Delta's Chapter 11 dogfight

By staving off bankruptcy for a year, the carrier thought it was taking the high road. Maybe not.

December 1, 2005: 9:47 AM EST

By John Helyar, Fortune Senior Writer

NEW YORK (Fortune) - Delta Air Lines CEO Gerald Grinstein stood before 1,700 retirees -- men and women whose benefits and pensions will be slashed in Chapter 11 proceedings -- and swore he shared their pain.

"Bankruptcy is beyond strange," he told them in late October at an Atlanta convention center. "I now know why we fought so hard to avoid it."

It's amazing that his remarks didn't spark a riot.

After all, Chapter 11 has become a last-resort management tool: A way for airlines to slash labor costs, offload pension obligations, dump unwanted jets, and re-emerge as moneymakers.

UAL, for instance, which plans to exit bankruptcy in early 2006 after more than three years, projects over $1 billion in profits by 2007.

Yet Delta's retirees ended up giving the 73-year-old Grinstein -- who outlined the airline's financial straits but made no promises about their benefits—a standing ovation.

"That took a lot for [him] to be willing to come over and answer our questions," explains Cathy Cone, a retired flight attendant.

While the Delta "family," as its workforce still calls itself, evinces plenty of hostility toward Grinstein's predecessor Leo Mullin, the current management team has avoided most of the blame.

The honeymoon may end

Workers want to believe what the CEO espouses: That cost cuts and new revenue initiatives will return Delta to profitability by 2007.

But Grinstein and his team have struggled during the two months the airline has operated under Chapter 11 -- and, what's more, face the uncomfortable possibility that in delaying their day of reckoning they only made matters worse.

Delta averted bankruptcy in October 2004 by winning $1 billion in fresh financing and $1 billion in pilot pay concessions.

Yet in the year since, thanks in part to soaring jet-fuel costs, the airline's accrued losses since 2001 have continued to balloon, to some $11 billion. With all its assets pledged as collateral for previous loans, the airline's roughly $2 billion bankruptcy financing package carries an almost extortionate 11.5%

interest rate.

It gets worse. Delta's pilots are threatening to strike. Its bankruptcy-court judge is a loose cannon. And its bankruptcy-court adversaries have learned from the UAL case how banding together can give them additional leverage.

Delta aims to save $970 million a year by renegotiating leases and other creditor obligations, but the owners of Delta's aircraft -- comprising both lessors like General Electric and pools of institutional investors -- are pushing back hard.

Delta also aims to slash annual labor costs by $930 million, but after giving up so much a year ago, the pilots are resisting a new $325 million concession Delta is seeking. The carrier has asked U.S. Bankruptcy Court Judge Prudence C. Beatty to scrap the pilots' contract, freeing it to impose the pay cut.

It is a dangerous game of chicken. On the one hand, Judge Beatty has declared that Delta pilots, currently averaging $169,000 a year, are "hideously overpaid." (She denied the union's request that she recuse herself after the remark.)

On the other, she told Delta lawyers, in a hearing on abrogating the contract, "I say you're throwing darts at the pilots because they're smaller than you are and you think you can stomp on them." (At press time the hearings were still going on.)

Which way for Delta?

There are two schools of thought on airline bankruptcies.

In the Frank Lorenzo "Let them eat peanuts" approach, carriers force their will on workers and, if possible, other stakeholders.

Northwest Airlines, which took Chapter 11 the same day as Delta, has basically followed that mold, already cramming interim or permanent pay cuts on its unions.

UAL took the opposite, "Kumbaya," approach: It made nice with its unions and the Pension Benefit Guaranty Corp. (PBGC), among others, crafting deals that gave the carrier's potential adversaries stakes in its survival.

"You can punch each other out, or you can say, 'We're in this together,' " says Jonathan Rosenthal of Saybrook Capital, advisor to UAL's creditors committee. "I think UAL showed that cooperation works better."

Delta seems to be caught straddling both schools.

It's trying to obtain a 19 percent pilot pay cut in court and imposed a 9 percent cut on most of the rest of its workforce, which is nonunion, in November. (Management has taken 15 percent pay cuts.)

But it has also tried to preserve what it can of the old family culture, as with

Grinstein's address to the retirees.

Even Delta's pilots still tend to blame the lawyers in Manhattan -- where management's lead bankruptcy firm, Davis Polk & Wardell, is based -- as the bad guys.

Mike Donatelli, chairman of the pilots union's Strike Preparedness Committee, says of a Delta court filing that compared the union's strike threat to a murdersuicide, "Some lawyer came up with that.... To throw that term around in public after you've had airplanes hit the World Trade Center, hit the Pentagon -- that's as egregious and cavalier as you can get."

Bankruptcies are notoriously unpredictable, and Delta's is still early in the process.

CFO Edward Bastian insists the airline has a leg up on previous legacy carriers in Chapter 11, having entered it "with a transformation plan we've been working on for the past two years."

The carrier also has an ace in the hole: GE, the world's biggest aircraft lessor and a major jet engine maker.

Sometimes called the "patron saint of failing airlines," GE (Research) knows that liquidations are bad for business. It helped keep US Airways aloft until that carrier finally merged with America West, and it is unlikely to let the U.S.'s third-biggest carrier disappear. (GE is already the lead provider of Delta's bankruptcy financing.)

The real question is whether Delta's management will get its strategy together in time to ensure a post-Chapter 11 existence as a standalone carrier -- or whether Delta will survive only as part of another airline.