

Bankruptcy Courts' Treatment of Severance Agreements Providing for Continued Payments to Former Employees

By Michael J. Lichtenstein

WHEN COMPANIES FACE FINANCIAL DIFFICULTIES, management often negotiates severance agreements with employees that require certain payments for an extended period. In exchange, the former employees may agree to sign a non-compete, non-disclosure and non-solicitation agreement or to provide other consideration. For example, rather than pay a 6-figure salary to a senior executive who might be redundant, a company that is downsizing might terminate the employment contract but agree to pay some amount of severance over an extended period of time. If the company's fortunes fail further, resulting in the filing of a Chapter 11 bankruptcy petition, management may desire to escape liability for making continued payments under such severance agreements or under existing contracts with former employees. Unfortunately, under such circumstances, the Bankruptcy Code is not designed to favor the former employee. Many courts have severely curtailed former employees' rights to receive payment in full on account of such severance agreements.

In a Chapter 11 proceeding, a pre-petition severance agreement can be deemed to be executory¹ or non-executory. The consequence of which definition applies is the claim priority to which the former employee may be entitled. In plain English, this may mean a former employee receives either 100 cent dollars or "bankruptcy dollars" (typically less than 100 cents)² on account of payments due under the severance agreement. Obviously, a debtor company will usually seek a way to minimize payments to former employees, whereas, former employees would rather be paid in full. Infrequently, a reorganizing company may wish to continue such payments to engender contin-

ued good will from its current employees. Not surprisingly, the scales are tipped in favor of the debtor on this issue,³ and a former employee faces an uphill battle to convince a bankruptcy court that she is entitled to payment in full on account of her severance agreement with the employer for whom she no longer works. Unfortunately, this may be true whether a contract is deemed to be executory and therefore capable of rejection or not.

Section 365 of the Bankruptcy Code⁴ provides that a trustee⁵ may assume or reject any executory contract. Most courts defer to the debtor's business judgment in determining whether or not to allow rejection of an executory contract.⁶ The rejection of an executory contract enables the non-rejecting party to file an unsecured claim which is deemed to arise as of the date the bankruptcy petition was filed. However, until the court enters an order rejecting the contract, the non-debtor party

to the contract may be entitled to an administrative claim based upon the actual and necessary benefit provided to the estate.⁷ Thus, a party to a rejected executory contract, who can demonstrate actual and necessary benefit to the estate, will have a bifurcated claim consisting of an administrative portion for post-petition services through the rejection date (likely to be paid in full) and an unsecured portion for the rejection damages (unlikely to be paid in full).

There is no clear authority on how to treat severance agreements in a Chapter 11 proceeding. Like many bankruptcy issues, the outcome depends on the jurisdiction in which decisions have been made. This is the result of a lack of national binding precedent for bankruptcy courts located across the country. For example, a New York bankruptcy judge has rendered a decision on severance contracts that is directly at odds

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with one written by a Missouri bankruptcy judge. However, despite the differing analysis, the end result has been that courts have been reluctant to achieve a result that allows post-petition payments to former employees on account of severance agreements.

Some courts have been hesitant to classify pre-petition severance agreements as executory. For example, in *In re Spectrum Information Technologies, Inc.*,⁸ the debtor contended that certain separation agreements were executory contracts subject to rejection.⁹ Before the bankruptcy filing, the debtor entered into separation agreements, agreeing to make certain payments to former employees in exchange for those former employees accepting termination payments, modification of existing stock options and agreeing to comply with confidentiality, non-interference and non-compete provisions and to provide consulting.¹⁰

The Court noted that several courts have rejected the Countryman test as the sole benchmark for determining whether a contract is executory.¹¹ Instead, some courts apply a “functional approach” which focuses on any potential benefit to the bankruptcy estate from the assumption or rejection of a contract, rather than the mutuality of obligations.¹² With this goal in mind, but ostensibly applying the Countryman test, the Court in *Spectrum* concluded that the former employees’ contractual obligations did not rise to the level of material future performance.¹³ The Court made this determination even as to two former employees whose continuing duties included consulting obligations.¹⁴

gation is a pre-petition obligation. In other words, the former employee would not be entitled to assert an administrative claim.



On the other hand, in *In re Farmland Indust., Inc.*,¹⁶ the Court applied a different analysis where the debtor sought to reject certain employment agreements of four former executives. The debtor contended that the contracts were executory agreements under which the debtor had continuing severance payment obligations exceeding \$120,000.00 per month.¹⁷ The former employees were obligated to provide consulting services upon demand and to refrain from competition or interference with the debtors’ businesses.¹⁸

One of the employees argued that his agreement was not executory because he had no remaining material obligations under the agreement.¹⁹

The Court disagreed, concluding that the agreement of the former president and chief financial officer of a major corporation not to disclose confidential information, not to compete and to assist in claims’ evaluation were highly pertinent and material obligations, even if the person were never asked to do anything else.²⁰ Therefore, the contracts in question were executory and could be rejected.²¹ The Court agreed with the debtor’s business judgment that there was no continuing benefit to the debtor because the former employees were unlikely to provide meaningful services in the bankruptcy proceeding.²²

The problem with the *Farmland* decision is that it fails to address fully the consequences of rejection. While it is clear that the former employees could file unsecured claims for the rejection damages²³, the Court did not opine whether the former employees could assert administrative claims for the post-petition pre-rejection period. If the former employees had only unsecured claims, they ended up in the same place as the *Spectrum* former employees, albeit via a different

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The practical result of the Court’s decision in *Spectrum* was that the former employees had no right to a rejection claim, essentially taking away any argument of an entitlement to an administrative claim up to the rejection date. In reaching this conclusion, the Court followed the Fourth Circuit,¹⁵ which held previously that, regardless of the nature of the contract, if the debtor’s only post-petition obligation is to pay money, that obli-

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analysis. In one case, the severance contracts were deemed to be executory, whereas in another the contracts with former employees were deemed not to be executory. However, in both cases, all former employees presumably ended up with unsecured claims and both bankruptcy courts determined that there was no continuing benefit to the debtors' estates.

Because the *Spectrum* Court followed the Fourth Circuit's decision in *Stewart Foods*, it is probable that the former employees only had unsecured claims. However, it is possible that in Farmland, although unstated, the former employees could have asserted administrative claims for the period prior to rejection. To do so, they would have needed to demonstrate that they provided an actual and necessary service to the estate.



There is a lesson to be learned by future former employees who may be parties to severance agreements with companies that file for bankruptcy protection. A former employee is better off if a contract is deemed to be executory and subject to rejection. That determination allows a more viable argument that until contract rejection, the employee is entitled to an administrative claim for services provided post-petition to the debtor. When negotiating a pre-bankruptcy severance agreement, the employee should try and include language indicating that any agreement to provide consulting services or to refrain from competition and solicitation are material terms in the agreement. Armed with

such language, a former employee should be prepared to argue that her agreements to act or to refrain from acting provide actual and necessary benefits to the debtor's estate. While this will not guarantee an administrative claim, allowing payment of the severance agreement in full, it

may help the former employee present a credible argument that the bankruptcy estate benefited from the agreement. **BLB**

ENDNOTES: *Michael J. Lichtenstein*

- ¹ While not defined in the Bankruptcy Code, the traditional definition of an executory contract (known as the "Countryman" definition) requires that some performance be due by both parties to a contract. See Countryman, Vern, "Executory Contracts in Bankruptcy," Part I, 57 MINN. L. REV. 439 (1973).
- ² "little tiny Bankruptcy Dollars which may be worth only ten cents in U.S. Dollars." *In re Child World*, 147 B.R. 847, 850 (Bankr. S.D.N.Y. 1992) (citation omitted).
- ³ The purpose of Chapter 11 is to provide a debtor with breathing room and the opportunity to reorganize.
- ⁴ 11 U.S.C. § 365.
- ⁵ In a typical Chapter 11 case, the pre-filing management continues in place and the company operates as a debtor-in-possession which is the functional equivalent of a trustee.
- ⁶ See, e.g. *In re Food Barn Stores, Inc.*, 107 F.3d 558, 567 (8th Cir. 1997).
- ⁷ Section 503(b) discusses the allowance of administrative claims.
- ⁸ 190 B.R. 741, 744 (Bankr. E.D.N.Y. 1996).
- ⁹ One might expect a debtor to agree that a pre-petition contract was non-executory and therefore that the other party is only entitled to an unsecured claim.
- ¹⁰ *Id.* at 745.
- ¹¹ *Id.* at 747. Professor Countryman's widely quoted definition provides that an executory contract is one under which both parties' obligations are so far unperformed that the failure of either party to complete performance would constitute a material breach excusing the other's performance. 57 MINN. L. REV. 439, 460 (1973).
- ¹² *Id.*
- ¹³ *Id.* at 748. This appears to be a result oriented decision, based upon the court's perception of a lack of benefit to the estate. See also *In re Schneeweiss*, 233 B.R. 28, 32 (Bankr. N.D.N.Y. 1998) (covenant not to compete does not constitute material obligation sufficient to render contract executory).
- ¹⁴ *Id.* at 751. In the court's view, the consulting obligations were *de minimus* and were not the material purpose underlying the agreements.
- ¹⁵ *In re Stewart Foods, Inc.*, 64 F.3d 141, 145 (4th Cir. 1995).
- ¹⁶ 294 B.R. 903, 906 (Bankr. W.D. Mo. 2003).
- ¹⁷ *Id.* at 912.
- ¹⁸ *Id.*
- ¹⁹ *Id.*
- ²⁰ *Id.* at 923.
- ²¹ *Id.*
- ²² 11 U.S.C. § 502(g).