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Navigating Today's Environment

The Directors' and Officers' Guide to Restructuring

SECOND EDITION

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Published by

CAXTON Business & Legal inc.

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CHAPTER EXCERPT

10 TREATMENT OF WORKFORCE-RELATED CLAIMS IN FINANCIAL RESTRUCTURINGS

LEGAL PERSPECTIVE

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When a company is in financial distress, boards and senior leadership teams confront difficult choices, particularly in managing human capital. If a company seeks bankruptcy protection, having a clear and comprehensive labor strategy can help maintain employee morale, minimize potential disruptions and preserve the value of the enterprise. Developing such a strategy requires understanding the ways in which the U.S. Bankruptcy Code and courts treat employee-related claims. This chapter will cover three workforce-related claims—those arising from (i) the Worker Adjustment and Retraining Notification Act (“WARN Act”), (ii) severance programs and (iii) withdrawal from multi-employer pension plans—that, if not adequately planned for, can result in significant and potentially unnecessary liabilities.

How the bankruptcy code classifies claims

Before examining issues related to these types of labor claims, it is necessary to understand how the Bankruptcy Code generally classifies and prioritizes claims against a debtor and its estate, and the distinction between pre- and post- petition claims. Claims generally may be placed into three primary categories:

— **Secured claims**: A claim is secured to the extent of the collateral’s value. A creditor with a secured claim is entitled to priority payment out of its collateral. If the collateral value is less than the claim amount, the “deficiency” is treated as an unsecured claim.

— **Priority claims**: Under Bankruptcy Code section 507, ten categories of unsecured claims and expenses are entitled to payment priority in bankruptcy cases. Relevant to the workforce claims discussed herein are the second and fourth priorities: (i) administrative expenses, under Bankruptcy Code section 507(a)(2) and (ii) wage, salary and commission claims, under Bankruptcy Code section 507(a)(4).

— **Unsecured claims**: Claims that are not secured by collateral and are not entitled to priority are general unsecured claims and will receive a ratable distribution of the value remaining in the debtor’s estate after satisfying senior claims.

The foregoing classifications are important because they affect how workforce-related claims are treated. Equally significant to the treatment of these claims is whether the claims represent a pre-petition or post-petition liability.

— **Pre-petition wages and benefits**: Priority for wages and benefits earned pre-petition has been a long-standing feature of U.S. bankruptcy law. This priority, currently codified in Bankruptcy Code section 507(a)(4), elevates what otherwise would be an employee's unsecured claim to a preferred status — providing employees greater assurance that their wages will be paid and generally encouraging employees to remain working for the bankrupt company. The amount entitled to priority under this provision, however, is capped (though bankruptcy courts often allow a debtor to exceed such cap). Currently, this cap is $15,150 per employee and is adjusted every three years to account for changes in the cost of living. Additionally, for any wages or benefits to qualify for the priority, they must have been "earned" within 180 days of the petition date. All pre-petition wages and benefits that exceed the cap or were earned more than 180 days prior to the petition date are not entitled to priority. Instead, they are treated as general unsecured claims in the bankruptcy and a debtor is not required to pay such claims in full in cash.

— **Post-petition wages and benefits**: Claims arising after a debtor's petition date, including wages and benefits, are "administrative expenses" as they represent "actual, necessary costs and expenses of preserving the estate[,]" and are granted a second priority under section 507(a)(2) of the Bankruptcy Code. This priority ensures that, unless otherwise agreed with the claimant, administrative expenses are paid in full and in cash on the effective date of a Chapter 11 plan. Unlike pre-petition claims, the requirement to pay such claims in full and in cash can represent a significant restraint on a debtor's liquidity.

In sum, when considering workforce-related claims in bankruptcy, timing is critical.

Warn act claims

Enacted in 1988, the WARN Act, 29 U.S.C. §§ 2101 *et seq.*, protects employees affected by job loss due to "plant closings" and "mass layoffs." The WARN Act requires employers with 100 or more employees (which may, under limited circumstances, include part-time employees) to provide 60 calendar days' notice of any plant closing (including a permanent or temporary shutdown of a single site of employment or one or more facilities or operating units within such single site of employment) affecting 50 or more employees, or any mass layoff (such as a reduction in force at a single site of employment) that affects at least 50 employees, if such number represents at least 33% of the total workforce, or at least 500 employees, regardless of the percentage of the workforce impacted. When determining whether a plant closing or mass layoff has occurred, employment losses are measured during a rolling 30-day period and part-time employees are not included. If an employer fails to give its employees the full 60-days' notice, the employer will be liable to affected employees for back pay and benefits for each day of its violation. Depending on the size of the workforce reduction and the length of the violation, these damages can be significant. For employers on the brink of insolvency or already in bankruptcy, the treatment of WARN Act claims could significantly affect how much, if any, value is left in the estate for distribution. The key consideration in determining whether such claims are entitled to priority is the timing of when the claim arises—meaning: is the claim for damages under the WARN Act properly viewed as a pre-petition claim or a post-petition administrative expense, entitled to payment in full in cash? Not all courts have adopted the same view.

Prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), case law regarding the treatment of WARN Act claims in bankruptcy was clear: damages under the WARN Act were treated akin to wages and were subject to the same priority. *See, e.g.*, *In re Kitty Hawk Inc.* (Bankr. N.D. Tex. 2000); *In re Hanlin Group* (Bankr. D.N.J. 1995); *In re Cargo, Inc.* (Bankr. N.D.

Iowa 1992). Courts in these cases likened WARN Act damages to a "statutorily imposed form of severance pay," similar to severance pay in lieu of notice. Severance pay in lieu of notice is deemed to accrue or vest at the time of termination, because entitlement to such pay is predicated on whether notice had been given before the moment of termination. Likewise, since the WARN Act is either violated or not violated at the time of termination, damages were found to accrue at termination as well. This understanding, in turn, meant that a termination within 180 days before the petition date that violated the WARN Act could at most qualify for payment priority up to the statutory cap (i.e., $15,150), with the remaining damages classified as general unsecured claims. Meanwhile, a post-petition termination in violation of the WARN Act would result in an administrative expense claim. Thus, the only consideration was whether the termination happened pre- or post- petition.

With the enactment of BAPCPA, this binary analysis hit a snag. BAPCPA expanded the types of claims allowable as administrative expenses to include wages and benefits awarded pursuant to judicial proceedings as "back pay attributable to any period of time occurring after commencement of [a bankruptcy] case … without regard to …whether any services were rendered." This amendment created a split among bankruptcy courts regarding how it applied to damages under the WARN Act, with two main approaches emerging to date.

The first approach adheres to the pre-BAPCPA case law set forth above. Courts following this approach look to the time when the WARN Act claims "vest or accrue." *See, e.g.*, *In re Powermate Holding Corp.* (Bankr. D. Del. 2008). These courts focus on the statutory phrase "attributable" and find that the time to which back pay is attributable is when the rights vest or accrue, without regard to when the unlawful conduct or services occurred or when payment is due. Thus, in keeping with the pre-BAPCPA line of cases, a claim for WARN Act damages for a pre-petition termination under this interpretation does not constitute an administrative expense claim, while a claim for WARN Act damages for a post-petition termination would. Whether the termination occurred before or after the petition date remains the relevant inquiry under this line of cases.

In contrast, courts following the second approach find that focusing on the timing of when rights vest or accrue is inconsistent with the plain language of the amendment. *See, e.g.*, *In re Truland Group, Inc.* (Bankr. E.D. Va. 2014); *In re Phila. Newspapers, LLC* (Bankr. E.D. Pa. 2010). These courts instead focus on whether any portion of the WARN Act liability period extends post-petition to determine whether any portion of the related damages constitutes an administrative expense. In making such determination, these courts rely on the language in the amendment that employees are entitled to an administrative expense "without regard to the time of the occurrence of unlawful conduct on which such award is based or to whether any services were rendered[.]" Under this approach, as long as the other requirements of the amendment are met, an award of back pay "attributable to any time occurring after the commencement of [a] case" constitutes an administrative expense. By way of example, these courts reason that if employees are terminated without any advance notice (and are not paid severance in lieu of notice to effectively preclude relief for damages), the 60-day liability period begins on the date of such termination and ends 60 days later. If the bankruptcy petition was filed five days after the employees' termination, then 55 days out of the 60-day liability period occurred after the commencement of the case. Thus, the 55-day period attributable to the post-petition period will be considered an administrative expense and entitled to payment in full, in cash.

When considering a workforce reduction in or near bankruptcy, an employer should keep in mind the following:

— **WARN Act compliance**: Employers should, if feasible, adhere to the WARN Act's 60-day written notice requirement. In the event of uncertainty regarding whether a plant closing or mass layoff will occur, or whether certain employees may be impacted by such events, employers should err on the side of caution and provide the required notices since they may be withdrawn should circumstances change. Employers should also be aware of the exceptions to the WARN Act's notice requirement, which include the Faltering Company, Unforeseeable Business Circumstances and Natural Disaster exceptions. However, even when an exception applies, notice of termination must still be provided to employees as soon as possible. In addition, some states have enacted their own versions of the federal WARN Act, colloquially referred to as "mini-WARN Acts." Companies should review applicable state mini-WARN Acts if they anticipate any material workforce reductions.

— **Timing of workforce reduction**: If it is not possible to provide advance notice to employees of a plant closure or mass layoff, employers should consider both the timing of any workforce reduction and the jurisdiction of the bankruptcy court in which proceedings may be filed or pending because these may affect whether or not a WARN Act claim receives administrative expense status in bankruptcy. To date, there is no binding circuit-level precedent on how to interpret the BAPCPA amendment and different bankruptcy courts within the same jurisdiction have taken opposing views.

Severance claims

Severance benefits fall within the employee-priority set forth in Bankruptcy Code section 507(a)(4). Generally, employers pay severance to employees under three scenarios: (i) as compensation for job loss, with the benefit amount typically calculated based on years of service; (ii) as a payment in lieu of notice of termination; or (iii) under an employment contract, with the severance payment typically due if the employee is terminated without cause prior to expiration of the contract period. No universal rule exists on when severance is "earned," so care should be taken in considering the general approach in the applicable jurisdiction and the terms of any severance plan or employment contract. Nonetheless, the following are guidelines based on case law for considering the amount of liability a debtor may have for severance payments under the different types of severance.

— **Severance based on years of service**: For employees terminated post-petition, courts reason that, because an administrative expense claim must be supported by "services rendered after the commencement of a case," severance payments based on length of employment are entitled to administrative expense status only to the extent accrued during post-petition employment. Accordingly, courts will award administrative expense priority only to the portion of a severance award attributable to post-petition services, with the balance either (i) eligible for pre-petition priority if earned within the 180-day time period (up to $15,150) or (ii) a general unsecured claim for any amounts outside of the 180-day time period. By contrast, for employees terminated pre-petition, courts have reached differing results on when severance based on years of service is "earned" for purposes of calculating the portion attributable to the 180-day period. Some courts, including the Court of Appeals for the Fourth Circuit in *Matson v. Alarcon* (4th Cir. 2011), have concluded that no right to severance exists until an employee is involuntarily terminated — and thus, the full amount is earned upon termination. The Fourth Circuit reasoned that the entitlement to severance pay was triggered by the employer's decision to terminate the employment relationship (not by the employee's rendering of services) and, moreover, the board at all times retained the right to eliminate the severance program before employees became entitled to payments. The Fourth Circuit remains the only circuit that has addressed the question of when severance based on length of service is "earned," with other lower-level courts split in approach (i.e., whether the full amount of severance is earned at termination or whether the severance should be prorated). As the Fourth Circuit's decision indicates, how a court views severance may be informed by the terms of the applicable compensation plan and the specific rights that exist between the parties.

- **Severance in lieu of notice**: Courts recognize that, with severance in lieu of notice, the entire severance benefit is earned on the date of termination. This payment is considered earned at termination since no right to any severance benefit exists unless the termination occurs. Accordingly, for this type of severance, the amount of liability can be determined simply by reference to the termination date. If the termination occurs post-petition, the full amount will be granted administrative expense priority and entitled to payment in full in cash. If the termination occurs pre-petition and within the 180-day time period, up to the statutory cap of $15,150 will be entitled to priority, with the balance classified as a general unsecured claim. For any termination outside the 180-day time period, the employee will have only a general unsecured claim.
- **Severance under employment contracts**: For severance under an employment contract, courts have held that the severance payment was earned upon execution of the contract, rather than the termination date. For example, the Court of Appeals for the First Circuit, in *Mason v. Official Committee of Unsecured Creditors (In re FBI Distribution Corp.)* (1st Cir. 2003), upheld denial of administrative expense priority to an executive's severance benefit following a post-petition termination by reasoning that the executive provided the consideration supporting the severance payment pre-petition by forgoing other employment opportunities. The same reasoning applies in connection with pre-petition terminations and identifying whether the contract was executed within the 180-day time period and therefore "earned" at that time.

Finally, with respect to employment contracts, employers should also be aware that Bankruptcy Code section 502(b)(7) caps an employee's claim for severance at a year's compensation, starting from the earlier of (i) the date the bankruptcy case began or (ii) the termination of the employee's contract.

In addition to the foregoing, employers should keep in mind an additional restriction on severance. Severance claims by an "insider" (generally, for corporate debtors, meaning directors and officers) are limited by Bankruptcy Code section 503(c)(2). This provision requires that any severance payment to an insider must (a) be part of a program generally applicable to all full-time employees and (b) not be greater than ten times the amount of the mean severance pay given to non-management employees during the calendar year in which the payment is made.

Given these varied approaches on severance, it is important to develop a workforce reduction and severance strategy prior to filing a petition. Employers and their counsel should carefully evaluate (i) the state of the law in the potential filing jurisdictions, (ii) the terms of any severance plan or contract providing for severance, including whether such plans or contracts may be amended or replaced and (iii) the timing of terminations or workforce reductions that may give rise to severance obligations to minimize potential liabilities.

Withdrawal liability

Withdrawal liability can arise when an employer participating in a multi-employer pension plan exits that plan. Often a withdrawal occurs because the employer ceases to fulfill its obligations under a pension plan or discontinues its operations covered by a plan. The Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. §§ 1001 *et seq.*, as amended by the Multiemployer Pension Plan Amendments Act of 1980 ("MPPAA"), 29 U.S.C. §§ 1381 *et seq.*, imposes liability for withdrawals because, without payment of that liability, other contributing employers must shoulder increased funding obligations, leaving plans susceptible to failure.

An employer's withdrawal liability represents its share of the plan's unfunded vested benefits, which is "calculated as the difference between the present value of vested benefits and the current value of the plan's assets." *Pension Benefit Guar. Corp. v. R.A. Gray & Co.* (1984). The MPPAA sets out various formulas that plans can use to calculate the portion of unfunded vested benefits attributable to a given employer. This means when an employer withdraws, the pension plan trustee calculates the total unfunded vested benefits, determines the withdrawing employer's allocable share using a certain formula under the MPPAA and collects the portion of unfunded vested benefits attributable to the withdrawing employer. The calculation of unfunded vested benefits can be complicated by many other factors, including, for example, whether the employer's liability obligation is due in a lump sum or installments, whether a payment cap applies or whether an employer is assessed with multiple partial withdrawals.

The primary question that arises with respect to withdrawal liability claims in bankruptcy is the allocation of the claim among administrative expense priority and general unsecured status. Courts that have addressed this issue have come to varying conclusions, with some denying administrative expense status altogether, such as courts in the Sixth Circuit, and others allowing administrative expense status for the portion of withdrawal liability claims that are attributed to the post-petition period, including courts in Second and Third Circuits.

In line with the jurisprudence that denies administrative expense status altogether, the Bankruptcy Appellate Panel for the Sixth Circuit denied administrative expense priority for any portion of a withdrawal liability claim, even though the debtor continued operations two years post-petition during which contributions were made to the plan based on the work of employees. *See In re HNRC Dissolution Co.* (6th Cir. B.A.P. 2008). The court found that the calculation of the withdrawal liability claim included factors such as discount rates and market fluctuations that were not connected to post-petition work and so not entitled to administrative expense priority.

In contrast, the Court of Appeals for the Third Circuit apportioned liability between pre- and post- petition periods. *See In re Marcal Paper Mills, Inc.* (3d Cir. 2011). The Third Circuit found that the employees were required to work to keep the employer in business and consequently conferred a benefit to the estate. As a result, the Third Circuit held that the portion of liability attributable to post-petition work was entitled to administrative priority.

Notwithstanding the determination by some courts that a portion of withdrawal liability may be classified as an administrative expense, given the complexities of determining apportionment, it is the *amount* of such withdrawal liability that should be treated as an administrative expense that is likely an issue that will be subject to significant litigation in the bankruptcy courts. Besides *In re Marcal Paper Mills*, only two other circuit court decisions have addressed whether post-petition withdrawal liability can be classified as an administrative expense, and neither directly decided the issue of the allocation of claims between administrative and unsecured status. *See Food Employers' Labor Rels. Ass'n v. A&P* (2d Cir. 2015) (finding that the plan's calculation of withdrawal liability bore little if any relation to the amount of unfunded vested benefits from the plan year in which the bankruptcy petition was filed); *Trustees of Amalgamated Ins. Fund v. McFarlin's* (2d Cir. 1986) (holding that the withdrawal liability claim was only supported by pre-petition labor). Although many courts appear to agree that withdrawal liability claims should be prorated between the pre- and post- petition periods based on how much an employer's unfunded obligations increased during the plan year, those courts still question how to appropriately apportion the withdrawal liability claim amounts between pre- and post- petition periods. *In re Marcal Paper Mills*; *In re Cott Corp.* (Bankr. D. Ct.); *In re Pulaski Highway Express, Inc.* (Bankr. M.D. Tn. 1986).

Because courts differ in how they assess whether a portion of withdrawal liability claims are entitled to administrative expense status and, if so, what manner of calculation appropriately allocates such portion of a withdrawal liability claim to post-petition labor, it is essential to pay careful attention to the jurisprudence of the potential filing jurisdictions. Employers planning for bankruptcy should be aware of whether or not any withdrawal liability will be or could be incurred and should take the necessary steps to calculate the potential claim amounts.

Conclusion

Rarely do companies in financial distress have the luxury of time. But having a clear workforce strategy is among the most important tasks a board and senior leadership team can undertake in advance of a bankruptcy filing. Careful attention to the particular rules of a jurisdiction — particularly if a company has options on where to file its bankruptcy petition — and the various timing considerations for labor-related claims can help ensure a smooth, value-maximizing Chapter 11 process for all stakeholders.

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