behalf of its members. (Roth Decl., ¶ 7). Therefore, the description of the Agreement set forth herein also is a description of the agreement between the AFA Group, Wings Holdings and Northwest.

established for the benefit of the Debtors' unionized employees approximately 4.5 million shares of Series C Preferred Stock (the "Series C Stock"). The IAM received Series C Stock in direct proportion to the amount of wages and benefits that each IAM-represented employee otherwise would have received from August 1, 1993 through July 31, 1996, but for their wage and benefit concessions. Each trustee (as opposed to individual employees) was the registered owner of the preferred stock held in trust. Moreover, the Series C Stock could not be sold in the marketplace.[2] (Roth Decl., ¶ 8).

The key provision of the Agreement is the one-time "put right" (the "Put Right") exercisable in ten years under Section 3.5. The Put Right gave the trustee of the trust established for the IAM Group the right to require Wings to buy back the Series C Stock within 90 days of the Put Date of August 1, 2003. (Roth Decl., Ex. A, § 3.5(a)). The price Wings had to pay to repurchase the stock -- the so-called "Put Price" -- equaled the actual savings realized by Northwest from the IAM Group's three years of concessions divided by the number of Series C preferred shares issued to the IAM trust, plus accrued dividends. (*Id.*, Ex. A, §§ 1.15, 3.5(a)). No later than 60 days prior to the Put Date, Wings was required to elect the form of consideration it intended to use to re-purchase the Series C stock. (*Id.*, Ex. A, §§ 1.13, 3.5(a)). Wings could either (1) pay the Put Price in cash, (2) pay the Put Price in Class A Voting Stock, or (3) require the trustee to elect between accepting common stock or a combination of cash and common stock. Any election by Wings to pay entirely in common stock or not to repurchase the Series C

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[2] The provisions of the Agreement were implemented by and incorporated in several documents: (1) the Restated Certificate of Incorporation of Northwest Airlines' predecessor, Newbridge Parent Corporation, dated November 20, 1998; (2) the Certificate of Designations for the Series C Voting Preferred Stock which, upon filing with the Secretary of State of the State of Delaware, became a part of the Northwest Airlines' Restated Certificate of Incorporation; and (3) the Amended and Restated Bylaws of Northwest Airlines Corporation, adopted Apri1 23, 1999 (together, the "Corporate Instruments").

Stock required the approval of a majority of three members of Wings' board of directors appointed by the unions. (*Id*., Ex. A, §§ 1.20, 3.5(c), 5.1).

All parties understood that Wings, as a holding company whose only assets consisted of stock held in its subsidiaries, would rely on income up-streamed from Northwest Airlines, Inc. to repurchase the Series C Stock with cash. (Roth Decl., ¶ 10). Consequently, the Agreement contained a safeguard to prevent Wings from claiming lack of financial wherewithal to comply with the Put Right. If on the Put Date Wings' board of directors refused to repurchase all of the Series C Stock, then Wings was obligated to use all "Available Cash" of it and its subsidiaries (including Northwest Airlines, Inc.) to partially repurchase the preferred shares with cash. (*Id*., Ex. A, § 3.5(d)). The Agreement defined "Available Cash" as "cash held by Wings *and its subsidiaries*, or available under existing revolving credit agreements, which is in excess of all their then currently anticipated needs to use such cash for operating and capital requirements …." (*Id*., Ex. A, § 1.2 (emphasis added)).

The Put Right embodied the Company's obligation to repay the concessions agreed to by the IAM after ten years. The IAM negotiated -- indeed, insisted on -- this right in order to ensure that its members living paycheck-to-paycheck would get back the cash they voluntarily loaned to the airline in order to help it fly through its period of financial turbulence. Because the IAM could not afford to gamble with the membership's money, it refused to accept the investment risks that would have accrued from simply accepting common stock in exchange for the concessions. (Roth Decl., ¶ 11). As explained to the IAM's membership in a May 1993 pamphlet entitled "Summary of Proposed Agreement Between International Association of Machinists and Northwest Airlines, Inc.," which was distributed as part of the ratification process,

> *[t]he employee concessions are structured more like a loan to the Company than a give-back.* If Northwest prospers in the future, the employee's stock ownership will enable the employee to share in this success. If stock appreciation

> does not cover the value of the employees' wage and benefit reduction, then Northwest must pay back the full amount of the employees' concession, plus interest, 10 years from the effective date of the agreement.

(Roth Decl., Ex. B, at 6 (emphasis added); *see also id*., at 7 ("At the end of the 10th year following the effective date of the savings period, employees will be entitled to sell their stock back to the Company for a guaranteed price equal to the amount of their original concession plus accumulated dividends, if any. In essence if the stock does not appreciate in value, *the employee's concession is in the nature of a loan, with interest, which is due and payable in 10 years*.") (emphasis added)). In other words, for the first ten years, the IAM enjoyed the status of a creditor with the right to receive re-payment of its concessions from the airline. When the Put Right matured, however, the IAM could then make the decision whether, based on the performance of the airline at that time, it wanted to forego exercising the Put Right and invest in the airline as a preferred or common shareholder. (Roth Decl., ¶ 13).

The Agreement also gave the IAM (like the other unions) a one-time opportunity before the Put Right matured to forego their right to obtain repayment of their concessions through the Put Right and become a full-fledged investor in Northwest, with all of the attendant rewards and risks. Specifically, section 3.1(b) of the Agreement gave the unions a "Special Conversion Option" which allowed them a one-time opportunity (on or before the earlier of April 30, 1994 or ten days after Wings filed a registration statement with the Securities and Exchange Commission for an initial public offering) to convert each and every share of Series C Preferred Stock held in trust into 1.909 shares of Wings common stock. (Roth Decl., ¶ 14 and Ex. A, § 3.1(b)). However, as a condition of exercising this Special Conversion Option, the IAM would forfeit the Put Right. (*Id*., Ex. A, § 3.5(g)). In other words, by exercising the Special Conversion Option, the IAM could have made its members common shareholders of Northwest who would then be no different from any other common shareholders in terms of their rights

and expectations. They would benefit if the stock price went up, and suffer if the price went down. (Roth Decl., ¶ 14).

Wings issued the Series C Stock to the trusts for the IAM Group and the AFA Group in approximately three equal installments on March 10, 1995, March 1, 1996, and March 27, 1997. (Roth Decl., ¶ 16). The Special Conversion Option matured on February 9, 1994. The pilots exercised it -- consistent with their persistent demand all along for a greater common equity stake in the airline. The pilots thus became common shareholders with no Put Right or other contractual protections. (*Id.*, ¶ 15). By contrast, the IAM and the IBT both chose to retain their Put Right. The IAM determined that, notwithstanding whatever economic benefits might ultimately accrue from acquiring Wings common stock, its members wished to keep the relationship structured as a loan so as to minimize risk to the members' principal -- *i.e.*, the value of their concessions due to be repaid in 2003. Thus, the IAM consciously forwent the potential enhanced rewards of common stock ownership because it did not wish to assume the enhanced risk that would have accompanied such ownership. (*Id.*).

Over the ensuing ten-year period, Northwest repeatedly confirmed in public filings and annual reports the existence of the obligation to repurchase the Series C Stock and repay the concessions to the IAM and the IBT. (Roth Decl., ¶ 17 and Exs. C-T). Indeed, Northwest has never taken the position that it did not have such an obligation. (Roth Decl., ¶ 17). On or about June 3, 2003, Northwest Airlines elected to repurchase the Series C Stock by the payment of cash only. (Roth Decl., ¶ 18 and Ex. U). The IAM and IBT trustees then exercised the Put Right with respect to all the Series C Stock held in trust for their members. (*Id.* and Ex. V).

However, on or about August 1, 2003, Northwest announced that the board of directors of Northwest Airlines Corp. (the successor to Wings) had determined that the Company could not legally buy back the Series C Stock at that time. (Roth Decl., ¶ 19 and Ex. W). While "acknowledg[ing] the company's obligation to buy back

the Series C Preferred Stock from our employees," Northwest stated that it had determined that certain provisions of Delaware law prohibited it from fulfilling its obligation at that time. (*Id.*).

> Today's decision does not mean that Northwest's obligation to repurchase the Series C Preferred Stock has expired. Rather, the company's obligation to the holders of the Series C Preferred Stock continues until Northwest has the ability to repurchase the Series C Preferred Stock. The Northwest Board will, on a regular basis and with the assistance of its legal and financial experts, revisit the company's ability to buy back the Series C Preferred Stock with the objective of buying back the stock as soon as possible.

(*Id*. (internal quotation marks omitted)).

2. The New York State Court Litigation.

Like any other creditor, when faced with a breach of the contract by their obligor, the IAM and the IBT filed suit. In August 2003, the IAM and District Lodge 143 sued Northwest Airlines and Newbridge Parent Corporation in the Supreme Court of New York, New York County, in an action captioned *The International Association of Machinists and Aerospace Workers and Air Transport District 143 of the International Association of Machinists and Aerospace Workers v. Northwest Airlines Corporation f/k/a Wings Holdings, Inc. and Newbridge Parent Corporation*, Index No. 602476/03. The IBT suit against Northwest Airlines Corporation, entitled *The International Brotherhood of Teamsters, Local 2000 et al. v. Northwest Airlines Corporation f/k/a Wings Holdings, Inc.*, was commenced in the same court. (Roth Decl., ¶ 20). Both suits eventually were consolidated for disposition. (*Id.*). The IAM and IBT both sought damages from Northwest for breach of contract -- in particular, for its failure to pay to the IAM and IBT the cash called for by the Agreements once they exercised the Put Right. (*Id.*).

Before discovery was complete, the IAM and IBT filed motions for summary judgment. The sole meaningful issue in the case was the validity of Northwest's argument that Section 160 of the Delaware General Corporation Law prohibited it from repurchasing the Series C Preferred Stock. On March 22, 2005, Justice Helen Freedman rejected that argument and entered summary judgment in favor of the unions as to Northwest's liability for breach of contract. (Roth Decl., ¶ 21 and Ex. X). Justice Freedman reasoned that "Northwest could not avoid repurchase by first electing to pay cash and then claiming that cash payments would be illegal under Section 160." (*Id*., at 9). Although Northwest could have elected to pay with common stock and avoided the impact of Section 160 altogether, it did not do so. (*Id*.). Consequently, the Company breached its contracts with the IAM and IBT when it failed to pay cash for the Series C Preferred shares put to it by the unions. (*Id*.).

On August 24, 2005, the parties reached an agreement, among other things, to cancel the upcoming damages trial and stipulate to the amount of damages owed to IAM- and IBT-represented employees. The agreed-upon amount of the IAM's damages is $211,685,000, and the IBT's is $64,770,000. Judgments in those amounts were entered in favor of the unions on or about August 29, 2005 (the "New York Judgments"). (Roth Decl., ¶ 22 and Exs. Y, Z). Although Northwest appealed to the First Department of New York's Appellate Division, the appeal was never perfected or decided before the automatic stay went into effect.

3. Post-Petition Proceedings.

On September 14, 2005 (the "Petition Date"), the Debtors filed voluntary petitions for relief pursuant to chapter 11 of title 11 of the United States Code.

On August 14, 2006, the IAM timely filed Proof of Claim No. 8964. The IAM Claim asserts a total claim of $212,520,140.80, which represents the judgment amount of $211,685,000 plus interest at the statutory rate of 9% per year commencing on August 29, 2005 through and including September 14, 2005. (Roth Decl., ¶ 23 and Ex.

AA). On July 24, 2006, the IBT timely filed a proof of claim (Claim No. 4851) in the amount of $64,770,000 plus interest. (*Id*. and Ex. BB).

On February 15, 2007, the Debtors filed their First Amended Joint And Consolidated Plan Of Reorganization Under Chapter 11 Of The Bankruptcy Code (the "Plan") and accompanying disclosure statement (the "Disclosure Statement"). *See* Docket Nos. 4901, 4902. Among other provisions, the Plan provides that:

> On the Effective Date, the [IAM and IBT] Series C Judgment Claims shall become Allowed General Unsecured Claims in Class 1D. Subscription Rights shall not be distributed with respect to the Series C Judgment Claims.

(Plan at § 12.1). Thus, the Debtors concede that the Union Judgment Claims are allowable claims under section 502 of the Bankruptcy Code, which are not subject to setoff or subordination. Indeed, the Debtors have determined in the exercise of their business judgment to abandon their appeal from the New York Judgments and to support the allowance of the Union Judgment Claims as general unsecured claims in the stipulated amounts.

As a result of objections made by various parties -- including the Ad Hoc Committee of Certain Claims Holders (the "Ad Hoc Committee") -- to the Disclosure Statement, the Court ordered Debtors, the IAM and the AFA to submit a motion for allowance of the Union Judgment Claims.

ARGUMENT

A. The Union Judgment Claims Should Be Allowed Under 11 U.S.C. § 502.

The Union Judgment Claims easily satisfy the test for allowance under section 502 of the Bankruptcy Code. As a preliminary matter, a claim is "deemed allowed" unless a party in interest objects to it. 11 U.S.C. § 502(a). No objections to the Union Judgment Claims have been filed. The Debtors do not object to the Union

Judgment Claims; indeed, they believe the Claims should be allowed. Thus, at this juncture, the Union Judgment Claims are deemed allowed as a matter of law. *Id*.

But even assuming that a full-blown allowance analysis under section 502(b) is necessary, the Union Judgment Claims pass with flying colors. As the Supreme Court recently explained, a Bankruptcy Court facing an objection to a claim "shall allow" the claim "'except to the extent that' the claim implicates any of the nine exceptions" enumerated in § 502(b). *Travelers Cas. & Sur. Co. v. Pacific Gas & Elec. Co.*, 127 S.Ct. 1199, 1204 (2007) (quoting 11 U.S.C. § 502(b)). The only exception even arguably implicated in this case is § 502(b)(1), which authorizes disallowance where the claim "is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured[.]" 11 U.S.C. § 502(b). In plain English, this provision means that "with limited exceptions, any defense to a claim that is available outside of the bankruptcy context is also available in bankruptcy." *Travelers*, 127 S.Ct. at 1204. Thus, Bankruptcy Courts must "consult state law in determining the validity of most claims." *Id*. at 1205.

Here, there are no non-bankruptcy defenses to the Union Judgment Claims. The only meaningful defense the Debtors ever asserted was their argument under Section 160 of the Delaware General Corporations law, which Justice Freedman decided against them. Any other defenses were lost upon the entry of final judgment in favor of the IAM and IBT in August 2005. Where, as here, a creditor presents a liquidated claim which was reduced to judgment in the state courts before the bankruptcy petition was filed, no party -- not the debtor and not other creditors -- may re-litigate the validity of the claim in Bankruptcy Court under § 502(b).

Federal courts are required by statute to accord full faith and credit to judgments entered by state courts. 28 U.S.C. § 1738 (Judgments of state courts "shall have the same full faith and credit in every court within the United States and its Territories and Possessions as they have by law or usage in the courts of such State,

Territory or Possession from which they are taken."); *see also Kelleran v. Andrijevic*, 825 F.2d 692, 694 (2d Cir. 1987) ("'Congress has specifically required all federal courts to give preclusive effect to state-court judgments whenever the courts of the State from which the judgments emerged would do so ….'") (quoting *Allen v. McCurry*, 449 U.S. 90, 96 (1980)) (ellipse in original). Bankruptcy Courts are subject to this requirement to the same degree as other federal courts. *Kelleran*, 825 F.2d at 694; *Evans v. Ottimo*, 469 F.3d 278, 281 (2d Cir. 2006) ("It is well settled that preclusion principles apply in bankruptcy proceedings.") (citing *Grogan v. Garner*, 498 U.S. 279, 285-91 (1991)).

As final judgments entered by the Supreme Court of New York, the New York Judgments in favor of the IAM and IBT are entitled to preclusive effect under the laws of New York, *regardless* of the pendency of the Debtors' unperfected appeal from those judgments. *Lightning Park, Inc. v. Bank Leumi Trust Co. of N.Y.*, No. 97 Civ. 719 (PKL), 1997 WL 133319, at *4 (S.D.N.Y. March 24, 1997) ("The New York Supreme Court's ruling is, for the purposes of *res judicata*, a 'final judgment.' The fact that appeal could have been taken, and in fact was initiated but not perfected, does not change that fact."); *In re Best Payphones, Inc.*, No. 01-15472(SMB), 2002 WL 31767796, at *5 (Bankr. S.D.N.Y. Dec. 11, 2002) ("Under New York law, a judgment pending appeal is entitled to the same *res judicata* effect as a final judgment."); *see also Petrella v. Siegel*, 843 F.2d 87, 90 (2d Cir. 1988) ("Of course, the determination of the state supreme court that under New York law Petrella did not resign is entitled to *res judicata* effect, even though the city may be appealing that determination."); *Kandekore v. State of N.Y.*, No. 97CIV. 0032(JSR)(MHD), 1998 WL 150660, at *1 (S.D.N.Y. March 31, 1998) (holding that "under New York law, the mere pendency of an appeal does not deprive a challenged judgment of its *res judicata* effects"). Thus, under black letter *res judicata* principles, the judgments preclude re-litigation of the Debtors' liability for breach of contract in this Court. *Kelleran*, 825 F.2d at 694 (holding that, because state court default judgment was entitled to *res judicata* effect, the bankruptcy court "was bound to the liability

determinations in the state judgment" unless judgment was procured by collusion or fraud or the state court lacked jurisdiction); *Best Payphones*, 2002 WL 31767796, at *6 (holding that creditor was entitled to summary judgment as to debtor's liability for breach of contract based on final state court judgments making that determination).

Because the Debtors stipulated to the amount of damages owed to the IAM and the IBT and chose not to litigate that issue, the New York judgments are also binding with respect to the amount of the Union Judgment Claims. *In re Schick*, 232 B.R. 589, 594-95 (Bankr. S.D.N.Y. 1999) (holding that stipulated judgment entered by New York state court was entitled to *res judicata* effect as to amount of creditors' claim). But even were they not, these amounts cannot seriously be disputed -- which is exactly why the Debtors stipulated to the correct amount of damages before the New York courts. The Agreement establishes a straightforward mathematical formula -- corresponding to the savings realized from the employees' concessions -- for calculating the Put Price which the Debtors were obligated to pay. (Roth Decl., Ex. A, § 1.15). The Debtors' own business records establish the amount of actual savings realized from the three years of concessions provided by the IAM Group and the AFA Group, as well as the dividends which accrued on the Series C Preferred Stock. Nor is there any dispute over the number of Series C Preferred Shares held in trust. Therefore, at most, the only issue that even arguably remains is the appropriate amount of interest to be awarded on the judgments.

Alternatively, even if there were some basis for looking behind the New York Judgments (which there is not), the judgments at the very least provide persuasive evidence of the validity of the unions' claims. The Debtors took their best shot at trying to convince Justice Freedman that Delaware law prohibited them from re-purchasing the stock, and failed. (Roth Decl., Ex. X). No one can seriously argue that the Debtors were denied a full and fair opportunity to litigate that issue in state court. Thus, Justice Freedman's determination to reject the Debtors' argument, even if not technically binding

on this Court (which it is), is nevertheless entitled to respect for its persuasive value. Moreover, as discussed above, the Debtors never contested the validity of their underlying contractual obligation to repay the concessions by honoring the Put Right. In fact, they repeatedly (and publicly) reaffirmed that obligation, even *after* they refused to pay for the preferred shares. (Roth Decl., Ex. W). We are, consequently, hard pressed to conceive of any evidence the Ad Hoc Committee could possibly muster that would justify the conclusion that the Debtors kept reaffirming the validity of an invalid claim.

In sum, section 502(b)(1) is not applicable here. Therefore, the Court should allow the Union Judgment Claims in the full amount set forth in the respective proofs of claim.

B. The Union Judgment Claims Are Not Subject To Subordination Under 11 U.S.C. § 510(b).

The Ad Hoc Committee's primary attack on the Union Judgment Claims is its argument that they should be subordinated to the claims of general unsecured creditors under section 510(b) of the Bankruptcy Code. Among other things, section 510(b) automatically subordinates claims for damages which arise from a purchase or sale of the debtor's securities. *See* 11 U.S.C. § 510(b) ("For the purpose of distribution under this title, a claim … for damages arising from the purchase or sale of [] a security [of the debtor or of an affiliate of the debtor] … shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock."). Because the Union Judgment Claims are legitimate unsecured claims to recover on *bona fide* debts incurred by the Debtors, and not disguised attempts to recover equity investments, section 510(b) does not apply here.

Not every claim asserted by a nominal holder of an equity interest in a debtor is subject to automatic subordination. To the contrary, the Second Circuit has held that subordination of a shareholder's claim is improper where it would not further the

purposes of section 510(b). *Rombro v. Dyfrayne (In re Med. Diversified, Inc.)*, 461 F.3d 251, 259 (2d Cir. 2006) ("'Nothing in our rationale would require the subordination of a claim simply because the identity of the claimant happens to be a shareholder [or one who completed a bargain to become a shareholder], where the claim lacks any causal relationship to the purchase or sale of stock and when subordinating the claim[] would not further the policies underlying § 510(b)….'") (quoting *In re Telegroup, Inc.*, 281 F.3d 133, 144 n. 2 (3d Cir. 2002)) (alternations and ellipse in original); *Nisselson v. Softbank AM Corp. (In re MarketXT)*, -- B.R. --, 2007 WL 634098, at *15 (Bankr. S.D.N.Y. March 2, 2007). It is not enough simply to look at the form of the transaction which gave rise to the Union Judgment Claims and conclude that, because it involved the issuance of preferred stock, the claim must be subordinated. Rather, it is the economic substance of the transaction that matters. While section 510(b) requires courts to block true shareholders from bootstrapping their equity interests into general unsecured claims, courts must have "equal concern for guarding against attempts by a bankruptcy debtor [or other creditors] to clothe a general creditor in the garb of a shareholder[.]" *Rombro*, 461 F.3d at 258.

Under the test formulated by the Second Circuit, subordination under section 510(b) is required only where the claimant "(1) took on the risk and return expectations of a shareholder, rather than a creditor, or (2) seeks to recover a contribution to the equity pool presumably relied on by creditors in deciding whether to extend credit to the debtor." *Id.* at 256. Accordingly, the clearest instances of mandatory subordination involve claims by shareholders for fraud or other illegality in the issuance or open market sale of a debtor's securities, as well as those based on allegations that a debtor's post-purchase fraud induced shareholders to retain their stock in the debtor rather than sell it. *See, e.g., Telegroup*, 281 F.3d at 142 (concluding that "Congress enacted § 510(b) to prevent disappointed shareholders from recovering their investment loss by using fraud and other securities claims to bootstrap their way to parity with

general unsecured creditors in a bankruptcy proceeding"); *Allen v. Geneva Steel Co. (In re Geneva Steel Co.)*, 260 B.R. 517, 523 (10th Cir. B.A.P. 2001) (subordinating a fraudulent retention claim because a causal "connection exists where the holder of securities alleges post-investment fraud"), *aff'd*, 281 F.3d 1173 (10th Cir. 2002); *In re Enron Corp.*, 341 B.R. 141 (Bankr. S.D.N.Y. 2006) (subordinating claims by employee shareholders for fraudulent inducement and fraudulent retention); *In re Granite Partners, L.P.*, 208 B.R. 332 (Bankr. S.D.N.Y. 1997) (subordinating fraudulent retention claims); *see also* John J. Slain & Homer Kripke, *The Interface Between Securities Regulation and Bankruptcy -- Allocating the Risk of Illegal Securities Issuance Between Security Holders and the Issuer's Creditors*, 48 N.Y.U. L. REV. 261 (1973).

Also subject to subordination are breach of contract claims where the essence of the claim is that the shareholder was deprived of the value of its stock -- *i.e.*, of the upside rewards of making an equity investment in the debtor. *Telegroup*, 281 F.3d at 143-44 (subordinating claim for breach of provision in stock purchase agreement requiring the exercise of best efforts to register the debtor's stock with the SEC); *Am. Broad. Sys., Inc. v. Nugent (In re Betacom of Phoenix, Inc.)*, 240 F.3d 823, 830-32 (9th Cir. 2000) (subordinating breach of contract claim based on failure to issue stock to claimants in connection with merger); *In re PT-1 Comm., Inc.*, 304 B.R. 601, 607-09 (Bankr. E.D.N.Y. 2004) (subordinating claims arising from debtor's failure to issue shares to which claimants were entitled by virtue of an equity contribution they made); *In re Worldwide Direct, Inc.*, 268 B.R. 69, 73 (Bankr. D. Del. 2001) (subordinating claims for breach of a severance agreement which called for debtor to issue stock); *In re Kaiser Group Int'l, Inc.*, 260 B.R. 684, 687-89 (Bankr. D. Del. 2001) (subordinating claims for breach of merger agreement to issue stock when debtor's stock proved to be less valuable than represented); *In re Int'l Wireless Commc'n Holdings, Inc.*, 257 B.R. 739, 748 (Bankr. D.Del. 2001) (subordinating claims for breach of share purchase agreement). The common thread which connects these breach of contract claims with shareholder

fraud claims and requires their subordination is the claimant's attempt to obtain compensation for either a decline in the value of the debtor's stock or for loss of that value altogether -- in other words, the attempt by a shareholder to recover a portion of its equity investment *pari passu* with the claims of general creditors. *See Telegroup*, 281 F.3d at 142 ("Since claimants in this case are equity investors seeking compensation for a decline in the value of Telegroup's stock, we believe that the policies underlying § 510(b) require resolving the textual ambiguity in favor of subordinating their claims."); *Enron*, 341 B.R. at 157 ("Where the damages are connected to the declining value of the debtor's stock, the courts are inclined to read section 510(b) broadly[.]"). Section 510(b) was intended to prevent such a result.

The Union Judgment Claims do not fit into either category. They are not shareholder fraud claims, and they are not breach of contract claims premised on the decline or loss of the value of equity securities. Instead, they are *bona fide* claims to recover debts incurred by the Debtors. Accordingly, section 510(b) is inapplicable.

First, the substance of the underlying transaction between the Debtors and the IAM/IBT was a loan, as opposed to an equity investment. The membership of these two unions could not afford to take the gamble that an equity investment in Northwest *might* pay off at some unspecified time in the future, or not. Although they were willing to do their part to get the airline through rough skies successfully, the IAM Group and the AFA Group insisted that the concessions they provided be temporary, and that they be paid back within a reasonable period of time. Contemporaneous materials distributed to the IAM's membership in connection with the ratification process for the 1993 Agreement demonstrate that the IAM consciously structured the concessions as a loan to the airline. (Roth Decl., Ex. B). Although the form of the transaction involved the issuance to the IAM and IBT of preferred stock with a Put Right, that was done in order to address the airline's tax concerns. All parties understood that, in substance, the employees' Put Right was the equivalent of their loan's reaching maturity.

Accordingly, the IAM and IBT bargained for the rights, risks and expectations of a creditor, not of a shareholder, and their post-Agreement conduct confirms this. When given the opportunity to become true common stockholders by exercising the Special Conversion Option, the IAM and IBT -- unlike the more financially-secure pilots -- turned it down so that they could retain their Put Right and obtain repayment of their loan. Moreover, when Northwest breached the Agreement by refusing to pay cash for the Series C Preferred Shares after electing to do so, the IAM and IBT -- like any other aggrieved creditor -- sued to enforce the contract and recover the debt. In short, the IAM and IBT have acted as creditors of Northwest since the Agreement was signed -- because that is what they are. Under these circumstances, subordination under section 510(b) is totally inappropriate. *See Raven Media Inv. LLC v. DirecTV Latin Am., LLC (In re DirecTV Latin Am., LLC)*, No. 03-10805 (PJW), Civ. 03-981-SLR, 2004 WL 302303, at *2 (D. Del. Feb. 4, 2004) (refusing to subordinate claims for breach of put agreement under § 510(b) where claimant, although in form an equityholder, structured the transaction so as not to bear the risk of illiquidity or insolvency to which other equity owners were exposed, even though it had ability to share in profits); *In re Motels of Am., Inc.*, 146 B.R. 542 (Bankr. D. Del. 1992) (refusing to subordinate breach of contract claim relating to put right where claimant, although in form a shareholder, lacked indicia of ownership).

Second, the Union Judgment Claims do not seek compensation for a decline in the value of the Debtors' stock. Quite the contrary, the Put Right required the Debtors to re-purchase the Series C Preferred Shares at a fixed time, and at a fixed amount corresponding directly to the value of the savings achieved by Northwest as a result of the concessions given by the IAM Group and the AFA Group. The maturity of the Put Right was not in any way dependent on changes in the value of Northwest's stock, and neither was the price Northwest had to pay to repurchase the preferred shares. Moreover, the damages suffered by the IAM and IBT -- and awarded by the New York

Supreme Court -- consist of the fixed amount calculated under the Agreement, plus interest. This is virtually irrefutable evidence that the Union Judgment Claims are based on *bona fide* debts incurred by the Debtors, and are exempt from subordination under § 510(b). *Raven Media,* 2004 WL 302303, at *4 (holding that claim for breach of put agreement could not be subordinated under § 510(b) because, *inter alia*, claim was "no[t] measured by diminished share value" and arose "without relation to present value" of claimant's equity interest); *Montgomery Ward Holding Corp. v. Schoeberl (In re Montgomery Ward Holding Corp.)*, 272 B.R. 836, 842-45 (Bankr. D. Del. 2001) (refusing to subordinate claim to recover fixed debt incurred by debtor as partial payment for redeemed stock), *disagreed with on other grounds*, *Telegroup*, 281 F.3d 133; *Enron*, 341 B.R. at 157 ("[W]here the claim is for a fixed amount and does not arise in parallel with the fortunes of share price, the courts are inclined to read section 510(b) narrowly.").

Third, the IAM and IBT did not contribute to an equity pool on which general creditors of the Debtors relied in extending credit. As a preliminary matter, we are constrained to note that the Ad Hoc Committee is primarily made up of claims traders who, shortly before or after the bankruptcy petition was filed, acquired their claims against the Debtors from entities that had actually extended credit in the ordinary course of business. The irony (and inherent inequity) that speculators are now asking the Court to put their claims ahead of those of rank-and-file employees who voluntarily reduced their wages and benefits to keep the Debtors airborne in the early to mid-nineties should not be overlooked. It goes without saying that such creditors have no valid reliance interests. In any event, even creditors in real time had no basis for relying on any "equity contribution" by the IAM and IBT. To the contrary, Northwest consistently reported in its public filings and annual reports that it would have to pay the concessions back by honoring the Put Right when it matured. (Roth Decl., Exs. C-T). Thus, creditors were on notice that there was no "equity cushion" associated with the Series C Preferred Shares

issued under the Agreement. Accordingly, the "creditor reliance" policy recognized by the Second Circuit in *Rombro* is not applicable here.

Fourth, as of the date the Debtors filed under chapter 11, the IAM and IBT were judgment creditors. *See Nisselson*, -- B.R. --, 2007 WL 634098, at *15 ("It is black letter law that claims are analyzed as of the date of the filing of a petition, not as of a hypothetical date in the past."). Under New York law, the entry of the New York Judgments indisputably gave rise to a debt. *See Westinghouse Credit Corp. v. D'Urso*, 371 F.3d 96, 102 (2d Cir. 2004) ("The general rule under New York and federal law is that a debt created by contract merges with a judgment entered on that contract, so that the contract debt is extinguished and only the judgment debt survives."). Virtually every court to consider the question has held that a claim based on a judgment or other debt instrument cannot be subordinated under § 510(b), regardless of the nature of the underlying transaction which gave rise to the judgment. *See In re Am. Wagering,* 465 F.3d 1048, 1053 (9th Cir. 2006) (holding that money judgment "established a fixed, pre-petition debt due and owing to [the claimant] as a creditor, not the risk/return position of an equity investor in the now-bankrupt corporation" and could not be subordinated under § 510(b)); *Burtch v. Gannon (In re Cybersight LLC)*, No. 02-11033, Civ. A. 04-112 JJF, 2004 WL 2713098, at *3 (D. Del. 2004) (rejecting subordination under § 510(b) on the grounds that "[o]nce the state court entered [the claimant's] judgment, the judgment became a fixed debt obligation of Cybersight and [the claimant] was entitled to general unsecured claimant status"); *In re Mobile Tool Int'l, Inc.*, 306 B.R. 778 (Bankr. D. Del. 2004); *Montgomery Ward.*, 272 B.R. at 843 (absent an allegation of fraud in the purchase, sale, or issuance of a debt instrument, section 510(b) does not apply to a claim seeking simple recovery of an unpaid debt due upon a promissory note, even if the note was given in exchange for stock); *In re Wyeth Co.*, 134 B.R. 920, 921 (Bankr. W.D. Mo. 1991) (claims based on notes issued by debtor to redeem stock neither fall under the plain language of Section 510(b) nor "bear any relationship whatever" to its underlying policy

concerns); *In re Stern-Slegman-Prins Co.*, 86 B.R. 994, 1000 (Bankr. W.D. Mo. 1988) (claim of deceased shareholder's estate to enforce sale of stock to corporate debtor not subject to mandatory subordination because facts surrounding valid stock redemption agreement do not fit within purpose and meaning of Section 510(b)); *Nisselson*, -- B.R. -- , 2007 WL 634098, at *15 (holding that "§ 510(b) is not an avoidance provision and does not, in and of itself, give a trustee authority to recharacterize a claim based upon the creditor's past status as a stockholder").[3] Just as in *Am. Wagering*, the IAM and IBT filed suit against Northwest over two years prior to the bankruptcy filing and almost immediately after the breach occurred, thereby "rebutting any charge that [they were] trying to convert an equity interest into an unsecured claim only when the debtors' stock started to decline in value -- one of the claimed purposes behind section 510(b)." 465 F.3d at 1053.

In sum, on the facts of this case, subordinating the Union Judgment Claims would improperly turn general unsecured creditors into shareholders, flipping section 510(b) on its head. The Union Judgment Claims should be allowed to participate in distributions under the Plan as general unsecured creditors.

[3] The one outlying decision appears to be Judge Walrath's opinion in *In re Alta+Cast, LLC*, 301 B.R. 150, 154-55 (Bankr. D. Del. 2003), which subordinated a claim under section 510(b) even though the claimant obtained a *post-petition* judgment in his favor. This case is distinguishable on the grounds that, unlike the IAM and IBT/AFA, the claimant there was not a judgment creditor as of the petition date. In any event, it is doubtful that *Alta+Cast* is applicable beyond its specific facts in light of the subsequent decision by the District Court for the District of Delaware in *Cybersight* and Judge Walrath's own opinion in *Mobile Tool* distinguishing her prior ruling. *See Mobile Tool*, 306 B.R. at 781.

CONCLUSION

For the reasons and on the authorities cited herein, the IAM, IBT and AFA respectfully submit that the Court should allow the Union Judgment Claims in full as general unsecured claims.

Respectfully submitted,

INTERNATIONAL ASSOCIATION OF MACHINISTS AND AEROSPACE WORKERS

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