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In *Supplee v. Bethlehem Steel Corp* (*In re* Bethlehem Steel Corp.), 479 F.3d 167 (2d Cir. 2007), the Second Circuit Court of Appeals addressed the issue of whether early retirement benefits triggered by severance are entitled to administrative expense treatment. The court held that that early retirement benefits are not entitled to severance priority. While the Second Circuit generally treats severance payments as priority administrative expenses when employment is terminated during the employer's bankruptcy, *Bethlehem* determined that lump-sum retirement benefits for which the employee became eligible at termination did not constitute a new benefit earned at termination, and was thus not entitled to administrative priority. *In re Bethlehem Steel Corp.*, 479 F.3d at 171–175.

Section I of this will provide a general overview of administrative expense treatment under the Bankruptcy Code. Section II discusses a circuit split on the issue of whether severance payments qualify for administrative expense treatment, with particular focus on the Second Circuit's approach. Section III analyzes the Second Circuit's decision in *Supplee* to exclude lump-sum retirement payments as an administrative expense, and Section IV will briefly discuss the impact of the *Supplee*.

I. Administrative Expenses Generally Under The Bankruptcy Code

Under the Bankruptcy Code, the administrative expenses of the debtor-in-possession receive the second-highest priority, following only domestic support obligations. 11 U.S.C. §507(a)(2) (2006). Section 503(b) of the Bankruptcy Code defines those administrative expenses as "actual, necessary costs and expenses of preserving the estate, including . . . wages, salaries, and commissions for services rendered after the commencement of the case." 11 U.S.C. §503(b)(1)(A) (2006).

Because of the bankruptcy goal of providing equal distribution of a debtor's assets to all creditors, "statutory priorities are narrowly construed." *Supplee v. Bethlehem Steel Corp* (*In re* Bethlehem Steel Corp.), 2006 WL 510335 at *2 (S.D.N.Y. 2006); *Trustees of the Amalgamated Insurance Fund v. McFarlin's, Inc.*, 789 F. 2d 98, 100 (2d Cir. 1986). The Second Circuit has noted that an expense is administrative "only if it arises out of a transaction between the creditor and the bankrupt's trustee or debtor in possession, and only to the extent that the consideration supporting the claimant's right to payment was both supplied to and beneficial to the debtor-in-possession in the operation of the business." *In re Bethlehem Steel Corp.*, 479 F.3d at 172 *quoting McFarlin's, Inc.*, 789 F. 2d at 101. "The burden of proving entitlement to priority payment as an administrative expense . . . rests with the party requesting it.' *In re Bethlehem Steel Corp*., 479 F.3d at 172 *quoting Wodburn Assocs. V. Kahn* (*In re* Hemingway Transp., Inc.), 954 F.2d 1, 5 (1st Cir. 1992); *In re Drexel Burnham Lambert Group, Inc.,* 134 B.R. 482, 489 (Bankr. S.D.N.Y. 1991).

II. Do Severance Payments Qualify As An Administrative Expense? The Second Circuit's Approach

A. The Second Circuit's Treatment Of Severance Payments

Although there is a split in the circuits, the Second Circuit adopts the view that severance payments, a benefit created by termination, qualifies as an administrative expense. In the majority of circuits, severance pay is entitled to administrative priority only when an employee is due such payment in lieu of notice of termination or to the extent to which the claimed severance pay was earned post-petition. *See 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); *Cramer v. Mammoth Mart, Inc.* (*In re* Mammoth Mart, Inc.), 536 F.2d 950, 952 (1st Cir.1976). However, in the Second Circuit, where *Supplee* was decided, the right to severance pay "arises on the date of termination and the entire amount incurred during the administration of a bankruptcy case is entitled to administrative priority [under the Bankruptcy Code]." *Supplee v. Bethlehem Steel Corp*, 2006 WL 510335 at *2; *See Rodman v. Rinier* (*In re* W.T. Grant Co.), 620 F.2d 319 (2nd Cir. 1980) *cert. denied*, 446 U.S. 983 (1980); *Zelin v. Unishops, Inc.* (*In re* Unishops, Inc.), 553 F.2d 305 (2nd Cir. 1977); *See Straus-Duparquet, Inc., v. Local union No. 3 Int'l Bd. Of Elec. Workers*, 386 F.2d 649, 651 (2nd Cir. 1967); *See McFarlin's*, 789 F. 2d 98 (2d Cir. 1986).

For example, in *Straus-Duparquet*, the Second Circuit held that severance pay claimed by terminated employees after the commencement of Chapter 11 proceedings qualified as an administrative expense. *Straus-Duparquet*, 386 F.2d 649. The employees, who were represented in a collective bargaining agreement by a union, were employed by the debtor when the debtor filed for Chapter 11. *Id*. at 650. Soon after, the debtor-in-possession discharged the

employees. *Id.* The union filed a claim in their behalf for vacation pay and severance pay under the collective bargaining agreement between the union and the debtor. *Id*.

As to the severance pay claim, the court defined severance pay as "a form of compensation for the termination of the employment relationship, for reasons other than the displaced employees' misconduct, primarily to alleviate the consequent need for economic readjustment but also to recompense him for certain losses attributable to the dismissal." *Id.* at 651 *quoting Adams v. Jersey Central Power & Light Col.*, 21 N.J. 8, 13–14, (1956). Applying that definition, the court concluded that the employees' severance pay was triggered by termination, rather than a benefit accruing daily over the course of employment. *Id*. at 651. Thus, because the new benefit was incurred "as an incident of the administration of the bankrupt's estate," it was an administrative expense and 'entitled to priority as such an expense." *Id*.

B. Termination Severance Pay Distinguishable From Other Types Of Payments

The Second Circuit has distinguished the severance payments in *Straus-Duparquet* from other types of payments. *McFarlin's, Inc.*, 789 F. 2d 98. For example, in *McFarlin's*, the Second Circuit considered a unique type of benefit payment, concluding it was not an administrative expense. *Id*. Following the commencement of bankruptcy proceedings, the debtor-in-possession ended its participation in a multiemployer pension plan, giving rise to "withdrawal liability." *Id*. at 99. The employees' union claimed that the "withdrawal liability" was a benefit payment triggered by termination, thus qualifying as an administrative expense as put-forth in *Straus-Duparquet*.

However, the court distinguished the severance payments in *Straus-Duparquet* from the withdrawal liability payments in *McFarlin's*. According to the court, while severance payments

were earned at termination because they were compensation for the hardships associated with termination, withdrawal liability payments are "the means by which the employer funds the benefits that his employees have 'earned' by their past service and that he would normally finance through continuing contributions to his employees' pension plan." *Id*. at 104. That is, the withdrawal payment "represented an accelerated lump-sum contribution toward the benefits its employees had accrued over the course of their prepetition employment." *Supplee v. Bethlehem Steel Corp*, 479 F.3d at 173. Because the employees' service was the consideration for the withdrawal liability, the obligation to pay was "attributable to the period pre-dating the filing of the Chapter 11 petition." *Id*. at 173 *quoting McFarlin's, Inc.*, 789 F. 2d at 103.

The district courts within the Second Circuit adhere to the view that severance payments earned as past service do not qualify as an administrative expense, and have applied that view in several cases. For example, the Southern District of New York held that a $1 million payment as severance pay for a former executive claimed upon his termination was not severance pay entitled to administrative priority. *In re Jamesway Corp.,* 199 B.R. 836, 841 (Bankr. S.D.N.Y. 1996). The court reasoned that the payment was offered as an inducement for the executive to leave his former job and come to the Jamesway corporation. *Id*. Thus, it was earned once he began his employment with Jamesway, not at termination. *Id.*

The Southern District of New York has also held that an executive's claim of over $4 million in severance pay was not administrative priority because the consideration for the payment was the executive's commitment to a five-year term of employment with the debtors. *In re Hooker Invs.,* 145 B.R. 138, 140, 149 (Bankr. S.D.N.Y. 1992). Similarly, an executive's claimed severance pay was rejected in *In re Drexel Burnham Lamber Group*, Inc., 138 B.R. 687,

713 (Bankr. S.D.N.Y. 1992) because the consideration to the debtor occurred pre-bankruptcy petition rather than post-petition.

III. Do Early Retirement Benefits Constitute A Severance Package?

A. Case Background

In *Supplee*, the Second Circuit was confronted with another type of unique benefit payment – accelerated lump-sum retirement benefits. *Supplee v. Bethlehem Steel Corp*, 479 F.3d 167. John P. Supplee was employed by Lukens, Inc. since 1965 and was a participant in the two Lukens Supplemental Retirement Plans ("SERP"). *Id.* at 170. Bethlehem Steel Corp. acquired Lukens in 1998 and took over Lukens's obligations under the SERP plans. *Id*. Several years later in October 2001, Bethlehem filed for bankruptcy. *Id*. Upon selling substantially all its assets to another company, Bethlehem terminated Supplee's employment in April 2003. *Id.*

The SERP plans' benefits were available to employees who retired at or after the age of 62. *Id*. In the plans' early retirement provisions, there was a four percent reduction of a participant's accrued benefit for each year that the participant retired prior to age 62. *Id*. The plans also included "change-in-control" provisions, which, in the event of the sale of a company, a participant was allowed to receive a lump sum payment of his benefit without the application of the early retirement reduction percentage. *Id*. To receive the lump sum, a participant must have lost his job within five years of a change in control. *Id*.

Supplee filed a claim in the Bethlehem Steel Corp. bankruptcy proceeding for his lump sum retirement benefits under the SERP plans, which he estimated at $1,150,000. *Id*. After Bethlehem filed an objection, Supplee conceded that only a portion of his claim was entitled to priority as an administrative expense - the amount representing the waiver of the four percent per

year penalty. *Id*. Both parties agreed that the "change in control" provisions applied when Supplee was terminated, providing for a lump sum payment. However, Supplee argued that the waiver of the four percent reduction applying to his benefits due to the change in control constituted severance pay that was entitled to priority as an administrative expense in accordance with *Straus-Duparquet*. *Id*.

B. The District Court's Ruling

Both the bankruptcy court and the district court denied Supplee's claim. *In re Bethlehem Steel Corp.*, 2006 WL at *2. The district court, following the *McFarlin's* definition of severance pay, defined severance pay as compensation for the hardship employees face when terminated. *Id*. Accordingly, it was "earned" when the employees were dismissed and was thus granted administrative priority. *Id*; *McFarlin's*, 789 F.2d at 104.

The district court went on to explain that Supplee's continuous service to Lukens and Bethlehem already entitled him to the benefits under the plans, and that his termination merely accelerated the payment of these benefits. *Id*. As such, Supplee "earned" this benefit through his past employment, not through bankruptcy. Further, the court reasoned that the payments under these plans were not compensation for any hardship, but to supplement his retirement income. *Id*. at *3. Thus, it could not be classified as severance pay and was not entitled to administrative priority.

C. The Second Circuit's Ruling

The Second Circuit affirmed the District court's ruling by holding that early lump-sum retirement benefits are not entitled to administrative priority, relying heavily on *McFarlin's* and distinguishing from *Straus-Duparquet*. According to the court, when determining whether a payment related to termination qualifies as an administrative expense, "the key inquiry is

whether it represents a new benefit earned at termination or an acceleration of a benefit the employee earned over the course of his or her employment." *In re Bethlehem Steel Corp*., 479 F.3d at 172; *See Straus-Duparquet*, 386 F.2d at 650. Additionally, the benefit can only be an administrative expense if the debtor received consideration for the obligation after bankruptcy. *In re Bethlehem Steel Corp*., 479 F.3d at 172–73; *See McFarlin's*, 789 F.2d at 103.

The court first used the analysis from *Straus-Duparquet*, where two weeks severance pay claimed under a collective bargaining agreement was found to be an administrative expense. *Straus-Duparquet*, 386 F.2d at 650–51. In defining severance pay as compensation for economic hardship due to termination, the court noted that the severance pay in *Straus-Duparquet* did not accrue day to day over the course of employment, but was triggered by termination. *In re Bethlehem Steel Corp*., 479 F.3d at 173; *See Straus-Duparquet*, 386 F.2d at 651. Because the benefit stemmed from the bankruptcy, and not from past service, it was an administrative expense. *In re Bethlehem Steel Corp*., 479 F.3d at 173; *See Straus-Duparquet*, 386 F.2d at 651.

Next, the court discussed *McFarlin's*, which was distinguished from *Straus-Duparquet* in determining that withdrawal payments were not an administrative expense. *McFarlin's, Inc.*, 789 F. 2d 98. As explained above, the court found that the withdrawal liability payments in *McFarlin's* were benefits for employees earned through past service, normally paid through the employees' pension plans. *In re Bethlehem Steel Corp*., 479 F.3d at 173; *McFarlin's, Inc.*, 789 F. 2d at 104. And, that the lump-sum withdrawal payment was simply an accelerated payment of this benefit, rather than payment as compensation for hardships associated with termination. *In re Bethlehem Steel Corp*., 479 F.3d at 173; *McFarlin's, Inc.*, 789 F. 2d at 104. Since the employees' service was the consideration for the accelerated payment, and the obligation to pay

was attributable pre-bankruptcy, the payment was not an administrative expense. *In re Bethlehem Steel Corp*., 479 F.3d at 173; *McFarlin's, Inc.*, 789 F. 2d at 103.

Applying the analysis in *Straus-Duparquet* and *McFarlin's*, the court concluded that Supplee's lump-sum retirement benefits did not constitute an administrative expense. *In re Bethlehem Steel Corp*., 479 F.3d at 173–174. First, the court found Supplee's lump-sum retirement benefits were "analogous to the withdrawal liability" discussed in *McFarlins*. *Id*. at 174. Like the withdrawal liability in *McFarlin's*, Supplee's retirement benefits were accrued over the course of his employment, the lump-sum payment of which was an acceleration of those earned benefits. *Id*.

Contrary to the severance payment in *Straus-Duparquet*, which were "earned" and triggered by the company's bankruptcy, the court posited that the Supplee would have been entitled to his earned benefits – albeit not in lump sum – "even if he had not been terminated." *Id*. Thus, the lump sum payment "did not constitute a new benefit earned at termination." *Id*. at 174–175. The court noted that it was not relevant whether a payment is labeled as severance, as such a label does not automatically trigger administrative priority. *Id*. at 175. The key inquiry, according the court, is "whether payment is a new benefit earned at termination or instead an acceleration of benefits to which the employee was previously entitled." *Id*. The former is an administrative expense entitled to priority, while the latter is not. *Id*.

IV. Conclusion

Given the current economic crisis, ensuing bankruptcies, and increasing unemployment, a terminated employee's ability to seek early retirement benefits in addition to any possible severance packages will be limited in light of *Bethlehem*. While the Second Circuit was unique

from other circuits in viewing severance payments as qualifying for administrative priority, *Bethlehem* seems to limit the scope the benefit payments that can qualify for such treatment, bringing the Second Circuit more closely in line with the other circuits.

Given the apparent greater consistency between the circuits on this issue, bankrupt employers can continue to plan for the allocation of administrative expenses pursuant to sections 507(a)(1) and 503(b)(1)(A), without having to include early retirement benefits. That said, both employees and employers would benefit from more disclosure on pension benefit plans.

Accordingly, employees signing up for new pension plans – or those whom already possess such plans - may start to see employer-provided information relating to *Bethlehem*, explaining the differences between early retirement benefits and severance packages, and how the former is less likely to be provided to the employee in the event of a bankruptcy.