AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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Problems in the Code

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Into the Brambles: Section 507(a)(4) and Executoriness

Some courts have borrowed concepts of executoriness to grant certain severance claims § 507(a)(4) priority. But when courts must resort to a judicial doctrine notorious for being a "bramble-filled thicket,"[1] it is time for statutory intervention.

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The Problem of the Employee Who Is Terminated

The Fourth Circuit recently held that under § 507(a)(4), "severance pay is 'earned' on the day that an employee shows up to work and is terminated by the company without cause."[2] If that day occurs within 180 days of the petition date, the employee's entire severance claim (up to the § 507(a)(4)) cap is entitled to priority. The Fourth Circuit rejected the trustee's argument that severance is earned day-to-day, and that the amount entitled to priority should be calculated by dividing the number of days within the priority period that the employee worked by the total number of days that the employee worked for the debtor. Section 507(a)(4) only applies to claims that are "earned" within 180 days *before* the petition date. If a claim is "earned" *after* the petition date, then § 507(a)(4) does not apply, and § 503(b)(1) determines the claim's priority.[3]

Courts have adopted different approaches to determine whether severance claims arising after a post-petition termination are entitled to administrative priority. One line of cases looks to the terms of the severance or employment agreement. If the severance is in lieu of notice, then it receives administrative priority under the rationale that the severance pay is in lieu of post-petition wages. If the severance is based on length of service, any portion of the severance attributable to the post-petition work is entitled to administrative priority.[4] Under this approach, courts will prorate between the post- and pre-petition period, and also between the pre-priority period and the priority period.[5]

However, many other courts take a different approach and apply the standard two-pronged administrative-priority test, which requires (1) a post-petition agreement and (2) a benefit to the debtor in possession.[6] According to these decisions, if the severance claim does not meet both requirements, then *no* part of the claim is entitled to administrative priority. Under this line of cases, administrative priority for severance is "all or nothing." Those who stay on after the petition date cannot receive § 503(b)(1) administrative priority on any part of their claims and are relegated to general unsecured status.

In reaction to this all-or-nothing approach—which in effect punishes employees who remain with a distressed company through the bankruptcy by giving them a lower priority than is given to employees who are terminated shortly before bankruptcy—some bankruptcy courts have created a judicial rule that grants § 507(a)(4) priority to these severance claims.

1 *Cohen v. The Drexel Burnham Lambert Grp. Inc. (In re The Drexel Burnham Lambert Grp. Inc.)*, 138 B.R. 687, 690 (Bankr. S.D.N.Y. 1992).

2 *See Matson v. Alarcon*, 651 F.3d 404, 408-09 (4th Cir. 2011). The quoted statement in the text is from the affirmed bankruptcy court decision, *In re LandAmerica Fin. Grp. Inc.*, 435 B.R. 343, 351 (Bankr. E.D. Va. 2010).

3 *See Matson*, 651 F.3d at 410 (acknowledging difference between §§ 507(a)(4) and 503(b)(1) and pointing out that, unlike § 507(a)(4), "[s]ection 503(b)(1)(A) does not use the word 'earned'").

4 *See Lines v. Sys. Bd. of Adjustment No. 94 Bhd. of Ry., Airline & Steamship Clerks (In re Health Maint. Found.)*, 680 F.2d 619, 621 (9th Cir. 1982) (applying Bankruptcy Act).

5 *See, e.g., In re Russell Cave Co. Inc.*, 248 B.R. 301, 304 (Bankr. E.D. Ky. 2000) (prorating between pre- and post-petition period under § 503(b)(1)); *In re Yarn Liquidation Inc.*, 217 B.R. 544, 548-49 (Bankr. E.D. Tenn. 1997) (prorating between pre-priority and priority period under prior version of § 507(a)(4)).

6 *See In re Stewart Foods Inc.*, 64 F.3d 141, 145 n. 2 (4th Cir. 1995) (setting forth elements for administrative priority); *see also, e.g., Mason v. Official Comm. of Unsecured Creditors (In re FBI Distribution Corp.)*, 330 F.3d 36, 46 (1st Cir. 2003); *In re Commercial Fin. Servs. Inc.*, 246 F.3d 1291, 1294-95 (10th Cir. 2001); *In re Robb & Stucky Ltd.*, No. 8:11-bk-02801-CED, 2011 Bankr. LEXIS 229458, at *5-12 (Bankr. M.D. Fla. Sept. 7, 2011).

Trying to Solve the Problem Through an Executory/Rejection Analysis

The first reported decision that leverages a post-petition severance claim into pre-petition priority status via rejection is the chapter 11 case of *Dornier Aviation (North America) Inc.*[7] In *Dornier Aviation*, the court held, consistent with many other courts, that a claim for severance arising from a pre-petition severance agreement was not entitled to § 503(b) administrative priority, even though the employee was terminated and the severance was payable post-petition.

However, after denying the employee an administrative claim, the court held that the severance claim would be entitled to § 507(a)(4) priority because there was "little doubt" that the severance contract was executory and the debtor's rejection of the severance agreement constituted a breach of the severance contract as of the petition date pursuant to § 365(g).[8] Therefore, "his right to severance pay is properly treated as having occurred" within the priority period set forth in § 507(a)(4).[9]

Using rejection to leverage a claim into priority next appeared in *LandAmerica*, which the Fourth Circuit affirmed in *Matson*.[10] After holding that a severance claim was entitled to § 507(a)(4) priority because it was earned within six months prior to the filing, the court added that if the severance had been payable post-petition and had arisen pursuant to a rejected executory contract, it would have been entitled to § 507(a)(4) priority under *Dornier Aviation*.

In *Circuit City*,[11] the same judge who decided *LandAmerica* reiterated his agreement with the *Dornier Aviation* approach during claim objection hearings. He stated that he considered pre-petition retention and incentive bonus programs to be executory, and he suggested that therefore claims arising under these programs would also be entitled to § 507(a)(4) priority under the executory-rejection analysis employed in *Dornier Aviation*.[12] While these cases attempt to solve a genuine problem, they misunderstand the executoriness doctrine and violate the basic premise that priority should not be inferred by courts, but should be expressly stated by Congress.

The Controversy of Rejection

Michael T. Andrew (McKenna, Long & Aldridge LLP; San Diego) has argued in his oft-cited article[13] that rejection of an executory contract is nothing more than a deemed breach by the debtor of obligations going forward. As he states:

> [The assume-or-reject and deemed-breach rules] recognize that a party to a pending contract is fundamentally no different from other claimants, and thus *should not receive different treatment merely as a consequence of the contract's "executoriness."... Rather, the design of executoriness doctrine is to eliminate "executoriness" as a factor in determining the nondebtor party's rights when a contract is not assumed.*[14]

In practice, courts disagree regarding the effect of rejection. For example, in the bankruptcy case of *HQ Global Holdings*, the court held that the nondebtor party's "right to use the trademark stops on rejection."[15] In contrast, in the case of *Exide Technologies*, Judge Thomas L. Ambro stated in a concurring opinion: "Courts may use § 365 to free a bankrupt trademark licensor from burdensome duties that hinder its reorganization. They should not—as occurred in this case—use it to let a licensor take back trademark rights it bargained away."[16] The court in *Drexel Burnham* also explained that "'we can understand that the term 'rejection,' a product of the exclusionary doctrine, does not embody the contract-vaporizing properties so commonly ascribed to it.' Rejection merely frees the estate from the obligation to perform; it does not make the contract disappear."[17] This backdrop highlights the confusion among courts regarding the effect of rejection.

Rejection Should Not Elevate a Severance Claim into § 507(a)(4) Priority

In *Dornier Aviation* and *LandAmerica*,[18] the courts used rejection to grant priority to claims of employees who deserve priority but do not fit within the confines of either § 503(b) (administrative priority) or § 507(a)(4) (fourth-level wage priority). In light of its history, the deemed-breach rule is intended to put the nondebtor party to an executory contract on a par with parties to nonexecutory contracts. It is not intended to create priority rights. The *Dornier Aviation* line of cases directly contradicts this intent by putting executoriness front and center into the claims-priority analysis.

It also substitutes one arbitrary measure for another. Under § 507(a)(4), only employees who are terminated within the time period set forth in the statute are entitled to priority. By its terms, those terminated after the petition date are not entitled to § 507(a)(4) priority. *Dornier Aviation* tried to avoid this arbitrariness by holding that employees terminated post-petition will be entitled to priority (up to the statutory cap) if the severance claim arises from a rejected executory agreement. The problem is that executoriness is in the "eyes of the beholder."[19] Courts disagree on what is or is not executory[20] to such an extent that the case law has

7 *See generally In re Dornier Aviation (North America) Inc.*, No. 02-82003-SSM, 2002 Bankr. LEXIS 1653 (Bankr. E.D. Va. Dec. 18, 2002).

8 *Id.* at *7-8.

9 *Id.* at *28, n. 11.

10 *See generally LandAmerica*, 436 B.R. 343; *aff'd sub nom., Matson*, 651 F.3d 404.

11 *In re Circuit City Stores Inc., et al.*, Case No. 08-35653, pending in the U.S. Bankruptcy Court for the Eastern District of Virginia, Richmond Division, before Hon. **Kevin R. Huennekens**.

12 *In re Circuit City Stores Inc.*, Case No. 08-35653, Transcript of hearings dated March 8, 2010, March 25, 2010, and Oct. 19, 2011.

13 Michael T. Andrew, "Executory Contracts in Bankruptcy: Understanding 'Rejection,'" 59 *U. Colo. L. Rev.* 845, 908 (1988); see also Michael T. Andrew, "Executory Contracts Revisited: a Reply to Professor Westbrook," 62 *U. Colo. L. Rev.* 1, 19020 (1991). *See also* Jay Lawrence Westbrook, "A Functional Analysis of Executory Contracts," 74 *Minn. L. Rev.* 227 (1989) (arguing that rejection is nothing more than breach and that, as a result, any contract, executory or not, can be rejected).

14 Andrew, *supra*, n. 13, 59 *U. Colo. L. Rev.* at 908 and 922 (emphasis added); *see also generally* Westbrook, *supra*, n. 13, 74 *Minn. L. Rev.* 227 (arguing that rejection is nothing more than mere breach of obligations going forward).

15 *In re HQ Global Holdings Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003); *accord In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009); *Raima UK Ltd. v. Centura Software Corp. (In re Centura Software Corp.)*, 281 B.R. 660, 674 (Bankr. N.D. Cal. 2002); *In re Chipwich Inc.*, 54 B.R. 427, 431 (Bankr. S.D.N.Y. 1985).

16 *In re Exide Techs.*, 607 F.3d 957, 967-68 (3d Cir. 2010) (Ambro, J. concurring).

17 *Drexel Burnham*, 138 B.R. at 703 (quoting Andrew, *supra*, n. 13, 62 *U. Colo. L. Rev.* at 22); *see also In re Lakewood Eng'g & Mfg. Co.*, 459 B.R. 306, 346 (Bankr. N.D. Ill. 2011) (stating that rejection did not terminate trademark).

18 *See also In re Circuit City Stores Inc.*, Case No. 08-35653, Transcript of hearings dated March 8, 2010, March 25, 2010, and Oct. 19, 2011 (where court indicated its agreement with *Dornier Aviation* approach to rejection and priority).

19 *In re Riodizio Inc.*, 204 B.R. 417, 423 (Bankr. S.D.N.Y. 1997); *see also Drexel Burnham*, 138 B.R. at 703 (describing "chronic uncertainty and constant litigation" that characterize present state of law of executory contracts) (quoting Andrew, *supra*, n. 13, 59 *U. Colo. L. Rev.* at 932).

20 *Compare Dornier Aviation*, 2002 Bankr. LEXIS 1653, at *7 ("little doubt" that severance agreement was executory), *with In re Wang Laboratories*, 154 B.R. 389 (Bankr. E.D. Mass. 1993) (severance agreement not executory); *In re Metalsource Corp.*, 163 B.R. 260 (Bankr. W.D. Pa. 1993) (same); *compare also Lubrizol Enters. Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043, 1046 (4th Cir. 1985) (license agreement was executory), and *Riodizio*, 204 B.R. at 424 (option contract was executory), *with In re Qintex Entm't Inc.*, 950 F.2d 1492, 1496 (9th Cir. 1991) (license agreement was not executory), and *BNY, Capital Funding LLC v. U.S. Airways Inc.*, 345 B.R. 549, 552 (E.D. Va. 2006) (option contract was not executory).

been called "chaotic,"[21] even "psychedelic."[22] Priority claims should not depend on such an unreliable doctrine.

Further, many authorities state that priority should not be imposed by judicial gloss or inferred by courts, but should appear clearly from statute.[23] Finally, even if priority should be inferred by the courts, the inference drawn by *Dornier Aviation* is weak. Under § 365(g), rejection constitutes a *breach by the debtor* as of the petition date. However, the date that the debtor breaches is not necessarily the same as the date that the employee *earns* the severance pay as required by § 507(a)(4) because severance (or an incentive or retention bonus) could be due *after* the termination or other vesting date. The *Dornier Aviation* rule mistakenly assumes that the breach date and the earned date are necessarily the same.

Conclusion

Under the case law in many courts, employees who stay with a company after the petition date are relegated to general unsecured status, while employees who are terminated shortly before the petition date are rewarded with § 507(a)(4) priority, which is unfair. Employees who take the risk and stick with a debtor in possession should receive the same priority as those who are terminated shortly before the petition date.

However, the solution does not rest with a rejection/deemed-breach analysis. The law regarding rejection and executoriness is one of the most confused and inconsistent areas of bankruptcy law, and the priority of employee claims should not be dragged into this bramble-filled thicket. Instead, Congress should amend § 507(a)(4) so that employees who stay with a distressed company past the petition date are rewarded to the same extent as employees who stay with the company during the six months before the petition date. abi

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21 *In re Bergt*, 241 B.R. 17, 29 (Bankr. D. Alaska 1999).

22 Westbrook, *supra*, n. 13, at 228 (in no area of bankruptcy "has the law become more psychedelic than in the one titled 'executory contracts'").

23 *See Air Line Pilots Assoc., Int'l v. Shugrue (In re Ionosphere Clubs Inc.)*, 22 F.3d 403, 408 (2d Cir. 1994) ("Implying a superpriority for claims arising under [collective-bargaining agreements] also would disrupt the careful balancing of competing policies embodied in section 507."); *see also* 4 *Collier on Bankruptcy* ¶ 507.02[3] (Alan N. Resnick and Henry J. Sommer eds. 16th ed. 2012) ("The priorities created by section 507, as supplemented by other sections of the Code affecting priority of payment, reflect congressional intent to establish the priority of distribution in bankruptcy cases. Other than the priorities explicitly set forth in the Code, there are no other priorities that ought to be created or recognized in bankruptcy cases. Courts are not free to use equitable or other principles to alter the statutory priorities set forth in the Code."); *Nathanson v. NLRB*, 344 U.S. 25, 29 (1952) ("The theme of the Bankruptcy Act is equality of distribution; and if one claimant is to be preferred over others, the purpose should be clear from the statute." (internal citation and quotation marks omitted)).