

Delaware Bankruptcy Law Update

Delaware Bankruptcy Court holds that timing of employee termination -- pre-petition or post-petition -- determines whether WARN Act damages are accorded administrative expense priority

In a recent case of first impression in the Third Circuit, the United States Bankruptcy Court for the District of Delaware held that damages under the Worker Adjustment and Retraining Notification Act (“WARN Act”), arising from terminations earlier in the day that the petitions were filed, were not entitled to administrative expense priority under section 503(b)(1)(A)(ii) of the Bankruptcy Code, as such damages vested entirely upon termination (which was pre-petition). Henderson v. Powermate Holding Corp. (In re Powermate Holding Corp.), Case No. 08-10498 (KG), Adv. Proc. No. 08-50559 (KG) (Bankr. D. Del. Oct. 10, 2008). It follows from the opinion that had the terminations occurred post-petition, the damages claims would have been afforded administrative expense status. In the opinion, Bankruptcy Judge Kevin Gross thoroughly analyzed section 503(b)(1)(A), which was added as part of the 2005 Bankruptcy Code Amendments, as well as the WARN Act damages implications in a bankruptcy case.

The case arose out of the Powermate debtors firing of their employees without notice just prior to filing their chapter 11 petitions. The plaintiff was one of the terminated employees. He sued the debtors on behalf of himself and other discharged employees alleging that they violated his rights under the WARN Act, which entitles certain employees to at least sixty days’ notice of a potential termination. When an employer fails to give such a warning, the employees are entitled to damages in the form of back pay and benefits for up to sixty days, subject to certain exceptions.

The plaintiff claimed that he and other similarly situated former employees were entitled to recover their wages and benefits for sixty days pursuant to the WARN Act as an administrative priority under section 503(b)(1)(A)(ii), which grants priority to “actual and necessary costs and expenses of preserving the estate, including ... (ii) wages and benefits awarded pursuant to a judicial proceeding ... as back pay attributable to any period of time occurring after commencement of the case.” The debtors answered, moved to dismiss and sought the Court’s determination that even if they did violate the WARN Act, any damages be assigned fourth or fifth priority status under sections 507(a)(4) and (5) and not administrative expense priority status.

The Court did not address the debtors’ liability under the WARN Act, but rather considered only the priority issue, which according to the Court was ripe for decision under the two-prong test set out by the Supreme Court in *Abbot Laboratories*, which holds that an issue is ripe if it is “fit” for judicial decision and withholding review would cause “hardship” to the parties. Here, the issue was “fit” for review because the issue was purely legal, the parties to the action were adverse, the Court’s decision would have a significant effect for the parties and given the alleged facts in support of liability, the Court was likely to eventually adjudicate the priority issue anyway. The



“hardship prong” also favored immediate review because in light of the magnitude of the plaintiff’s claim, the debtors would be frustrated in their efforts to formulate a chapter 11 plan without knowing the priority of the damages. Deciding the priority issue at this time would give the debtors a better understanding of their position going forward in the main case.

On the issue of priority, the plaintiff argued that his WARN Act damages -- backpay and benefits -- should be entitled to administrative expense priority under section 503(B)(1)(A)(ii) of the Bankruptcy Code, which states that administrative expenses include:

- (1) actual and necessary costs and expenses of preserving the estate, including ...
- (ii) wages and benefits awarded pursuant to a judicial proceeding ... *as back pay attributable to any period of time occurring after commencement of the case* ... as a result of a violation of federal or state law by the debtor, without regard to the time of the occurrence of the unlawful conduct on which such award is based or to whether any services were rendered, if the court determines that payment of wages and benefits by reason of the operation of this clause will not substantially increase the probability of layoff or termination of current employees, or of nonpayment of domestic support obligations, during the case under this title.

In light of the unambiguous language of the section, the Court applied its plain meaning, which indicates that the only relevant consideration is *the time to which the back pay is attributable and how that time relates to the petition date*.

The Court’s review of case law revealed that back pay is attributable to the time an employee’s right to the backpay vests. If the right to back pay vests before the petition date, then the back pay is not an administrative expense, because it is not “attributable to any period of time occurring after commencement of the case.” If the right to back pay vests after the petition date, then it is an administrative expense.

The logical next step, then, was to determine the time at which a discharged employee’s right to damages vested under the WARN Act. The Court compared WARN Act back pay to severance pay, because like certain types of severance pay, it compensates discharged employees for lack of notice. The law of severance pay is well established, and although there are different types of severance pay, courts have routinely held that severance pay in the nature of ‘payment at termination in lieu of notice’ vests *entirely* at the time of the termination because it is based solely on lack of notice. Therefore, because WARN Act damages are like ‘payment at termination in lieu of notice,’ the rights of workers discharged in violation of the WARN Act accrued *in their entirety* at termination.

This leads to a simple rule: if the termination happens post-petition, then the WARN Act damages are administrative expenses, because they vest post-petition and thus are “back pay attributable to any period of time occurring after commencement of the case.” But if the termination occurs pre-petition -- even if earlier on the day the petition was filed -- they are not and fit within sections 507(a)(4) and (5) of the Bankruptcy Code to the extent that they fall within the \$10,950 caps of those sections, and are general unsecured claims for the balance.

As the termination occurred before the filing of the petition, it was a pre-petition termination. Accordingly, the plaintiff's right to damages under the WARN Act (up to sixty days' back pay and benefits) vested entirely pre-petition and was not an administrative expense. Instead, it was a fourth and fifth level priority.

The opinion provides guidance on the application of section 503(b)(2)(A) which previously was not addressed by courts in the Third Circuit. The bright line rule of the case - that the time of termination (pre-petition or post-petition) determines whether WARN Act damages are awarded administrative expense priority - is consistent with analogous and well-developed law in the Third Circuit relating to severance pay claims. Given the potential magnitude of WARN Act damages, debtors must pay particular attention to timing of mass employee terminations and the impact on the estate of such decisions. Particular care should be given to whether the WARN Act is triggered and, if so, whether any defenses are available. The bright line ruling in this case, and the recent trends with liquidating chapter 11 debtors make it clear that WARN Act claims and their priority will play a larger role in chapter 11 cases -- both in planning for future cases and in administering existing cases.