BLOG

Employee Considerations in Corporate Restructurings

JANUARY 27, 2023

The global economy is beset by challenges that will continue to affect companies throughout 2023. Growth has slowed, high inflation is widespread, and increasing interest rates are likely to worsen financial vulnerabilities. Companies reckoning with this difficult business environment are seeking to reduce costs, including through layoffs, such as those implemented throughout the financial and technology industries.

While the impact of present economic challenges is yet to be fully realized, and many companies have yet to consider restructuring as an alternative, companies and creditors can benefit now from learning how employee matters are treated in a bankruptcy proceeding under chapter 11 of the U.S. Bankruptcy Code (as amended, the Bankruptcy Code). This blog provides a high-level overview of some of the most material matters affecting an employee workforce in the context of a chapter 11 restructuring. The rules surrounding employee and benefit matters in chapter 11 restructurings are complex and include many nuances and exceptions. This summary is for general information purposes only and should not be considered legal advice.

Payment of Compensation and Benefits

A chapter 11 proceeding provides a debtor company with an opportunity to reorganize its business and emerge as a financially sound company. As with other types of bankruptcy cases (e.g., liquidation proceedings under chapter 7 of the Bankruptcy Code), general bankruptcy rules apply in chapter 11 proceedings, including the automatic stay rule and rules prohibiting paying prepetition obligations and entering into non-ordinary-course transactions without bankruptcy court approval. Due to these general rules, upon filing a bankruptcy petition, a debtor must determine whether compensation and benefits were earned “prepetition” or “postpetition” and administer payment in accordance with the requirements of the Bankruptcy Code.

Permitted Payments: First-Day Motions and Ordinary-Course Payments

First-day motions are filed at the onset of a chapter 11 proceeding to obtain bankruptcy court approval to pay prepetition expenses that are critical to the debtor’s ability to operate its business and that otherwise would be delayed or prohibited by the general rules. As relevant here, first-day motions usually seek payment of certain compensation and benefits for active employees and independent contractors, including accrued wages and salary, commissions and bonuses, paid time off, contributions to and benefits under most employee benefit plans, and payroll deductions and withholdings.

In general, a debtor may pay most compensation and benefits that are earned postpetition so long as such payments are made in the ordinary course of business. As such, most of these obligations do not require court approval and are otherwise not affected by the bankruptcy. To ensure these payments are not challenged, however, debtors often seek court approval of any non-standard employee or benefit-related transaction, such as entering into a new employment agreement with an executive or establishing an incentive compensation plan or severance program.

Priority of Claims

To the extent a first-day motion is not successful in obtaining court approval for payment of prepetition expenses related to compensation and benefits, or to the extent postpetition compensation and benefits are not earned in the ordinary course, employees entitled to such compensation and benefits are treated as creditors of the debtor.

Creditor claims for compensation and benefits in a chapter 11 proceeding are paid based on a cascade of priorities. As a general matter, claims are paid in the following order: (i) expenses that constitute necessary expenses of administering the bankruptcy (aptly called “administrative expenses,” which will be described further below); (ii) claims secured by collateral; (iii) certain priority claims, including, but not limited to, taxes and employee wages and benefits (the latter up to a certain cap); and (iv) general unsecured claims. In certain circumstances, a lender that extends credit after the bankruptcy case commences may be entitled to a superpriority claim for repayment of its loan ahead of administrative expense claims, other secured claims, and unsecured claims. As discussed further below, the priority given to claims for compensation and benefits can be critical to determining whether such compensation and benefits get paid. Claims for compensation and benefits are generally not secured by collateral.

Postpetition Claims – Administrative Expenses

Wages, salaries, and commissions for services an employee renders after the commencement of a bankruptcy case may qualify as administrative expenses if they constitute actual, necessary costs and expenses of preserving the debtor’s assets. By and large, to qualify as an administrative expense, the claim must both (i) arise from a transaction with the postpetition debtor company, not the prepetition company, and (ii) provide a direct and substantial benefit to the estate. Additional restrictions are placed on certain administrative claims for “insiders,” as discussed below.

In light of the two-prong test for administrative expense priority, claims based on service spanning prepetition and postpetition periods have stirred considerable debate and varying results among circuit courts. For example, depending on the jurisdiction, service-based severance pay (e.g., one week of salary for every year of service) triggered by a postpetition termination of employment might either be (i) treated entirely as a postpetition expense under the theory that it was entirely earned on the date of termination, or (ii) treated partially as a postpetition expense only to the extent directly attributable to postpetition services. Another example concerns multiemployer pension fund withdrawal liability that is assessed postpetition. To the extent a portion of such liability relates to postpetition services, that portion typically will constitute a postpetition expense entitled to administrative priority—but courts differ on how to determine the specific portion of the assessed postpetition withdrawal liability that relates to postpetition services.

Administrative expense claims may also relate to certain awards of wages and benefits as back pay attributable to any postpetition period due to the debtor’s violation of law. For example, violations under the Workers Adjustment and Retraining Notification (WARN) Act can result in such awards of back pay and benefits. Under the WARN Act and parallel state laws, certain employers are required to provide advance notice of plant closings or mass layoffs. If the required notice is not provided, then affected employees are entitled to claims for back pay and benefits for the number of days for which the required notice was not given. Although jurisdictions vary, typically back pay due under the WARN Act is deemed to be earned at the date of termination. If the back pay is earned postpetition, the claims are generally entitled to second-level priority as administrative claims; if the back pay is earned prepetition, the claims are generally afforded fourth-level priority as unpaid compensation.

Priority Unsecured Claims – Unpaid Employee Compensation and Employee Benefits

Claims for unpaid wages, salaries, commissions, severance pay, vacation and sick-leave pay, and claims for contribution to an employee benefit plan, that were earned within 180 days before the date on which the debtor filed for bankruptcy or the date the debtor ceased doing business, whichever occurred first, are entitled to priority above general unsecured claims. These claims for compensation and benefits are subject to monetary caps that periodically adjust to reflect changes in the Consumer Price Index. Amounts that exceed these caps are generally treated as general unsecured claims not entitled to priority status.

General Unsecured Claims

Absent court approval, employee claims that are not entitled to priority status are treated as general unsecured claims without priority, last in the creditor pecking order followed only by equity holders and, occasionally, subordinated creditors. Claims for wages earned more than 180 days prior to the filing of the bankruptcy petition, claims for multiemployer pension plan withdrawal liability that are assessed prepetition, certain employment discrimination claims, claims for benefits earned prepetition under non-qualified deferred compensation plans, and claims for damages resulting from the termination of an employment contract are all examples of claims that are typically treated as general unsecured claims not entitled to priority.

Insiders — Key Employee Retention and Severance Programs

The Bankruptcy Code provides that severance payments and bonuses paid under a key employee retention plan (KERP) that are made to “insiders” are eligible for administrative expense claim priority only if certain conditions are satisfied. As set forth in the Bankruptcy Code, the term “insiders” generally refers to directors, officers, and persons in control of the debtor company.

Retention bonuses paid under a KERP will constitute administrative expenses only if the services provided by the insider are essential to the survival of the business and the bonus is essential to retention of the insider because the individual has a bona fide job offer from another business at the same or greater rate of compensation. Moreover, a retention bonus paid under a KERP will constitute an administrative expense only if the bonus amount does not exceed either: (i) 10 times the mean bonus amount paid to non-management employees during the calendar year in which the KERP bonus is paid or (ii) if no such bonuses were paid to non-management employees, 25% of any similar bonus paid to the insider during the calendar year prior to the year in which the KERP bonus payment was made.[1]

To constitute an administrative expense, a severance payment made to an insider must be made pursuant to a program that is generally applicable to all full-time employees, and the amount of the payment must not exceed 10 times the amount of the mean severance payment given to non-management employees during the calendar year in which the insider payment is made.

Debtor Relief — Rejecting CBAs and Modifying Retiree Welfare Benefits

For bargaining unit employees represented by a labor union pursuant to a collective-bargaining agreement (CBA), the terms and conditions of employment cannot be modified without bankruptcy court approval. With approval, the Bankruptcy Code allows a debtor to reject a CBA, provided that such rejection is necessary to permit the reorganization of the debtor. Rejecting a CBA must be achieved pursuant to a debtor’s negotiations with the collective-bargaining representative for the affected employees.

To the extent a CBA is not rejected, the Bankruptcy Code also provides that, except upon court order or agreement with an authorized representative, a debtor must timely pay and must not modify any “retiree benefits” after a bankruptcy petition is filed. For this purpose, “retiree benefits” means payments to retired employees, their spouses, and dependents for medical, surgical, or hospital care, and sickness, accident, disability, or death benefits under any plan, fund, or program maintained or established by the debtor. Most courts have interpreted this provision in the Bankruptcy Code to apply only if such benefits are vested, and since these welfare benefits are not required to be vested by law, they become vested by contract—e.g., pursuant to language in CBAs, plan documents, summary plan descriptions, and other related documents.

Similar to rejecting a CBA, the bankruptcy court must approve the termination or modification of retiree benefits and will do so only if such termination or modification is necessary to permit the reorganization of the debtor. Any payments for retiree benefits that are required to be made before a restructuring plan becomes effective are entitled to priority as an administrative expense claim without regard to the aforementioned two-prong test for administrative expense priority. Any retiree benefits lost due to modification are normally treated as general unsecured claims.

Employee Benefits — Retirement Plans, PBGC Liens, Health Plans, and Controlled Groups

Retirement Benefits

Creditors are not entitled to claims for the assets of retirement plans that are qualified under the Internal Revenue Code and subject to the Employee Retirement Income Security Act (ERISA), primarily because such plan assets must be held in trust and are not alienable. On the other hand, nonqualified retirement plans generally are subject to general unsecured creditor claims because they are not required to be, and frequently are not, prefunded; in other words, they are typically paid out of the general assets of the debtor.

Although creditor claims for qualified retirement plan assets typically are not raised in chapter 11 cases, a debtor entering a chapter 11 proceeding with an underfunded single-employer defined-benefit pension plan may encounter other obligations, including filing “reportable event” notices with the Pension Benefit Guaranty Corporation (PBGC), implementing restrictions on benefits, terminating the pension plan, paying the compulsory PBGC termination premiums, and responding to PBGC claims for missed minimum required contributions, underfunded benefit liabilities, and missed PBGC premium payments.

A debtor that sponsors a defined-benefit pension plan and fails to make minimum required contributions in an aggregate amount equal to $1 million or more can be subject to a lien in favor of the plan, or in the event of a plan termination, a lien in favor of the PBGC for the unfunded benefit liabilities. If these liens are perfected prior to the debtor commencing its chapter 11 case, the PBGC, or the PBGC on behalf of the plan, will be a secured creditor (with the lien on the plan assets as collateral). If the liens do not arise or the PBGC fails to perfect the liens prepetition, such claim would be entitled to an unsecured status. However, it is important to note that, while the automatic stay may prevent perfection of a lien that was not perfected before the bankruptcy case was commenced, non-debtor controlled group members are not protected by the automatic stay and may become subject to perfection of such a lien. If a PBGC claim for pension funding is unsecured, most courts that have considered the issue have found such a claim to be entitled to administrative expense priority only to the extent that the claim is actually attributable to postpetition services performed by plan participants. Nonetheless, the PBGC can wield a variety of tools to secure additional funding for the defined-benefit pension plans, including asserting its right to terminate the plan, seeking appointment to the creditor’s committee appointed to the debtor’s case, and otherwise obstructing any sale transactions.

It is important to note that, whether a qualified retirement plan is underfunded or fully funded, inadvertent plan terminations and other liabilities and reporting requirements can arise in connection with a workforce reduction associated with restructuring. A partial termination may be deemed to occur if more than 20% of all plan participants are laid off in a particular year.

Controlled Groups and Withdrawal Liability

If a debtor is unable to cover the liability associated with an underfunded single-employer defined-benefit pension plan, the PBGC will look to other members of the debtor's "controlled group" to pick up the shortfall. ERISA and the Internal Revenue Code provide that controlled group members are jointly and severally liable for certain pension plan liabilities and that the liens discussed above attach to the property and property rights of all controlled group members. As discussed further below, liability assessed for a debtor's withdrawal from a multiemployer pension plan also raises controlled group liability concerns.

While there are several ways that a controlled group can arise, in general, a controlled group includes corporations connected by 80% or more of common ownership (based on vote or value of the corporation's stock) as well as groups of unincorporated "trades or businesses" under common control (applying an 80% profits or capital ownership test for a partnership or limited liability company). Under ERISA's controlled group liability doctrine, as expanded by federal court decisions in the First Circuit, there is the potential that private equity funds and other investors can be deemed to be in a controlled group with a portfolio company and therefore be liable for the portfolio company's ERISA-controlled group liabilities. Controlled group liability is discussed in our article, Sun Capital Funds Withdrawn from Withdrawal Liability: First Circuit Court of Appeals.

CBAs often require employer contributions to a multiemployer pension fund, i.e., a pension plan maintained under one or more CBAs to which multiple unrelated employers contribute. If a debtor ceases to make such contributions or otherwise withdraws its participation in the multiemployer pension plan, the debtor and each of the debtor's controlled group members may be jointly and severally liable for the debtor's portion of the multiemployer plan's unfunded vested benefits ("withdrawal liabilities"). A debtor conducting an asset sale in connection with its chapter 11 restructuring may be able to take advantage of certain statutory rules that deem a withdrawal not to have occurred if certain conditions under ERISA are satisfied.

Health and Welfare Benefits

In a chapter 11 restructuring, healthcare coverage could continue unchanged while the debtor reorganizes or it could be reduced or eliminated altogether. Before terminating all group health plans, a debtor should consider the consequences of such action, including whether the termination will trigger penalties for failure to offer coverage as required under the Patient Protection and Affordable Care Act, and whether the debtor's controlled group members are required to provide continued coverage to qualified beneficiaries pursuant to the Consolidated Omnibus Budget Reconciliation Act (COBRA).

Winston Takeaway

Now is an ideal time for companies and creditors to become familiar with the treatment of employee matters in a chapter 11 proceeding. The COVID-19 pandemic may have already encouraged companies and creditors to consider the relief afforded by a chapter 11 restructuring, but every company and creditor can benefit from thinking about these issues as economic uncertainty and challenges to business-as-usual persist throughout 2023. This blog is intended to provide a high-level overview of various complex and technical issues and rules; it should not be considered a substitute for a conversation with counsel.

Please contact a member of the Winston & Strawn Employee Benefits and Executive Compensation Practice Group, Restructuring and Insolvency Practice Group, or your relationship attorney for further information.

Sam Ellison was a contributor on the article

---

[1] 11 U.S.C. § 503(c)(1)(C)(i)–(ii).

10+ Min Read

Authors

Scott Landau

Carrie Hardman

Related Locations

Chicago

New York

Related Topics

Blog

Corporate

Employee Benefits

Health and Welfare Benefits

Chapter 11

Related Capabilities

Labor & Employment

Related Regions

North America

Related Professionals

Scott Landau

Carrie Hardman

This entry has been created for information and planning purposes. It is not intended to be, nor should it be substituted for, legal advice, which turns on specific facts.