INSIGHTS + NEWS

Client Alert: Getting Paid in Bankruptcy – Part IV, Employees

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In this series, we look at how various payment rights are treated in bankruptcy. A summary like this could not possibly address every right that might arise in any given bankruptcy case. We have omitted several of the Bankruptcy Code's more esoteric legal protections and exceptions that arise in specific kinds of bankruptcy cases. When bankruptcy strikes, creditors should always consult a bankruptcy lawyer to understand what actions they need to take to preserve their rights and maximize their recovery.

THE BASIC CONCEPT OF A "CLAIM"

The Bankruptcy Code defines a "claim" to include any right to payment against the bankrupt entity (called the "Debtor"), regardless of whether the claim is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured. It's a broad definition.

Claims break down into four basic categories: (1) secured claims ("secured" because the Debtor has pledged property if it fails to repay the debt); (2) administrative expense claims; (3) priority claims; and (4) general unsecured claims.

It is no surprise that in bankruptcy there is seldom enough money to pay every creditor in full. Order of priority, therefore, is critical. Imagine the creditors forming a line: secured claims, followed by administrative expense claims, priority claims, and general unsecured claims. Equity claims – the owners' stake in the Debtor – are technically at the end of this line, but since the estate is often insolvent, they usually do not receive any payment at all.

Outside of bankruptcy, the creditor probably thinks about the money that the Debtor owes as a single debt. As we shall see, however, the Bankruptcy Code's payment hierarchy can slice and dice this debt into several tranches according to what portions of the debt qualify as administrative expense, priority, or general unsecured claims. Creditors need to think about the money they are owed according to these claims, which can differ in value significantly. A $100,000 administrative expense claim could be worth far more in real dollars than an $1 million general unsecured claim, for example, and consequently worth investing more resources pursuing.

Creditors assert priority and general unsecured claims by filing a short and simple form with the bankruptcy court called a proof of claim. This can be done for little cost. If no one objects to the proof of claim, the claim is allowed. Administrative expense claims require a more extensive application filed through counsel. The bankruptcy court must approve the application before an administrative expense claim is allowed.

In a successful reorganization, administrative expense claims and priority claims are paid in full, while general unsecured claims can receive as little as nothing or as much as 100% plus accrued interest if the estate ends up being solvent. In most cases, the dividend on general unsecured claims is very small.

If the creditor owes the Debtor property (including money), it cannot receive payment until it has turned such property over to the Debtor. This allows the Debtor to net out liabilities with its creditors as part of the claim administration process.

EMPLOYMENT BASED CLAIMS

Employees provide labor on credit: wages are paid in arears every week or two. This makes employees creditors of their employer. If the employer files bankruptcy, the employees (and former employees) may have claims against the bankruptcy estate. They may also continue to work for the employer during the bankruptcy case, in which case, they will have claims for their post-petition labor. Employees have an administrative expense claim for the value of their services rendered post-petition. Money for services rendered prior to bankruptcy, however, are general unsecured claims, with limited exceptions discussed below.

1. Current Employees

As an employee of the Debtor you have a priority claim for pre-petition wages, commissions, vacation, severance, and sick leave earned within 6 months of the filing date, up to a capped amount of $13,650. To the extent there are funds remaining under the cap after paying the forgoing, you will have an additional priority claim for contributions to benefit plans. Although a Debtor does not have to pay priority claims until a plan is confirmed, the Debtor will typically seek court approval to pay employee wages immediately and pay other benefits (including vacation, severance, and sick leave) as they are incurred in the ordinary course of business as a necessary expense of maintaining its workforce.

If you have an employment agreement with the Debtor, the Debtor may assume or reject that agreement prior to the conclusion of the bankruptcy case. While you will have an administrative expense claim for services rendered post-filing, any liquidated damages arising from contract rejection will be treated as a general unsecured claim. Typically, the Debtor will wait until the end of the case to decide whether to assume or reject an employment agreement. Critically, because such contracts are personal in nature, the Debtor is not able to assign an employment agreement without the employee’s consent. This may provide leverage to C-Suite executives and other critical employees with employment agreements if the Debtor proposes a going-concern sale of its business during the bankruptcy. As “NewCo” acquires the assets of the Debtor, your ability to veto an assignment of your employment agreement could result in improved terms with NewCo.

The Debtor might seek court approval of a “key employee retention plan (KERP)” or a “key employee incentive plan (KEIP)” to incentivize critical employees to remain with the company during its reorganization. KERPs and KEIPs typically provide cash bonuses to employees who stay. The Bankruptcy Code imposes several restrictions on KERPs to avoid excessive transfers to management that provide no tangible benefit to the estate. KEIPs must be structured as an exchange for value: the employee must meet performance goals such as helping the Debtor successfully reorganize or meet sales targets.

The federal Worker Adjustment and Retraining Notification Act (WARN) requires covered employers to give 60 days’ advanced written notice of plant closings or mass layoffs. If a terminated employee did not receive a WARN notice, they are entitled to back pay for the period of the violation plus penalties and attorneys’ fees. Many states have “baby WARN” statutes imposing similar damages. Several bankruptcy court decisions hold that WARN claims are a form of severance, which means that if the Debtor terminates employees within 6 months of the bankruptcy without giving the WARN notice, those former employees will have WARN damages payable as a priority claim up to $13,650, with any remaining WARN damages payable as a general unsecured claim. Employees who are terminated *after* the bankruptcy filing without proper WARN notice might be able to obtain an administrative expense claim for their WARN damages.

2. Collective Bargaining Agreements

A collective bargaining agreement (CBA) is a contract between an employer and a union representing the employees regarding topics such as wages, hours, and the terms and conditions of employment. CBAs are heavily negotiated and typically run for multiple years. And yet, like any other executory contract, the Debtor may reject a CBA in bankruptcy.

The default rule is that a Debtor can reject a contract if, in its business judgment, rejection is better for the Debtor than assumption. The "business judgment" test is a relatively low bar to meet. Because contract rejection is so easy for the Debtor to accomplish, the Bankruptcy Code has special protections for CBAs. The Debtor must first propose modifications to the CBA that would permit a reorganization while ensuring that all stakeholders are treated fairly and equitably. The Debtor and CBA representative must then attempt to negotiate such modifications in good faith. The bankruptcy court can only approve rejection of the CBA if the parties fail to reach an agreement and only after a hearing during which all sides may be heard. The court may approve interim changes to the CBA to allow the Debtor's business to continue to operate pending the final outcome on modification or rejection.

3. Former Employees

If the Debtor is reorganizing (as opposed to closing its business and liquidating), it must continue to timely pay benefits owed to retirees whose gross income is less than $250,000 per year. If the Debtor wishes to modify its retiree payments, the Bankruptcy Code imposes a process similar to the CBA modification process described above. The court will appoint one or more persons to represent the retirees and will rule on the Debtor's proposed modification after notice and a hearing.

A Debtor may also offer retirement benefits in the form of a defined benefit pension plan. The pension plan is a separate legal entity from the Debtor and, therefore, the plan assets are not part of the bankruptcy estate. Nevertheless, the plan itself might be underfunded and if the Debtor terminates the plan (or withdraws from a multi-employer plan) it will incur a liability for the underfunding payable to the Pension Benefit Guaranty Corporation (PBGC) (in the case of a single employer plan) or the plan administrator (in the case of a multi-employer plan). This liability is treated as a general unsecured claim. Retirees will continue to receive payments from a multi-employer plan after the Debtor has withdrawn. Either the Debtor or the PBGC will wind down a terminated single employer plan. Within statutory limitations, the PBGC will pay retiree benefits to the extent plan funds are not available.

4. Fraudulent Transfer Liability

Employees who receive excessive compensation from the Debtor prior to the bankruptcy might have to return the money. The Bankruptcy Code allows the Debtor to avoid and recover as a "fraudulent transfer" property that the Debtor transferred to a third party while insolvent and without receiving reasonably equivalent value in exchange. If the transfer was to an insider under an employment contract, the Debtor does not need to have been insolvent at the time of the transfer. Whether the Debtor received reasonably equivale value in exchange for the compensation it paid the employee is a factual question to be resolved by the court. The Bankruptcy Code's fraudulent transfer statute applies to transfers made within 2 years of the bankruptcy. In some circumstances, however, the Debtor can bring fraudulent transfer claims under state law, which have average "look-back" periods of 4 years.

Read Part 1: Lender Claims, Part 2: Goods and Services, and Part 3: Landlords, Leases, and Licenses.