First Impressions: Prepetition Severance Pay Entitled to Priority Under Section 507(a)(4)

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In the first circuit-level opinion on the issue, the Fourth Circuit Court of Appeals in *Matson v. Alarcon*, 651 F.3d 404 (4th Cir. 2011), held that, for purposes of establishing priority under section 507(a)(4) of the Bankruptcy Code, an employee's severance pay was "earned" entirely upon termination of employment, even though the severance amount was determined by the employee's length of service with the employer.

Section 507(a)(4)

Section 507 sets forth the categories of claims that are entitled to priority treatment under the Bankruptcy Code. Under section 507(a)(4), a fourth priority is given (with emphasis added) to "allowed unsecured claims, but only to the extent of [$11,725] for each individual . . . *earned within 180 days* before the date of the filing of the petition . . . for . . . wages, salaries, or commissions, including vacation, severance, and sick leave pay *earned* by an individual."

Priority for wages earned prepetition has been a feature of U.S. bankruptcy law since the Bankruptcy Act's original enactment in 1898. This priority protects workers from hardship imposed by an employer's bankruptcy filing and encourages employees to remain working for a company despite its financial distress. With these same concerns in mind, courts often grant debtors' "first day" motions to pay prepetition wage claims at the inception of a chapter 11 case. Although there is no explicit statutory authority for paying such claims prior to the confirmation of a chapter 11 plan, some courts, invoking the "doctrine of necessity" or otherwise, have

justified the payments in light of the priority afforded to the underlying claims by section 507(a)(4).

Matson v. Alarcon

In 2004, LandAmerica Financial Group, Inc. ("LandAmerica"), which was at one time the third-largest title insurance group in the U.S., established a "severance benefits plan" for its employees. An employee would become a participant in the plan, which was amended in 2008, if he or she was terminated without cause after having signed a severance agreement and, upon termination, a release. However, an employee would not qualify as a participant if the employee was rehired within 30 days or offered an equivalent position with the company within a 50-mile radius, or if the termination was due to the employee's death or resignation.

A participant in the severance benefits plan was entitled to compensation equal to the employee's weekly salary for a specified number of weeks. The number of weeks was calculated on the basis of the employee's length of employment with LandAmerica. Thus, for example, an eligible participant who worked for more than one year but fewer than two years would receive two weeks of pay as severance, while an employee who worked more than eight years but fewer than 10 years would receive six weeks of pay. LandAmerica's board of directors retained the unilateral right to modify or eliminate the severance benefits plan at any time prior to an employee's termination.

Between August and November 2008, more than 100 employees were terminated by LandAmerica and became participants in the severance benefits plan (the "Claimants"). On November 26, 2008, LandAmerica filed for chapter 11 protection in Virginia. The Claimants

filed proofs of claim for their severance compensation, taking the position that their claims were entitled to priority treatment under section 507(a)(4) because the underlying severance benefits were "earned" when the employees were terminated in the months leading up to the bankruptcy.

LandAmerica's chapter 11 plan created a liquidating trust. The liquidating trustee acknowledged that the Claimants were owed the amounts claimed as severance, but it argued that the Claimants "earned" their severance compensation over the entire course of their employment and were therefore entitled to priority status for only the (relatively small) portion of their Claims "earned" within the 180 days before the bankruptcy. To calculate the amount entitled to priority, the trustee prorated each employee's severance benefits across all the days of his or her employment. Then, the trustee multiplied that daily rate by the number of days the employee worked within the 180 days prior to the bankruptcy. According to the trustee, only this smaller portion of the total severance benefits was entitled to priority status because only that portion was "earned" within the 180-day period.

The Bankruptcy Court's Decision

The bankruptcy court rejected the trustee's proposed calculation, holding instead that the severance involved was "earned" in its entirety at the moment the employees were terminated and became eligible participants in the severance benefits plan. In reaching this conclusion, the court focused on what it characterized as the "absurd result" of the trustee's proposed calculation: "The result of [the trustee's] calculation is that terminated employees who worked many years at the company will receive a much smaller percentage of their severance package as a priority payment than will employees who worked for only a short period of time." According to the

court, Congress could not have intended the "inequitable result" of punishing long-term employees because they worked for a longer time period.

The bankruptcy court then examined the purpose of severance pay, explaining that severance is "earned" on the day the employee "shows up to work and is terminated by the company without cause." The purpose of severance pay, the court noted, is to compensate employees for the economic disruption following termination of employment. An employee's length of service is simply a useful tool for measuring the scope of that disruption. According to the bankruptcy court, "It does not matter what factors go into an employee's severance package, only what the severance package is during that 180-day period."

Finally, the bankruptcy court decided that case law regarding the administrative priority of postpetition severance payments under section 503(b)(1)(A) is not relevant because the purpose and language of the provision differ significantly from those of section 507(a)(4). Section 503(b)(1)(A), the court explained, grants administrative-expense priority to claims for "services rendered" postpetition and is traditionally construed narrowly. By contrast, the court said, section 507(a)(4) covers severance benefits "earned" prepetition and is traditionally construed liberally.

Because the issue was an unsettled one of first impression in the circuit, the bankruptcy court certified a direct appeal to the Fourth Circuit Court of Appeals.

The Fourth Circuit's Decision

A three-judge panel of the Fourth Circuit affirmed the ruling below. In doing so, however, the court focused on different facts in reaching the same conclusion. Initially, the court pointed out that the triggering event permitting employees to "earn" severance benefits was entirely outside the employees' control. Unlike traditional wages, 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. Since LandAmerica's decision to terminate the Claimants' employment occurred within the applicable 180-day window, the Fourth Circuit reasoned, the severance pay was "earned" in its entirety within the time period entitled to priority.

The Fourth Circuit found further support for its position in the fact that the board of directors could unilaterally eliminate the severance plan before the employees became entitled to payments. Under the trustee's "accrual" position, employees "earned" their severance benefits over the course of their employment. Yet, if the board had decided to eliminate the severance plan before the employees were terminated, the employees would have been "earning" severance benefits to which they would ultimately have no entitlement. The Fourth Circuit found this interpretation to be untenable.

Finally, the Fourth Circuit agreed with the bankruptcy court's reasoning that none of the cases regarding administrative priority under section 503(b)(1)(A) was relevant in analyzing section 507(a)(4). Just as the bankruptcy court had pointed out, the Fourth Circuit contrasted section 507(a)(4)'s reference to "earned" severance payments with the reference to "services provided" in section 503(b)(1)(A). On the basis of this difference, the court of appeals concluded that case law from other circuits holding that severance compensation based on length of employment has

administrative priority only to the extent the compensation was based on services provided postpetition does not apply to section 507(a)(4).

Outlook

Matson clarifies the application of section 507(a)(4) to severance benefits earned as a result of a prepetition termination. Any ramifications of the reasoning articulated by the Fourth Circuit on whether severance payments should be entitled to priority when a termination occurs postpetition remain to be seen.