

A FORMER CEO'S CLAIM FOR SEVERANCE PAY IS NOT ENTITLED TO PRIORITY PAYMENT AS AN ADMINISTRATIVE EXPENSE WHEN THE CLAIM IS BASED ON A PRE-PETITION EMPLOYMENT AGREEMENT

In re Phones for All, Inc., 288 F.3d 730 (5th Cir. 2002), affirming 249 B.R. 426 (Bankr. N.D. Tex. 2000) and 262 B.R. 914 (N.D. Tex. 2001).

Following most other Courts of Appeal, the Fifth Circuit held that a bankrupt company's CEO, who executed an employment agreement pre-petition but was terminated post-petition, is not entitled to administrative priority for his contractual severance pay claim. *In re Phones for All, Inc.*, 288 F.3d 730 (5th Cir. 2002). Accordingly, the employee only has an unsecured, pre-petition claim against his former employer.

The employee, Isaac Lasky ("Lasky"), entered into an employment agreement with Phones for All ("Phones") to serve as President and Chief Executive Officer. In addition to a base annual salary, bonus, and out-of-pocket expenses, Phones further agreed to pay Lasky a severance benefit if his employment was terminated without cause.

Approximately five months later, Phones filed a petition for bankruptcy relief under Chapter 11, and Phones terminated Lasky's employment three weeks thereafter. Because the parties agreed that Lasky's employment was terminated without cause, Lasky claimed he was entitled to severance pay in accordance with his employment contract in the amount of more than \$430,000. 249 B.R. 426, 428 (N.D. Tex. 2000). Lasky further claimed that because he was terminated post-petition, his severance benefit claim should be paid as an administrative expense for wages and salary under 11 U.S.C. § 503(b)(1) and thus entitled to payment as a first priority under 11 U.S.C. § 507(a)(1). That is, under the Bankruptcy Code, claims that qualify for administrative expense treatment under section 503(b) are paid first—and before the payment of pre-petition claims—in accordance with the priorities established by section 507. Phones and the creditors' committee objected, claiming that Lasky's severance benefits were only a pre-petition claim against the estate.

The bankruptcy court held that Lasky was not entitled to an administrative—and thus a first priority—claim for three reasons. First, although section 503(b) gives administrative expense status to post-petition claims for wages and salaries, it is wholly silent with respect to the treatment of severance pay.

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Section 507(a)(3)(A), however, accords third priority status for wage claims and expressly includes severance pay within its terms. Thus, the bankruptcy court concluded that “Congress intended to include severance pay within wages for unsecured priority wage claims but not for administrative expense wage claims,” and thus severance pay is not entitled to treatment as an administrative expense. 249 B.R. at 429. As the Fifth Circuit explained, “Congress’s omission of severance pay from administrative priority status must . . . have been deliberate.” 288 F.3d at 732.

Second, administrative expenses must result from a post-petition transaction between the creditor and the debtor-in-possession or trustee. A claim is not necessarily entitled to administrative priority merely because the right to payment arose post-petition. The bankruptcy court concluded, therefore, that severance benefits from pre-petition contracts can become administrative expense wages only where the employee “earned his severance pay post-petition or where the debtor gave the severance benefit in lieu of other benefits or rights operating post-petition.” 249 B.R. at 429. Because Lasky conditionally “earned” his severance pay when he entered into the contract pre-petition and not for services rendered post-petition, his claim was not entitled to administrative status. *Id.*

Third, even if severance benefits were included within the statutory definition of wages and salaries under section 503(b)(1)(A), the claim for severance must nevertheless confer a benefit on the debtor’s estate, such as enhancing the debtor’s ability “to function as a going concern.” *Id.* at 430. Because “Lasky produced no evidence that suggests that the debtor induced Lasky to continue working post-petition by offering severance compensation, . . . the severance provision of his employment agreement did not actually impact his decision to continue to work post-petition.” *Id.*

In affirming the judgments of the bankruptcy and district courts, the Fifth Circuit agreed with the bankruptcy court’s reasoning that “no plain reading of the Bankruptcy Code” supported treating Lasky’s pre-petition severance claim as an administrative expense. 288 F.2d at 732. The Fifth Circuit, relying on the Tenth Circuit’s decision in *In re Commercial Financial Services, Inc.*, 246 F.3d 1291, 1294 (10th Cir. 2001), held that to attain such status, a severance claim “must have arisen from a transaction with the debtor in possession” and must then confer a benefit on the debtor’s estate. 288 F.3d at 732. Accordingly, the Fifth Circuit made it clear that any employee, including senior executives, of a company that files for Chapter 11 bankruptcy relief and who remains employed post-petition must reconfirm or renegotiate his employment contract with severance benefits after the bankruptcy filing to have his sever-

ance claim paid as a first priority.

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Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

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