

## Priority Treatment of Employee Severance Compensation Claims

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### Introduction

When a bankrupt company terminates employees, those former employees often have claims against the estate for severance compensation. Sections 507(a) and 503(b)(1)(A) of the Bankruptcy Code provide for the priority treatment of such claims.<sup>1</sup> Those sections apply to claims arising both pre-petition and post-petition. In the pre-petition context, courts must determine if a claim was earned within the pre-petition period prescribed by section 507(a)(4). For post-petition claims, whether such claims are given administrative expense priority for the full amount claimed turns on courts' analysis of when the claims were earned, when services were rendered, and if and when the employer benefited.

Most courts have granted priority to only a pro-rated portion of post-petition severance claims, whereas the Fourth Circuit recently granted priority to the full amount of similar claims that arose pre-petition.<sup>2</sup> The key consideration in most of these cases turned on when the employee became entitled to payment. When employees render services pre-petition, most

<sup>1</sup> 11 U.S.C. § 507(a) (2006); 11 U.S.C. § 503(b)(1)(A) (2006).

<sup>2</sup> *In re Mammoth Mart, Inc.*, 536 F.2d 950 (1st Cir. 1976); *In re Health Maint. Found.*, 680 F.2d 619 (9th Cir. 1982); *In re Roth Am., Inc.*, 975 F.2d 949 (3d Cir. 1992); *In re Commercial Fin. Servs., Inc.*, 246 F.3d 1291 (10th Cir. 2001); *In re Phones for All, Inc.*, 288 F.3d 730 (5th Cir. 2002); *In re FBI Distrib. Corp.*, 330 F.3d 36 (1st Cir. 2003); *but see Straus-Duparquet, Inc. v. Local Union No. 3 Int'l. Bhd. of Elec. Workers*, 386 F.2d 649 (2d Cir. 1967); *Matson v. Alarcon*, 651 F.3d 404 (4th Cir. 2011) (granting priority treatment for claims arising pre-petition).

circuits have ruled that those employees became entitled to payment pre-petition. Accordingly, those circuits have pro-rated the claims to grant priority treatment to only the post-petition portion.

Part I of this memorandum outlines priority treatment of claims in section 507(a) and the allowance of administrative expenses under section 503(b)(1)(A) of the Bankruptcy Code. Part II discusses two groups of cases: cases that grant priority for the full amount of severance claims and cases that do not allow priority or allow it for only a portion of the claim. Part III examines the differences in the approaches of the courts in each group of cases based on the types of claims at issue. Part III also predicts how those other circuits might handle pre-petition claims for severance compensation, based on the trends in the circuit courts' reasoning in cases of post-petition claims.

## **I. Priority Treatment of Claims: Bankruptcy Code Provisions**

### *A. Section 507(a)*

Section 507(a) provides the order in which expenses and claims are entitled to priority treatment. The second and fourth priorities are pertinent to the issues discussed in this memorandum. Section 507(a)(2) provides second priority for administrative expenses, which are “the actual, necessary costs and expenses of preserving the estate.”<sup>3</sup> Section 507(a)(4) grants fourth priority to unsecured claims for “wages, salaries, or commissions, including vacation, severance, and sick leave pay earned by an individual” within 180 days before the filing of the petition.<sup>4</sup>

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<sup>3</sup> 11 U.S.C. § 507(a)(2); 11 U.S.C. § 503(b)(1)(A).

<sup>4</sup> 11 U.S.C. § 507(a)(4).

*B. Section 503(b)(1)(A)*

Section 503(b)(1)(A) includes “wages, salaries, and commissions for services rendered after the commencement of the case” within the category of administrative expenses.<sup>5</sup>

Administrative priority helps rehabilitate businesses by encouraging third parties to continue providing goods and services to a debtor post-petition.<sup>6</sup> Third parties are willing to provide benefits because their claims for payment are paid before claims arising pre-petition. Most of the cases discussed in this memorandum apply section 503(b)(1)(A) where employees continued working for the employer post-petition. These cases considered when employees became entitled to payment of severance compensation and whether the employees conferred benefits post-petition upon the trustee or debtor in possession.

**II. Cases Deciding Scope of Priority for Employees’ Claims Following Termination**

*A. Priority Treatment For Full Amount of Severance Compensation Claims*

The Second Circuit granted administrative expense priority to severance claims in *Straus-Duparquet, Inc. v. Local Union No. 3 International Brotherhood of Electrical Workers*.<sup>7</sup> In that case, the claims for severance compensation arose when employees were terminated one month after the debtor filed for bankruptcy. The Second Circuit noted that even though the calculation of severance compensation was based on length of employment, severance does not accrue, but rather is due in full upon termination.<sup>8</sup> The Second Circuit stressed that “severance pay is compensation for termination of employment,” and that its purpose is “primarily to alleviate the consequent need for economic readjustment but also to recompense . . . [the employee] for

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<sup>5</sup> 11 U.S.C. § 503(b)(1)(A)(i).

<sup>6</sup> *In re Mammoth Mart*, 536 F.2d at 954 (explaining the reason for administrative expense priority in section 64(a)(1) of the Bankruptcy Act, from which section 503(b) was derived).

<sup>7</sup> 886 F.3d 649 (2d Cir. 1967).

<sup>8</sup> *Id.* at 651.

certain losses attributable to the dismissal.”<sup>9</sup> Therefore, the Second Circuit held that the employees became entitled to severance compensation upon termination, the time at which they actually suffered those losses.<sup>10</sup> Since the employees were terminated post-petition, the full severance compensation was an expense of administration.<sup>11</sup> The Second Circuit is the only circuit that has granted administrative expense priority to the full amount of post-petition claims for severance compensation based on length of service.

The Fourth Circuit, in *Matson v. Alarcon*, extended the Second Circuit’s holding to pre-petition severance claims.<sup>12</sup> Under the company’s severance plan in that case, the number of weeks of severance compensation was based on the length of employment.<sup>13</sup> Within 180 days before filing its bankruptcy petition, the company terminated 125 employees who were eligible to participate in the severance plan.<sup>14</sup> The trustee of the estate argued that employees “earned” severance compensation over the course of employment, so only the portion that fell within 180 days before the petition should be entitled to priority treatment under section 507(a)(4).<sup>15</sup> The Fourth Circuit disagreed, and defined “earn” as “to become entitled.”<sup>16</sup> The Fourth Circuit reasoned that the employees became entitled to severance compensation when they were terminated, so they “earned” the full amount upon termination.<sup>17</sup> The Fourth Circuit contrasted severance compensation with wages, salaries, and commissions, which are earned as employees

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<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Matson*, 651 F.3d at 410.

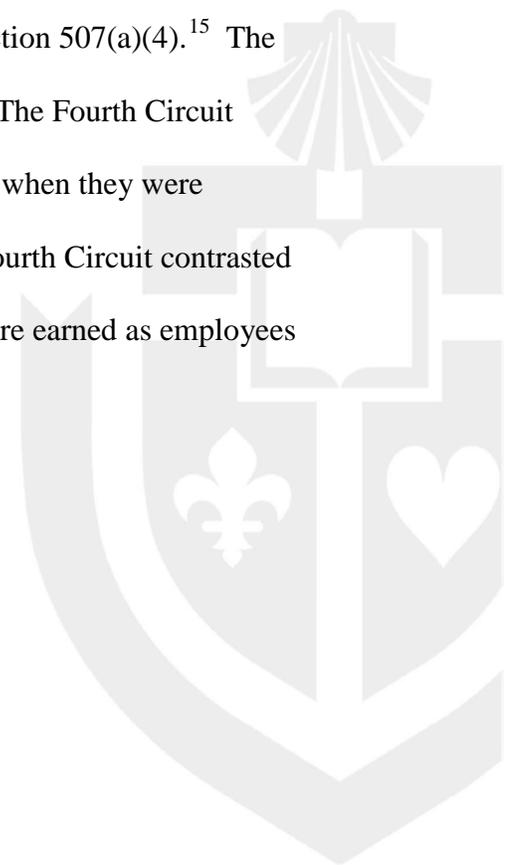
<sup>13</sup> *Id.* at 406–07.

<sup>14</sup> *Id.* at 407.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at 410.

<sup>17</sup> *Id.*



render services.<sup>18</sup> Unlike those other claims, severance compensation arose from a singular triggering event, the employer terminating the employees. Furthermore, the severance plan's stated purpose was "to assist eligible Employees upon termination."<sup>19</sup> Therefore, the Fourth Circuit held that the employees earned the severance compensation when they were fired, and thus their entire claims fell within the 180-day period necessary for priority treatment.<sup>20</sup>

In a case where employees' contracts provided for severance compensation in lieu of notice of termination, the Third Circuit granted administrative priority to the employees' severance claims.<sup>21</sup> In *In re Public Ledger*, the employees' contracts stipulated that employees had to be given two days' notice before termination, or else they would be entitled to severance compensation.<sup>22</sup> The trustees did not give the necessary notice. Although it was unclear why the trustees failed to give notice, the court considered the severance compensation a "necessary expense in administering the estate," thus entitling the compensation to priority as an administrative expense. The entire amount of the severance claim arose from the trustees' failure to give notice, which meant that the entire claim fell in the post-petition period.

*B. Majority of Circuits Do Not Grant Administrative Expense Priority to Full Amount of Claims for Severance Compensation Based on Length of Employment*

The majority of circuits grant administrative expense priority for only a portion of the total amount of a claim for severance pay. They reason that the employees "earned" at least some of the severance compensation prior to the filing of the petition. The First Circuit, in *In re Mammoth Mart, Inc.*, provided a general requirement for when a claim in its entirety would be entitled to first priority as an administrative expense: "[t]he debt must arise from a transaction

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<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 409.

<sup>20</sup> *Id.* at 410.

<sup>21</sup> *In re Public Ledger*, 161 F.2d 762, 771 (3d Cir. 1947).

<sup>22</sup> *Id.* at 769.

with the debtor-in-possession.”<sup>23</sup> Once this requirement is satisfied, claims are entitled to priority treatment if one of two conditions is met. First, courts will treat a claim as an administrative expense if the consideration provided by the claimant benefited the debtor-in-possession.<sup>24</sup> Second, priority will be given when a party is induced to supply goods or services to the debtor-in-possession.<sup>25</sup>

In *In re Mammoth Mart*, the employer paid one week’s salary per year of employment – but only up to a maximum of four week’s salary – after terminating the employees post-petition.<sup>26</sup> The employees who had worked for more than four years filed claims for the rest of the severance compensation.<sup>27</sup> The court determined that the amount of severance paid by the debtor-in-possession “fully compensated the employees for the services performed after the petition was filed,” so the claims at issue were “based entirely upon services performed by appellants to the debtor.”<sup>28</sup> As a result, the claims at issue were connected to the employees’ work for the company more than four years before the bankruptcy case. The First Circuit reasoned “where no portion of appellants’ claims can be apportioned to their employment after the arrangement was filed, no portion of the severance pay claims can be entitled to . . . priority.”<sup>29</sup>

Applying the *Mammoth Mart* test, the Tenth Circuit, in *In re Commercial Financial Services, Inc.* found that lump sum termination payments arose from a pre-petition agreement

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<sup>23</sup> *In re Mammoth Mart, Inc.*, 536 F.2d at 954.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* at 952.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 955.

<sup>29</sup> *Id.*

rather than a post-petition agreement with the debtor-in-possession.<sup>30</sup> In that case, three employees, who had provisions in their contracts for lump sum severance payments equal to their base salaries, were fired three weeks after the bankruptcy petition. The debtor-in-possession had not promised to pay the employees the lump-sum payment if they continued to work post-petition.<sup>31</sup> As a result, the court, analogizing the case to *Mammoth Mart*, said that the debtor-in-possession did not induce the employees to continue working post-petition.<sup>32</sup> Moreover, the employees' services were not beneficial to the debtor-in-possession. Thus, the claims did not meet the first or second prongs of the *Mammoth Mart* test, and so they were not entitled to administrative expense priority.<sup>33</sup>

In *In re Roth American, Inc.*, the Third Circuit allowed administrative priority only for the pro-rated portion of employees' claims attributable to the post-petition services provided to the estate.<sup>34</sup> The company in this case ceased operations a few months after filing its bankruptcy petition, and then laid off all its employees.<sup>35</sup> The court found that the employees' consideration for their severance compensation was given continuously over the whole duration of employment rather than just during the post-petition period.<sup>36</sup> The court stated that this pro-ration approach was consistent with the plain language of section 503(b) and the policy "to ensure that services needed to preserve the estate will be performed by minimizing the risk that the debtor will ultimately not be able to provide payment."<sup>37</sup> Under similar facts, the Ninth

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<sup>30</sup> 246 F.3d at 1295.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> 975 F.2d at 958.

<sup>35</sup> *Id.* at 951.

<sup>36</sup> *Id.* at 957.

<sup>37</sup> *Id.* at 958.

Circuit followed this approach and emphasized that the employees' work prior to bankruptcy was the consideration for the severance pay.<sup>38</sup>

The Fifth Circuit also refused to grant administrative priority to severance compensation when an employee entered into a contract with a severance clause prior to bankruptcy and then was terminated three weeks after the bankruptcy filing.<sup>39</sup> The employee signed a contract providing for a severance plan five months before the bankruptcy filing, and then was terminated three weeks after the filing.<sup>40</sup> The amount of severance compensation was not based on length of service, but rather upon the employee's salary in the prior year.<sup>41</sup> Accordingly, the court determined that the severance compensation was not for the employee's past services but instead it was "earned" when he entered into the contract.<sup>42</sup>

The First Circuit analyzed the consideration supporting an employee's claim for severance compensation.<sup>43</sup> The court said that the consideration for the employee's severance benefits was "her agreement to forgo other employment opportunities . . . which she provided prepetition to the debtor the moment she signed the Employment Agreement."<sup>44</sup> Unlike in other cases, in which courts stated that severance pay is accrued, the court in this case held that severance pay was not at all a component of compensation for services rendered by the employee. Therefore, the First Circuit did not grant priority treatment to any portion of the employee's severance claim.<sup>45</sup>

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<sup>38</sup> *In re Health Maint. Found.*, 680 F.2d at 622.

<sup>39</sup> *In re Phones for All, Inc.*, 288 F.3d at 731.

<sup>40</sup> *Id.*

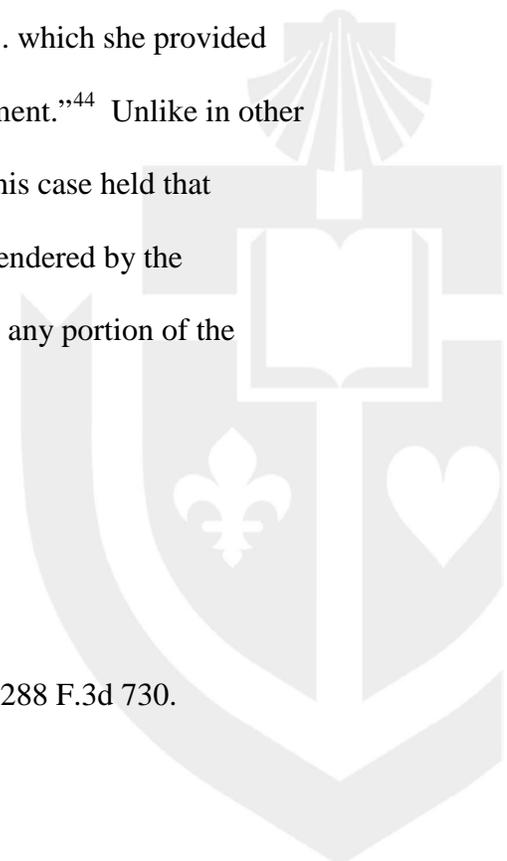
<sup>41</sup> *In re Phones for All, Inc.*, 262 B.R. 914, 917 (N.D. Tex. 2001), *aff'd*, 288 F.3d 730.

<sup>42</sup> 288 F.3d at 732.

<sup>43</sup> *In re FBI Distrib. Corp.*, 330 F.3d 36.

<sup>44</sup> *Id.* at 46.

<sup>45</sup> *Id.* at 49.



### **III. Reconciling the Approaches to Priority for Employees' Claims**

#### *A. The Crucial Question: When A Party Becomes Entitled to Payment*

Whether it is a pre-petition or post-petition claim, priority treatment turns on the question of when the employee becomes entitled to severance payment. For pre-petition claims to have priority treatment, employees must become entitled to payment during the 180-day period prior to the bankruptcy petition. In the post-petition context, administrative priority will be granted to the entire claim only if the employee became entitled to the whole amount during the post-petition period. The type of claim at issue dictates the time at which entitlement to payment arises. Moreover, courts have disagreed on how a claimant becomes entitled to payment.

For example, severance in lieu of notice is afforded administrative priority because the consideration for the compensation arises post-petition, once the trustee or debtor-in-possession terminates the employee. The entitlement to payment comes once the employees are fired without the proper notice. It is only on the termination date that the employee could possibly get the right to that compensation. If the employee gets the necessary notice, then the employee never has any right to the severance compensation. Therefore, the question of the time at which an employee gets becomes entitled to payment seems to be relatively clear in the context of severance compensation in lieu of notice.

In contrast, the treatment of severance compensation based on length of employment has proven to be less definite. The majority of circuits have held that consideration for the claims in this context arises throughout the duration of employment. Since the amount of severance was based on the length of employment, the majority of circuits have found that employees were effectively earning the severance as they gave services to the employer. However, the Second Circuit focused on the purpose of severance compensation and from that concluded that the

compensation was “earned” all at once upon termination. The Fourth Circuit followed that view and applied it to the pre-petition claims that fell within the statutory look-back period of section 507(a)(4). This approach has treated longevity-based severance compensation similarly to compensation in lieu of notice. The circuits following this view arrived at the holding that severance is earned all at once because they started their analysis with the purpose of severance compensation, which is to help employees at the time of termination.

*B. How the Other Circuits Might Decide a Pre-Petition Claim for Severance Compensation*

If the other circuits were presented with a question of severance compensation claims in the pre-petition context, it seems that they might disagree with the Fourth Circuit’s holding. The other circuits might continue to employ the pro-ration scheme for longevity-based severance compensation. The analysis would place just a portion of the severance compensation within the statutorily defined 180-day period before the bankruptcy filing. In the pre-petition context, the courts might have to come to their own understanding of “earned” as it is used in section 507(a)(4). They did not have to define “earned” in the administrative expense cases but instead dealt with “services rendered.”<sup>46</sup> However, in the administrative expense cases, the courts reason that employees continuously earn severance compensation throughout their employment. They might also point out that section 507(a)(4)(A) lumps together “wages, salaries, or commissions, including vacation, severance, and sick leave pay.”<sup>47</sup> The courts might assess the claims other than severance, and if they find that those claims are more clearly accrued, they could reason that the inclusion of severance along with the others could support treating severance compensation as an accrued claim.

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<sup>46</sup> See 11 U.S.C. § 507(a)(4); 11 U.S.C. § 503(b)(1)(A).

<sup>47</sup> 11 U.S.C. § 507(a)(4)(A).

## **Conclusion**

Courts have faced the issue of priority treatment of employee claims for severance in the pre-petition and post-petition contexts. Courts have diverged in their treatment of these claims due to different views on when employees become entitled to a particular claim. The split in authority comes down to a distinction between the views that severance compensation is earned all at once or that it is accrued. The accrual approach has allowed courts to pro-rate the total amount of a claim to find the portion that employees actually earned within a certain timeframe. The simple disagreement over how employees earn severance compensation has very significant consequences when it comes to determining priority treatment of claims.

