New Program to Focus on Fundamentals: Nuts & Bolts for Young Practitioners

BI will hold its first-ever CLE program covering bankruptcy fundamentals for young and new practitioners on April 10, 2003, in Washington, D.C. Nuts and Bolts for Young Practitioners will be held in conjunction with ABI’s Annual Spring Meeting. The day-long session features an outstanding faculty of judges and practitioners, all led by ABI Resident Scholar David G. Epstein, one of the nation’s leading teachers of bankruptcy for more than a generation.

The program will focus on the structure of the Code, the commencement of the case, key concepts such as property of the estate, claims, priority, adequate protection, discharge, avoiding powers and more. Separate tracks will cover both consumer and business cases from start to finish. “The goal of the program is to prepare lawyers who are new to bankruptcy to work effectively in bankruptcy cases and on deals that might be affected by bankruptcy,” said Prof. Epstein.

Faculty members include: Michael L. Bernstein (Arnold & Porter, Washington, D.C.), co-author of Bankruptcy in Practice, published by ABI last year; Ford Elsaesser (Elsaesser, Jarzabek et al.; Sandpoint, Idaho); and Mark S. Hodes (Kirkland & Ellis, Washington, D.C.).

Rocky Mountain Conference Sets Record

More than 200 bankruptcy professionals attended the Eighth Annual Rocky Mountain Bankruptcy Conference in Denver, Jan. 30-Feb. 1. This was our largest crowd ever at this event. Attendees came from 20 different states from all regions of the country.

Program chairs were Jim Markus (Block Markus Williams; Denver) and Danny C. Kelly (Stoel Rives; Salt Lake City). The judicial chair was Hon. Elizabeth Brown (D. Colo.). Other judges on the faculty included Hon. Judith Boulton, Hon. Sidney Brooks, Hon. Bruce Campbell, Hon. Donald Cordova, Hon. Todd Neilson (Neison Eastman; Los Angeles). 

Conference Program Chairs: Hon. Markus (Denver) and Danny C. Kelly, Jr. (Salt Lake City); Hon. Amanda Hodes (Hon. Mark S. Hodes, Kirkland & Ellis; Washington, D.C.), and Todd Neilson (Neison Eastman; Los Angeles).

ABI thanks the many sponsors for their financial support: West; Liquidity Solutions; KPMG; Holland & Hart; Holm Roberts & Owen; Stoel Rives; and Wiener. Neison Eastman; Rothgerber Johnson & Lyons; PricewaterhouseCoopers; Jessop & Company and Montega Capital.

Payment of Pre-petition and Post-petition Employee Severance Benefits

Part 1

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This article examines whether severance benefits promised to employees pre-petition may be paid after the employer has filed a chapter 11 bankruptcy petition. The answer depends on whether the severance benefits were payable based on length of service or in a single lump-sum payment, and whether the debtor is in a majority- or minority-rule jurisdiction.

For most debtors, pre-petition lump-sum severance benefits are not payable as an administrative expense. Severance benefits based on length of service must be allocated between pre- and post-petition service. This article does not deal with benefits provided under a collective bargaining agreement, which are governed under §1113 of the Bankruptcy Code and may be modified only with court approval.

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Employee Severance Benefits
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Typical Scenario

A typical chapter 11 debtor may offer severance benefits based on the number of years of service to the company, or as a lump-sum payment regardless of length of time employed by the debtor. For example, the company may provide for one week of severance pay for each full year of employment for hourly employees. The company may also offer a lump-sum payment of up to a year of base salary as a termination benefit for salaried employees. In addition, medical benefits may be offered as part of the severance package.

Severance Benefits Based on Length of Service

1. Minority Rule: Severance Is Payable Based on the Date that the Claim Arises. The Second Circuit has held that where severance payments arise post-petition, the full amount of the payments are entitled to administrative priority, regardless of when the services giving rise to the payments were performed. Thus, where severance benefits are based on length of service, an employee terminated post-petition may receive the entire amount of his severance benefits as an administrative expense, even if most of his service was prior to the bankruptcy. Strauss-Duparquet Inc. v. Local Union No. 3, International Brotherhood of Electrical Workers, 386 F. 2d 649 (2d Cir. 1967). The ruling has been criticized by some cases within the Second Circuit (see cases cited in In re Commercial Financial Services Inc., 233 B.R. 885, 889 (Bankr. N.D. Cal. 1999)). Although this is still the rule in the Second Circuit (In re Spectrum Information Technologies Inc., 193 B.R. 400, 407 (Bankr. E.D.N.Y. 1996)), no other circuits follow it.

2. Majority Rule: Must Allocate Between Pre-petition and Post-petition Service. The majority rule is that only the portion of the severance pay claim that can be apportioned to post-petition service may be afforded priority treatment as an administrative expense. In re Levinson Steel Co., 117 B.R. 194, 195-96 (Bankr. W.D. Pa. 1990). The majority rule is based on the seminal case of In re Public Ledger Inc., 161 F.2d 762 (3d Cir. 1947). In that case, the court held that only vacation pay and severance pay that was earned under the management of bankruptcy trustees could be given priority as an administrative expense. Id. at 773. Most courts outside the Second Circuit have followed this rule.

Where severance pay is based on length of service, the consideration for the pay is the services performed for the employer over the entire period of an employee’s employment. If no part of the claim for severance is based on post-petition employment, then none of the severance claim is entitled to administrative expense priority. In re Mammoth Mart Inc., 536 F.2d 950, 955 (1st Cir. 1976); In re Public Ledger Inc., 161 F.2d 762 (3d Cir. 1947); Matter of Health Maintenance Foundation, 680 F.2d 619, 621 (9th Cir. 1982).

More recently, the Third Circuit in Former Employees of Builders Square v. Hecchinger Investment Co. of Delaware (In re Hecchinger Investment Co. of Delaware), 298 F.3d 219 (3d Cir. 2002), dealt with "stay-on" benefits promised prior to the bankruptcy filing. The company decided to close certain stores and wanted to ensure that experienced staff would be available to help liquidate inventory at the going-out-of-business sale held at each store. The stay-on benefits consisted of special enhanced accumulation of vacation, sick days and personal time. Full-time employees who had completed nine months of service by the date of termination were also entitled to additional severance pay. In order to receive the enhanced benefits, the employee had to remain with the company until the employee’s store was closed or the employee was released by the company. Shortly thereafter, the company filed for bankruptcy, and many employees continued to work for the company while the stores were conducting the going-out-of-business sales.

In seeking to obtain payment of the entire amount of stay-on benefits as administrative priority, the employees argued that the benefits were not earned until after the last day of business of the individual store or the employee’s release date, which for each plaintiff was after the bankruptcy filing date. The court rejected this argument, finding that the consideration furnished by the employees for the stay-on benefits was the work they did each day from the time they agreed to the stay-on benefits until the time their store was closed or they were released. Thus, allocation of pre-petition and post-petition services was necessary. The court found that §503(b)(1)(A) gives administrative priority based on the time the service was rendered, not the time scheduled for payment. 298 F.3d at 225. It was irrelevant that the employees’ pre-petition services continued to benefit the estate. Section 503(b)(1)(A) only gives priority to services “rendered after the commencement of the case.” 298 F.3d at 226.

3. How to Allocate Between Pre-petition and Post-petition Severance. The court in In re Yarn Liquidation Inc., 217 B.R. 544 (Bankr. E.D. Tenn. 1998), devised a formula for determining the amount of severance benefits earned after the filing date. The amount of benefits is calculated by determining the rate at which severance pay is earned, then multiplying that rate by the number of days worked post-petition, divided by 365. 217 B.R. at 547. Thus, if severance is earned at the rate of one week per year of service, the calculation is as follows:

<table>
<thead>
<tr>
<th>Days worked post-petition</th>
<th>Weekly salary x</th>
<th>365</th>
</tr>
</thead>
</table>

The court in In re Russell Cave Co. Inc., 248 B.R. 301 (E.D. Ky. 2000), reached a similar result. In that case, creditors objected to payment of the full amount of severance claims as an administrative expense. The court found that severance pay claims were entitled to administrative priority only to the extent that they were earned after the bankruptcy petition was filed. Severance pay based on length of service was an administrative expense only to the extent it was earned by service during the bankruptcy case. The court adopted the same formula used in Yarn Liquidation for calculating the amount of post-petition severance benefits.

Lump-sum Severance Benefits May Be Disallowed as an Administrative Claim

1. Minority Rule: The Entire Severance Claim Is An Administrative Expense. In the case of In re Miami General Hospital Inc., 89 B.R. 980, 986 (Bankr. S.D. Fla., 1988), a hospital executive was hired under a pre-petition severance agreement that provided for a lump-sum payment upon termination other than “for cause.” The debtor sold the hospital facility, and all employees were terminated as a part of the sale. The court held that because the employee was terminated incident to the administration of the estate, the severance pay was an expense of the administration of the estate and entitled to priority. As an alternative theory, the court also found that the debtor assumed that the claimant’s agreement was implied by accepting the post-petition services. Id. at 988.

The decision in In re Miami General Hospital was based on two earlier cases, Matter of Tucson Yellow Cab Co. Inc., 789
F. 2d 701 (9th Cir. 1986), and In re Northwest Engineering Co., 43 B.R. 603 (Bankr. E.D. Wis. 1984). In Northwest Engineering, the debtor’s employees were terminated post-petition, but before their severance pay agreement was rejected as an executory contract by the debtor. The court held that their claims for severance were entitled to administrative priority because the motion to reject did not vitiate the employee’s right to severance pay that had accrued before the motion to reject was filed. Tucson Yellow Cab actually went further in holding that even though the executory contract with employees was rejected 11 days before the employees were terminated, the fair value of the services rendered to the estate was the contract value, and thus the employees were entitled on a quantum meruit basis to payment of severance pay as a cost of administration.

As with severance pay based on length of service, the Second Circuit in Straus-Duparquet allows the entire amount of lump-sum severance benefits as an administrative expense for post-petition terminated employees, reasoning that severance pay is compensation for the hardship that all employees suffer when they are terminated and is therefore earned upon dismissal. In re Spectrum Information Technologies Inc., 193 B.R. 400, 405 (E.D.N.Y. 1996). This is a minority rule.

2. Majority Rule: For Lump Sum Severance as an Administrative Expense, Employer Must Assume the Severance Agreement or Induce the Employee to Continue Employment with Promise of Severance Pay. The court in In re Uly-Pak, 128 B.R. 763 (Bankr. S.D. Ill. 1991), expressly rejected the holding of In re Miami General Hospital. In Uly-Pak, an employee had a pre-petition agreement that provided for lump-sum severance pay upon termination for any reason. The employee continued to work for the debtor post-petition, although his contract was neither assumed or rejected. After the debtor’s assets were sold and the employee was terminated, the employee sought payment of severance benefits as an administrative expense. In rejecting the claim, the court found that the severance claim did not arise from a transaction with the debtor, nor did it benefit the estate. The claimant asserted that it was induced to work for the debtor by the expectation of receiving severance pay and that it would therefore be inequitable to deny the claim. However, the court held that the provisions of §503(b) left no room for equitable considerations, and furthermore, the claimant could have requested that the court order the debtor to assume or reject the agreement. 128 B.R. at 768. Thus, the court appears to suggest that had the debtor assumed the employment contract, then severance benefits could have been paid as an administrative expense.

### Straight & Narrow

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restructure the agreement with the purchaser, whereby the Tri-State estate would receive $730,000 for the Maine property, and the owners of Tri-State would receive nothing. Rosen was convicted of four counts of federal mail fraud stemming from the misrepresentations he made to the bankruptcy trustee in this case.

### Representing Debtors in Complex Chapter 11s is not the Way to Learn Bankruptcy Law

As noted in the introduction to this article, attorney Parkhill in the case of U.S. v. Parkhill was convicted of fraudulent concealment of assets and the improper transfer of assets from bankruptcy estates by virtue of a complex set of transactions. Specifically, after the conversion of an involuntary chapter 7 petition to a voluntary chapter 11 proceeding, Parkhill assisted the principal of the debtor in transferring various pieces of property and motor vehicles out of the name of the debtors to a third party for payments of $150,000, which the debtor’s principal received and which were not disclosed in the debtor’s bankruptcy case. Parkhill was not helped by his co-defendant in this case, the owner of the debtor corporations, who insisted that all of his actions were taken solely upon the advice of his attorney.

### Yes, Selling the Entire Business in a Chapter 11 Proceeding Does Require Bankruptcy Court Approval

The case of United States v. Edgar shows that forgetting “small” things, such as obtaining bankruptcy court approval for the sale of all of a chapter 11 debtor’s assets, can cause an attorney significant criminal liability. In this case, the debtor, Dupli Tech Corp., had filed a chapter 11 bankruptcy. Edgar, acting as the debtor’s owner’s attorney, negotiated the sale of the chapter 11 debtor’s assets for payments to be made directly to the owner, which the owner would “use” to pay off or compromise the bankruptcy claims against the debtor. The owner of the debtor was also given a lucrative employment agreement under the terms of the sale. Perhaps not surprisingly, the attorney structured the sale so that the assets and proceeds would be difficult to trace and the owner of the debtor did not use any of the proceeds to pay any of the Dupli Tech creditors.

After this “minor oversight” was uncovered, the subsequently appointed trustee sued the purchaser of the assets and settled for $300,000, the present value of the payments to be made under the sale agreement and, with the help of the FBI, obtained the indictment of the debtor’s owner and Edgar for bankruptcy fraud. Given the blatantness of the fraud in this case, Edgar did not appeal the underlying merits of his conviction, but rather appealed only certain technical determinations of his sentencing under the U.S. Sentencing Guidelines.

### How Not to Make 2014 Disclosures—the Most Infamous Bankruptcy Criminal Case

Although within the scope of this particular article, the case of U.S. v. Gellene has already been discussed in detail by a large number of commentators and will not be rehashed in any great detail in this article. The most important lesson that attorneys can take from this Gellene case is to compare the findings made by the jury in Gellene—i.e., that Gellene (1) knew of his firm’s representation of a secured creditor, (2) knew under Bankruptcy Rules and Code the representation had to be disclosed, and (3) deliberately failed to disclose this representation in order to conceal that information from the court—to the findings of the Seventh Circuit decision in Matter of Firstmark Corp., where the Seventh Circuit found that the inadvertent failure to disclose a conflict warranted only a fine or a reduction in fees, not disbarment and certainly not criminal sanctions. This distinction is at least some comfort to those, like this author, who have to conduct many of the conflicts checks in large chapter 11 representations, as it indicates that they will not go to jail if they merely make a mistake in their affidavits in support of their firm’s retention. Gellene clearly shows that knowledge and intent to conceal are required for such severe sanctions.

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3 This defense did not help the owner defend, as his convictions were affirmed by the Fifth Circuit, 775 F.2d at 617.
4 971 F.2d 10 (8th Cir. 1992).
5 182 F.3d 578 (7th Cir. 1999).
7 132 F.3d 1179 (7th Cir. 1997).
8 However, significant issues of fees may be considered extenuated by your firm’s executive or compensation committee as a form of criminal activity.

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