

ILLUSORY PROTECTION: THE TREATMENT OF SEVERANCE PACKAGES IN BUSINESS BANKRUPTCIES

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I. INTRODUCTION

To compete for qualified personnel, an increasing number of companies are offering severance packages as an employee benefit. In a 1997 survey, the United States Department of Labor Bureau of Labor Statistics reported that thirty-six percent of all medium and large private companies have a formal policy regarding structured payments payable to employees in the event that their employment is terminated through no fault of their own.¹ Although a majority of those packages are exclusively available to executive-level employees,² similar, albeit less lucrative, packages are being offered to many corporate employees.³ For example, forty-eight percent of the companies included in the Bureau of Labor Statistics' study responded that severance packages are offered to employees who are involved in professional, technical, or related fields.⁴ Moreover, forty-three percent of employers replied that clerical and sales staff are afforded similar protection.⁵ Perhaps most surprisingly, twenty-six percent of employers extend employment benefits that include some form of severance package to their blue-collar and service-field employees.⁶ Although severance packages benefit employees who are protected in the event that their position is terminated due to circumstances beyond their control, the corporate motives underlying their increased use are not entirely altruistic. These severance packages allow employers not only to attract more qualified personnel, but also to minimize the risk associated with wrongful termination lawsuits.⁷

One circumstance where employees are certain to look to their severance benefits packages for protection is when a reduction of the employer's workforce is necessitated by economic restraints placed upon

1. UNITED STATES DEP'T OF LABOR BUREAU OF LABOR STATISTICS, EMPLOYEE BENEFITS IN MEDIUM AND LARGE PRIVATE ESTABLISHMENTS, 1997 (1999), *available at* 1. UNITED STATES DEP'T OF LABOR BUREAU OF LABOR STATISTICS, EMPLOYEE BENEFITS IN MEDIUM AND LARGE PRIVATE ESTABLISHMENTS, 1997 (1999), *available at* <http://ftp.bls.gov/pub/news.release/ebs3.txt> [hereinafter *BLS Study*].

2. Debbie Strickland, *More Executives Negotiate Golden Parachutes Up Front*, ATLANTA BUS. CHRON., Aug. 20, 2000, at 11.

3. Packages to upper-echelon executives often include one to three times their base yearly salary including bonuses. *Id.* Further, in a marked change from the mergers and acquisitions boom in the late 1980's, these packages are no longer contingent upon a change of corporate control or ownership. *Id.*; *see also infra* note 17 and accompanying text.

4. *BLS Study*, *supra* note 2.

5. *Id.*

6. *Id.*

7. *See infra* notes 75-76 and accompanying text. For additional reasons that employers chose to award severance packages to employees, *see infra* note 15 and accompanying text.

the company.⁸ This is particularly true when the company is operating as a debtor-in-possession under Chapter 11 of the Bankruptcy Code (“the Code”).⁹ As one court noted, “[t]he purpose of [Chapter 11] is to provide a debtor with the legal protection necessary to give it the opportunity to reorganize, and thereby to provide creditors with going-concern value rather than the possibility of a more meager satisfaction of outstanding debts through liquidation.”¹⁰ Therefore, throughout a Chapter 11 bankruptcy, the debtor-in-possession must develop the most valuable company possible to enhance the return to its creditors and to increase the opportunity for the reorganization of its business.¹¹ In most cases, this requires the debtor-in-possession to maintain an effective workforce. Paradoxically, because a debtor-in-possession must maximize the value of the estate for the benefit of its creditors,¹² it will often be required to evaluate the employees it wishes to retain considering the budgetary constraints placed upon it by either the court or the trustee. As many employees who are “protected” under severance plans have discovered, however, lucrative severance packages may become “paper tigers” in the event of their employer’s bankruptcy.

This article will begin by providing background information about the nature of severance pay. Next, it will examine the components of standard termination clauses in employment contracts. The discussion of termination clauses will emphasize the ability of a debtor-in-possession to either reduce an employee’s salary or to completely eliminate a position due to adverse economic circumstances impacting the company. Also, this article will consider whether such a termination is “for cause” within the meaning of the employment contract and under common law. This article will then turn to the disparate treatment that severance packages have received in bankruptcy cases. It will focus specifically on the executory

8. This article will only address the validity of a discharge premised upon economic hardship of the employer as a tangential issue. *See infra* Part II.

9. 11 U.S.C. §§ 101-1330 (2000). A debtor-in-possession is a “debtor except when a person that has qualified under § 322 of this title is serving as trustee in the case.” *Id.* at § 1101. Section 1108 of the Code authorizes the corporate debtor to operate the corporation throughout the reorganization process as a debtor-in-possession. *Id.* at § 1108.

10. *Canadian Pac. Forest Prods. Ltd. v. J.D. Irving, Ltd. (In re Gibson Group, Inc.)*, 66 F.3d 1436, 1442 (6th Cir. 1995).

11. *In re BMW Group I*, 168 B.R. 731, 736-37 (Bankr. W.D. Okla. 1994) (quoting Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURV. AM. L. 9 (1991)).

12. *See Commodity Futures Trading Comm’n v. Weintraub*, 471 U.S. 343, 352 (1985); *Louisiana World Exposition v. Fed. Ins. Co.*, 858 F.2d 233, 246 (5th Cir. 1988). This choice is obviated in the event that the reorganization fails and the company is forced to liquidate under Chapter 7. In such a situation, all of the company’s employees who are not essential to the winding-up and eventual dissolution of the business would be discharged. Notwithstanding the logistical distinctions between a Chapter 11 and a corporate liquidation, the treatment of severance packages in the two situations is similar.

nature of the obligations created under severance clauses and the concomitant ability of a debtor-in-possession to reject employment agreements containing a clause providing for severance pay, as well as the ability of an employee to collect severance pay as an administrative expense. After discussing the various approaches that courts have taken in determining the priority afforded to severance packages under the Code, this article will conclude by recommending that courts eschew the traditional rationale underlying their decisions and adopt an approach that is more flexible, equitable, and consonant with the changing nature of severance packages.

II. CONTRACTUAL SEVERANCE PACKAGES AND TERMINATION CLAUSES

A. *The Nature of Severance Packages*

What constitutes a “severance package” is a rather amorphous concept because companies offer different benefits to different employees. As such, it is not surprising that courts have failed to reach an agreement regarding the treatment of severance packages in the event that the employer files bankruptcy and as to the reason that severance packages are offered to employees.¹³ Generally speaking, however, and for the purposes of this article, a “severance package” is “in essence[,] a form of compensation for the termination of the employment relation[ship], for reasons other than the displaced employees’ [sic] misconduct, primarily to alleviate the consequent need for economic readjustment but also to recompense him for certain losses attributable to the dismissal.”¹⁴ It is “a means of recompense for the economic exigencies and privations and detriments resulting from the permanent separation of the employee from service for no fault of his own. In a real sense it is remuneration for the service provided during the period covered by the agreement.”¹⁵ Severance

13. Notwithstanding the number of reasons that a severance package could be offered to an employee, courts have been rather narrow-minded with respect to exactly what severance packages are designed to do. See sources cited note 165 *infra*.

14. *Adams v. Jersey Cent. Power & Light Co.*, 120 A.2d 737, 740 (N.J. 1956). *But see* *Bolta Prods. Div. v. Dir. of the Div. of Employment Sec.*, 255 N.E.2d 357, 361 (Mass. 1970) (noting that under Massachusetts law, “severance pay” is “a payment to an employee at the time of his separation in recognition and consideration of the past services he has performed for the employer and the amount is usually based on the number of years of service”). Although some sources give a broader definition of “severance pay,” for the purposes of this article, the application of the term will be limited to those contingent upon termination of employment. See, e.g., BLACK’S LAW DICTIONARY 1374 (7th ed. 1999) (defining “severance pay” as “[m]oney . . . paid by an employer to a dismissed employee”).

15. *Adams*, 120 A.2d at 740 (quoting *Owens v. Press Publ’g Co.*, 120 A.2d 442, 445 (N.J. 1947)) (internal quotation marks omitted); *accord* *Guiliano v. Cleo, Inc.*, 995 S.W.2d

pay has “other objectives, such as the necessity of developing new skills and the readjusting of the employee’s life to altered circumstances It . . . contributes much to the maintenance of the good will of employees and the community generally.”¹⁶

An employee’s entitlement to such payments can arise from a myriad of circumstances, the most publicized of which is the so-called “golden parachute” paid to upper-echelon corporate executives in the event of a change in corporate control.¹⁷ In contrast to “golden parachutes,” middle management and lower-level employees often receive “silver” or “tin” parachutes, providing them with some lesser degree of protection.¹⁸ Aside from the merger and acquisition context, severance packages can be found in formal employment agreements between a single employee and employer,¹⁹ in collective bargaining agreements between union members and their employers,²⁰ in formal company policies,²¹ and in statutes

88, 97 (Tenn. 1999) (opining that “[t]he reason for severance pay is to offset the employee’s monetary losses attributable to the dismissal from employment and to recompense the employee for any period of time when he or she is out of work”) (internal footnotes omitted) (citing *Bradwell v. GAF Corp*, 954 F.2d 798, 800 (2d Cir. 1992)); *see also* 27 AM. JUR. 2D *Employment Relationship* § 70 (1996). The *Guiliano* court noted that such “monetary losses” may include “seniority rights, pension recovery, and re-training costs or other burdens associated with obtaining new employment.” *Guiliano*, 995 S.W.2d at 97 n.6.

16. *Adams*, 120 A.2d at 741.

17. “A ‘golden parachute’ is a provision in an executive’s contract that provides for payment in the event of termination or a defined loss in status after a defined change in control of the company.” *In re Crystal Apparel, Inc.*, 220 B.R. 816, 821 n.2 (Bankr. S.D.N.Y. 1998). *See, e.g.*, Calvin Trillin, *Deep Pocket, Short Reach*, TIME, Jan. 13, 1997, at 24 (discussing Michael Ovitz’s \$90 million severance package).

18. This article will only focus upon severance packages triggered by termination of employment and not those severance packages triggered by changes of control.

19. *See, e.g.*, *Dullanty v. Selectors, Inc. (In re Selectors, Inc.)*, 85 B.R. 843 (B.A.P. 9th Cir. 1988); *In re Phones for All, Inc.*, 249 B.R. 426 (Bankr. N.D. Tex. 2000); *In re DeMert & Dougherty, Inc.*, No. 96-B-00851, 1999 WL 1140859, at *1 (Bankr. N.D. Ill. Dec. 13, 1999); *In re Comm. Fin. Servs., Inc.*, 233 B.R. 885 (Bankr. N.D. Ok. 1999); *Campo Elecs., Inc. v. Ross (In re Campo Elecs., Inc.)*, 247 B.R. 646 (D. La. 1998); *In re Crystal Apparel, Inc.*, 220 B.R. at 816; *In re Bryant Universal Roofing, Inc.* 218 B.R. 948 (Bankr. D. Ariz. 1998); *In re Spectrum Info. Techs., Inc.*, 193 B.R. 400 (Bankr. E.D.N.Y. 1996); *In re Jamesway Corp.*, 199 B.R. 836 (Bankr. S.D.N.Y. 1996); *In re Ralph Lauren Womenswear, Inc.*, 197 B.R. 771 (Bankr. S.D.N.Y. 1996); *In re Wang Labs., Inc.*, 154 B.R. 389 (Bankr. D. Mass. 1993); *Cohen v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group)*, 138 B.R. 687 (Bankr. S.D.N.Y. 1992); *In re Hooker Invs., Inc.*, 145 B.R. 138 (Bankr. S.D.N.Y. 1992); *In re Child World, Inc.*, 147 B.R. 847 (Bankr. S.D.N.Y. 1992); *In re Uly-Pak, Inc.*, 128 B.R. 763 (Bankr. S.D. Ill. 1991); *In re Miami Gen. Hosp., Inc.*, 89 B.R. 980 (Bankr. S.D. Fla. 1988); *In re Rawson Food Servs., Inc.*, 61 B.R. 207 (Bankr. M.D. Fla. 1986).

20. *See, e.g.*, *In re Roth Am., Inc.*, 975 F.2d 949 (3d Cir. 1992); *Teamsters Local No. 310 v. Ingram (In re Tucson Yellow Cab Co., Inc.)*, 789 F.2d 701 (9th Cir. 1986); *Lines v. Sys. Bd. of Adjustment No. 94 Bhd. of Ry., Airline & S.S. Clerks (In re Health Maint. Found.)*, 680 F.2d 619 (9th Cir. 1982); *Straus-Duparquet, Inc. v. Local Union No. 3 Int’l Bhd. of Elec. Workers (In re Straus-Duparquet, Inc.)*, 386 F.2d 649 (2d Cir. 1967); *Arabian*

mandating their payment in certain specified circumstances.²²

B. Termination Clauses in Employment Contracts

Almost every formal employment contract contains some variety of a termination clause which sets forth the rights of both the employer and employee. In most employment contracts, the employer will reserve the right to terminate the agreement at any time "for cause" or without "cause." The distinction between discharge "for cause" and discharge absent "cause" is crucial, as severance pay is often conditioned upon the occurrence of the latter.²³ Thus, what constitutes "cause" under either the employment contract or under common law is the entry point for any analysis of an employee's right to severance pay.

However, before discussing the enforceability of termination clauses in employment contracts, it is perhaps helpful to provide a brief overview of the employment law concepts involved. Employment contracts can be divided into two categories: (1) contracts for an indefinite term and (2) contracts for a definite term.²⁴ The law regarding termination is well-settled. Whereas an employment contract for an indefinite term is a contract at-will and may be terminated by either party at any time, "a contract for a definite term may not be terminated before the end of the

v. Coleman (*In re Ad Serv. Engraving Co.*), 338 F.2d 41 (6th Cir. 1964); *In re Pub. Ledger*, 161 F.2d 762 (3d Cir. 1947); *Teamsters Indus. Sec. Fund v. World Sales, Inc.* (*In re World Sales, Inc.*), 183 B.R. 872 (B.A.P. 9th Cir. 1995); *In re St. Louis Globe-Democrat*, 86 B.R. 606 (Bankr. E.D. Mo. 1988); *In re Chicago Lutheran Hosp. Ass'n*, 75 B.R. 854 (Bankr. N.D. Ill. 1987); *In re United Dep't Stores, Inc.*, 49 B.R. 462 (Bankr. S.D.N.Y. 1985); *In re Cott Corp.*, 47 B.R. 487 (Bankr. D. Conn. 1984); *In re B. Kessler, Inc.*, 23 B.R. 722 (Bankr. S.D.N.Y. 1982); *In re Schatz Fed. Bearings Co.*, 5 B.R. 549 (Bankr. S.D.N.Y. 1980).

21. See, e.g., *Northwest Eng'g Co. v. United Steelworkers of America* (*In re Northwest Eng'g Co.*), 863 F.2d 1313 (7th Cir. 1988); *Cramer v. Mammoth Mart, Inc.* (*In re Mammoth Mart, Inc.*), 536 F.2d 950 (1st Cir. 1976); *Roeder v. United Steelworkers of Am.* (*In re Old Electralloy Corp.*), 167 B.R. 786 (Bankr. W.D. Pa. 1994); *Official Comm. of Unsecured Creditors Metalsource Corp. v. U.S. Metalsource Corp.* (*In re U.S. Metalsource Corp.*), 163 B.R. 260 (Bankr. W.D. Pa. 1993); *In re Landmark Land Co. of Okla., Inc.*, 136 B.R. 410 (D.S.C. 1992); *Jeannette Corp. v. Gilardi* (*In re Jeannette Corp.*), 118 B.R. 327 (Bankr. W.D. Pa. 1990).

22. *In re Lykes Bros. S.S. Co.*, 213 B.R. 401 (Bankr. M.D. Fla. 1997); *In re Malden Mills, Inc.*, 45 B.R. 408 (Bankr. D. Mass. 1984). A separate, yet related, issue is the treatment of withdrawal liability under an employment contribution plan. See text accompanying note 146 *infra*.

23. Some employment contracts also stipulate that the employer is required to give the employee a requisite amount of notice if the employee's position is terminated. In some cases, the employee's entitlement to severance pay is contingent upon the employer not giving the amount of notice provided for in the employment contract. See, e.g., Part III.B.1. In other cases, the availability of severance pay is not conditioned either upon whether notice is given timely or whether notice is given at all. See *id.*

24. *Little v. Fed. Container Corp.*, 452 S.W.2d 875, 877-78 (Tenn. Ct. App. 1969).

term, *except for cause* or by mutual agreement, unless the right to do so is reserved in the contract.”²⁵ Within this statement of the law, two separate situations are addressed. The “except for cause” language is applicable in situations where the employer’s reason for terminating the employee is justified as “for cause” pursuant to the interpretation of the term as it has developed via common law. Conversely, the qualification, “unless the right to do so is reserved in the contract,” addresses situations where the contract contains a termination clause specifying acts or omissions that constitute “cause” as per the language of the employment contract itself. The two situations, however, are not mutually exclusive because “[t]he fact that the contract of employment authorizes the employer to terminate [the employee] for certain specified causes does not necessarily prevent the employer from discharging the employee for a cause not so specified.”²⁶ Accordingly, where a court is called upon to determine the propriety of an employer’s decision to discharge an employee with whom the employer has entered into a valid employment contract, the court must look not only to the employment agreement itself, but also to common law.

1. “Cause” as Defined by the Employment Contract

A majority of employment contracts contain a list of enumerated circumstances that constitute “cause” for terminating an employee. These so-called “bad boy” clauses—or where they govern the employee’s post-termination activities, “golden handcuffs”—vary from the extremely specific to the overly broad often within each individual contract. These lists allow an employer to terminate the employee without notice and, oftentimes, without any severance pay. Typically, grounds for termination include work-related bases such as failure to meet agreed upon performance goals, failure to abide by established company policies, or failure to comply with established company procedures. Furthermore, many employment contracts contain provisions governing the employee’s activities outside the office and provide that the employee’s conviction for any felony, any crime involving fraud or dishonesty, or any act abhorrent to the community-at-large constitutes “cause” for discharge. Some agreements do not even require a conviction and, instead, dictate that a reasonable suspicion that the employee has committed such acts is grounds for termination. It is also commonplace for the employment contract to contain a “blanket” provision providing the company with the discretion to terminate the employee

25. *Id.* (emphasis added). If the employment is for a definite duration then it is implied by law that, even if not explicitly stated, the employee can only be discharged for good or just cause. *Toussaint v. Blue Cross & Blue Shield of Mich.*, 292 N.W.2d 880, 891 (Mich. 1980) (footnote omitted).

26. 56 C.J.S., *Master & Servant*, § 42(a) (1985).

because of any other act or omission by the employee that the company deems to be “for cause.”

These so-called “blanket” provisions are the most problematic in practice because of the ambiguity, breadth and, thus, discretion afforded to the company in its determination of what constitutes “cause” for termination under the employment agreement.²⁷ For example, one way in which these discretionary provisions could be employed is to justify termination of personnel due to fiscal constraints placed upon the company. It is certainly true that most well-drafted employment contracts will make clear that the enumerated grounds for “termination for cause” are illustrative rather than exclusive, but only in rare cases should a “blanket” clause allow an employer to terminate an employee “for cause” because of the economic condition of the company.²⁸ When called upon to resolve issues concerning the interpretation of a contract, courts should attempt “to ascertain the intention of the parties based upon the usual, natural, and ordinary meaning of the contractual language.”²⁹ An examination of most employment contracts will demonstrate that termination clauses act as a sanction against *actions of the employee*. It is, therefore, unlikely that a discretionary provision within a termination clause is intended to operate as a blanket authorization to render an employee’s termination as one “for cause” in a situation where the reasons for the discharge have nothing to do with the actions of the employee, but rather, are the result of the economic considerations of the employer.³⁰

27. See *Toussaint*, 292 N.W.2d at 895 (stating that “[a] promise to terminate employment for cause only would be illusory if the employer were permitted to be the sole judge and final arbiter of the propriety of the discharge”); accord *Sanders v. Parker Drilling Co.*, 911 F.2d 191, 194 (9th Cir. 1990); *Rutledge v. Alyeska Pipeline Serv. Co.*, 727 P.2d 1050, 1056 (Alaska 1986).

28. The anomalous case where the language of the employment agreement may support a conclusion that economic reasons constitute “cause” for termination would be if the employment agreement either specifically provided that such circumstances constitute “cause” or if the contract contained language in the termination clause allowing termination because of actions of the employer as opposed to the employee. It should be noted, however, that such an inclusion in an employment contract would be highly irregular.

29. *Guiliano v. Cleo, Inc.*, 995 S.W.2d 88, 95 (Tenn. 1999). See also *Bob Pearsall Motors, Inc. v. Regal Chrysler-Plymouth, Inc.*, 521 S.W.2d 578, 580 (Tenn. 1975).

30. A tangential issue, but one which has a similar solution, is where the employment contract contains a salary modification clause, pursuant to which the employer has the discretion either to raise or reduce an employee’s base salary because the employer deems such an adjustment to be in the best interests of the company in light of the company’s overall financial condition. If such a clause is invoked merely to reduce an employee’s salary, then the action will likely be upheld if challenged. If, however, the clause is invoked to reduce an employee’s salary to such a point where the employee is constructively discharged, then it is likely that a court would find that the employer’s implementation of the clause is a violation of the contract. This conclusion is reinforced by the cannon of contractual interpretation that “[a]ll provisions in the contract should be construed in harmony with each other, if possible, to promote consistency and to avoid repugnancy

2. “Cause” as Defined Under Common Law

Because most employment contracts do not limit “cause” to the specific acts or omissions enumerated within the agreement, courts should look to judicial decisions to determine whether the employee’s termination was “for cause” under common law.³¹ The acts and omissions that constitute “just cause” for termination under common law often mirror those contained in employment contracts; therefore, the problematic aspect of the common law definition of “just cause” arises in situations where employees are discharged pursuant to the power afforded employers via discretionary “blanket provisions.” In situations where the employment contract specifically provides that severance packages are contingent upon discharge “without cause,” there can be little doubt that any denial of benefits to the employee is based upon the validity of that contract. Likewise, in situations where the employee is terminated because of reasons not specifically enumerated in the employment agreement, the ability of an employer to deny severance benefits to the employee is also based upon the validity of the contract. Thus, the difficulty in judicial application of the common law decisions addressing the propriety of a discharge is that those decisions are not premised upon the enforcement of the employment contract, but rather upon the employer’s breach of the contract, which, in turn, has given rise to a wrongful discharge action by the employee.

This contradistinction can be illustrated by a truncated survey of the judicial decisions addressing the issue of whether the adverse economic circumstances can constitute “just cause” for termination where the employment contract at issue did not specify that “economic reasons” were cause for termination. For example, in *Boynton v. TRW, Inc.*,³² the Sixth Circuit held that a “plaintiff’s discharge for economic reasons, as determined by and within the complete discretion of the board of directors of the . . . corporation, constitutes *termination for sufficient cause*.”³³ The court reasoned that “[t]he [employment] agreement empowered the board of directors to terminate the plaintiff’s employment for sufficient cause. The determination as to what constituted sufficient cause was left to the

between the various provisions of a single contract.” *Guiliano*, 995 S.W.2d at 95. Where a salary modification clause is viewed in conjunction with a termination clause within the same contract, it is clear that to allow the employee’s salary to be reduced to such a point where it results in constructive termination would enable the employer to undermine the security afforded the employee under the termination clause of the employment agreement and vitiate the operation of the termination clause in its entirety.

31. See *supra* note 26 and accompanying text.

32. 858 F.2d 1178 (6th Cir. 1988).

33. *Id.* at 1184 (emphasis added).

board's discretion."³⁴ The court further reasoned that "[t]o hold otherwise would impose an unworkable economic burden upon employers to stay in business to the point of bankruptcy in order to satisfy employment contracts and related agreements terminable only for good and sufficient cause."³⁵

The cases addressing the issue of whether economic reasons constitute "cause" for termination of an employment relationship have arisen in the context of plaintiffs' assertions that they have been wrongfully discharged by their employers in breach of their respective employment contracts. Thus, the application of those decisions to cases where employees are attempting to enforce their employment contracts in order to obtain the severance benefits provided within them proves to be problematic. The crux of this difficulty is that courts are in disagreement as to the nature of severance. Some courts and commentators have concluded that "[s]everance pay . . . serves as a liquidated damages clause, compensating an employee for the breach of an agreement As a liquidated damages clause, severance pay substitutes for post-breach calculations of loss in individual cases."³⁶ Other courts have concluded, however, that "severance

34. *Id.*

35. *Id.* The Sixth Circuit cited several cases as supporting its conclusion that economic reasons constitute "just cause" for termination of an employment relationship. *See id.* at 1183-84. Arguably, however, only one of those cases actually supports the proposition for which it is cited by the court. *Compare* Friske v. Jasinski Builders, 402 N.W.2d 42, 46 (Mich. Ct. App. 1986) (holding that "[c]ase law indicates that termination of the employment of an otherwise competent employee due to an economically motivated business closing is not grounds for a wrongful discharge claim") with *F.S. Royster Guano Co. v. Hall*, 68 F.2d 533, 535 (4th Cir. 1934) (concluding that a contract for lifetime employment is contingent upon the business remaining viable) and *Sahadi v. Reynolds Chem.*, 636 F.2d 1116, 1118 (6th Cir. 1980) (opining that, where a former employee was asserting an age discrimination claim against a business, a showing by the employer that the employee was actually discharged for economic reasons was sufficient to refute the age discrimination claim).

In addition, the conclusion that *any termination that is not a consequence of the an act or omission on the employee* is for "just cause" is difficult to reconcile with the majority of judicial decisions addressing the issue. *See e.g.*, 53 AM. JUR. 2D *Master & Servant* § 49 (1970) (noting that "in order to justify dismissal of one employed for a specific period, [an employer] must be able to show a breach *on the part of the employee*") (emphasis added); 56 C.J.S. *Master & Servant* § 42(a) (1985) ("As a general proposition, *any act of the servant* which injures or has a tendency to injure his master's business, interests, or reputation will justify the dismissal of the servant.") (emphasis added). Indeed, if an employer could discharge an employee for almost any reason pursuant to the power and discretion granted to it under a blanket termination clause, then the operation of all clauses allowing for severance payments would be entirely vitiated, as any discharge could be deemed "for cause" under common law.

36. *Int'l Bhd. of Elec. Workers v. The Okonite Co.*, 189 F.3d 339, 346-47 (3d Cir. 1999) (Rosen, J., dissenting); *Howell v. FDIC*, 986 F.2d 569, 573 (1st Cir. 1993); *Westport Bank & Trust Corp. v. Geraghty*, 865 F. Supp. 83, 86 (D. Conn. 1994); *Wanhope v. Press Co.*, 10 N.Y.S.2d 797, 799 (N.Y. 1939); Ralph Weber, *Severance Pay, Sales of Assets, and*

pay is a form of compensation paid by an employer to an employee at a time when the employment relationship is terminated.”³⁷

The distinction between the two characterizations is of great importance because of its effects upon the priority afforded to these payments under §§ 502 and 507 of the Code.³⁸ However, in the context of employment law, the distinction may be inconsequential. On one hand, if the severance payments are classified as liquidated damages, then the judicial decisions addressing “cause” in the context of wrongful discharge claims are relevant and, perhaps, controlling in a case where an employer asserts that its discharge of an employee for economic reasons was a discharge “for cause.” Notwithstanding, it appears that employees would still be entitled to severance pay, but it would be paid to the employee under the guise of liquidated damages for the wrongful discharge.³⁹

If, on the other hand, the severance payments are classified as part of the employee’s compensation package, then those cases addressing “cause” in the context of a wrongful discharge action would be inapplicable to an action to recover severance payments in a situation where the employee is discharged for economic reasons. As stated by the Third Circuit in *In re Public Ledger*:

The cases [cited] . . . do not involve severance pay contractual provisions but rather damages for alleged breaches of contracts of employment. The claims in those cases were based on the theory that a collective bargaining agreement amounted to a promise by the employer to furnish each member of the contracting union employment for the term of the contract In the instant case the claims are not for damages for breaching the contract . . . , but rather for severance pay, which accrued under the contract when they [the union members] lost their jobs through the business management’s act of shutting the business down.⁴⁰

This distinction, therefore, could lead a court to conclude that—although economic reasons may indeed be “good cause” for termination in the context of a wrongful discharge claim—an economic justification for discharge does not relieve an employer of its contractual duty to pay severance benefits to its employees.⁴¹

the Resolution of Omitted Cases, 82 COLUM. L. REV. 593, 597 (1982).

37. *Guiliano v. Cleo, Inc.*, 995 S.W. 2d 88, 97 (Tenn. 1999); *accord* Office & Prof’l Employees Int’l Union v. FDIC, 27 F.3d 598, 604 (D.C. Cir. 1994);

38. *See id.* 11 U.S.C. §§ 502, 507 (1994); *see also infra* Part III.A.4. (discussing the priority afforded severance packages in bankruptcy).

39. It is important to note that an employee’s entitlement to the severance package is often conditioned upon the employee releasing the employer from any further claims relating to the employment relationship.

40. 161 F.2d 762, 772-73 (3d Cir. 1947) (citations omitted).

41. A danger is always present in such a characterization, however, as a court could

At this point, this article will assume that the employee is entitled to the severance benefits provided for in the employment contract and, thus, will shift focus to the treatment the severance packages will receive under the Bankruptcy Code.

III. SEVERANCE PAY UNDER THE BANKRUPTCY CODE

An employment contract is a contract and, thus, by definition, “bestows on those party to it certain rights in exchange for which they taken on certain obligations.”⁴² These rights and obligations are reciprocal in nature, in that the rights of one party to the contract are the obligations of the other and vice-versa. Both the rights and obligations incident to its contracts follow a Chapter 11 debtor into its bankruptcy pursuant to § 541(a) of the Code, which creates an estate consisting of “all legal and equitable interests of the debtor in property,” regardless of location or possession.⁴³ The legislative history underlying § 541(a) indicates the broad scope of the provision,⁴⁴ and the Supreme Court has effectuated Congressional intent by interpreting § 541(a) as encompassing “all kinds of property,” including not only tangible, but also intangible property.⁴⁵ Because contractual rights are a form of intangible property, those rights are included in the debtor’s bankruptcy estate.⁴⁶

construe the employee’s entitlement to severance payments as compensation for discharge “absent cause.” The court could then look to the case law stating that economic reasons constitute “cause” for termination and conclude that the employee is not entitled to severance benefits.

Such a ruling, however, would vest employers with the discretionary power to vitiate any severance payments to which an employee may be entitled by merely giving an economic justification for the employee’s dismissal. This conclusion would undermine the reasons for severance packages in general. See *supra* notes 7 and 16 and accompanying text (setting forth the reasons businesses offer severance packages to employees). Furthermore, the policy underlying the Sixth Circuit’s rationale for allowing economic reasons to constitute “just cause” for termination, see *supra* note 35 and accompanying text, would not be effectuated by denying severance benefits where the employee was discharged for economic reasons post-petition.

42. *Cohen v. Drexel Burnham Lambert Group, Inc.* (*In re Drexel Burnham Lambert Group, Inc.*), 138 B.R. 687, 700 (Bankr. S.D.N.Y. 1992); see, e.g., 17A AM. JUR. 2D, *Contracts*, § 18 (1991); 17 C.J.S. *Contracts*, § 1(2) (1963).

43. 11 U.S.C. § 541(a)(1) (1994). Section 541(b) and 541(c)(2) of the Code contain exceptions to this general rule, pursuant to which certain property is specifically excluded from the bankruptcy estate. See *id.* at § 541(b), (c)(2).

44. See H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 367, 367 (1977).

45. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204, 205 (1983).

46. *In re Chateauguay Corp.*, 116 B.R. 887, 898 (Bankr. S.D.N.Y. 1990). This conclusion was expressly reiterated by the Court of Appeals for the Ninth Circuit in *In re Computer Communications, Inc.* See 824 F.2d 725 (9th Cir. 1987). In *In re Computer Communications*, the creditor unilaterally terminated a contract with the debtor pursuant to a bankruptcy default clause and argued that because executory contracts are not property of

A. *Executory Contracts—A General Overview*

From the debtor's perspective, the upshot of a contract being classified as property of its estate under § 541(a) is that the trustee⁴⁷ has the power to assume or reject that contract *if it is executory in nature*.⁴⁸ The provisions of § 365 of the Code govern the assumption or rejection of an executory contract.⁴⁹ Specifically, § 365(a) permits assumption or rejection of executory contracts and unexpired leases,⁵⁰ and § 365(b) conditions the ability to assume or reject upon adequate assurance that the debtor-in-possession will promptly cure any default in the contract or lease,⁵¹ compensate the non-debtor party for any pecuniary loss resulting from the default,⁵² and continue to perform pursuant to the terms of the contract in the future.⁵³

1. The Debtor-in-Possession's Ability to Reject Executory Contracts

The purpose of the doctrine of rejection is "to enable bankruptcy estate fiduciaries to free the estates under their control from the onerous obligations of executory contracts and leases."⁵⁴ As the Sixth Circuit has noted:

The legislative purpose underlying § 70b [the predecessor to §

the estate, the automatic stay did not bar its termination of the contract. *Id.* at 726. The Ninth Circuit rejected this argument and held that the bankruptcy estate included the contract "despite non-assignability or the existence of a bankruptcy default clause." *Id.* at 730.

47. In the context of a Chapter 11 case, the debtor-in-possession possesses the same powers as the trustee. See 11 U.S.C. §§ 330 and 1106(a) (1994). Accordingly, this article will employ these two terms interchangeably.

48. See *In re Taylor*, 103 B.R. 511, 515 (D.N.J. 1989).

49. See 11 U.S.C. § 365.

50. Section 365(a) of the Code states in full that "[e]xcept as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." *Id.* at § 365(a).

51. *Id.* at § 365(b)(1).

52. *Id.* at § 365(b)(2).

53. *Id.* at § 365(b)(3).

54. *CASC Corp. v. Milner (In re Locke)*, 180 B.R. 245, 260 (Bankr. C.D. Cal. 1995); *accord Leasing Serv. Corp. v. First Tenn. Bank, N.A.*, 826 F.2d 434, 436 (6th Cir. 1987) ("The statutory purpose of § 365 of the Bankruptcy Code is to enable the trustee to assume those executory contracts which are beneficial to the estate while rejecting those which are onerous or burdensome to perform."); *In re Spectrum Info. Techs., Inc.*, 190 B.R. 741, 746 (Bankr. E.D.N.Y. 1996) (stating that one significance of a debtor-in-possession's ability to reject an assumed executory contract is that "it . . . relieves the estate of onerous and burdensome future obligations").

365] was to solve the problem of assumption of liabilities, i.e., excusing or requiring future specific performance by the bankrupt [W]hat § 70b actually proposed to do was to secure this continued mutuality [of obligation and performance] *wherever it was felt to be of greater benefit to the estate to proceed in accordance with the bankruptcy debtor's plans rather than to freeze his commercial relations as of the filing date.*⁵⁵

a. Rejection of General Employment Contracts

Most courts apply the “business judgment test”⁵⁶ to determine whether a debtor-in-possession is permitted to reject an executory contract.⁵⁷ Pursuant to this test, “[a] court will approve the rejection of an executory contract . . . if rejection would benefit the debtor’s estate.”⁵⁸ Admittedly, the business judgment rule affords corporate directors broad discretion in determining whether to assume or reject executory contracts,⁵⁹ and bankruptcy courts will routinely defer to the decision of the debtor-in-possession after a perfunctory review of the facts.⁶⁰ Thus, motions to reject are seldom denied.⁶¹

b. Rejection of Collective Bargaining Agreements

In contrast to general executory contracts, which are governed by § 365 of the Code, the treatment of collective bargaining agreements upon

55. *Leasing Serv. Corp.*, 826 F.2d at 436-37 (quoting 2 Collier On Bankruptcy ¶ 365.01[2] (15th ed. 1987)) (alterations in original) (emphasis added) (internal quotation marks omitted).

56. Under the “business judgment test,” courts are hesitant to interfere with corporate governance and generally defer to the decisions of the corporate directors. *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Lubrizol Enters.)*, 756 F.2d 1043, 1046 (4th Cir. 1985). Transposed to the context of a Chapter 11 bankruptcy case, the decision to reject an executory contract will be accepted by courts unless the creditor can demonstrate that the debtor-in-possession’s decision was made “in bad faith or in gross abuse of its business discretion.” *Id.* It is important to note that the debtor-in-possession will carry the ultimate burden of proof with respect to the issue of whether rejection would benefit the bankruptcy estate. *In re Sun City Invests., Inc.*, 89 B.R. 245, 248 (Bankr. M.D. Fla. 1988).

57. See, e.g., *In re Lubrizol Enters.* 756 F.2d at 1046; *Bourman’s Inc. v. Allied Supermarkets, Inc.*, 706 F.2d 778, 782 (9th Cir. 1979); *In re Pesce Baking Co.*, 43 B.R. 949, 956 (Bankr. N.D. Ohio 1984); *In re Hurricane Elkhorn Coal Corp.*, 15 B.R. 990, 995 (Bankr. W.D. Ky. 1981); *In re Marina Enters.*, 14 B.R. 327, 330 (Bankr. S.D. Fla. 1981).

58. *In re Pesce Baking Co.*, 43 B.R. at 956.

59. See generally *Lewis v. Anderson*, 615 F.2d 778, 782 (9th Cir. 1979); *Polin v. Conductron Corp.*, 552 F.2d 797, 809 (8th Cir. 1977).

60. *In re Sun City Invests.* 89 B.R. at 248.

61. *But see In re Ron Matusalem*, 158 B.R. 514 (Bankr. S.D. Fla. 1993) (denying a motion to reject an executory contract where the court felt that the bankruptcy petition was filed in bad faith).

the filing of a Chapter 11 petition is governed by § 1113 of the Code.⁶² Section 1113 permits a debtor-in-possession to assume or reject a collective bargaining agreement, but only if the debtor-in-possession acts in accordance with the requirements of the provision.⁶³ Whereas subsections (b) and (d) provide the procedural requirements,⁶⁴ subsection (c) sets forth the burden of proof the debtor-in-possession must carry in order for a court to permit rejection of this specific type of employment contract.⁶⁵ It is important to note, however, that the burden of proof placed upon the debtor-in-possession is much more stringent than the business-judgment test which applies to general employment contracts.⁶⁶ Not only does the debtor-in-possession have the burden of proving that the collective bargaining agreement burdens the estate,⁶⁷ but the debtor-in-possession

62. See 11 U.S.C. § 1113 (1994). The National Labor Relations Act (NLRA), which guarantees, *inter alia*, the rights of union employees to organize, bargain collectively and to strike, is codified at title 29 of the United States Code. See 29 U.S.C. §§ 151-169 (1994). Specifically, 29 U.S.C. § 158(d) contains requirements with which an employer must comply where it either modifies or terminates such an agreement.

63. 11 U.S.C. § 1113(a).

64. Subsection (b) contains extrajudicial requirements such as providing an authorized representative of the union with the proposed modifications to the collective bargaining agreement, with assurances that all affected parties are being treated fairly and equitably, and with any information needed to evaluate the information contained in the proposal. 11 U.S.C. § 1113(b)(1). Furthermore, the debtor-in-possession is required to meet regularly with the authorized representative to effectuate the modification of the agreements. *Id.* at § 1113 (b)(2).

Subsection (b) provides for the extrajudicial procedure. In contrast, subsection (d) sets forth the procedural guidelines. See *id.* at § 1113(d). Subject to permissive extensions, the bankruptcy court is required not only to conduct a hearing within fourteen days after the date upon which the debtor-in-possession filed its motion to reject, but also to rule on the motion within thirty days after the date upon which the hearing is commenced. *Id.*

65. See *id.* at § 1113(c).

66. The United States Supreme Court recognized and applied this more stringent standard in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984), reasoning that such agreements create a “law of the shop” and, thus, promote peaceful labor practices. *Id.* at 520. For the Supreme Court’s discussion of the requirements, see *id.* at 521-22.

67. In converse phraseology, the trustee or debtor-in-possession must demonstrate that rejection of the collective bargaining agreement would benefit the estate. Obviously, to varying degrees, all executory contracts will burden the estate. The trustee or debtor-in-possession, therefore, must come forth with evidence demonstrating more than merely a burden. *Id.* However, courts generally do not require proof that the reorganization will fail absent rejection. *Id.* A sufficient burden to warrant rejection of collective bargaining agreements has been evidenced where the debtor-in-possession has established that the agreements imposed restrictive work environments, thus increasing costs and reducing both efficiency and competitiveness. See, e.g., *In re Briggs Transp. Co.*, 39 B.R. 343, 351 (Bankr. D. Minn. 1984) (concluding that collective bargaining agreement was burdensome where the debtor’s wage costs were 10-14% greater than the industry standard). Similarly, in *In re Rath Packing Co.*, the United States Bankruptcy Court for the Northern District of Iowa concluded that rejection of a collective bargaining agreement was beneficial to the debtor’s estate because such rejection would significantly reduce the debtor’s health care

must also demonstrate that it has complied with the extrajudicial formalities of subsection (b),⁶⁸ that the authorized representative has refused to accept the proffered proposal “without good cause,”⁶⁹ and that “the balance of the equities clearly favors rejection of the agreement.”⁷⁰

Before the debtor-in-possession can make a motion either to assume or reject pursuant to § 365(a) of the Code, however, the debtor-in-possession must first demonstrate that the contract is indeed executory in nature. Curiously, neither the Code nor the legislative history of § 365 contains a definition of “executory contract.” The legislative history, however, does contain a statement that an “executory contract” *generally includes* contracts on which performance remains due to some extent on both sides.⁷¹ As a result of the congressional silence on the issue, two approaches have developed as to what constitutes an executory contract.

2. The Countryman Approach

The first, and perhaps most well-established, approach to determining whether a contract is executory in nature is the definition espoused by Professor Vern Countryman in his two landmark articles published in the *University of Minnesota Law Review* in the early 1970s.⁷² Under the Countryman Approach, an executory contract is “a contract under which the obligations of both the bankrupt and the other party to the contract are so unperformed that the failure of either to complete performance would

costs. 36 B.R. 979, 991 (Bankr. N.D. Iowa 1984). It is also interesting to note that the court, in balancing the equities involved pursuant to § 1113(c)(3), opined that rejection benefited the employees as well because they were now free to obtain better health benefits than the debtor could otherwise provide. *Id.*

68. *Id.* text accompanying note 64 (describing the extrajudicial formalities).

69. 11 U.S.C. § 1113(c)(2).

70. *Id.* at § 1113(c)(3). In balancing the respective equities, courts have looked to the good or bad faith of the parties, *see In re C & W Mining Co.*, 38 B.R. 496, 502-03 (Bankr. N.D. Ohio 1984), the cost-spreading abilities of the parties, *see In re Brada Miller Freight Sys., Inc.*, 702 F.2d 890, 897-98 (11th Cir. 1983), and the possibility of liquidation in the event that the motion to reject is denied, *see NLRB v. Bildisco & Bildisco*, 465 U.S. at 522; *In re Brada Miller Freight Sys., Inc.*, 702 F.2d at 897-98; *In re C & W Mining Co.*, 38 B.R. at 502-03.

71. H.R. REP. NO. 95-598, at 347 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6303 (emphasis added).

72. *See* Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439 (1973) [hereinafter *Part I*]; Vern Countryman, *Executory Contracts in Bankruptcy: Part II*, 58 MINN. L. REV. 479 (1974) [hereinafter *Part II*]. The definition espoused by Professor Countryman has been termed the “Countryman Approach” by courts and scholars and has been referred to as “a godsend to judges perplexed by the strange results they found in bankruptcy contract cases.” Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 237 (1989).

constitute a material breach excusing the performance of the other.”⁷³

In the context of employment agreements, the Countryman Approach would lead to the result that the contract is executory in nature for one of several reasons. The first, and perhaps most apparent reason is that if the contract has not expired pursuant to its own terms as of the petition date, then there is performance due on the part of both the employer and the employee. Simply stated, the employer must continue to employ the employee for the time period specified in the agreement, and the employee must continue to perform his or her duties under the contract. The failure of either party to do so would constitute a material breach of the contract.⁷⁴ In a situation where the contract has expired according to its own terms, a court may nonetheless find that the contract is executory based upon the presence of a release clause within the contract, pursuant to which the employee is required to release the employer from liability on claims relating to the employment relationship upon receipt of the first installment of the severance payments.⁷⁵ Therefore, if the employee has yet to release

73. Countryman, Part I, *supra* note 73, at 460. Under both the Countryman Approach and the “Functional Approach,” *see* discussion *supra* Part I.A.2, “[t]he critical date for determining the executory nature of a contract is the date on which the bankruptcy court considers the debtor’s application to assume or reject the contract,” as opposed to the petition date. *Camp v. Nat’l Union Fire Ins. Co. (In re Gov’t Sec. Corp.)*, 101 B.R. 343, 349 (Bankr. S.D. Fla. 1989); (citing *In re Pesce Baking Co.*, 43 B.R. 949, 957 (Bankr. N.D. Ohio 1984)) (emphasis added); *accord Gloria Mfg. Corp. v. Int’l Ladies’ Garment Workers’ Union*, 734 F.2d 1020, 1022 (4th Cir. 1984). *Cf. In re Child World, Inc.*, 147 B.R. 847, 851 (Bankr. S.D.N.Y. 1992) (noting the validity of the *Gloria Mfg.* line of cases, but opining that under the functional approach, “consideration must be given first to the obligations of the parties at the time when the bankruptcy petition was filed rather than when the motion to assume or reject was made.”).

Thus, it is possible that a contract may be executory as of the petition date, but due to circumstances that occur before the hearing date, the contract may no longer be executory in nature as of the hearing date. An example of such a situation is where “the contract expired by its own terms before the bankruptcy court considers the application to assume or reject the contract.” *In re Gov’t Sec. Corp.*, 101 B.R. at 349 (citing *In re Pesce Baking Co.*, 43 B.R. at 957).

74. It can be surmised that many courts neglect to address the issue of whether the employment contract is executory in nature because the conclusion is overtly clear based upon this characteristic.

75. Indeed, many standard-form employment contracts condition the employee’s receipt of the severance payments upon the employee releasing the employer from any claims based upon the scope of the employee’s employment. The language of such a clause may read, “Upon acceptance of the first installment of the Termination Fee, the Employee releases and discharges the Company and its officers, directors, owners and agents of and from any and all manner of liability relating to the Employee’s employment with the Company.”

These release provisions are often unduly broad and will often encompass the release of all employee rights to claims against the employer. Obviously, a release of any rights which are already vested in favor of the employee, i.e., rights to benefits under ERISA-qualified plans, would be unenforceable. Moreover, some employment agreements will

the employer from liability, there is still material performance due on the part of the employer and employee, in that the employer must pay the first installment of the severance package due to the employee, who, upon receipt and retention of the payment, impliedly releases the employer from liability. From a practitioner's perspective, the continued mutuality of obligation is important because it is necessary to overcome the general proposition that "where the only performance obligation remaining under the employment contracts is the payment of money, the contract will not be found executory."⁷⁶

3. The Functional Approach

A second, albeit minority, approach employed by courts in determining whether a contract is executory in nature is the "functional approach," which looks not to the "mutuality of commitments" under the contract, but rather to "the nature of the parties and the goals of reorganization."⁷⁷ In analyzing contracts under the functional approach, courts consider "the purpose behind allowing the debtor or trustee to assume or reject a contract."⁷⁸ Consequently, the functional approach requires courts to look first to the goals of § 365: "(1) taking advantage of

contain a provision under which the employer will release all claims against the employee, including claims for theft that may not be discovered until after the employee has been discharged and the employment contract has been performed in full.

76. *In re Bryant Universal Roofing, Inc.*, 218 B.R. 948, 953 (Bankr. D. Ariz. 1998).

77. *In re Gov't Sec. Corp.*, 101 B.R. 343, 347 (Bankr. S.D. Fla. 1989). The "functional approach" was proposed by Professor Westbrook in *A Functional Analysis of Executory Contracts*. See generally Westbrook, *supra* note 73, at 227. Westbrook's proposed approach sought to remedy three common situations where the application of the Countryman approach produces erroneous conclusions:

The first consists of cases concerned with whether particular contracts are "executory" as a preliminary to determining whether rejection will be permitted. The second consists of cases holding that when a contract is "executory" and is rejected, the contract is somehow destroyed or otherwise altered. The third category, an aggravated derivative of the second, is comprised of cases holding that rejection of a contract somehow destroys a right in or to property created by the contract, even if that right is otherwise good as against all competing claimants and as against the estate itself.

Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. COLO. L. REV. 845, 884 (1988). Notwithstanding the differences between the Countryman and Functional approaches, this article will not focus upon the merits of the two distinct approaches because the outcome is the same with respect to the treatment of employment contracts regardless of the approach adopted by the jurisdiction. See *supra* notes 57 and 58 and accompanying text; *infra* notes 83-88 and accompanying text (discussing the conclusion that most employment contracts would be considered executory in nature under not only the Countryman approach, but also under the Functional approach).

78. *In re Gov't Sec. Corp.*, 101 B.R. at 348.

contracts which will benefit the estate;⁷⁹ (2) relieving the estate of burdensome contracts; (3) promoting the debtor's fresh start; (4) permitting the allowance and determination of claims; and (5) preventing parties from remaining in doubt concerning their status *vis-a-vis* the estate."⁸⁰ Next, the court must determine whether those purposes have already been accomplished in the bankruptcy case via another substantive or procedural mechanism or whether they can be accomplished solely by the rejection of the executory contract.⁸¹ If the court finds either that those purposes have already been accomplished or that rejection would not effectuate those purposes, then the functional approach dictates that the contract is not executory within the meaning of § 365.⁸²

As the Countryman approach would result in the conclusion that employment contracts are executory in nature, so too would the functional approach. As dictated by the United States Bankruptcy Court in *In re Bluman*, a court applying the functional approach would look first to the purposes of the debtor-in-possession's ability to reject executory contracts.⁸³ Disregarding the first purpose,⁸⁴ rejection of an employment agreement not only relieves the bankruptcy estate of a burdensome contract, but also effectuates the fresh start of the debtor in its emergence from an effective reorganization under Chapter 11 of the Code. A Chapter 11 reorganization requires the debtor-in-possession to reevaluate many aspects of its operation, the most obvious of which is its profitability. In an effort to increase profits, a debtor-in-possession will often be compelled to reduce costs, including labor costs. This compulsion may arise from the demands of the creditors' committee during plan negotiations or from the budgetary operating restraints placed upon it by either post-petition lenders or the bankruptcy court presiding over its case. A debtor-in-possession has

79. The inclusion of a rationale for assumption is perhaps appropriate when considering the purposes of § 365. It is puzzling, however, that the *Bluman* court would advocate the consideration of the policy reasons underlying assumption in a situation where a debtor-in-possession was attempting to reject the contract. Indeed, it is unclear as to how a consideration of the policies supporting assumption would aid a court in determining a debtor-in-possession's ability to reject an executory contract. It is not surprising, therefore, that neither *Bluman*, nor any other court upon which the *Bluman* court relied has been able to articulate a situation where the policies underlying assumption would be beneficial to a court applying the functional approach to a debtor-in-possession's motion to reject. See *In re Bluman* 125 B.R. at 363; see, e.g., *In re Jolly*, 574 F.2d 349, 351 (6th Cir. 1978); *In re Monument Record Corp.*, 61 B.R. 866, 868-69 (Bankr. M.D. Tenn. 1986); *In re Norquist*, 43 B.R. 224, 225-26 (Bankr. D. Wash. 1984).

80. *In re Bluman* 125 B.R. at 363 (citation omitted in original) (internal quotation marks omitted).

81. *Id.* (other citations omitted).

82. *Id.*

83. See *id.*

84. See *supra* text accompanying note 79 (commenting on the puzzling inclusion of the assumption rationale).

an affirmative duty to maximize the value of its bankruptcy estate for the benefit of its creditors,⁸⁵ and the rejection of certain employment contracts can enable the debtor to reorganize effectively.⁸⁶ Furthermore, allowing a debtor-in-possession to reject an employment contract permits the determination and administration of claims against the estate and does so in an efficient manner. As will be discussed in Part III.A.4 *supra*, the rejection of employment contracts will facilitate the filings of proofs of claim against the employer on account of the rejected contracts.⁸⁷ Consequently, the presiding bankruptcy court will be provided an opportunity to administer these claims, and the terminated employees will be apprised of their status as unsecured creditors of their former employer's bankruptcy estate.

Next, a court applying the functional approach would determine whether these goals could be effectuated by another mechanism provided for in the Code and whether rejection would help facilitate these goals in light of the particular facts of the case before it. In the context of employment agreements, no other bankruptcy provision would enable the debtor-in-possession to reduce costs and increase profitability in a manner equivalent to that allowed by § 365. Although there are specific fact patterns that could lead a court to conclude that rejection would not facilitate the purposes underlying rejection, those cases would likely be the exception and not the rule.⁸⁸

85. Admittedly, the maximization of the bankruptcy estate is not as prevalent in a Chapter 11 as would be the case if the debtor was in liquidation. Notwithstanding, the debtor-in-possession does have an obligation to preserve the assets of its bankruptcy estate, *Bennett v. Williams*, 892 F.2d 822, 823 (9th Cir. 1989), which may require the debtor to cut expenses in order to free-up funding for maintenance of, and insurance coverage on, its hard assets. Moreover, the return for the creditors will almost certainly be greater if the debtor-in-possession can reorganize. Thus, allowing the debtor to cut expenses in order to effectuate a plan of reorganization not only furthers the fresh start policy of the Code, but also is consonant with one of the principal reasons for Chapter 11, which is to enhance return to the creditors. See generally *In re BMW Group I, Ltd.*, 168 B.R. 731, 737 (Bankr. W.D. Ok. 1994); *supra* notes 10-12 and accompanying text.

86. An interesting issue that could arise in the context of a debtor-in-possession's motion either to assume or reject an employment contract under § 365 is whether the debtor can reject certain contracts and assume others in a situation where the contracts are interrelated. Although courts have yet to address this argument in the context of employment agreements, it is foreseeable that an employer may desire to reject certain employment contracts and assume others. For an excellent article discussing the issue of the severability of related contracts in the context of motions to assume and reject, see Jerald I. Ancel, et al., *All for One and One for All? The Assumption and Rejection of Multiple Intertwined Executory Contracts and Unexpired Leases*, 18 AM. BANKR. INST. J. 16 (1999).

87. See 11 U.S.C. § 501 (1994).

88. For example, if the Chapter 11 petition was filed by a business with adequate capitalization, then budgetary constraints and maximization of value may not be a controlling concern. However, in a case where the business has filed for protection under Chapter 11 because of financial distress, profitability and maximization of asset value will

4. The Effect of Rejection Upon the Priority of Claims

As discussed *supra*, § 365(a) of the Code provides that a debtor-in-possession may either assume or reject its executory contracts or unexpired leases.⁸⁹ On one hand, if the debtor-in-possession elects to assume the contract or lease, then its pre-petition obligations under the contract or lease become the obligations of the debtor-in-possession. As such, the debtor-in-possession's obligations—or, stated differently, the rights of the creditor—become administrative expenses of the estate.⁹⁰ For a creditor, the upshot of the characterization as an administrative expense is that administrative expenses are granted first priority among unsecured claims.⁹¹ On the other hand, if the debtor-in-possession rejects the contract or lease, “the non-debtor party to the contract has a claim against the debtor for damages for the breach of the contract, which . . . is deemed to have arisen immediately before the filing of the petition and is a pre-petition claim.”⁹²

From the perspective of a creditor, a debtor-in-possession's decision either to assume or reject an executory contract is of the utmost importance because, in accordance with the fundamental policy of equitable distribution to all similarly situated claimants, unsecured creditors share proportionately in distributions.⁹³ The result of this proportional

play a substantial role in the business' decisions within its reorganization.

89. 11 U.S.C. § 365(a) (2000).

90. Section 503 of the Code defines administrative expenses as “the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case.” *Id.* at § 503(b)(1)(A).

91. *Id.* at § 507(a)(1).

92. *In re Hooker Invs., Inc.*, 145 B.R. 138, 144 (Bankr. S.D.N.Y. 1992). The statutory mandate for this treatment is § 365(g), which provides:

(g) Except as provided in subsections (h)(2) and (i)(2) of this section, the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease—

(1) If such contract or lease has not been assumed under this Section or under a plan confirmed under Chapter 9, 11, 12, or 13 of this title, immediately before the date of the filing of the petition

11 U.S.C. § 365(g)(1).

93. *See* 11 U.S.C. § 1123. Section 1123 mandates:

(a) Notwithstanding any otherwise applicable non-bankruptcy law, a plan shall—

(1) designate, subject to section 1122 of this title, classes of claims, other than claims of a kind specified in section 507(a)(1), 507(a)(2), or 507(a)(8) of this title, and classes of interests

. . . .

(4) provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less

distribution between claimants within the same class is that the claimants are almost never paid in full:

[Although the creditor's] claims are calculated in full under state law. . . , their actual relief, the payment of the claims, can be thought of as being in little tiny Bankruptcy Dollars, which may be worth only ten cents in U.S. dollars. In sharp contrast, if the trustee assumes a contract, then it is converted into an estate obligation, a post-petition obligation, and the . . . [non-debtor party] becomes entitled to full performance or payment as an administrative claim. Because administrative claims are paid first in any distribution, they are usually paid in full, 100-cent U.S. dollars.⁹⁴

Because rejection gives rise to a pre-petition claim against the debtor-in-possession, it may not only severely prejudice a claimant's prospect of full recovery under the plan of reorganization, but also trigger the operation of § 502(b)(7) of the Code where it is an employment contract that is rejected.⁹⁵ § 502(b)(7) limits claims for damages resulting from a debtor-in-possession's termination of employment contracts to "the compensation provided by such contract, with acceleration, for one year following the earlier of" the petition date or the "date on which the employer directed the employee to terminate, or such employee terminated performance under such contract plus . . . any unpaid compensation due under such contract, without acceleration, on the earlier of such dates."⁹⁶

Notwithstanding the general principle that a creditor's claims arising from a rejected contract will be considered a pre-petition claim against the debtor-in-possession, a claimant can elevate its claim to that of an administrative expense if the claimant can demonstrate that his or her claim falls within the language of § 503(b)(1)(A) of the Code.⁹⁷ Section 503 requires that an administrative expense must "be for services rendered in 'preserving the estate'" and that the claims must "be the 'actual, necessary costs and expenses' of preserving the estate."⁹⁸ In the past several decades,

favorable treatment of such particular claim or interest

Id.

94. Westbrook, *supra* note 73, at 253.

95. See 11 U.S.C. § 502(b)(7).

96. *Id.*

97. For the full text of the section, see *supra* text accompanying note 91. It is important to note that the Code contains another source for priority of severance pay in § 507(a)(3), which provides for a priority in respect of "allowed secured claims, but only to the extent of \$4,000 for each individual or corporation, as the case may be, earned within 90 days before a the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first." *Id.* at § 507(a)(3). This priority is limited, however, to the amount of \$4,000. It is, therefore, not surprising that the battleground with respect to the priority of severance pay in bankruptcy lies in § 503.

98. *In re Williams*, 165 B.R. 840, 841 (Bankr. M.D. Tenn. 1993) (quoting 11 U.S.C. §

courts have applied three different tests to determine whether an employee's entitlement to severance benefits under a rejected employment contract constitutes an administrative expense of the debtor's bankruptcy estate. The application of these different approaches, however, has resulted in the disparate treatment of severance packages in business bankruptcies. Accordingly, the next section of this article will discuss these different approaches with particular emphasis upon their effect on the priority afforded to severance packages in a Chapter 11 reorganization.

B. The Priority Afforded to Employee Claims for Severance Payments

As discussed *supra*, the nature of severance pay has been classified as either compensation for loss of employment or as liquidated damages in the event that the employment contract is terminated without cause.⁹⁹ Indeed, the priority of severance packages has often turned upon the nature of such payments. If on the one hand, a court characterizes the termination clause as a liquidated damages provision in the contract, then it is likely that the court will classify the employee's entire severance package as a pre-petition right to damages. As such, no portion of the severance payments will be afforded administrative expense priority.¹⁰⁰ On the other hand, the courts that have historically classified severance payments as compensation have divided that compensation into one of two categories based upon whether the payments were (1) intended to compensate for length of service or (2) intended to compensate for lack of notice.¹⁰¹

1. The Lack of Notice/Length of Service Dichotomy

A clear majority of cases decide the priority of an employee's entitlement to an administrative expense priority for severance payments due under a rejected employment contract based upon whether the payments were compensation for the employee's length of service with the business or whether the payments were intended to compensate the employee for termination absent the requisite amount of notice specified in

503(b)(1)(A)).

99. See *supra* notes 38 and 39 and accompanying text.

100. *In re Ad Serv. Engraving Co.*, 338 F.2d 41, 44 (6th Cir. 1964); see also *In re Hooker Invs., Inc.*, 145 B.R. 138, 147 (Bankr. S.D.N.Y. 1992) (concluding that the employee's claim for severance pay could not be afforded administrative expense priority because the termination clause in the employment agreement at issue characterized the payments as "damages").

101. See *In re Health Maint. Found.*, 680 F.2d 619, 621 (9th Cir. 1982); *Cramer v. Mammoth Mart, Inc.*, 536 F.2d 950, 955 (1st Cir. 1976); *In re Pub. Ledger*, 161 F.2d 762, 771-73 (3d Cir. 1947); *In re Yarn Liquidation, Inc.*, 127 B.R. 544, 546 (Bankr. E.D. Tenn. 1997); *In re Miami Gen. Hosp.*, 89 B.R. 980, 984 (Bankr. S.D. Fla. 1988).

the contract. The two leading cases adopting this approach are the Third Circuit's opinion in *In re Public Ledger, Inc.*¹⁰² and the First Circuit's opinion in *Cramer v. Mammoth Mart, Inc.*¹⁰³ *In re Public Ledger* involved the claims of two different groups of employees: members of the Philadelphia Typographical Union (Union) and members of the Newspaper Guild of Philadelphia and Camden, New Jersey (Guild).¹⁰⁴ Both of these parties asserted that their claims for severance pay were entitled to priority after their former employer was declared bankrupt.¹⁰⁵ Whereas the employment agreement entered into with the Union stipulated that "two working days notice shall be given a situation holder before being laid off,"¹⁰⁶ the Guild's employment contract provided that the employee would be entitled to "[t]wo weeks' pay if employed more than a total of six months and less than one year" in the event that the employee was discharged with cause.¹⁰⁷

In analyzing the Union members' claims for priority of their severance pay under the Bankruptcy Act (Act),¹⁰⁸ the court concluded that "the severance pay, *in that it moves to all employees regardless of length of service*, is . . . wages wholly earned and accrued under the trustees' management and, therefore, is entitled to priority as such."¹⁰⁹ In contrast, the court only afforded priority to the part of the severance pay entitled to the Guild members that was "earned under the administration of the trustee."¹¹⁰ The Third Circuit reasoned:

[T]he discharge provision of the Guild contract relates to wages and any sum received by the employee under it is a part of his wage. Upon the conditions of the contract being met, money earned each day of the service matures in time to the status of a

102. 161 F.2d at 762.

103. *Cramer*, 536 F.2d at 950.

104. *In re Pub. Ledger, Inc.*, 161 F.2d at 764.

105. *Id.* at 765, 769.

106. The *Public Ledger* court did not expressly state that the severance pay was conditioned upon termination without notice. It is apparent, however, from the court's opinion that this was indeed the case. *See id.* at 769-71. The Union employment agreement also contained a provision providing two weeks vacation time with pay for "[e]mployees who have . . . [been employed] . . . during the entire previous year" and one day of vacation time with pay "for each twenty-six days worked in the preceding calendar year" for all other employees. *Id.* at 765.

107. *Id.* at 771 (internal quotation marks omitted).

108. The case was decided under § 64(a)(2) of the Act, which provided that wages, not to exceed \$600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding, due to workmen [and] servants" are entitled to priority. *Repealed by Bankruptcy Reform Act of 1978*, Pub. L. No. 95-598, 92 Stat. 2586 (1978).

109. *In re Pub. Ledger, Inc.*, 161 F.2d at 771 (emphasis added).

110. *Id.* at 774. That is to say, the amount earned after the business was adjudicated a bankrupt.

due debt. Each claim, therefore, should be allowed its rightful sum as a charge against the estate and that portion which was so earned under the trustees' management should be given the priority due to administrative expense[s].¹¹¹

The Third Circuit's cryptic rationale in *Public Ledger* was adopted by the First Circuit several decades later in *In re Mammoth Mart, Inc.*¹¹² While noting the Second Circuit's adherence to the "economic adjustment and recompense approach,"¹¹³ the First Circuit agreed with the distinction drawn by the Third Circuit in *Public Ledger* between severance pay conditioned upon termination without notice and severance pay conditioned upon an employee's length of service with the business.¹¹⁴

When the debtor-in-possession has assumed an employment contract providing that *all discharged employees* are entitled to their salaries for a brief period following the discharge as severance pay, the apparent consensus in the federal courts is that the employee claims are entitled to . . . [Section] 64(a)(1) priority However, in cases like the one at bar, *where only those employees who have served for a certain period of time* are entitled to severance pay and *where the amount thereof varies with the length of service* . . . the once conclusion that is consistent with the objectives of . . . [Section] 64(a)(1), Chapter XI, and the Bankruptcy Act as a whole is that such claims are not entitled to first priority in their entirety . . . where no portion of [the] . . . [employees'] claims can be apportioned to their employment after the arrangement has been filed, no portion of the severance pay claims can be entitled to . . . [Section] 64(a)(1) priority.¹¹⁵

The First Circuit premised its holding upon one of the underlying policies of Chapter 11—the effective reorganization of the debtor—and noted the importance of the continuation of goods supplied and services rendered to the debtor-in-possession as a means of effectuating that goal.¹¹⁶ Section 64(a)(1), in the *Mammoth Mart* court's opinion, was Congress' method of inducing parties to continue business with a debtor-in-possession.¹¹⁷ The court opined, therefore, that to be entitled to the priority, "the debt must

111. *Id.* at 773.

112. *Cramer*, 536 F.2d at 955.

113. *See* discussion Part III B.2 *infra*.

114. 536 F.2d at 953.

115. *Id.* (emphasis added) (internal footnotes omitted). The court dropped a footnote to explain that in the case *sub judice* the employees had only worked for a short period of time after the petition date and that they had already received severance pay equal to their entitlement. *Id.* at n.2. The court thus concluded that no other portion of their claims should be entitled to priority. *Id.*

116. *Id.* at 954.

117. *Id.*

arise from a transaction with the debtor-in-possession” and that the priority only exists to “the extent . . . [which] the consideration supporting the claimant’s right to payment was both supplied to and beneficial to the debtor-in-possession in the operation of the business.”¹¹⁸ Accordingly, in a case where *all employees* are to receive severance pay, the consideration underlying the claim, i.e., being an employee in good standing at the time of discharge, will have been supplied to the debtor-in-possession.¹¹⁹ In contradistinction, in a case where the amount of severance pay depends upon the length of employment, the consideration underlying the claim, i.e., continued work for the entire period of employment, will have been supplied to both the pre-petition business and the debtor-in-possession.¹²⁰ Consequently, and in accordance with the purposes of the priority, only the portion of the claim that was supplied to and benefited the debtor-in-possession should be afforded priority.¹²¹

Based upon the holdings and rationale set forth by both the *Public Ledger* and *Mammoth Mart* courts, the following rules have been ossified into a rule of law to which this article will refer as the “Lack of Notice/Length of Service Dichotomy.” The rule first divides severance packages into two general classifications: (1) pay at termination of employment in lieu of notice and (2) pay at termination of employment based upon length of service. If the employee’s entitlement arises out of the former, then courts are generally in agreement that it is entitled to priority as a cost of the administration of the bankruptcy estate because the claimant’s entitlement to severance pay is contingent upon being an employee at the time the debtor-in-possession terminates the contract. Thus, the full consideration has been supplied to the debtor-in-possession.¹²² If, however, the employee’s entitlement arises out of the latter, then only the amount of severance that has accrued while the business has been operating as a debtor-in-possession will be considered an administrative expense because it is only that portion of the consideration which has been supplied to the debtor-in-possession.¹²³

118. *Id.*

119. *Id.* at 955.

120. *Id.*

121. *Id.*

122. See e.g., *Wyle v. Pacific Maritime Assoc. (In re Pacific Far E. Line, Inc.)*, 713 F.2d 476, 479 (9th Cir. 1983); *In re Elliott Wholesale Grocery*, 98 F. Supp. 1017, 1018-19 (C.D. Cal. 1951); *In re Levinson Steel Co.*, 117 B.R. 194, 196 (Bankr. W.D. Pa. 1990); *In re Miami Gen. Hosp., Inc.*, 89 B.R. 980, 988 (Bankr. S.D. Fla. 1988).

123. See, e.g., *In re Roth Am., Inc.*, 975 F.2d 949, 957-58 (3d Cir. 1992); *In re Health Maint. Found.*, 680 F.2d at 621; *In re Russell Cave Co.*, 248 B.R. 301, 304-05 (Bankr. E.D. Ky. 2000); *In re Demert & Dougherty*, No. 96-B-00851, 1999 WL 1140859, at *4 (Bankr. N.D. Ill. Dec. 13, 1999); *In re Yarn Liquidation, Inc.*, 127 B.R. 544, 546 (Bankr. E.D. Tenn. 1997); *In re Old Electralloy Corp.*, 167 B.R. at 795-96; *In re U.S. Metalsource Corp.*, 163 B.R. at 271; *Jeannette Corp. v. Gilardi (In re Jeannette Corp.)*, 118 B.R. 327, 329-30

2. The Economic Readjustment and Recompense Approach

In contrast to those courts that have applied the lack of notice/length of service dichotomy,¹²⁴ some courts have taken a more liberal approach to the priority which should be afforded to severance pay in the event that an employer files a petition under Chapter 11. The leading case adopting this approach is the Second Circuit's opinion in *In re Straus-Duparquet, Inc.*¹²⁵ The severance package in dispute provided that

those employees who have been in the employ of the company one (1) year but under three (3) years, one (1) week's severance pay [and that] those over three (3) years, two (2) weeks' severance pay, provided, however, that they were discharged through no fault of their own. Employees shall be paid at the time of separation.¹²⁶

The court concluded that the claimants were entitled to priority under the Act, reasoning that "[s]everance pay is 'a form of compensation for the termination of the employment relation, for reasons other than the displaced employees' misconduct, primarily to alleviate the consequent need for economic readjustment, but also to recompense him for certain losses attributable to the dismissal.'"¹²⁷ Accordingly, the court held that because "severance pay is compensation for termination" and because the termination was "an incident of the administration of the bankruptcy estate," the "severance pay was an expense of administration and is entitled to priority as such an expense."¹²⁸ It is important to note that the Second Circuit so concluded despite the fact that the severance payments were tied to the length of the employees' service.¹²⁹

The rule of law adopted by the *Straus-Duparquet* court has been followed not only by courts within the Second Circuit,¹³⁰ but also courts

(Bankr. W.D. Pa. 1990); *In re Allegheny Int'l Inc.*, 118 B.R. 276, 281 (Bankr. W.D. Pa. 1990); *In re Levinson Steel Co.*, 117 B.R. at 196; *In re N.W. Eng'g Co.*, 43 B.R. 603, 605 (Bankr. E.D. Wis. 1984).

124. *See supra* Part. III. A.1.

125. 386 F.2d at 649.

126. *Id.* at 650 (internal quotation marks omitted).

127. *Id.* at 651 (quoting *Adams v. Jersey Cent. Power & Light Co.*, 120 A.2d 737, 740 (N.J. 1956)) (emphasis added).

128. *Id.*

129. *See id.* at 650, 651. The court, however, did hold that the vacation pay that accrued based upon the employees' length of service was not entitled to priority, as it was earned day to day and, thus, accrues throughout the employment relationship. *Id.* at 650.

130. *See, e.g.*, *Rodman v. Rinier (In re W.T. Grant Co.)*, 620 F.2d 319, 321 (2d Cir. 1980) (holding that severance pay was entitled to priority as an administrative expense because of the "definition of severance pay as compensation for termination, as opposed to a form of wages that accrues from day to day"); *In re Unishops, Inc.*, 553 F.2d 305, 308 (2d Cir. 1977) (allowing administrative expense priority for the severance package due to the

outside the Circuit. For example, the United States District Court for the Eastern District of Louisiana concluded that an executive vice-president of the debtor corporation was entitled to administrative expense priority for his claims arising from a severance package within his employment agreement.¹³¹ The court noted that the issue was one of first impression within the Fifth Circuit and, after addressing both the lack of notice/length of service dichotomy and the economic readjustment and recompense approach, agreed with the Second Circuit.¹³² The *Campo Electronics* court supported its conclusion that the severance payments should be afforded priority as an administrative expense with what it opined to be an important policy consideration:

[S]uch agreements are offered to employees of financially troubled companies as an incentive not to leave. Companies faced with financial problems and/or impending bankruptcy must have the authority to enter into enforceable severance agreements with key employees. If severance pay is denied priority status, this incentive will be lessened.¹³³

Similarly, the United States District Court for the District of South Carolina adopted the economic readjustment and recompense approach because of fairness considerations.¹³⁴

Courts both within and outside of the Second Circuit have adopted the

debtor's chief executive officer); *Amalgamated Ins. Fund v. William B. Kessler, Inc.*, 55 B.R. 735, 739 (S.D.N.Y. 1985) ("Where the termination occurs during the bankruptcy proceeding, the termination pay is a cost of business activity occurring during that proceeding, and so is an administrative expense."); *In re Crystal Apparel, Inc.*, 220 B.R. 816, 835 (Bankr. S.D.N.Y. 1998) ("The [Second Circuit] cases have held that if the debtor in possession continues the employment of a worker after the filing date and then terminates the worker, the worker has an expense of administration claim for the entirety of the severance pay available under company policy."); *In re Spectrum Info. Techs., Inc.*, 193 B.R. 400, 407 (Bankr. E.D.N.Y. 1996) ("[The debtor-in-possession] received the benefits of [the claimant's] expertise and services during the administration of the estate. . . . [T]he value of the benefits conferred included the indirect compensation of severance payments which . . . is intended to compensate employees for the hardships attributable to termination and is when the employee is dismissed.").

131. *In re Campo Elecs., Inc.*, 247 B.R. 646, 651-52 (E.D. La. 1998).

132. *Id.* at 651.

133. *Id.*

134. *In re Landmark Land Co. of Okla., Inc.*, 136 B.R. 410, 414 (D.S.C. 1992). The court reasoned:

Loyal employees who have remained and will remain on the job need to be assured that should the debtors [sic] reorganization efforts require areas of service to be streamlined and employees discharged, the discharged employees will be treated fairly and in accordance with the same policy provisions under which they initially agreed to be employed and under which they have remained with the debtor companies through this period of financial strife.

Id. For another case outside the Second Circuit that has adopted the economic readjustment and recompense approach, see *In re St. Louis Globe-Democrat, Inc.*, 86 B.R. 606, 606 (Bankr. E.D. Mo. 1988).

economic readjustment and recompense approach and support its viability with sound policy concerns; nevertheless, the approach has also been criticized with respect to the outcomes achieved via its application.¹³⁵ In *In re Ralph Lauren Womenswear*,¹³⁶ the court purported to reject the economic readjustment and recompense approach espoused by the Second Circuit in *Straus-Duparquet*, relying heavily upon a discussion of the doctrine of *stare decisis* in *In re Hooker Investments, Inc.*¹³⁷ The *In re Ralph Lauren Womenswear* court noted that courts within the Second Circuit had begun to move away from the precedent set forth in *Straus-Duparquet* not by expressly rejecting it, but instead by consistently narrowing its scope in application.¹³⁸ *In re Ralph Lauren Womenswear*, however, did not altogether reject the underlying rationale of *Straus-Duparquet*, but rather limited the priority afforded the employee's claim to a quantum meruit basis.¹³⁹

The *In re Ralph Lauren Womenswear* court was indeed correct that several courts have distinguished *Straus-Duparquet* from the cases pending before them. The issue of whether those courts were merely drawing legitimate distinctions or were affirmatively acting to limit the application of the economic readjustment and recompense approach is debatable. For example, in *Hooker Investments*, the Bankruptcy Court for the Southern District of New York discussed why the precedential value of the *Straus-Duparquet* decision either has been greatly diminished or is non-existent.¹⁴⁰ First, the court noted that *Straus-Duparquet* was decided under the former Act and that several post-Code developments have called the tenets upon which the decision was based into question. For example, the *Hooker*

135. Most of the cases adopting the lack of notice/length of service dichotomy, expressly rejected the economic readjustment and recompense approach that has been adopted by the Second Circuit. See *supra* Part III. B.1.

136. 197 B.R. at 771.

137. *Id.* at 775-76. See *In re Hooker Invs., Inc.*, 145 B.R. 138, 146-47 (Bankr. S.D.N.Y. 1992); see also *infra* notes 140-45 and accompanying text (discussing the *In re Hooker Invs.* opinion).

138. *In re Ralph Lauren Womenswear*, 197 B.R. at 776 (citing *In re Hooker Invs.*, 145 B.R. at 150).

139. *Id.* at 777-78. Indeed, the court agreed with the *Straus-Duparquet* line of cases in stating that the severance package was intended to constitute compensation for loss of employment:

As an employee who was earning a very substantial salary, Kreisler [the claimant] obviously was going to suffer a greater pecuniary loss than someone who was making less money. Consequently, it is not surprising that the severance agreement he negotiated with the debtors was as generous as it was. . . . Here the severance benefit agreed to by the parties was not based upon some enormous figure pulled from thin air. Rather, it was an attempt to approximate Kreisler's total salary for year

Id. at 777.

140. 145 B.R. at 146.

Investments court stated that the Code brought with it the “limitation on the allowability of claims arising from the rejection of employment agreements.”¹⁴¹ Another important development, in the opinion of the *Hooker Investments* court, was the enactment of § 1113 of the Code.¹⁴² Further, the court noted the importance of §§ 365(d)(3) and 1114 of the Code, which mandate that the pre-rejection amount paid landlords be the rent reserved in the lease¹⁴³ and that certain insurance benefits must be paid to retirees, respectively.¹⁴⁴ All of these factors, in addition to the court’s conclusion that the Second Circuit has “hinted that it might be prepared to reconsider” its earlier decisions adopting the economic adjustment and recompense approach, held that the doctrine of *stare decisis* did not command its adherence to the *Straus-Duparquet* line of cases.¹⁴⁵

141. *Id.* (citing 11 U.S.C. § 502(b)(7) (1994)). For a discussion of § 502(b)(7), see *supra* note 96 and accompanying text.

142. *Id.* (citing 11 U.S.C. § 1113). For a discussion of § 1113 of the Code, see *supra* notes 62-70 and accompanying text).

143. See 11 U.S.C. § 1114.

144. *In re Hooker Invs.*, 145 B.R. at 146; see also 11 U.S.C. § 365(d)(3).

145. 145 B.R. at 147 (citing *Trustees of the Amalgamated Ins. Fund v. McFarlin’s, Inc.*, 789 F.2d 98, 104 (2d Cir. 1986)). It is important to note, however, that the *Hooker Invs.* court denied administrative expense priority based upon the fact that the employment contract designated the severance packages as “damages.” *Id.* at 147-48. See also *supra* note 39 and accompanying text (discussing the effect of a judicial characterization that severance packages are a form of liquidation damages clause in an employment agreement would have upon the priority afforded to the employee’s claim).

It is important to note, as well, that the *Hooker Invs.* court’s statement, as to the Second Circuit’s intimation in *McFarlin’s* that it may be prepared to revisit the *Straus-Duparquet* line of cases, may have been hyperbolic, in that the Second Circuit expressly reaffirmed its adherence to *Straus-Duparquet* in its *McFarlin’s* opinion:

Our decision is not inconsistent with cases holding a bankrupt’s obligation to pay severance pay, which arises out of the termination of an employee during bankruptcy is an administrative expense entitled to priority. These decisions rest on the basis that severance pay is compensation for the hardship which all employees, regardless of their length of service, suffer when they are terminated and that it is therefore “earned” when the employees are dismissed. Accordingly, it is granted a first priority as a cost of doing business during the bankruptcy proceeding.

McFarlin’s, Inc., 789 F.2d at 104 (internal citations omitted) (emphasis added).

The Second Circuit’s holding in *McFarlin’s, Inc.* that the employee’s claim was not entitled to an administrative expense priority was premised upon the fact that the claim in the nature of withdrawal liability was made under an ERISA-qualified plan. *Id.* The crux of the court’s opinion, therefore, was not the rejection of the economic readjustment and recompense approach adopted by *Straus-Duparquet*, but rather the manner in which withdrawal liability is earned—day to day, as opposed to the date upon which the employee is discharged. See *id.* Similarly, the other courts within the Second Circuit that have not found *Straus-Duparquet* to be controlling have premised their opinions upon the fact that the employee’s entitlement was not in the nature of severance. For example, bankruptcy courts in both *In re Crystal Apparel, Inc* and *In re Child World, Inc*, held that the employees’ claims were not administrative expenses because the entitlements under their

Another court has limited the *Straus-Duparquet* holding in its application to “golden parachutes.”¹⁴⁶ In *In re Drexel Burnham Lambert Group, Inc.*, Cohen, a former general counsel of the financial services company, averred that he was entitled to over five million dollars in severance payments pursuant to his employment contract and that such payments were entitled to priority as administrative expenses of the bankruptcy estate.¹⁴⁷ Cohen’s employment contract provided for a general severance payment, which included “all accrued but unpaid amounts of Base Salary and Annual Bonuses to the date of . . . termination” in the event that his employment was terminated “other than due to Disability or for Cause.”¹⁴⁸ Moreover, the agreement contained a provision entitled “Special Severance Payment,” which entitled Cohen to

a lump sum payment equal to the sum of the total cash compensation, including Base Salary and Annual Bonuses, which, if [Cohen’s] employment had not been terminated, would have been payable to [Cohen] by [Debtor] and DBL during the period commencing with the termination of [Cohen’s] employment and ending on the fourth anniversary of the Commencement Date.¹⁴⁹

In addition, the language of the employment agreement indicated that it was entered into with the prospect that the company might subsequently become insolvent or declare bankruptcy.¹⁵⁰ In such an event, Cohen would be entitled to the “Special Severance Payment” even if *he decided* to leave the company.¹⁵¹ Near the one-year anniversary of the “Commencement Date,” and after the company had filed under Chapter 11, the president of the company informed Cohen that he would be terminated “because, with the change in the nature of Drexel’s operations, Cohen was no longer

respective employment agreements were not “severance pay.” *In re Crystal Apparel, Inc.* 220 B.R. at 853 (reasoning that entitlement was not severance pay because it was not based upon length of service and because the amount of which was indirectly proportional to the amount of time the claimant was employed); *In re Child World, Inc.*, 147 B.R. at 853 (concluding that claim was not severance pay because the entitlement was not based upon length of service).

146. See *In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 687, 687 (Bankr. S.D.N.Y. 1992). For a general discussion of “golden parachutes,” see *supra* text accompanying note 17.

147. 138 B.R. at 690.

148. *Id.* at 692-93.

149. *Id.* (alterations in original). The employment relationship was one for a specific term of four years. *Id.* at 691. “Commencement Date” was a defined term within the employment contract and referred to the date upon which Cohen was to begin employment with the company. *Id.*

150. *Id.* at 693.

151. *Id.* This provision had little influence upon the court’s ultimate decision, however, as the right to the payments is much different from the right to an administrative expense priority in their full amount.

needed to perform the functions contemplated by the Employment Agreement.”¹⁵²

Cohen argued that “the Special Severance Payment provided an inducement to join [the company], in the prime of his professional career at a time when he had a flourishing law practice” and that it “was a shield to protect [him] from unwarranted action by [the debtor]’s tainted management.”¹⁵³ The court incisively noted that Cohen had perhaps made the best argument against a conclusion that his claim should be afforded an administrative expense priority, as this statement, taken in conjunction with his citation to *McFarlin’s*, “devastate[d] his position.”¹⁵⁴ Cohen cited to the following language in *McFarlin’s* to support his claim:

[A]n expense is administrative only if it arises out of a transaction between the creditor and the bankrupt’s trustee or debtor-in-possession, and “only to the extent that the consideration supporting the claimant’s right to payment was both supplied to and beneficial to the debtor-in-possession in the operation of the business.”¹⁵⁵

The court, however, concluded that both the transaction and the beneficial consideration—as per Cohen’s statement—were supplied pre-petition.¹⁵⁶ Thus, the court found that Cohen’s claim to the “Special Severance Payment” was not an expense incurred in the administration of the debtor-in-possession’s bankruptcy estate.¹⁵⁷

152. *Id.* at 691.

153. *Id.* at 713 (alterations in original have been omitted) (third and fourth alterations in original) (first alteration added) (internal quotation marks omitted).

154. *Id.* at 712-13.

155. *Id.* (quoting *McFarlin’s, Inc.* 789 F.2d at 101).

156. *Id.* at 713.

157. The court, however, did hold that his claim for payments under the general severance provision was entitled to an administrative expense priority. *See supra* note 148 and accompanying text; *Drexel Burnham Lambert Group, Inc.*, 138 B.R. at 711. Based upon the court’s holding in regard to the “Special Severance Payment,” the reader would expect that Cohen not have been entitled to an administrative expense priority with respect to the general severance payment as well, or, in the alternative, that the only portion of the general severance payment entitled to priority as an administrative expense would be that portion which was earned from the petition date to the date upon which Cohen’s termination became effective. *See supra* notes 155-57 and accompanying text. The court’s rationale for this extraordinary conclusion could be an important tool for labor and employment practitioners engaged in the representation of executive-level employees in contract negotiations with current or prospective employers. One component of Cohen’s compensation package was a group of four stock portfolios purchased by Cohen for \$100 each, but, when assembled by the Drexel Burnham Lambert Group, were valued at \$500,000 each at the time of purchase. *In re Drexel Burnham Lambert Group, Inc.* 138 B.R. at 692. The bond portfolios matured successively upon the each anniversary of the “Commencement Date” for the four-year span of employment. *Id.* These portfolios were placed into escrow by Cohen, whose agent was instructed, under the employment agreement, to release the portfolios to Cohen upon their respective maturity dates. *Id.*

Notwithstanding the criticisms of the economic readjustment and recompense approach, it has yet to be overruled. Accordingly, *Straus-Duparquet* and its progeny remain a viable approach for determining the priority afforded to severance packages.

3. The *Uly-Pack* Approach

In *In re Uly-Pak, Inc.*,¹⁵⁸ the United States Bankruptcy Court for the Southern District of Illinois expressly repudiated the lack of notice/length of service dichotomy in favor of a more flexible approach.¹⁵⁹ *In re Uly-Pak* involved a claim for severance pay under an employment contract which provided that if the claimant was terminated for any reason other than willful misconduct, he would receive either his salary for the term of the contract or a lump sum payment equal to 300% of his annual salary.¹⁶⁰ The claimant's employer filed its Chapter 11 petition approximately two years after the claimant entered into the employment agreement, and a month after the petition date, the claimant was terminated.¹⁶¹

In its analysis of whether the claimant was entitled to an administrative expense priority for the severance payments due under his employment contract, the court acknowledged that the lack of notice/length of service dichotomy "has become ossified into a rule of law" and that "[l]ower courts now tend to apply the rule blindly, placing severance pay into one of the two categories while ignoring the rationale underlying the distinction."¹⁶² The *In re Uly-Pak* court noted that, although the lack of notice/length of service dichotomy may be a workable standard where the severance payments are clearly compensation either for discharge without the requisite amount of notice provided for in the employment contract or based upon length of service, the approach must be rejected because it does "not exhaust all possible types of severance pay."¹⁶³ Consequently, the *Uly-Pak* court opined that the lack of notice/length of service dichotomy forces courts to place severance payments into "artificial categories" to

In reaching its conclusion with respect to Cohen's entitlement to the portfolios, the court noted that "under New York law[,] legal title to property placed in escrow remains with the grantor until the occurrence of the condition specified in the escrow agreement." *Id.* at 710 (citations omitted). The upshot, for Cohen at least, is that because it was *he, rather than the company* who placed the portfolios into escrow, the portfolios did not become property of the estate under § 541(a) of the Code and, instead, will become his property outright as they vest. *See id.* at 710-11.

158. *In re Uly-Pak, Inc.*, 128 B.R. 763 (Bankr. S.D. Ill. 1991).

159. *Id.* at 767-68.

160. *Id.* at 764.

161. *Id.* Between the petition date and the date upon which the claimant was discharged, the Chapter 11 was converted to a Chapter 7. *Id.*

162. *Id.* at 767.

163. *Id.* at 767-68.

which the payments would not otherwise belong.¹⁶⁴ Indeed, the severance package before the *Uly-Pak* court did not fit into either category because “[n]owhere in the contractual provision is notice mentioned” and “[t]here was no vesting provision; by its terms, the severance pay provision became effective when the contract was signed.”¹⁶⁵

Therefore, the court looked to the statutory definition of an “administrative expense,” as set forth by the Seventh Circuit and concluded that to be afforded an administrative expense priority, the severance payment must “(1) arise[] from a transaction with the debtor in possession and (2) . . . [be] beneficial to the debtor in possession in the operation of the business.”¹⁶⁶ Under the Seventh Circuit’s approach, “the determinative factor is not when the right to payment matured but, rather, when it was earned.”¹⁶⁷ The court then concluded that the employee’s claim should be denied priority as an administrative expense, reasoning that the “severance pay neither arose from a transaction with the debtor in possession nor benefited the debtor in possession in the operation of the business because the severance pay was “earned” when he entered into the employment agreement.¹⁶⁸ To support this conclusion, the court noted that if the employee had been terminated pre-petition, he would still have been entitled to the entire amount of the severance package provided for in the employment agreement.¹⁶⁹

164. *Id.* at 768. For examples of cases supporting the accuracy of this statement, see *In re Pacific Far E. Line, Inc.*, 713 F.2d 476, 479 (9th Cir. 1983) (noting that the district court observed that the lack of notice/length of service dichotomy was imperfect because the payments due to the employee were due regardless of eligibility or length of service); *Dullanty v. Selectors, Inc. (In re Selectors, Inc.)*, 85 B.R. 843, 846 (B.A.P. 9th Cir. 1988) (encountering difficulty arriving at a conclusion under the lack of notice/length of service dichotomy because the severance payments were not “pay at termination based upon length of employment,” and, “just as clearly . . . not ‘pay at termination in lieu of notice’”); *In re Crystal Apparel, Inc.*, 220 B.R. 816, 816 (Bankr. S.D.N.Y. 1998) (refusing to classify the employee’s entitlement as “severance pay” simply because it was not based upon length of service); *In re Child World, Inc.*, 147 B.R. 847, 847 (Bankr. S.D.N.Y. 1992) (holding that the contractual provision did not provide for “severance pay” because, under Massachusetts law, severance pay is usually based upon length of service); *In re Hooker Invs., Inc.*, 145 B.R. 138, 149-50 (Bankr. S.D.N.Y. 1992) (concluding that the payments did “not have the typical characteristics of severance pay” because the amount to which the employee was entitled was inversely proportional to length of employment).

165. *In re Uly-Pak, Inc.*, 128 B.R. at 768; see also *In re M Group, Inc.*, 268 B.R. 896 (Bankr. Del. 2001).

166. *Id.* at 766 (citing *In re Jartran, Inc.*, 732 F.2d 584, 586-87 (7th Cir. 1984)).

167. *Id.* (citing *In re Chicago Lutheran Hosp. Ass’n*, 75 B.R. 854, 856 (Bankr. N.D. Ill. 1987)).

168. *Id.*

169. *Id.* But see *In re Artesian Indus., Inc.*, 183 B.R. 496, 501 (Bankr. N.D. Ohio 1995) (disagreeing with this proposition and reasoning that “[i]f the claimant had “earned” his severance pay pre-petition, which was before he was terminated, he should have been entitled to receive the severance pay if he left the company prior to being terminated”).

The *Uly-Pak* decision eschewed the distinctions upon which many prior cases addressing severance packages in bankruptcy rested, yet, at the same time, it reinforced the rationale underlying those distinctions. *Uly-Pak* “trimmed the fat,” so to speak, from these decisions to uncover their common denominator: the two-prong test for an administrative expense priority.¹⁷⁰ And so, it is with that observation that the focus of this Article will shift into a critical discussion of these different approaches.

IV. ANALYSIS

A. *Flexibility and Equity in Judicial Application*

Each approach taken in an attempt to ascertain the priority afforded to severance packages in the event of a business bankruptcy has focused upon

170. See *supra* note 166 and accompanying text (setting forth the two-prong test for determining whether a claim is entitled to an administrative expense priority under §§ 503 and 507 of the Code). A similar approach was recently adopted by the Tenth Circuit in *Bachman v. Commercial Fin. Servs., Inc.* (*In re Commercial Fin. Servs., Inc.*), 246 F.3d 1291 (10th Cir. 2001) and applied by the United States Bankruptcy Court for the District of Delaware in *In re M Group, Inc.*, 268 B.R. at 896. The crux of the Tenth Circuit’s opinion in *Commercial Financial Services* was that the claimants’ right to severance was not a result of transaction entered into with the debtor because “[i]n determining administrative priority, courts look to ‘when the acts giving rise to a liability took place, not when they accrued.’” *Bachman*, 246 F.3d at 1295 (quoting Pension Benefit Guar. Corp. v. Sunarhauserman, Inc., 126 F.3d 811, 818 (6th Cir. 1997)). The Tenth Circuit reasoned that “[t]he liability arose at the time the contracts were executed,” which the court distinguished from the time at which the right to payment arose—upon termination of the employment relationship post-petition—and thus, held that no portion of the claimants’ severance packages were entitled to priority. *Id.* (citing *Isaac v. Temex Energy, Inc.* (*In re Amarex, Inc.*), 853 F.2d 1526, 1530 (10th Cir. 1988)).

There, however, are problems with the Tenth Circuit’s reasoning as a consequence of its reliance upon the First Circuit’s opinion in *Cramer*, 536 F.2d. at 950. See *supra* notes 113-122 and accompanying text (discussing *Cramer*). The most obvious problem is seen when one compares a statement by the First Circuit in *Cramer*. to the facts of *In re Commercial Financial Services*. In *Cramer*, the First Circuit opined that “[I]f an employment contract provides that all discharged employees will receive severance pay equal to their salaries for a specified period . . . the former employees will be entitled to priority.” *In re Mammoth Mart, Inc.*, 536 F.2d at 955 (citing *In re Public Ledger*, 161 F.2d at 769-71) (emphasis added). The Tenth Circuit stated the facts of *In re Commercial Financial Services* as follows: “Appellants *Bachman* and *Phelps* entered into employment contracts with CFS in which both employees were promised lump sum cash payments upon termination by CFS prior to the expiration of the contracts unless such termination was for cause. *The lump sum payments equaled appellants’ annual base salaries of \$120,000 and \$150,000, respectively.*” *In re Commercial Fin. Servs.*, 246 F.3d at 1292-93 (emphasis added). Thus, *Commercial Financial Services* is essentially the fact pattern under which the First Circuit stated it *would allow* an administrative expense priority to the employee.

whether the consideration underlying the payments was conferred upon the debtor-in-possession and whether that consideration benefited the debtor-in-possession in the operation of its business.¹⁷¹ Specifically, with respect to the lack of notice/length of service dichotomy, the First Circuit stated in *In re Mammoth Mart* that “the priority will depend upon the extent to which the consideration supporting the claim was supplied during the reorganization.”¹⁷² The distinction between severance payments made in lieu of notice or based upon length of service may be a useful shorthand for determining whether the payment should be afforded priority as an administrative expense, but the difference between the two categories is superfluous and, in some cases, quite misleading.¹⁷³ Furthermore, the crux of the economic readjustment and recompense approach is the determination that the termination of the employee was incident to the administration of the estate.¹⁷⁴ Three conclusions are implicit in that statement. First, although the contract may have been entered into with the debtor pre-petition, the transaction triggering the employee’s right to severance pay was the termination of the employment contract by the debtor-in-possession. Second, the employee’s entitlement to severance payments under the employment contract is supported entirely by post-petition consideration, i.e., the consideration put forth for the payments by the employees is merely that the employees would be employees in good standing on the date of termination and that the discharges were without cause. And, third, the employee’s discharge benefited the debtor-in-possession in the operation of its business.

Indeed, in their most basic sense, both the lack of notice/length of service dichotomy and the economic recompense and readjustment turn upon the same test. Thus, it is the recommendation of this article that courts following both approaches should eschew these semantic distinctions in favor of the simple approach advocated by the United States Bankruptcy Court for the Southern District of Illinois in *In re Uly Pak, Inc.*¹⁷⁵

However, the solution to the issue of whether severance packages should be afforded a priority as an expense incurred in the administration of the debtor-in-possession’s bankruptcy estate is not that simple. The primary reason for this difficulty is the problematic aspects of the application of this test. The first prong of the test advocated in *Uly-Pak* is a

171. See *infra* Part V.

172. *In re Mammoth Mart, Inc.*, 536 F.2d at 955.

173. See *supra* text accompanying note 164 (discussing the problematic results of the lack of notice/length of service dichotomy in situations where the payments are dependent upon neither condition).

174. See *supra* notes 126-28 and accompanying text (discussing the reasoning of the court’s adopting the economic readjustment and recompense approach).

175. See *supra* notes 166 and accompanying text (discussing the *Uly-Pak* approach).

determination that the transaction was entered into with the debtor-in-possession.¹⁷⁶ If a court applying the *Uly-Pak* test finds that the transaction was indeed entered into with the debtor-in-possession, then the court must determine not only whether the consideration was supplied to the debtor-in-possession, but also whether the consideration benefited the debtor-in-possession in the operation of its business. As the underlying principles behind all three approaches are the same, it necessarily follows that the true distinction between the approaches is in their application of those principles. Moreover, because the approaches are somewhat result-oriented, it is perhaps easiest to work backwards, gleaning the courts' reasoning from their conclusions.

On the one hand, those courts applying the lack of notice/length of service dichotomy have found that (1) severance packages based upon lack of notice are to be afforded administrative expense priority and (2) severance packages based upon length of service are entitled to an administrative expense priority only to the extent that they were earned post-petition.¹⁷⁷ Thus, there are several implicit conclusions within the holdings of these respective courts. First, and most importantly, because a portion of the payments were entitled to an administrative expense priority, it can be surmised that these courts reasoned that the transaction was indeed entered into with the debtor-in-possession.¹⁷⁸ Without this initial conclusion, the court could not afford any portion of the severance pay priority as an administrative expense. Second, because these courts viewed payments tied to length of service as pre-petition claims, but allowed priority to the amount of the claim that was either earned or accrued post-petition if the severance payments were in lieu of notice, it can be assumed that these courts concluded that the consideration for the employment *could* be supplied to the debtor-possession and that the debtor-in-possession *could* derive a benefit from that consideration in the operation of its business.¹⁷⁹ The conclusion follows, therefore, that these courts viewed the consideration in these employment contracts to be the employee's standing within the business at the time of termination, in that if the employee's entitlement to severance pay was tied to length of service, the consideration, i.e., the amount of time the debtor served the business, was supplied to both the business as it existed pre-petition and to the post-petition debtor. Conversely, if the employee's entitlement to severance pay is based upon the failure of the business to give the requisite amount of notice prior to termination, then the consideration, i.e., the fact that the employee was still employed by the company on the date of termination,

176. *See id.*

177. *See supra* Part IV.B.1.

178. *See id.*

179. *See id.*

was supplied to the debtor-in-possession where the employee was terminated post-petition. Thus, according to the courts that have followed the lack of notice/length of service dichotomy, where the consideration is supplied to the debtor-in-possession, it will necessarily follow that the amount of that consideration will benefit the debtor.

On the other hand, courts adopting the economic readjustment and recompense approach have concluded that severance packages are entitled to an administrative expense priority, regardless of the conditions to which the employee's right is tied.¹⁸⁰ From this conclusion, it necessarily follows that these courts opine that the claim arises from a transaction with the debtor-in-possession. Moreover, these courts expressly put forth several different lines of reasoning as to how the debtor-in-possession was benefited.¹⁸¹ The important aspect of this reasoning, however, is that it demonstrates the different manner in which the test for administrative expense priority is applied by courts espousing the two different approaches. *Antithetical to the courts applying the lack of notice/length of service dichotomy, in which there is a benefit to the debtor-in-possession in the amount of the consideration furnished to it, the courts following the economic readjustment and recompense approach appear to reason that there is consideration furnished to the debtor-in-possession where the debtor-in-possession benefits from the termination.* This distinction, albeit minute, accounts for the different conclusions under each approach.

Although the *approach* adopted by the *Uly-Pak* court¹⁸² is the most efficient, in that it provides a uniform test for determining whether an employee's claim for severance pay should be afforded an administrative expense priority, the *conclusion* reached by the court in its application of the approach¹⁸³ is problematic in several respects. First, it leads to not only a rule, but also a conclusion that is the exact converse of the lack of notice/length of service dichotomy. By focusing upon when the right to payment was "earned," rather than when the right to payment "matured," the *Uly-Pak* rationale would lead to the conclusion that any severance package *connected to neither length of service nor lack of notice* would be denied an administrative expense priority because the right to payment was earned upon the consummation of the employment agreement. In contrast, severance packages tied to the length of the employee's service would be entitled to priority as an expense of administration to the extent that the employee "earned" the payments after the commencement of the Chapter 11 case.

180. See *supra* Part III.B.2.

181. See *supra* text accompanying notes 131 and 134, and note 135 and accompanying text.

182. See *supra* note 160 and accompanying text.

183. See *supra* notes 168-69 and accompanying text.

An example of this rule in practice demonstrates the inequitable result it produces. Employee A entered into an employment contract with the X Corporation on December 1, 2001. Employee A's contract provided for two weeks salary, which would amount to \$2400, for every six months in which she was employed by the corporation in the event that she was terminated "without cause." Employee B entered into an employment contract on the same date as Employee A. Employee B's contract, however, provided that he would be entitled to a lump-sum payment of \$2400, which would equal two weeks salary, in the event that he was terminated "without cause." X Corporation filed a Chapter 11 petition on April 1, 2002, but both A and B remained with the corporation after that date. On May 1, 2002, X Corporation, Debtor-in-Possession, was permitted by the bankruptcy court to reject its employment contracts with both A and B. Consequently, both A and B filed their respective proofs of claim against the estate.

If the bankruptcy court charged with the administration of X Corporation's bankruptcy estate strictly followed the *Uly-Pak* decision, then Employee A would be entitled to an administrative expense priority in the amount of \$400, which would equal the amount of severance pay earned while X Corporation was a debtor-in-possession, and a pre-petition, unsecured claim of \$5600, which would represent the amount of severance pay she earned prior to X Corporation's operation as a debtor-in-possession. Employee B, however, would be entitled to the same total amount as Employee A, \$6000, but none of that claim would be afforded an administrative expense priority because Employee B "earned" the severance on December 1, 2001. This would be the proper outcome under *Uly-Pack* notwithstanding the fact that both A and B conferred the same benefit upon the X Corporation, Debtor-in-Possession. The same inequity would result from the application of the lack of notice/length of service dichotomy if Employee B's severance was designated as severance "in lieu of notice." Only in that situation, Employee B would receive the entire amount as an administrative expense priority, whereas Employee A would still only be entitled to the priority in the amount of \$400.

According to *Uly-Pak*, the distinction is that Employee B could have received the entire amount even if he was terminated the day after the employee contract became effective and before the corporation filed under Chapter 11. This fact, however, is irrelevant as it relates to the issue of whether the transaction was entered into with the debtor-in-possession or whether the consideration was supplied to the corporation post-petition, as this article asserts that *the consideration put forth by both employees is not their standing as of the date of termination, but instead the work they*

*perform for the corporation.*¹⁸⁴ This conclusion is consonant with the termination provisions of most employment contracts that continued employment is conditioned upon the employee's fitness for that employment. For example, if the employee fails to meet certain enumerated employment-related goals, then discharge will be "for cause" pursuant to the employment agreement. Similarly, this fitness can be affected by the employee's unlawful activity outside the workplace. Thus, to the extent that the employee rendered services to the debtor-in-possession and to the extent that the debtor-in-possession benefited from those services, the employee should be entitled to an administrative expense priority in that amount. This conclusion would be the most consonant not only with the policies underlying Chapter 11 reorganization, but also the purposes of severance packages.

B. The Policies Underlying Chapter 11 Reorganization

Although the most overt purpose of Chapter 11 is the effective reorganization of the debtor, there is a coequal purpose of equitable distribution to creditors.¹⁸⁵ Allowing all severance payments to be administrative expenses could be viewed as manifestly unjust, not only to the debtor-in-possession who must pay these claims in full, but also to the unsecured creditors, who are likely to receive less under the plan as a result. To add to this inequity, the claims of some of those creditors will have likely arisen in the same manner as the payments due to the claimant-employee—based upon a pre-petition contract that was rejected. Whereas the third-party creditors would only receive priority in the amount of the goods or services provided to the debtor-in-possession, the claimant-employee, under the economic readjustment and recompense approach, would receive the entire amount of the claim as an administrative expense.

It is important to note, however, that—unlike suppliers of goods and services, whose sources of income are often diversified such that they are not wholly dependent upon the debtor company—the sole source of income for many employees is their salary. This distinction is reflected in the limited priority granted in § 507(a)(3) of the Code. Since 1994, Congress has twice increased the amount of this priority to its present amount of \$4,650, thereby expressing its intention to allow a limited inequity between employee severance claims and the claims of goods and service providers.

When one examines the opposite end of the spectrum, it is apparent that following the lack of notice/length of service dichotomy or the *Uly-Pak* decision would hinder the reorganization process, as there would be no

184. See sources cited *supra* note 15 (stating that severance pay "is a remuneration for the service provided during the period covered by the agreement").

185. See *supra* note 10 and accompanying text.

incentive for employees to remain with the debtor-in-possession as it struggles through the Chapter 11 process. Likewise, businesses that are in poor financial condition, but have yet to file bankruptcy, will have a more difficult time attracting the employees who have the expertise to help those businesses recover.¹⁸⁶

The *Uly-Pak* two-prong test applied such that the consideration provided to the debtor-in-possession is the work performed by the employee, would achieve a balance between the concerns that plague analysis under the other two approaches by entitling the employee-claimant to an administrative expense priority as to the percentage of the severance package which accrued post-petition. Further, the employee-claimant would possess a second, albeit limited, priority claim under § 507(a)(3).¹⁸⁷ In addition, this approach would provide employees with some incentive to remain with companies in poor financial positions and, more importantly, during the reorganization process. Admittedly, this approach undermines the degree of financial protection provided by severance packages outside of bankruptcy. Because the application of the economic readjustment and recompense approach would certainly allow the employee-claimant to receive that to which he or she should be entitled considering that one of the purposes of severance packages is to protect the employee from economic hardship due to termination of employment for circumstances beyond his or her control.¹⁸⁸ Such a conclusion, however, would result in an inequity of distribution between third-party contract claimants and employee-claimants beyond that which Congress envisioned and, accordingly addressed in § 507(a)(3). Likewise, the lack of notice/length of service dichotomy would lead to similar inequities amongst the employee-claimants.

Thus, in balancing the fairness to similarly situated claimants, the application of the two-pronged general administrative expense priority test—with the employee's services to the business viewed as the consideration underlying the employment contract—would provide the most equitable result. Under such an approach, all similarly situated employee-claimants would receive the same pro-rata amount of their severance payments regardless of the terminology or maturity conditions of the termination clauses within their respective employment contracts.

V. CONCLUSION

Under the approach advocated by this article, the claimant-employees will receive a lesser degree of protection than they would otherwise be

186. See *supra* note 34 and accompanying text.

187. See *supra* text accompanying note 98.

188. See *supra* notes 7 and 16 (discussing the purposes of severance packages).

provided under either the economic readjustment and recompense approach or the lack of notice/length of service dichotomy in certain circumstances. Bankruptcy law, however, is a delicate, and oftentimes awkward, balancing act, and thus, courts must consider the equities of their decisions with respect to all parties involved. The approach this article espouses is not only the most equitable with respect to the debtor-in-possession and all of its creditors, but also the most efficient with respect to judicial economy.

Notwithstanding the critical nature of this article, its goal was to provide a broad overview of the employment-related issues that can arise in the context of the administration of a Chapter 11 case, as well as a detailed discussion of the treatment of severance packages within a Chapter 11 case. Admittedly, this article has raised more questions than it has answered. However, with respect to the subject matter of this article, perhaps it is enough merely to raise these questions, as the answers will most likely be supplied by the courts called upon to resolve these conflicts.