Pratt's Journal of Bankruptcy Law

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Library of Congress Card Number: 80-68780

ISBN: 978-0-7698-7846-1 (print)

ISBN: 978-0-7698-7988-8 (eBook)

ISSN: 1931-6992

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT'S JOURNAL OF BANKRUPTCY LAW [page number] ([year])

Example: Patrick E. Mears, *The Winds of Change Intensify over Europe: Recent European Union Actions Firmly Embrace the "Rescue and Recovery" Culture for Business Recovery*, 10 PRATT'S JOURNAL OF BANKRUPTCY LAW 47 (2025)

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(2025–Pub.4789)

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What Will Happen to My Severance Payments If My Employer Files for Bankruptcy?

By Evelyn J. Meltzer*

In this article, the author explains the potential implications on employee severance rights in the event their former employer enters bankruptcy.

Pursuant to Section 503(b)(1)(A) of the Bankruptcy Code, "wages, salaries, and commissions for services rendered after the commencement of the case" are treated as administrative expense claims.

Additionally, Section 507(a)(4) of the Bankruptcy Code grants priority status to "wages, salaries, or commissions, including vacation, severance, and sick leave" earned within 180 days of the bankruptcy case up to $15,150.[1] While both sections aim to protect employees' compensation in the event of an employer's bankruptcy, they apply to different time periods and have different priority levels, thus affecting severance payments differently.

KEY ISSUES

Types of Claims

In a bankruptcy case, claims are categorized and prioritized to determine the order in which creditors are paid. The four main types of claims, in order of priority, are secured claims, administrative expense claims, priority claims, and general unsecured claims. Secured claims are those supported by a creditor's security interest collateral.

Administrative expense claims are claims associated with the ongoing operation of the debtor or the bankruptcy case following the filing of the bankruptcy petition. Priority claims are unsecured claims that the Bankruptcy Code elevates over general unsecured claims. General unsecured claims are claims against the debtor that are not secured by collateral (and are not administrative expense claims or priority claims).

Length of Service

Some severance agreements provide that upon termination without cause, severance will be based on the employee's length of service with the company. For example, an employee may be entitled to one or two weeks' salary for each year that the employee worked for the company.

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[1] Amount as of January 1, 2025.

- *Termination Prior to Bankruptcy*. Where the severance payment is based on the length of service and the services were provided and the employee terminated prior to the bankruptcy, the former employee's severance claim is not entitled to administrative priority. This is because the employee cannot meet the requirement of Section 503(b)(1)(A) that the payments must arise from a postpetition transaction with the debtor. Moreover, the former employee cannot show, as required by Section 503(b)(1)(A), that the severance payments are an "actual" and "necessary" expense of preserving the bankruptcy estate.
- *Termination After Bankruptcy*. Courts are split on how to treat length of service severance claims where the employee is fired after the bankruptcy is filed. Most courts take the position that the former employee's severance claim is not entitled to administrative priority (although the former employee would be entitled to an administrative expense claim for wages earned postpetition). These courts find that the severance payments were earned when the agreement was entered into prepetition. Other courts, trying to avoid this harsh outcome, will proportion the severance claim prepetition and postpetition, awarding administrative priority only for the postpetition portion.

In both situations, the former employee may still be able to assert a priority claim up to the statutory cap pursuant to Section 507(a)(4) of the Bankruptcy Code to the extent that part of the severance claim was earned during the 180-day period prior to the bankruptcy case being filed. The remaining severance claim will be treated as a general unsecured claim.

Termination in Lieu of Advance Notice

Some severance agreements provide that upon termination without cause, an employee will be entitled to a lump sum payment. The idea behind such an arrangement is that the employee waives the right to advance notice of termination in exchange for payment. Most courts take the position that this type of arrangement means that the employee earns the right to payment of the severance amount at the time of termination.

- *Termination Prior to Bankruptcy*. Where the employee is terminated prior to the bankruptcy being filed, the severance was earned prepetition and does not qualify for administrative expense status. However, to the extent that the severance payment was earned during the 180-day period prior to the bankruptcy being filed, the former employee's claim would be entitled to priority treatment up to the statutory cap pursuant to Section 507(a)(4) of the Bankruptcy Code.
- *Termination After Bankruptcy*. Where an employee is terminated after

the bankruptcy is filed, most courts hold that termination in lieu of advance notice severance claims are entitled to be treated as administrative expense claims pursuant to Section 503(b)(1)(A). These courts take the position that the severance was earned on the day that the employee came to work and was terminated without cause.

CONCLUSION

Severance packages are an important component of an employee's compensation. Employees are well advised to consult with experienced bankruptcy counsel before entering into a severance agreement to understand the potential implications on their severance rights in the event the company files for bankruptcy.

Moreover, once a bankruptcy is filed, it is critical to engage with bankruptcy counsel who can ensure that the employee's rights are protected, including timely and proper filing of the severance claim.