AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
Issues and Information for the Insolvency Professional

The Deflation of the "Golden Parachute" in Bankruptcy

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Courts are showing increasing reluctance to allow lump-sum payments to executives under pre-petition employment contracts as an administrative expense, particularly those with characteristics of "golden parachutes," and have narrowly applied the Bankruptcy Code for prioritizing such payments as an administrative expense. The seminal case of *Straus-Duparquet Inc. v. Local Union No. 3,* 386 F.2d 649 (2d. Cir. 1967), decided under the now-superseded Bankruptcy Act, allowed "severance" payments to employees to be treated as an administrative expense and is often relied on by employees to claim all termination payments as an administrative expense. This article addresses the impact of *Straus-Duparquet* on the current state of the law in this area and concludes with recommendations for executives to avoid the increasing disfavor toward allowing termination pay as an administrative expense.

The Legacy of *Straus-Duparquet*

Straus-Duparquet involved claims brought by a union on behalf of employees after they were discharged post-petition.[2] The court held that claims for two weeks severance pay under a collective bargaining agreement were entitled to administrative expense priority if the employees worked during the chapter 11 case, stating, "severance pay is compensation for termination of employment, and since the employment of these claimants was terminated as an incident of the administration of the bankrupt's estate, severance pay was an expense of the administration and is entitled to priority as such an expense." *Id.* at 651.

The Second Circuit later reaffirmed *Straus-Duparquet* in several cases.[3] In all of these cases, the employees provided service to the debtor post-petition under contracts that were not rejected.

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In *In re Unishops,* 553 F.2d at 305 (2d Cir. 1977), a former executive employee filed a claim for termination payments provided for in a pre-petition letter agreement.[4] The court held that the termination pay was an administrative claim because the debtor received benefits under the agreement from the claimant and had not rejected the agreement. *Id.* at 308. Had the debtor disaffirmed the agreement before filing its petition, "[the claimant's] claim for $100,000 would have been the claim of a general creditor." *Id.*

In *In re W.T. Grant,* 620 F.2d 319 (2d Cir. 1980), the Second Circuit allowed as an administrative expense the severance pay claims of some 32,000 employees that had been retained by the debtor during its reorganization attempt. Lately, courts have begun questioning whether the term "severance" as used in employment agreements is really a disguised "golden parachute." The severance payments allowed in the earlier cases of *Straus-Duparquet* and *W.T. Grant* were based on length of service by the workers and were no greater than two weeks' pay. In subsequent cases, the employment agreements provided for substantial payments to senior executives in multiples of their annual salary and were not based on length of service.[5] In such cases, courts found that salary-continuation payments, particularly those of a large magnitude, were not severance payments and not entitled to administrative status.[6]

In *In re Applied Theory Corp.,* 312 B.R. 225, 228 (Bankr. S.D.N.Y. 2004), the executives sought payment of multiple years' salaries as "severance."[7] The court found that the continuation payments "far exceed the amounts necessary to compensate for the economic hardship of temporary joblessness, and in no way can be fairly regarded as 'in lieu of notice'." *Id.* at 244. "[T]he 'severance' obligation in the executives' employment contract did not rest on the length of his service, like traditional severance pay." *Id.*

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In *In re Child World Inc.,* 147 B.R. 847 (Bankr. S.D.N.Y. 1992), the court found that the continuation payment claimed by a key executive did not qualify as "severance" since it "is not related to the employees' years of past service, but is bottomed instead on the employee's base salary at the time of termination." 147 B.R. at 853.

In *In re Hooker Investments Inc.,* 145 B.R. 138 (Bankr. S.D.N.Y. 1992), the court held that continuation payments were not administration expenses because, unlike severance, the payments were inversely related to the length of services. 145 B.R. at 149-51. In *dicta,* the court reasoned that *Straus-Duparquet* and its progeny were inapplicable because the executive was not the type of union employee that *Straus-Duparquet* intended to protect. *Id.* at 147-151.

The Objectives of Chapter 11

The paramount objectives of chapter 11 are to rehabilitate and preserve the value of the debtor by allowing it to discharge debt,

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2 386 F.2d at 650.

3 *See, e.g., Zelin v. Unishops Inc. (In re Unishops Inc.),* 553 F.2d 305 (2d. Cir. 1977); *W.T. Grant Co. v. Rodman (In re W.T. Grant),* 620 F.2d 319 (2d. Cir. 1980); *Trustees of Amalgamated Ins. Fund v. McFarlin's Inc. (In re McFarlin's),* 789 F.2d 98 (2d. Cir. 1986).

4 553 F.2d at 307.

5 *See, e.g., In re Applied Theory Corp.,* 312 B.R. 225, 228 (Bankr. S.D.N.Y. 2004); *In re Jamesway Corp.,* 199 B.R. 836, 840 (Bankr. S.D.N.Y. 1996); *In re Child World Inc.,* 147 B.R. 847, 849 (Bankr. S.D.N.Y. 1992); *In re Hooker Investments Inc.,* 145 B.R. 138, 141 (Bankr. S.D.N.Y. 1992).

6 *See In re Applied Theory,* 2004 Bankr. LEXIS 975, at *55-57; *In re Child World Inc.,* 147 B.R. at 853; *In re Hooker Investments Inc.,* 145 B.R. at 147.

7 *Applied Theory,* 312 B.R. at 225.

streamline its finances and fairly distribute its remaining assets according to the priority scheme set forth in the Code. Allowing payments to employees under pre-petition executory contracts raises two issues that challenge the dual objectives of the Code: first, whether the services provided by the employee were provided post-petition and, if so, whether they were necessary to the preservation of the debtor's estate; and second, whether the executory contract at issue was formally rejected or disaffirmed by the bankrupt employer.

Bankruptcy Code Standard for Granting Administrative Expense

Section 503(b)(1) 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." Administrative expenses were granted priority by Congress to allow the debtor to prioritize debts that would facilitate its rehabilitation and thus benefit the creditors.[8] Since the debtor has limited resources, priority status must be narrowly construed and the burden of entitlement rests with the party seeking it.[9]

Courts have held that whether termination pay is entitled to an administrative status requires a determination that the employee's services provided a benefit to the estate post-petition.[10] The oft-cited *Mammoth Mart* test for allowance of administrative expenses sets forth two requirements for approval of an administrative expense under §503(b)(1)(A):

1. It must result from a post-petition transaction with the debtor or trustee; and
2. It may be allowed only to the extent that the consideration supplied by the creditor was beneficial and supplied to the debtor in the operation of its business.[11]

Executives have a high, though not insurmountable, burden to prove that substantial continuation payments are beneficial to a debtor's estate, particularly when they have been adequately compensated for the value of their post-petition services to the debtor.

Bankruptcy Code Standards for Rejecting Pre-Petition Executory Contracts

Another significant factor used to determine whether an employee's termination payment is entitled to administrative status is whether or not the employee's pre-petition contract has been rejected by the debtor. Section 365(a) of the Code provides that a trustee or debtor-in-possession (DIP), "subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." If a debtor determines that an executory contract is beneficial to its estate and assumes it under §365(a), then the liabilities incurred in the performance of such contract will be treated as an administrative expense. If the debtor rejects the contract, it is deemed breached "immediately before the date of the filing of the petition," 11 U.S.C. §365(g)(1), giving rise to an unsecured claim pursuant to §502(g) of the Code.

Courts have consistently held that only a formal rejection is sufficient to disaffirm an executory contract.[12] If the contract has not been rejected, a debtor may be liable for its obligations under such contract as an administrative expense claim.[13] On the other hand, rejection of a contract gives rise to a pre-petition general unsecured claim because it would defeat the purpose of allowing debtors to reject burdensome executory contracts if they were forced to pay the obligation they initially sought to avoid as an administrative expense.

Current State of Law Interpreting *Straus-Duparquet* and its Progeny

Recent cases have questioned whether *Straus-Duparquet* is applicable under the Code, especially in cases involving high-priced executives where the purported "severance" payment is two to four times the salary, with attributes of a "golden parachute."[14]

In *Applied Theory,* the U.S. Bankruptcy Court for the Southern District of New York set forth the most comprehensive departure from the legacy of *Straus-Duparquet*[15] to date.[16] Former executives of the debtors contended that the termination payments owed to them under their pre-petition employment agreements should be paid as administrative expenses because they provided post-petition services to the debtor before their employment agreements were rejected. *Id.* at 241. The court, after analyzing the relevant case law, rejected the executives' arguments and reclassified their claims as general claims for two primary reasons:

1. Where a pre-petition contract is duly rejected, *Straus-Duparquet* is inapplicable and the claims arising from such contract are treated as pre-petition claims; and
2. Where the facts demonstrate a substantial claim for multiple years' salary with the attributes of a "golden parachute" and have no relationship to length of service, lack of notice or any other characteristic of traditional severance pay, *Straus-Duparquet* is inapplicable. *Id.* at 248.

Conclusion

As *Applied Theory* and other recent case law indicate, *Straus-Duparquet* and its progeny, though not overruled, have lost their vitality having been distinguished on a myriad of factual and legal grounds. Executives of troubled companies seeking chapter 11 rehabilitation face a harsh reality if they choose to provide post-petition services to a debtor and rely on the "severance" or other "termination payments" owing to them under a pre-petition employment agreement to be paid as an administrative expense. In balancing the objectives of chapter 11, courts have become increasingly reluctant to find that such payments are administrative expenses and instead, through a strict interpretation of the Code, are holding that such claims are general unsecured claims. Executives who are willing to shepherd a company through chapter 11 are not without recourse. Executives should review their employment agreements, ensuring that references to termination payments have the attributes and characteristics of a true "severance" payment; *i.e.,* it should be called "severance" and not "termination" pay; it should be based on length of service, if possible; and there should be an obligation to mitigate damages. Finally, executives can request that the debtor assume the employment contract at issue, thereby insuring that any claim under the contract will have administrative status. ■

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8 H.R. Rep. No. 595, 95th Cong., 1st Sess. 186, 186-87 (1977).
9 *In re Filene's Basement,* 330 F.3d 36, 42 (1st Cir. 2003).
10 *In re Filene's Basement,* 330 F.3d at 42-43; *McFarlin's,* 789 F.2d at 101; *In re Mammoth Mart Inc.,* 536 F.2d 950, 954 (1st Cir. 1976). *In re Mammoth Mart* predates the enactment of the Bankruptcy Code and, though not overruled, has been superseded as it pertains to the treatment of collective bargaining agreements under 11 U.S.C. §1113.
11 536 F.2d at 954.
12 *In re Unishops,* 553 F.2d at 308; *W.T. Grant,* 620 F.2d at 321.
13 *See, e.g., In re Unishops,* 553 F.2d at 308.
14 *See, e.g., Applied Theory,* 312 B.R. at 243; *Hooker,* 145 B.R. at 145.
15 Though questioning the applicability of *Straus-Duparquet,* it is notable that the court did not opine on whether *Straus-Duparquet* was wrongly decided or good law. *See Applied Theory,* 312 B.R. at 228 fn. 6.
16 *Applied Theory.*