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Executive Compensation and Severance Agreements in Bankruptcy

A Lexis Practice Advisor® Practice Note by Ira L. Herman, Blank Rome LLP

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This practice note discusses (1) employment agreements antedating a bankruptcy filing and (2) executive compensation and employee retention programs proposed by a debtor in possession in a Chapter 11 case. As to the former, when an executive or nonexecutive employee's employment straddles a bankruptcy filing, and the executive or nonexecutive is terminated post-filing, the priority of the employee's severance claim may be difficult to determine. This is because such severance claims do not fit neatly into the pre-petition/post-petition paradigm underpinning the administrative priority determination, due to the fact that unlike ordinary wages, severance pay can be earned at different times during a term of an employee's employment.

As to the latter, executive compensation programs consist of retention, severance, and incentive plans for the debtor's management. If a debtor in possession enters into an employment agreement (post-petition), an employee's claims for compensation and severance payable under the agreement, generally, are entitled to administrative expense priority treatment, subject at all times to the limits imposed by the Bankruptcy Code on executive and insider compensation and severance.

This practice note addresses severance agreements and the Section 503(c) requirements for executive compensation programs and as follows:

- Severance Agreements
- Overview of Section 503(c) Requirements for Executive Compensation Programs and Severance Agreement Claims
- Retention Plans under Section 503(c)(1)
- Incentive Plans under Section 503(c)(3)
- Retention or Incentive Plans
- Severance Payments under Section 503(c)(2)
- The Priority Status of Severance Claims Is Limited to One Year of Benefits
- Assumption, Rejection, and Avoidance Risk

For related information, see Treatment of Claims in Bankruptcy.

Severance Agreements

If a debtor in possession enters into an employment agreement (post-petition), an employee's claims for compensation and severance payable under the agreement generally are entitled to administrative expense priority treatment. Note that an insider's severance claims are limited by Section 503(c)(2) (discussed below). Where the debtor enters into an employment agreement before filing for bankruptcy relief and the employee continues to work for the debtor during the administration of the debtor's case before being terminated, the priority of the employee's

severance claim is more difficult to determine. This is because severance claims do not fit neatly into the pre-petition/post-petition paradigm underpinning the administrative priority determination, due to the fact that unlike ordinary wages, severance pay can be "earned" at different times during a term of the employee's employment.

Several courts that have faced the issue have subscribed to the view that severance pay is compensation for the hardship that all employees, regardless of their length of service, suffer when they are terminated, and that severance, therefore, is earned when an employee is dismissed. However, this approach has been largely discredited. Instead, most courts will carefully examine the particular type of severance payment involved to determine whether the employee's claim should qualify for administrative priority. See, e.g., In re Majestic Capital, Ltd., 463 B.R. 289, 294–95 (Bankr. S.D.N.Y. 2012) (rejecting severance where the claimant was "indisputably an insider, and his claim satisfied neither requirement of section 503(c)(2) of the Bankruptcy Code"); In re Forum Health, 427 B.R. 650, 655 (Bankr. N.D. Ohio 2010) (rejecting severance for a former CEO where "[d]ebtors' severance program, although generally applicable to all full-time non-union employees, is not generally applicable to all full-time employees"); In re Dana Corp., 351 B.R. 96, 102 (Bankr. S.D.N.Y. 2006) (rejecting proposed compensation plans for certain executives given that the plans did not meet the requirements of Section 503(c)(2) of the Bankruptcy Code); In re Phones for All, Inc., 249 B.R. 426, 429 (Bankr. N.D. Tex. 2000) aff'd, 262 B.R. 914 (N.D. Tex. 2001) aff'd, In re Phones For All, Inc., 288 F.3d 730 (5th Cir. 2002) (denying administrative priority for severance payments); see generally Straus-Duparquet, Inc. v. Local Union No. 3 Int'l Bhd. of Elec. Workers, A F of L, CIO, 386 F.2d 649, 651 (2d Cir. 1967) ("Since severance pay is compensation for termination of employment and since the employment of these claimants was terminated as an incident of the administration of the bankrupt's estate, severance pay was an expense of administration and is entitled to priority as such an expense.").

There are two general types of severance pay. The first consists of a payment to the employee at termination, based upon the length of his or her employment. Most courts find that "length of service" severance does not qualify for administrative expense priority because the severance pay was earned prior to the bankruptcy filing. Other courts have adopted a less draconian approach and will prorate the severance claim into pre-petition and post-petition amounts corresponding to the duration of the employee's service during both periods. These courts reason that the latter qualifies for administrative priority, while the former may qualify at least in part as a priority pre-petition unsecured claim. See, e.g., In re Roth Am., Inc., 975 F.2d 949, 957 (3d Cir. 1992); Lines v. System Bd. of Adjustment No. 94 Bhd. of Ry. (In re Health Maintenance Found.), 680 F.2d 619, 621 (9th Cir. 1982); In re Mammoth Mart, Inc., 536 F.2d 950 (1st Cir. 1976); In re Public Ledger, 161 F.2d 762 (3d Cir. 1947).

The second general type of severance is a payment at termination in lieu of advance notice of termination. This kind of severance payment generally is viewed as compensating a terminated employee for being deprived of advance notice of his or her termination. As such, most courts take the view that this type of severance is earned on the termination date. See Public Ledger, 161 F.2d at 771–73; In re Phones for All, Inc., 262 B.R. 914, 916 (N.D. Tex. 2001), aff'd, In re Phones for All, Inc., 288 F.3d 730 (5th Cir. 2002) ("When an agreement provides for severance in lieu of notice, the full claim for severance pay is accorded administrative priority, if the employee was terminated post-petition."). Accordingly, these courts hold that "termination in lieu of notice" severance qualifies for treatment as an administrative priority claim. See, e.g., Teamsters Local No. 310 v. Ingrum (In re Tucson Yellow Cab Co.), 789 F.2d 701, 704 (9th Cir. 1986).

Other severance packages may not fit neatly into either category and may have characteristics of both. For example, many companies struggling to restructure their operations and avoid bankruptcy retain crisis managers and other workout professionals under employment agreements with severance provisions entitling the employee to severance if he or she is terminated at any time after executing the agreement. Courts confronted with hybrid severance arrangements have sometimes struggled to articulate a rational standard to apply to the employee's request that the claim be accorded priority status. See, e.g., Matson v. Alarcon, 651 F.3d 404, 409 (4th Cir. 2011) ("[A]n employee 'earns' the full amount of 'severance pay' on the date the employee becomes entitled to receive such compensation, subject to satisfaction of the contingencies provided in the applicable severance compensation plan."); In re Plymouth Rubber Co., Inc., 336 B.R. 16, 21 (Bankr. D. Mass. 2005) (allowing administrative priority for a severance plan where, although the amount was related to pre-petition service, the consideration was "to forego other employment opportunities post-bankruptcy in consideration of post-petition services"). A majority of courts find that severance payable under a pre-bankruptcy employment agreement does not qualify for administrative claim treatment.

Overview of Section 503(c) Requirements for Executive Compensation Programs and Severance Agreement Claims

Prior to 2005, deference was given to management in a Chapter 11 case to approve executive compensation, and the Bankruptcy Code did not purport to regulate or limit post-filing date executive compensation programs. In response to certain actual and perceived abuses, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 added provisions to the Bankruptcy Code that substantially tightened the standards applicable to retention and severance agreements, as well as the standards that apply to other compensation arrangements in bankruptcy. Section 503(c) of the Bankruptcy Code provides that retention, severance, and other compensation arrangements meet three specific criteria. 11 U.S.C. § 503(c). First, Section 503(c)(1) limits payments to insiders (usually highly compensated executives) under key employee retention plans (KERPs), which are plans generally designed to induce employees to remain with the debtor while it is in a Chapter 11. Second, Section 503(c)(2) limits severance payments to insiders (usually highly compensated executives). And third, Section 503(c)(3) requires that all other compensation arrangements considered to be outside of the ordinary course of a debtor's business must be justified by the facts and circumstances of the case.

Prior to the 2005 amendments to the Bankruptcy Code, retention plans often were proposed to ensure that crucial employees would remain with a company during its bankruptcy case. These retention plans were designed to address the risk that executives employed by a business that was attempting to reorganize would seek other employment opportunities, because of such debtor's uncertain future. Retention plans were proposed and approved under Sections 105(a) and 363(b) of the Bankruptcy Code. Under these sections, courts generally reviewed proposed retention plans by considering whether the retention plan was a proper exercise of the debtor's business judgment and whether such plan was fair and reasonable. See, e.g., In re Georgetown Steel Co., LLC, 306 B.R. 549, 556 (Bankr. D.S.C. 2004). Courts usually approved retention plans, thereby, deferring to the debtor's business judgment.

Retention plans became particularly controversial after several large companies controlled by purportedly corrupt executives filed for Chapter 11 relief (including Enron, WorldCom, and Polaroid). The proposed retention plans in such cases (which were often approved) paid these executives significant sums despite employee wage cuts and layoffs and were viewed by many as being an abuse of the bankruptcy system. In response, in 2005, Congress added Section 503(c) to the Bankruptcy Code. Section 503(c) was designed to curb the abuses and prevent executives from receiving bonuses or other retention payments for simply remaining with a debtor. In re Borders Group, Inc., 453 B.R. 459, 470–71 (Bankr. S.D.N.Y. 2011). Section 503(c) also limits the generous severance packages that often were received by executives after a bankruptcy filing. The more exacting standards of review included in Section 503 for approving insider retention and severance programs replaced the deferential business judgment standard for approving such programs.

Section 503(c) operates to prohibit or limit payments under retention, severance, and incentive plans from being considered allowed administrative expense, that must be paid in full to confirm a plan under Chapter 11 of the Bankruptcy Code. However, Section 503(c) does not restrict executives from receiving a general, unsecured claim based on payments owed under these plans. In re Dana Corp., 358 B.R. 567, 578 (Bankr. S.D.N.Y. 2006). In most cases, the debtor and executive are not proposing a general, unsecured claim for the post-petition work performed under a retention, severance, or incentive plan.

Notably, Section 503(c) does not prevent another party from making plan payments from non-estate funds. Thus, secured creditors may pay retention bonuses provided that the payment is not from estate funds and the secured creditor does not seek reimbursement from the estate. Official Comm. of Unsecured Creditors v. Airway Indus. (In re Airway Indus.), 354 B.R. 82, 87 (Bankr. W.D. Pa. 2006). This is consistent with the general purpose underlying Section 503(c) that insiders should be prevented from benefiting themselves at the estate's expense. In re Pilgrim's Pride Corp., 401 B.R. 229, 234 (Bankr. N.D. Tex. 2009). However, courts may closely scrutinize arrangements where the secured creditor compensates an executive because of the potential conflict of interest that arises when the executives propose a course of action that will result in a secured lender compensating the debtor's executives.

Retention Plans under Section 503(c)(1)

Section 503(c)(1) includes strict requirements for a court to approve retention plans for insiders. To meet these requirements, the court must find that:

- The payment is necessary to retain the manager because the manager has a bona fide job offer from another business at the same or greater pay rate
- The manager's services are essential to the survival of the business

Even if these requirements are met, Section 503(c)(1) restricts the amounts that can be paid to retain the employee. Retention payments are limited to 10 times the amount of such payments to nonmanagement employees, or if no such payments were made, to 25% of the amount of similar payments to the insider in the year preceding the bankruptcy filing.

Section 503(c)(1) restricts and limits payments made to insiders, while purportedly still allowing a debtor to induce insiders to remain with the debtor. Courts cannot approve retention plans that do not meet the Section 503(c)(1) requirements. Section 503(c)(1) creates a very high and challenging standard for the debtors to overcome to obtain court approval of payments under a retention plan.

In practice, even if these requirements are met, pure retention payments largely have been eliminated because the statute imposes near-impossible prerequisites and severely limits on such payments. Thus, pre-petition retention agreements with executives often are replaced after a Chapter 11 filing by an incentive program primarily designed to reward executives for achieving specified performance goals, not for simply remaining with a debtor's business (as discussed below).

Insiders under Section 503(c)(1)

Section 503(c)(1) only applies to retention payments to "insiders." Section 503(c)(3) governs retention plans for non-insiders and has less rigorous requirements (as discussed below in Incentive Plans under Section 503(c)(3)). As a result, debtors sometimes will try to argue that a proposed retention plan is not for insiders in order to avoid the statutory limitations on insider plans.

Courts are divided over which parties are considered insiders under Section 503(c)(1). Section 101(31)(B) defines an insider in the context of a corporation to include, among others, a director or officer of the debtor, or person in control of the debtor. 11 U.S.C. § 101(31)(B). Certain courts find that if the person holds the titles referenced in this definition, then that person is an insider for purposes of Section 503(c). Office of the U.S. Trustee v. Fieldstone Mortg. Co., 2008 U.S. Dist. LEXIS 91479, at *11–14 (D. Md. Nov. 5, 2008).

Other courts have found that a person's title does not definitively establish whether the person is an insider or not. Borders, 453 B.R. at 468–69. These courts make this determination on a case-by-case basis after considering a totality of the circumstances, including the degree of involvement in the debtor's business. To be considered an insider under this line of cases, the executive must have a controlling interest or sufficient authority over the corporation's policy and asset disposition.

Incentive Plans under Section 503(c)(3)

Compensation-plan payments that do not fall within the language of subsections (c)(1) or (2) still must satisfy the requirements of subsection (c)(3). Section 503(c)(3) is a catch-all provision that applies to all other transfers made outside the ordinary course of business, including payments made to officers, managers, or consultants hired after the bankruptcy filing. This section requires that such payments must be justified by the facts and circumstances of the case.

This covers incentive plans for insiders (as opposed to retention plans under Section 503(c)(1)) and to persons that are not insiders. Therefore, Section 503(c)(3)applies to retention and incentive plans that do not involve transfers to insiders. GT Advanced Techs., Inc. v. Harrington, 2015 U.S. Dist. LEXIS 94743, at *11 (D.N.H. July 21, 2015).

Outside of the Ordinary Course of Business

Section 503(c)(3) applies to compensation plan transfers made outside of the ordinary course of business, while Section 363(c)(1) applies to transfers made within the ordinary course of business. What this means is that Section 363(c)(1) will allow a debtor to enter into a transactions and use property of the estate in the ordinary course of business, without first seeking court approval. 11 U.S.C. § 363(c)(1). For instance, a debtor does not need court approval for routine, day-to-day business decisions. Thus, courts generally do not entertain objections to ordinary-course transactions if the conduct involves "a business judgment made in good faith upon a reasonable basis and within the scope of authority under the Bankruptcy Code." In re Nellson Nutraceutical, Inc., 369 B.R. 787, 797 (Bankr. D. Del. 2007). Therefore,

court approval may be unnecessary for certain payments made under a compensation plan or revisions to a plan if such transactions are made within the ordinary course of business.

Disputes can arise over whether a transaction is an ordinary-course matter under Section 363(c)(1). Courts generally use a vertical and horizontal test to determine this. The horizontal test focuses on whether the transaction is common in the debtor's industry while the vertical test focuses on whether the transaction subjects a creditor to an economic risk different from the risks the creditor accepted when the credit was extended. Id. Thus, a bonus compensation plan that is within market norms and is consistent with the debtor's pre-petition practices may be considered an ordinary-course transaction that is not subject to court oversight.

Courts faced with whether to approve a compensation plan generally first analyze whether the proposed plan is outside of the ordinary course of business. Courts will analyze the propriety of the compensation plan under Section 503(c)(3) if the transaction is outside the ordinary course of business. If the court finds the compensation plan is an ordinary-course transaction, then the inquiry usually ends and the debtor is authorized to proceed with the transaction. Notably, Section 503(c)(1) does not contain an ordinary-course requirement, and therefore, applies to payments made in and outside of the ordinary course of business (i.e., retention plans for insiders under Section 503(c)(1) must be approved by the court regardless of whether such plans are considered part of the debtor's ordinary course of business).

Section 503(c)(3) Test

Section 503(c)(3) requires that all compensation arrangements outside of the ordinary course of business be justified by the facts and circumstances of the case. Courts are divided over the appropriate standard to make this determination. Certain courts examine the facts and circumstances of the case together with the business judgment rule. In re Residential Capital, LLC, 491 B.R. 73, 84 (Bankr. S.D.N.Y. 2013). Under the business judgment rule, courts generally defer to a debtor when the debtor is able to demonstrate a valid business purpose for a proposed compensation program. This standard is used by courts considering the approval of the use, sale, or other disposition of a debtor's property outside of the ordinary course of a debtor's business pursuant to Section 363(b). Residential Capital, 491 B.R. at 84.

Other courts use a stricter standard than the business judgment rule. Pilgrim's Pride, 401 B.R. at 236. These courts require that even where a debtor satisfies the business judgment rule, the court must also make its own determination that the compensation program is in the best interests of the debtor's estate and its creditors. This test requires courts to scrutinize a transaction more closely. GT Advanced, 2015 U.S. Dist. LEXIS 94743, at *20.

Under both tests, courts look at similar factors when deciding if the facts and circumstances of the case justify approving a compensation plan under Section 503(c)(3). These factors were articulated in the *Dana Corp.* case and therefore are referred to as the *Dana* factors:

- Is there a reasonable relationship between the plan proposed and the results to be obtained (i.e., will the key employee stay for as long as it takes for the debtor to reorganize or market its assets, or, in the case of a performance incentive, is the plan calculated to achieve the desired performance)?
- Is the cost of the plan reasonable in the context of the debtor's assets, liabilities, and earning potential?
- Is the scope of the plan fair and reasonable? Does it apply to all employees? Does it discriminate unfairly?
- Is the plan or proposal consistent with industry standards?
- What were the due diligence efforts of the debtor in investigating the need for a plan, analyzing which key employees need to be incentivized, what is available, and what is generally applicable in a particular industry?
- Did the debtor receive independent counsel in performing due diligence and in creating and authorizing the incentive compensation?

Dana Corp., 358 B.R. at 576–77.

As a practical matter, regardless of the test employed, bankruptcy judges generally apply their own judgment in analyzing the reasonableness of a compensation plan under Section 503(c)(3). The bottom line is that courts will focus on the question of whether a proposed compensation plan is fair and likely to maximize the value of the bankruptcy estate.

Retention or Incentive Plans

Courts must determine whether a proposed compensation plan is a Key Employee Retention Plan (KERP) designed to retain executives or a Key Employee Incentive Plan (KEIP) designed to incentivize management. KERPs are governed by the strict standard set forth in Section 503(c)(1), and KEIPs are governed by the more lenient, less rigorous standard set forth in Section 503(c)(3). A debtor bears the burden of proof to demonstrate by a preponderance of the evidence that the KEIP is primarily incentivizing and not retentive. Residential Capital, 478 B.R. at 170.

Courts generally ignore labels, as debtors as a litigation strategy, will characterize a payment plan being proposed as an incentive bonus plan, rather than as a retention plan, to avoid the application of Section 503(c)(1), rather than the application of the less exacting standard required by Section 503(c)(3). Instead, courts consider whether the primary purpose of a proposal is to retain an employee or to induce the employee to perform and achieve certain metrics. Wisper II, LLC, v. Abernathy (In re Wisper, LLC), 2015 Bankr. LEXIS 4083, at *174–75 (Bankr. W.D. Tenn. Dec. 2, 2015). In making this determination, courts consider the proposal, along with the structure of the compensation packages.

Plans that (1) provide insiders with payments to perform the same duties they were performing prior to a bankruptcy filing, or (2) guarantee payment by proposing easily achievable performance metrics, are generally held to be retentive. For instance, a program providing for payment of a bonus upon exiting Chapter 11 or confirming a reorganization plan usually is found to be a retention plan because such a plan is not based on performance, but rather, by the employee remaining in a debtor's employ. Residential Capital, 478 B.R. at 172. Similarly, courts will treat a program that grants a bonus after an asset sale as retentive, if the sale was negotiated prior to the bankruptcy filing, because the sale would still occur regardless of the executive's involvement post-bankruptcy. On the other hand, a plan providing for payment of a bonus tied to hitting certain milestones, such as for a sale or plan confirmation, may be considered incentivizing. See, e.g., In re Alpha Natural Res., Inc., 546 B.R. 360 (Bankr. E.D. Va. 2016).

Incentive payments typically are comprised of bonuses under a program that present targets that are difficult to achieve, forcing the executives to work hard to achieve their bonuses. GT Advanced, 2015 U.S. Dist. LEXIS 94743, at *14. Courts recognize that any payment to an employee, including salary and bonuses, is partially designed to retain an employee. However, incentive programs should provide management with the inventive to take actions that will increase the value of estate assets. Because of the restrictions placed on KERPs under Section 503(c)(1), and the importance of retaining and motivating skilled managers, debtors generally propose to implement KEIPs. By successfully tying compensation and bonuses to performance under a KEIP, a debtor will avoid the application of Section 503(c)(1). However, counsel should be wary of attempts to circumvent the statutory payment limits set forth in Section 503(c)(1) by characterizing payments as incentive bonuses that are substantively retention or severance payments. Courts generally do not favor attempts to bypass the Section 503(c)(1) standard by mischaracterizing a retention program as an incentive program. GT Advanced, 2015 U.S. Dist. LEXIS 94743, at *13–14.

Severance Payments under Section 503(c)(2)

Section 503(c)(2) requires that severance payments to insiders be part of a program generally available to all full-time employees. The section limits severance payments to insiders to an amount not greater than 10 times the amount of severance pay given to nonmanagement employees. Thus, if hourly employees received severance benefits during a calendar year say, for example, for an average of four weeks or less of benefits, the portion of the executives' severance claim otherwise entitled to administrative priority status will be reduced to a relatively small portion of the total claim. This requirement applies regardless of whether the debtor or the executive seeks payment of a severance claim. In re Majestic Capital, Ltd., 463 B.R. 289, 298 (Bankr. S.D.N.Y. 2012). Section 503(c)(2) only applies to insiders and, therefore, courts' differing interpretation of which parties are considered insiders under Section 503(c)(1) (as discussed herein) are also relevant to severance payments under Section 503(c)(2).

There are only a handful of cases interpreting Section 503(c)(2). As a result, there is little case law addressing what it means for a severance program "to be generally available to all full-time employees." If Section 503(c)(2) is read narrowly, it could be read to require all employees to be subject to the same severance program. This interpretation would mean that most severance payments will not qualify as administrative expenses under Section 503, as it is rare that executives and rank and file employees would be subject to the same severance policy. See Collier on Bankruptcy P 503.17. If read broadly, the requirement could apply to several different severance policies if these severance policies cover all full-time employees. In one case, a court held that the proposed severance payment did not meet the Section 503(c)(2) requirement of being generally applicable to all full-time employees, as the severance program only applied to nonunionized workers. In re Forum Health, 427 B.R. 650, 655 (Bankr. N.D. Ohio 2010). However, the court adopted the broad interpretation of Section 503(c)(2) stating that if the collective bargaining agreements with the unionized employees included a severance program, then the court would consider whether that program, together with the debtor's other severance programs, satisfied the requirement.

In other cases discussing Section 503(c)(2), courts have addressed additional issues, including whether payments based on noncompetition provisions or agreements are severance payments within the meaning of Section 503(c)(2). These courts analyzed the facts underlying the noncompetition agreement to determine if a payment was

in the nature of severance or compensation in exchange for noncompetition agreement, and therefore, not subject to Section 503(c)(2). In re Dana Corp., 351 B.R. 96, 103 (Bankr. S.D.N.Y. 2006). Another issue the courts have looked at is whether a plan can provide for severance payments if such payments were made after such plan's effective date. One court held that severance payments proposed in a plan of reorganization should not be approved, as such payments violated Section 503(c)(2) even though the payments were scheduled to be paid after the effective date. In re TCI 2 Holdings, LLC, 428 B.R. 117, 172 (Bankr. D.N.J. 2010).

The Priority Status of Severance Claims Is Limited to One Year of Benefits

Section 502(b)(7) of the Bankruptcy Code limits total severance claims to a single year of compensation, measured from the date of the bankruptcy filing or the date of termination, whichever is earlier. Thus, for example, an executive who otherwise is entitled to 24 months of severance loses at least 12 months of benefits the moment that his or her employer files its bankruptcy petition. If the executive was terminated before the filing date, any severance benefits that he or she received prior to the filing date count against the one-year cap, potentially wiping out additional months of the remaining severance claim or even wiping out such claim in its entirety.

One court, in examining the interplay between Section 503(c)(2) and Section 502(b)(7),found no conflict between the two sections, as, among other things, Section 503(c)(2) applies to administrative expense claims for insider severance payments while Section 502(b)(7) deals with allowance of claims or interests without reference to the priority of claims. Majestic Capital, 463 B.R. at 298. The court held that Section 503(c)(2) applies to administrative claims for severance pay and Section 502(b)(7) may provide an opportunity for a pre-petition claim based on the termination of the contract. Id.

Assumption, Rejection, and Avoidance Risk

If an executive is terminated before commencement of a bankruptcy case, then his or her employment agreement may no longer be amenable to assumption. Instead, his or her agreement would almost certainly be subject to immediate rejection. For more information, see Special Considerations for Assumption, Assignment, and Rejection of Certain Executory Contracts and Assumption, Assignment, and Rejection of Executory Contracts.

Any severance payments received by an executive prior to a bankruptcy filing could constitute an avoidable preferential transfer under Section 547 of the Bankruptcy Code. There also is a fraudulent conveyance risk under Section 548 of the Bankruptcy Code that should not be disregarded. For more information on preferential transfers generally, see Preferences. For more information on fraudulent transfers generally, see Fraudulent Transfers.

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