THE FRUITS OF LABOR: WORKER PRIORITIES IN BANKRUPTCY

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I. INTRODUCTION

During the past several years, the intersection between bankruptcy and retirees' rights has been thrust into the national legal spotlight. First there was the enactment of § 1114, a provision that Congress inserted into the Bankruptcy Code as an attempt to protect retirees whose medical benefits were underfunded by employers who later filed for Chapter 11.[1] This solution by Congress was a relatively costless one and, not surprisingly, later events have demonstrated that Congress got just about what it paid for.[2]

Next came the rash of problems precipitated by the bankruptcy filings of companies with underfunded pension plans. In these cases, however, it was not the retirees who were forced to feel the pain. Instead, the Pension Benefit Guaranty Corporation, the federal agency that insures workers' pensions, has lately found itself in the hole for up to $2 billion in a single bankruptcy.[3]

As Congress has contended with these new problems created by companies who borrowed on the backs of either retirees or the Pension Benefit Guaranty Corporation which insures them, courts have quietly continued to confront an equally complex intersection: the clash between bankruptcy's equality of distribution norm and the special rights that current workers enjoy either through non-bankruptcy law or through some special Bankruptcy Code priority.

This Article is the first to explore comprehensively the numerous issues that arise when workers assert their unique rights as claimants in the bankruptcy of their employer.[4] Whenever Congress creates special rights for

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1. *See* Daniel Keating, *Good Intentions, Bad Economics: Retiree Insurance Benefits in Bankruptcy*, 43 VAND. L. REV. 161 (1990).

2. *See* Daniel Keating, *Bankruptcy Code § 1114: Congress' Empty Response to the Retiree Plight*, 67 AM. BANKR. L.J. 17 (1993).

3. *See* Daniel Keating, *Chapter 11's New Ten-Ton Monster: The PBGC and Bankruptcy*, 77 MINN. L. REV. 803 (1993); Daniel Keating, *Pension Insurance, Bankruptcy and Moral Hazard*, 1991 WIS. L. REV. 65.

4. This Article will not address the numerous issues that arise when a Chapter 11 debtor attempts to reject a collective bargaining agreement. For a treatment of those issues, see Anne J. McClain, *Bankruptcy Code Section 1113 and the Simple Rejection of Collective Bargaining Agreements: Labor Loses Again*, 80 GEO. L.J. 191 (1991), and Mitchell Rait, *Rejection of*

certain parties outside of bankruptcy, the nature and priority of those rights will invariably have to be translated into the bankruptcy forum. The labor arena is one field in which there are a number of statutorily created rights that workers enjoy outside of bankruptcy.

For example, the Fair Labor Standards Act (FLSA) requires, among other things, that employers pay their workers a minimum wage as well as time-and-a-half for overtime.[5] In order to give that requirement some teeth, FLSA also includes some provisions that effectively give the workers a super-priority for the minimum wages that FLSA requires employers to pay. Consequently, courts have been forced to struggle with how to reconcile this isolated statutory priority with the special positions enjoyed both by parties with a bankruptcy-only priority and by those holding a perfected Article 9 lien.

In addition to giving workers certain special rights outside of bankruptcy, Congress included in the Bankruptcy Code a number of provisions that give employees a priority that operates only when their employer has filed for bankruptcy.[6] Whether a bankruptcy court is contending with a non-bankruptcy right of employees or a specially-created bankruptcy priority, a number of issues must be resolved. In the case of employees' non-bankruptcy rights, the difficult question for the bankruptcy court to resolve is how those rights and priorities intersect with bankruptcy's own unique distribution policies.[7]

With bankruptcy-only priorities for employees, the terms of the battle typically involve issues such as which of the employee's claims actually qualify for the defined priority category, and whether employee claims that otherwise qualify for priority status have met the specific timing requirements contained in the Code's priority provisions.[8] Perhaps the most fascinating employee priority that bankruptcy courts have had to contend with is the one that cannot be found in a statute: the workers' ability to withhold their labor as a way to extract a better position vis-a-vis other creditors of their employer.

Section II of this Article examines the Bankruptcy Code-created priorities for workers' wages and benefits. The section discusses such issues as the definition of wages and benefits, how one qualifies for the Code timing requirements, and assignees' attempts to inherit priority. Section III of the Article addresses the troublesome questions that arise when workers attempt to leapfrog past other creditors by exerting their inherent leverage as employees of the business. In Section IV, the Article then explores two major sources of non-bankruptcy priorities enjoyed by workers: the FLSA claim referred to above and the back pay damage claim available under the Worker Adjustment and Retraining Notification Act [hereinafter WARN]. Finally, the Article concludes in Section V by questioning whether the benefits created by the various worker priorities are indeed worth the litigation and uncertainty that such priorities have often created.

Collective Bargaining Agreements Under Section 1113 Of The Bankruptcy Code: The Second Circuit Enters the Arena, 63 AM. BANKR. L.J. 355 (1989).

5. *See generally infra* text accompanying notes 94–99.

6. *See, e.g.*, 11 U.S.C. §§ 507(a)(3)–(a)(4) (1988) (priority for certain pre-petition wages and contributions owed to employee benefit plans).

7. *See generally infra* text accompanying notes 94–130.

8. *See generally infra* text accompanying notes 9–81.

II. Bankruptcy Code-Created Wage and Benefit Priorities

It is not difficult to think of arguments why employees ought to enjoy some favored status as creditors of an employer who files for bankruptcy. First, employees are typically not as able as large institutional creditors to diversify their credit portfolio so as to minimize the impact of their employer filing bankruptcy. Second, in a case where the employer is attempting to reorganize in bankruptcy, the employees will almost always be crucial to the success of such an undertaking. It is not surprising, then, that Congress gave employees a couple of specific priorities in Code § 507. Despite the clarity with which Congress attempted to delineate the extent of the employee priorities, a number of interpretive issues concerning these priorities have been extensively litigated. These issues include defining wages for the purposes of § 507(a)(3) and determining exactly when they are earned.

A. The § 507(a)(3) Wage Priority

Section 507(a)(3) appears by its terms to be straightforward enough. That provision gives a third unsecured priority for "wages, salaries, or commissions, including vacation, severance, and sick leave pay," subject to two limitations.[9] First, an individual must have earned the wages within ninety days of either the employer's bankruptcy filing or the employer's cessation of business, whichever occurs first.[10] Second, the priority attaches only to the extent of $2000 for each worker.[11]

Courts have identified a couple of rationales for the wage priority. One explanation is that the existence of the wage priority will encourage employees not to desert a sinking ship.[12] Another reason given to justify the priority is that the employee's claim often ends up being the only source of income for this class of creditors.[13]

A separate potential source of priority for an employee's wages in the bankruptcy of its employer is found in § 503(b)(1)(A) and § 507(a)(1). Section 503(b)(1)(A) allows as an administrative expense claim any necessary cost or expense of preserving the post-petition estate, "including wages, salaries, or commissions for services rendered after the commencement of the case."[14] Section 507(a)(1), in turn, gives a first unsecured priority to any claim qualifying for the § 503(b)(1)(A) category.[15] Unlike the § 507(a)(3) priority for certain pre-petition wages, which is limited to $2000, the administrative expense priority contains no dollar limit. Thus, as long as the work is necessary and is performed post-petition for the benefit of the estate, the employee's wage claim should qualify for the priority.

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9. 11 U.S.C. § 507(a)(3) (1988).
10. 11 U.S.C. § 507(a)(3)(A) (1988).
11. 11 U.S.C. § 507(a)(3)(B) (1988).
12. *See In re* Northwest Eng'g Co., 863 F.2d 1313, 1315 (7th Cir. 1988).
13. *Id.* at 1318.
14. 11 U.S.C. § 503(b)(1)(A) (1988).
15. 11 U.S.C. § 507(a)(1) (1988).

B. Defining Wages for § 507(a)(3) Purposes

Although it is perhaps fruitless to question the wisdom of the § 507(a)(3) wage priority generally, debtors and non-employee creditors have not hesitated to question its application to a particular case. A common source of disagreement in the § 507(a)(3) context has been the question of what constitutes a "wage" that qualifies for the priority.

Courts have been fairly strict about what qualifies for the § 507(a)(3) wage priority. Claimants have unsuccessfully attempted to assert the wage priority in cases involving a state penalty wage,[16] a workers' compensation claim,[17] a "salary" owing to the president and sole owner of the debtor,[18] and money earned for work performed as an independent contractor.[19]

The independent contractor cases have been the most fruitful source of litigation in this area, and the courts have uniformly taken a strict approach in insisting on a true master-servant relationship as a prerequisite to the application of § 507(a)(3).[20] *In re Saint Joseph's Hospital*[21] is illustrative of this trend. In that case, a dentist who operated an oral surgery clinic for a hospital asserted a priority wage claim in the hospital's Chapter 11 case.

The court in *Saint Joseph's* conceded that the debtor-hospital's reference to the dentist's "salary" and "employment" were substantial evidence in favor of the dentist's characterization of his claim as wages. However, the court stressed that it was not bound by the parties' own characterization of the relationship.[22] In this case, the court concluded, there was a lack of substantial control over the claimant's conduct by the employer-debtor. Because the key factor of control in the employer-employee relationship was missing, the court determined that the dentist was not technically an employee of the debtor; consequently, the dentist did not qualify for the § 507(a)(3) priority.[23]

C. Severance Pay

The language of § 507(a)(3) leaves no doubt that severance pay is to be included within that priority category.[24] Similarly, courts have had little trouble considering severance pay to be a wage substitute that, when triggered

16. *In re* Garlepied Transfer, Inc., 97 B.R. 305 (E.D. La. 1989).
17. *In re* Webster, 126 B.R. 4 (Bankr. D. Me. 1991).
18. *In re* Comtec Indus., 91 B.R. 344 (Bankr. E.D. Pa. 1988). *But see In re* Microwave Products of Am., 100 B.R. 379 (Bankr. W.D. Tenn. 1989) (allowing president of Chapter 11 debtor to get § 503(b)(1)(A) priority for his one week's worth of post-petition work since court concluded that president provided valuable service to preservation of the estate).
19. *In re* American Shelter Sys., Inc., 40 B.R. 793 (Bankr. W.D. La. 1984).
20. *See In re* Grant Indus., 133 B.R. 514 (Bankr. W.D. Mo. 1991) (§ 507(a)(3) priority denied to temporary service on theory that such priority should be reserved for true master/servant relationship between claimant and debtor); *In re* Kasson Inc., 109 B.R. 352 (Bankr. E.D. Wis. 1989) (claims of milk supplier who supplied debtor cheese in ninety days before filing denied § 507(a)(3) priority in that no employer-employee relationship existed between parties); *In re* Dahlman Truck Lines, 59 B.R. 218 (Bankr. W.D. Wis. 1986) (claimant corporation that had provided trucking services to debtor within ninety days of debtor's filing denied wage priority on ground that claimant's workers were not shown to be employees of debtor).
21. 126 B.R. 37 (Bankr. E.D. Pa. 1991).
22. *Saint Joseph's Hosp.*, 126 B.R. at 42–43.
23. *Id.*
24. 11 U.S.C. § 507(a)(3) (1988) (allowing priority for "wages, salaries, or commissions, including vacation, severance, and sick leave pay").

post-petition, qualifies for the administrative expense priority. The fighting issue in this realm has been how much of the severance pay qualifies for the relevant priority in those cases where the right to severance pay arises during the priority period.

In order to understand how courts have resolved the severance pay priority issue, one must first appreciate that there are essentially two types of severance pay. First, there is severance pay in lieu of notice, which represents a lump sum owed to the terminated employee in the case where the employee is not given the required notice prior to termination.[25] Second, there is severance pay that is based on seniority or length of service. Under that latter arrangement, the severance pay is essentially a form of payment for work previously performed by the employee.[26]

In the § 507(a)(3) context, courts have generally agreed on the resolution of the severance pay priority question. Where the severance pay is deemed to be in lieu of notice and the termination takes place during the ninety-day pre-bankruptcy period, courts have held that the employee is entitled to the § 507(a)(3) priority for the full amount of the severance pay.[27] The priority, however, is still limited to the $2000 cap inherent in § 507(a)(3).

If, on the other hand, the severance pay is determined to be seniority-based, then even a termination during the ninety-day priority period will not make the entire amount of severance pay a priority claim for the employee. Instead, the employee may claim a § 507(a)(3) priority only for that portion of the severance pay representing work that was performed by the employee during the ninety-day priority period.[28]

In a variation on the above two scenarios, the employee in *In re General Information Services*[29] was terminated more than ninety days before his employer's bankruptcy, but his severance pay was to be distributed to him over three months. Some of the severance pay was due to be distributed to the employee during the ninety-day pre-bankruptcy period. The employee argued that at least this latter portion of the severance pay should enjoy the § 507(a)(3) priority, on the theory that the severance pay was "earned" when it was due. The court rejected this argument, noting that because the employee's right to receive his severance pay was fixed and unconditional upon his termination, it was upon termination that the severance pay was "earned" for purposes of the ninety-day window.[30]

In the situation where the employee is terminated by the debtor post-petition, courts will distinguish between severance pay in lieu of notice and severance pay based on seniority for purposes of determining the extent of the employee's administrative expense priority. In other words, when the severance

25. *See In re* Pacific Far E. Line, 713 F.2d 476, 478 (9th Cir. 1983).
26. *Id.*
27. *In re* Guardianship Trust and Home Program, 80 B.R. 268 (Bankr. D.N.H. 1987); *cf. In re* Jeannette Corp., 118 B.R. 327 (Bankr. W.D. Pa. 1990) (since severance pay arrangement was based on length of service, employees terminated within ninety days before filing were entitled to priority only for that portion of severance pay earned within ninety days of filing; had severance pay been in lieu of notice, employees would have been entitled to priority for full amount of severance pay).
28. *Jeannette Corp.*, 118 B.R. at 330.
29. 68 B.R. 419 (Bankr. E.D. Pa. 1986).
30. *General Info. Services*, 68 B.R. at 420–21.

pay is deemed to be in lieu of notice, courts will give a § 503(b)(1)/§ 507(a)(1) priority to the entire amount of the severance pay.[31] Where the severance pay is based on length of service, most courts will allocate that portion of the severance pay which is attributable to the employee's post-petition service and award the administrative expense priority only to that extent.[32]

D. When are Wages and Benefits Earned

The hardest questions concerning the timing requirements of bankruptcy wage and benefit priorities involve claims for vacation and holiday pay. The reason is that many employers separate the earning of such pay from the vesting of such pay. With standard wages, on the other hand, the employee's earning and vesting of the wages almost always takes place simultaneously.

Thus, if an employee ended up working twenty-three days for which the employee did not get paid during the ninety days before filing, the employee would be entitled to a § 507(a)(3) priority for 23 days worth of pay. If an employee worked seventeen days post-petition and was not paid for that work, the employee would be entitled to a § 503(b)(1)/§ 507(a)(1) priority for the wages relating to those seventeen days of post-petition labor. Just because an employee gets a paycheck every two weeks does not normally mean that the employee's right to the wages fails to vest until the date the paycheck is due. Rather, an employee's right to wages typically vests simultaneously with the employee's earning of those wages.

Vacation and holiday pay schemes often separate the earning of benefits from their vesting. For example, a company might provide that an employee earns one day of vacation for every fifteen days worked, but that none of the earned vacation time vests until the employee works the first day of the following calendar year.[33] This separation of earning and vesting creates some tricky priority issues when the employee's company files for bankruptcy.

The Seventh Circuit was forced to grapple with some of these questions in *In re Northwest Engineering Co.*[34] In that case employees earned vacation pay the preceding year but only became entitled to use it upon working at least one day the following year. At the time the employer filed bankruptcy, there was a group of employees whose year's worth of vacation had already vested prior to the ninety-day priority period. The issue facing the court was whether any of that already-vested vacation pay would be entitled to a § 507(a)(3) priority notwithstanding that the vesting took place before the priority period.

The vacation pay the workers were earning during the ninety days before filing was not eligible for a priority since that contingent right was not even a claim in the bankruptcy. The reason it was not a claim was that the inchoate right to the vacation pay never became vested. Nevertheless, the court gave an

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31. *In re* Tucson Yellow Cab Co., 789 F.2d 701 (9th Cir. 1986); *In re* Pacific Far E. Line, 713 F.2d 476 (9th Cir. 1983); *In re* W.T. Grant Co., 620 F.2d 319 (2d Cir.), *cert. denied*, 446 U.S. 983 (1980).

32. *In re* Health Maintenance Found., 680 F.2d 619 (9th Cir. 1982); *In re* Mammoth Mart, 536 F.2d 950 (1st Cir. 1976); *In re* Public Ledger, 161 F.2d 762 (3d Cir. 1947).

33. *Cf. In re* Northwest Eng'g Co., 863 F.2d 1313 (7th Cir. 1988) (employees earned vacation pay the preceding year but only became entitled to it upon working at least one day the following year).

34. 863 F.2d 1313 (7th Cir. 1988).

apportionable § 507(a)(3) priority to ninety days' worth of the vacation pay that had already been earned and vested. The court contended that the employees should receive third-priority treatment for benefits "earned" in the ninety days before filing, even though the condition subsequent of the vesting rule would not be satisfied with respect to that earned vacation.[35]

In reaching the above result, the court relied mainly on the undesirability of what it considered to be its alternatives. On the one hand, the court reasoned that it would be unfair to send the workers away with no priority even though the firm owed vacation pay accrued over the prior year as a debt, and even though the employees built up more potential entitlements during the ninety days before the filing. On the other hand, the court was not willing to give a 100 percent priority to the entire vacation pay of the employee whose right to such vacation pay happened to vest within the ninety days before bankruptcy, while at the same time denying any priority to the vacation pay of the worker whose rights to it vested ninety-one days before bankruptcy.[36]

Other courts have followed the apportionment approach suggested in *Northwest Engineering* with respect to the § 507(a)(3) priority.[37] Courts have adopted a similar pro-rata approach for the administrative expense priority of § 503(b)(1)/§ 507(a)(1), focusing on the amount of vacation pay that was earned for work performed by the employees post-petition.[38] One court specifically rejected an argument, used unsuccessfully in other contexts, that an employee's termination post-petition transformed the employee's entire vacation pay claim into an administrative expense claim.[39]

An interesting timing issue was raised in *In re Crouthamel Potato Chip Co.*[40] In that case, the debtor-employer filed bankruptcy on October 16, and immediately dismissed all of its employees. The union then filed a proof of claim for the holiday pay representing the two upcoming Thanksgiving Day holidays to which union workers were entitled under the employer's collective bargaining agreement. Specifically, the agreement stated that the company would owe holiday pay to an employee that was laid off prior to a holiday if the employee had worked some time within the forty-five days prior to the holiday for which pay was sought. The union took the position that this holiday pay was entitled either to § 507(a)(1) or § 507(a)(3) priority.

The union ultimately lost both of its priority arguments. The district court resolved only the § 507(a)(3) issue and remanded with instructions to the bankruptcy court on the § 507(a)(1) question. In resolving the § 507(a)(3) argument, the court stressed that wages must be earned during the ninety-day priority period in order to qualify for the § 507(a)(3) priority. The problem here, the court said, was that the holiday wages were not owed at the point of filing, nor was the employee's right to receive wages fixed such that it could

35. *Northwest Eng'g Co.*, 863 F.2d at 1317.
36. *Id.*
37. *In re* Roth Am., Inc., 120 B.R. 356 (Bankr. M.D. Pa. 1990); *In re* Chicago Lutheran Hosp. Ass'n, 75 B.R. 854 (Bankr. N.D. Ill. 1987); *In re* Columbia Packing Co., 35 B.R. 447 (Bankr. D. Mass. 1983); *In re* Big Horn Fastener Co., 23 B.R 243 (Bankr. D. Colo. 1982); *In re* Beck, 24 B.R. 296 (Bankr. D. Haw. 1982).
38. *In re* Roth Am., Inc., 120 B.R. 356 (Bankr. M.D. Pa. 1990); *In re* Chicago Lutheran Hosp. Ass'n, 75 B.R. 854 (Bankr. N.D. Ill. 1987).
39. *Chicago Lutheran Hosp. Ass'n*, 75 B.R. at 856.
40. 52 B.R. 960 (E.D. Pa. 1985).

not be taken away from the employee by the occurrence of some contingent event.[41]

Here, the court explained, the right to the holiday wages accrued not when the employees were laid off within forty-five days of the holiday, but rather when, on the date of the holiday, the employees were still laid off. Accordingly, the court said, this was not an appropriate claim to qualify for the § 507(a)(3) priority.[42]

On the § 507(a)(1) question, the bankruptcy court in *Crouthamel* originally denied administrative expense status on the sole basis that no services were rendered by the employees after the filing of the bankruptcy petition. The district court remanded on this issue, however, since the district court determined that the fact of services rendered was not necessarily dispositive of the existence of an administrative expense priority. Instead, the district court instructed the bankruptcy court to ask 1.) whether the claim was for costs incurred post-petition which were necessary for the preservation of the estate or provided some benefit to the estate; and 2.) whether the claim resulted from some transaction or relationship between the debtor-in-possession and the creditor, as distinguished from expenses resulting solely from pre-petition relationships between the debtor and the creditor.[43] On remand, using this new standard, the bankruptcy court again denied administrative expense status to the union's holiday claim.[44]

E. Defining Cessation of Business

In most cases the ninety-day priority period under § 507(a)(3) and a similar 180-day period under § 507(a)(4) will be measured by the debtor's bankruptcy filing. However, the language of those provisions is clear that if the debtor ceases doing business prior to filing bankruptcy, the relevant priority period will be measured from the point immediately preceding the cessation of business.

There have been occasional arguments under § 507(a)(3) and § 507(a)(4) about whether the debtor ceased doing business for purposes of those Code provisions prior to the time when the debtor finally filed for bankruptcy. As a general rule, courts have very strictly construed the "cessation of business" language, and have considered a debtor to have ceased doing business only when all lines of a debtor's business have halted operations.[45]

The Fourth Circuit case of *Davidson Transfer v. Teamsters Pension Trust Fund*[46] is illustrative. In that case, the debtor had ended a major line of its

41. *Id.* at 965.
42. *Id.*
43. *Id.* at 967.
44. *In re* Crouthamel Potato Chip Co., 52 B.R. 43 (Bankr. E.D. Pa. 1985).
45. *In re* Rau, 113 B.R. 619 (Bankr. 9th Cir. 1990) (cessation of business language in § 507(a)(3) refers to all of debtor's various business operations in the aggregate if debtor operates more than one business; thus, despite debtor's mining business ceasing operations, there was no cessation of business where debtor's distinct restaurant business continued to operate until debtor filed for bankruptcy); *In re* Danborn Contracting Co., 56 B.R. 8 (Bankr. N.D. Ohio 1985) (debtor's failure to employ union members to haul its materials and instead contracting work out to independent agents did not constitute "cessation of business" for § 507(a)(4) purposes, where debtor was still engaged in main business of repairing concrete highways and bridges up until filing).
46. 817 F.2d 1121 (4th Cir. 1987).

business prior to the time when the debtor filed for bankruptcy. Employees of that line of business argued that the priority periods under § 507(a)(3) and § 507(a)(4) should be measured as to the line of business in question rather than as to the debtor's business as a whole. The court refused to accept this argument, despite the fact that the debtor had closed down a division which resulted in laying off 600 out of 800 of the debtor's total employees.

In refusing to consider the debtor's business as having ceased by the division shutdown, the court emphasized that the debtor had continued its remaining operations in a sincere and energetic effort to preserve that part of its business. The court noted also that its ruling would not allow a manipulation by the debtor of the priority periods created under § 507, because the court had the inherent ability to pierce a corporation's paper existence and determine whether the corporation truly had discontinued its operations.[47]

While courts have been strict in construing what constitutes a cessation of business, the cases have not gone so far as to remove any independent significance to that alternative basis with which to measure the priority periods of § 507(a)(3) and § 507(a)(4). In *In re Bodin Apparel*,[48] the debtor argued that it ceased doing business only when it filed for bankruptcy, an argument that if accepted by the court would have denied any priority claim to the pension plan claimant under § 507(a)(4). The court, however, held that the "cessation of business" language in § 507(a)(4) had to be construed more broadly than simply whenever the debtor finally filed bankruptcy.[49]

In *In re Bodin Apparel*, the court agreed with the claimant seeking priority that the debtor's cessation of business occurred on the final day of the month in which the company last maintained facilities to produce clothing. The court conceded, however, that the debtor had been engaged in certain activities for a short period of time after this latter event but before filing bankruptcy. Nonetheless, the court stated, these particular activities were merely incidental to the liquidation of the business and were consistent with a determination that the company had ceased doing business at the point when it last maintained facilities to produce clothing.[50]

F. Benefit Priorities of § 507(a)(4)

Section 507(a)(4) gives a fourth unsecured priority to certain claims for "contributions to an employee benefit plan." There are three limitations on this priority. First, the claims must arise from services rendered to the debtor within 180 days of the debtor's bankruptcy filing or cessation of business, whichever occurs first.[51] Second, the claims are limited for each plan to $2000 times the number of employees covered by that plan.[52] Finally, the amount of the § 507(a)(4) priority is reduced by the aggregate amount paid to the same employees under the § 507(a)(3) wage priority as well as by any amounts paid by the estate to any other employee benefit plan on behalf of the employees.[53]

47. *Davidson Transfer*, 817 F.2d at 1123–24.
48. 56 B.R. 728 (S.D.N.Y. 1985).
49. *Bodin Apparel*, 56 B.R. at 732.
50. *Id.*
51. 11 U.S.C. § 507(a)(4)(A) (1988).
52. 11 U.S.C. § 507(a)(4)(B)(i) (1988).
53. 11 U.S.C. § 507(a)(4)(B)(ii) (1988).

A number of minor interpretive questions have arisen under § 507(a)(4). Most of them have involved the issues of who can assert the priority, what constitutes an employee benefit plan, and what qualifies as "contributions" to such a plan. Case law is clear that the parties asserting the priority need not be the employees themselves, but may include the plan administrator or the insurance company that is sponsoring the plan.[54]

One court noted that allowing the insurer to obtain its premiums through the priority would seem to be the surest way to provide the employees with the policy benefits to which they were entitled.[55] That same court pointed out that employees would not ultimately be harmed by the insurance company's right to assert the § 507(a)(4) priority since that priority is expressly subordinated to the § 507(a)(3) wage priority.[56]

There has also been some litigation concerning whether eligible employee benefit plans under § 507(a)(4) must meet the definition of employee benefit plan that is provided in the ERISA statute. The issue has arisen in at least two contexts: first, whether meeting the ERISA definition is necessary to eligibility for the bankruptcy priority;[57] and second, whether meeting the ERISA definition is by itself sufficient to fit the § 507(a)(4) category.[58] Regarding the second context, at least one workers compensation plan that technically met the ERISA definition of employee benefit plan used that fact in the district court to reverse a bankruptcy court determination that had denied priority status to the carrier's claim for unpaid premiums.[59] Indeed, thus far the ERISA definition has only served to further a claimant's priority argument under § 507(a)(4) and has not been used successfully to preclude it.

Courts have been fairly strict about limiting the § 507(a)(4) priority to true plan contributions, and have not given a priority for such items as liquidated damages and attorneys' fees for delinquent plan contributions.[60]

One court strictly construed the qualification in § 507(a)(4) that limits the priority to $2000 times the number of employees covered by each plan.[61] In calculating the number of employees for this purpose, the court refused to include the employees of a subdivision of the debtor that was sold prior to the 180-day period. The court also refused to include in the calculation the

54. *In re* Miller Block Co., 63 B.R. 99 (Bankr. W.D. Pa. 1986) (employee pension fund entitled to priority status for debtor's delinquent plan contributions); *In re* Saco Local Dev. Corp., 711 F.2d 441 (1st Cir. 1983) (rejecting trustee's argument that § 507(a)(3) priority can be claimed only by employees or their "fiduciaries," and not by insurers such as this claimant); *cf. In re* Jet Florida Sys., 80 B.R. 544 (S.D. Fla. 1987) (reversing bankruptcy court and holding that debtor-employer's self-insurance program for reimbursement of medical expenses was "employee benefit plan" for § 507(a)(4) purposes, thus giving priority status to individual claims of employees for covered medical expenses).

55. *Saco Local Dev. Corp.*, 711 F.2d at 449.

56. *Id.*

57. *In re* Jet Florida Sys., 80 B.R. 544 (S.D. Fla. 1987) (fact that debtor's self-insurance program did not qualify under ERISA definition of "employee benefit plan" did not prevent claims for reimbursement thereunder from receiving priority treatment under § 507(a)(4)).

58. *In re* Plaid Pantries, 137 B.R. 405 (D. Or. 1991); *In re* AOV Indus., 85 B.R. 183 (Bankr. D.D.C. 1988); *In re* Saco Local Dev. Corp., 23 B.R. 644 (Bankr. D. Me. 1982), *aff'd*, 711 F.2d 441 (1st Cir. 1983).

59. *Plaid Pantries*, 137 B.R. at 407.

60. *In re* Miller Block Co., 63 B.R. 99 (Bankr. W.D. Pa. 1986).

61. *In re* Unimet Corp., 100 B.R. 881 (Bankr. N.D. Ohio 1988).

employees of a subdivision of the debtor whose bankruptcy had been voluntarily dismissed.

The § 507(a)(4) priority may even be available in the bankruptcy of someone other than the employer itself. In *In re Faber*,[62] the chief executive officer of a company filed an individual bankruptcy. The company had deducted contributions from the weekly earnings of union employees, but not all of the contributions had found their way into the benefit plan for which they were purportedly earmarked. Under an Illinois statute, the executive of the company was personally liable for any contributions that were taken from employee paychecks but not put into the appropriate benefit plan. The court in *Faber* allowed the union to assert a § 507(a)(4) priority claim against the debtor, even though the debtor in this case was the individual executive and not the company itself.[63]

G. Inheriting Wage and Benefit Priorities

Section 507(d) provides that a party which is subrogated to the rights of a holder of certain priority claims, including § 507(a)(3) and § 507(a)(4), is not subrogated to that holder's priority status.[64] An assignee of these priority claims, however, will be entitled to enjoy the priority of its assignor in the bankruptcy of the original obligor.[65] The general distinction between a subrogee and an assignee is that the subrogee inherits its rights through a payment that it is required to make; an assignee, on the other hand, voluntarily makes the payment that entitles it to inherit the assignor's rights.[66]

In practice, the distinction in the case law between the subrogee and the assignee for purposes of § 507(d) has been a relatively fine one. Consider the contrasting outcomes in two fairly similar cases. First, in *In re Allen Carpet Shops*,[67] a drawee bank cashed the debtor's payroll checks one day before the debtor's bankruptcy, even though there were insufficient funds in the debtor's checking account at the time. The bank subsequently sought a § 507(a)(3) wage priority in the bankruptcy of its customer, the employer, on the theory that by cashing the checks on insufficient funds it had become an assignee of the workers' claims for wages. The court denied the bank's argument for priority, noting that in cashing the checks without adequate funds in the account the bank never became an assignee of the workers' rights but merely made what amounted to a loan to the employer.[68]

In the Fifth Circuit case of *In re Missionary Baptist Foundation of America*,[69] a grocery store cashed payroll checks for employees of the debtor that totaled about $7000. Those checks ultimately bounced, leaving the store temporarily out the $7000. The question the court faced was whether the store could assert the § 507(a)(3) wage priority of the employees as an assignee in the bankruptcy of the employer, or whether instead the store would be barred from doing so as a subrogee under § 507(d).

62. 52 B.R. 563 (Bankr. N.D. Ill. 1985).
63. *Id.* at 566.
64. 11 U.S.C. § 507(d) (1988).
65. *In re* Paris Indus. Corp., 95 B.R. 258 (Bankr. D. Me. 1989).
66. *Id.* at 259.
67. 27 B.R. 354 (Bankr. E.D.N.Y. 1983).
68. *Id.* at 357–58.

The trustee argued that in many instances courts had treated the terms "subrogee" and "assignee" as synonymous, and that therefore the two concepts had merged. Thus, the trustee concluded, Congress must have intended for § 507(d) to encompass assignees as well as subrogees.[70] The court disagreed with the trustee, noting an old Bankruptcy Act case in which Judge Learned Hand determined that a person who cashed checks for employees of the bankrupt was an assignee rather than a subrogee and was thus entitled to the employees' wage priority. The court in *Missionary Baptist* reasoned that Congress must have been aware of this case and nevertheless created no language in the Bankruptcy Code that purported to overrule it.[71]

Finally, the court relied on a practical consideration in reaching its result. Absent giving the priority to the store that cashed the check, the court said, the employees themselves would be subject to liability as endorsers of the checks. Thus, the employees might themselves be required to reimburse the store if the employees' priority were not accorded to the store.[72]

At least on the surface, it seems rather difficult to reconcile how a drawee bank that cashes checks with insufficient funds is not an assignee whereas a nondrawee party like the grocery store that cashes employees' checks is an assignee entitled to the wage priority. In fact, however, commercial paper law would support this distinction.

When a drawee bank pays checks for which there are insufficient funds, the bank's claim against its customer, the drawer, is a direct claim owned by the drawee that is implied in law by the U.C.C.[73] The drawee is not assigned any rights of the payee on the check and, in any event, it does not need such an assignment to have rights against its customer. The grocery store, by contrast, is not serving as a drawee when it cashes the employee's check. The grocery store's "cashing" of the check can be more accurately understood as a purchase of the employee's rights on the instrument against the employer who drew the check.[74] The store, then, is a true assignee of the workers' rights on that check and is therefore entitled to the priority that would otherwise be asserted by the employee in the bankruptcy of its employer.

H. Employees' Potential Use of § 506(c)

There is yet another source of potential priority in the Code, besides § 507 and § 503(b)(1), from which employees might benefit in an appropriate case. Section 506(c) provides that the trustee may recover from a secured creditor's collateral "the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of

69. 667 F.2d 1244 (5th Cir. 1982).
70. *Id.* at 1245.
71. *Id.* at 1246–47.
72. *Id.* at 1247.
73. *See* U.C.C. § 4–401(1) (a bank may charge the customer's account for an item even though payment results in an overdraft).
74. *Cf.* U.C.C. § 3–203(b) ("Transfer of an instrument, whether or not the transfer is a negotiation, vests in the transferee any right of the transferor to enforce the instrument ...."). The reason that the movement of the check to the drawee bank does not constitute a "transfer" for purposes of the § 3–203(b) consequences is that the movement to the drawee bank is considered a "presentment" rather than a "transfer." *See* § 3–501(a) ("'Presentment' means a demand made by or on behalf of a person entitled to enforce an instrument (i) to pay the instrument made to the drawee or a party obliged to pay the instrument ....").

such claim."[75] A couple of courts have suggested that employees' labor might constitute a cost or expense of preserving a secured creditor's collateral, which would therefore entitle the employees to payment of their wages from the collateral.

In *In re Mechanical Maintenance*,[76] the district court upheld the bankruptcy court's rejection of an argument by the debtor's employees that their claim for post-petition employee benefit contributions could somehow qualify for a § 507(a)(4) priority. After rejecting that argument, however, the district court noted that this might nevertheless be a proper case in which § 506(c) could apply to give the employees' claim for their benefit contributions a special priority in the proceeds of certain collateral.[77]

In order to qualify for that priority, the court stated, the employees must show that their labor was a reasonable and necessary cost of preserving the collateral, here accounts receivable. The factual issues that the district court left for the bankruptcy court on remand were whether the expenses in question for the benefit fund were reasonable, necessary, and beneficial to the secured party.[78]

In *In re Chicago Lutheran Hospital Ass'n*,[79] the bankruptcy court rejected the employees' argument that the mere post-petition termination of employees would transform pre-petition vacation pay and severance pay claims into post-petition administrative priority claims. The court did note, however, that the expenses in this instance might be reimbursed from the secured creditor's collateral under § 506(c) to the extent the expenses benefited the secured creditor.[80] In order for the § 506(c) argument to work, the court stated, the employees would need to show that the secured creditor received a direct and quantifiable benefit from services provided by the employees during the post-petition period. At the time of this hearing, the court stated, the employees had not made that showing.[81]

III. EMPLOYEES' USE OF LEVERAGE FOR ADDITIONAL PRIORITY

As noted earlier,[82] at least part of the justification for giving workers a special priority in the bankruptcy of their employer is that employees as creditors are in an especially vulnerable position. It is ironic, then, that one of the most vexing issues for bankruptcy courts in the employee claim arena has been whether workers should be allowed to exert their unique leverage of work stoppage as a means of extracting non-Code priorities for their pre-petition wage and benefit claims.

Rare is the business that can expect to be successful in a reorganization effort without the full support of its work force. Therefore, the employees as a group will invariably be in a position to influence significantly their employer's

75. 11 U.S.C. § 506(c) (1988).
76. 128 B.R. 382 (Bankr. E.D. Pa. 1991).
77. *Id.* at 389.
78. *Id.* at 390.
79. 75 B.R. 854 (Bankr. N.D. Ill. 1987).
80. *Chicago Lutheran Hosp. Ass'n*, 75 B.R. at 857.
81. *Id.*
82. *See supra* text accompanying notes 8–9.

ultimate prospects of emerging from Chapter 11. In some sense, though, this leverage presents the classic prisoner's dilemma, since the workers have their own self-interested reasons for continuing to work and for wanting their employer to stay in business. This reality suggests one possible argument for not acceding to employees' demands for an enhanced priority: if one calls the employees' bluff on their threatened use of leverage, chances are they may not use it after all.[83]

The courts facing this issue have handed down conflicting decisions. In *In re Chateaugay Corp.*,[84] the district court reviewed a bankruptcy order granted to LTV on the day of its bankruptcy filing. The bankruptcy order authorized and empowered LTV to continue payment of pre-petition wages and salaries, employee reimbursement expenses, and benefits. The order did not limit such payment to amounts that would otherwise be given priority treatment under the Code. The district court upheld the bankruptcy court order, concluding that a "rigid application" of the § 507 priorities would be "inconsistent with the fundamental purpose of reorganization and of the Act's grant of equity powers to bankruptcy courts."[85] The purpose of reorganization, according to the district court, was to "create a flexible mechanism that will permit the greatest likelihood of survival of the debtor and payment of creditors in full or at least proportionately."[86]

In *In re Gulf Air*,[87] the bankruptcy court allowed the immediate payment of all pre-petition wage claims of current workers without requiring that the wages otherwise qualify for priority status. In justifying these payments, the court noted that without immediate payment, many skilled employees of the debtor would abandon their employment, thereby precluding a successful reorganization. Specifically, the court concluded that "retention of skills, organization, and reputation for performance must be considered valuable assets contributing to going-concern value and aiding rehabilitation where that is possible."[88]

Not every court is willing to keep the debtor's employees happy at all costs. In *In re FCX*,[89] the debtor requested permission to pay its employees

83. *See* Charles Jordan Tabb, *Emergency Preferential Orders in Bankruptcy Reorganizations*, 65 AM. BANKR. L.J. 75, 97 (1991) ("If the possibility of preferential treatment is simply not available as a matter of law, *ever*, then pre-petition creditors who attempt to extort such payments by threatening economic sanctions against the estate would be wasting their time").

84. 80 B.R. 279 (S.D.N.Y. 1987).

85. *Chateaugay Corp.*, 80 B.R. at 287.

86. *Id.*

87. 112 B.R. 152 (Bankr. W.D. La. 1989).

88. *Id.* at 154. Another case following the *Gulf Air* court's approach to this issue was *In re* Ionosphere Clubs, 98 B.R. 174 (Bankr. S.D.N.Y. 1989), where the court denied payment of pre-petition wages to striking employees even though the court had allowed the payment of pre-petition wages to those employees who were currently working for the debtor-in-possession. *See also* Russell A. Eisenberg & Frances F. Gecker, *The Doctrine of Necessity and its Parameters*, 73 MARQ. L. REV. 1, 12–15 (1989) (describing a number of different cases, most of them unreported, in which courts have authorized the debtor to pay employees either wages, expenses, insurance premiums, or the like); Christine Lutgens, *Employee Benefit Plans in Chapter 11 Reorganizations*, 19 TAX MGMT. COMPENSATION PLAN. J. 27, 36 (1991) (noting that in the Federated case, in an unreported decision, the court allowed payment of pre-petition benefit claims to employees, due to the nature of the retail business and its dependence on a stable work force).

89. 60 B.R. 405 (E.D.N.C. 1986).

some pre-petition wages that had not been paid, alleging that the employees would quit if they were not made whole. The debtor also contended that in this case, a confirmed plan would probably result in full payment to the employees in any event. The district court, however, ultimately reversed a bankruptcy court order that had allowed such payments to be made by the debtor.

The district court in *FCX* indicated that allowing such payment would be contrary to the priority provisions set up by Congress in the Code. Further, the court said that paying these selected pre-petition claims had the effect of subordinating the claims of the remaining unsecured creditors. Such subordination, the court said, was not authorized absent inequitable conduct on the part of these remaining unsecured creditors.[90]

In *In re Structurlite Plastics Corp.*,[91] the debtor sought authority from the court to pay certain pre-petition medical claims on the grounds that failing to do so might lead to a strike. The court responded that "selective re-payment of pre-petition debts should not be authorized as a result of threats or coercion by disgruntled creditors."[92]

The court in *Structurlite* did leave open the possibility that a deviation from the Code priorities could be justified in a proper case. Specifically, the court said in dictum that it would consider authorizing such selective pre-petition payments where: 1) such payments would be absolutely vital to reorganization; 2) absent such payments the debtor's rehabilitation effort would be immediately aborted; and 3) authorizing such payments would create the greatest likelihood of payment in full, or at least proportionately to all creditors.[93]

IV. CLAIMS UNDER THE FAIR LABOR STANDARDS ACT

One piece of labor legislation that has had an unexpected impact in bankruptcy is the Fair Labor Standards Act [hereinafter FLSA]. The purpose of the FLSA was merely to ensure that workers were not subjected to substandard labor conditions. The way in which the Act achieves its purposes, however, has caused an unforeseen entanglement with bankruptcy's priority scheme. Specifically, case law interpreting the FLSA has created, for certain types of FLSA claims, a "superlien" status that trumps even secured creditors. Further, courts have held that the injunctive power which gives rise to this FLSA superlien is effective inside of bankruptcy notwithstanding the automatic stay. The irony is that the very cases which have endorsed the superlien result have steadfastly denied creating any such lien-like status for these FLSA claimants.

A. *The Fair Labor Standards Act*

Congress passed the Fair Labor Standards Act in 1938 as a means to address what were perceived to be substandard labor conditions.[94] Among other provisions, the Act prescribes a minimum wage for the first forty hours

90. *Id.* at 410.
91. 86 B.R. 922 (Bankr. S.D. Ohio 1988).
92. *Id.* at 932.
93. *Id.*
94. 29 U.S.C. § 202 (1988) ("Congressional finding and declaration of policy").

worked each week[95] and also mandates that workers be paid time-and-a-half for overtime.[96]

The key provision of the FLSA for purposes of bankruptcy law has been section 215, the so-called "hot goods" provision of the Act. Section 215 prohibits "any person" from transporting or selling goods that are made in violation of the Act.[97] The two statutory exceptions to this prohibition are for common carriers who have an obligation to accept goods for transportation, and for good-faith purchasers who acquire goods with written assurance that they were produced in compliance with the Act.[98]

Under section 217 of FLSA, courts may enjoin violations of the hot goods provision and, further, may compel an employer to pay its employees the required but unpaid wages.[99] Under section 216, courts may also impose civil and criminal liability upon those employers who violate the mandate of section 215.[100]

B. FLSA and the Secured Creditor

The first major controversy involving the debtor–creditor implications of FLSA arose with respect to secured creditors. Imagine that there is a firm which, due to financial difficulties, has failed to pay its workers their wages for a period of two weeks. Suppose further that the firm has, during the period in which it has failed to pay wages, created a significant amount of inventory. All of this inventory has been pledged to a secured creditor.

The struggling firm defaults on its loan to the secured creditor, which then wishes to foreclose on its collateral. Following foreclosure, the secured creditor wants to sell the seized inventory to a third party. At that point, the Department of Labor, which is charged with enforcing the hot goods provisions of FLSA, seeks an injunction against the secured creditor. The DOL points to section 215 of FLSA and argues that the secured creditor is "any person," and therefore is prohibited from transporting or selling these goods, which were made in violation of the Act.

Federal courts struggled for a number of years with the issue of whether the FLSA injunction provisions were intended to prevent an otherwise innocent secured creditor from pursuing its standard remedies against a debtor-employer that had failed to pay minimum wage to its workers. Some courts said that they could not believe that Congress intended that the foreclosing creditor would have to pay the wage earner in cases like that presented above.[101] Other courts, by contrast, relied on a plain meaning approach to conclude that secured creditors were indeed bound by the anti-transfer restrictions of FLSA.[102] These latter courts pointed to the "any person" language in section 215 as well as the

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95. 29 U.S.C.A. § 206(a)(1) (West Supp. 1993).
96. 29 U.S.C. § 207(a)(1) (1988).
97. 29 U.S.C. § 215(a)(1) (1988).
98. *Id.*
99. 29 U.S.C. § 217 (1988).
100. 29 U.S.C. § 216(a) (1988).
101. *See* Wirtz v. Powell Knitting Mills Co., 360 F.2d 730 (2d Cir. 1966); *see also* Shultz v. Factors, 65 Lab. Cas. (CCH) 32,487 (4th Cir. 1971).
102. *See* Brock v. Ely Group, Inc., 788 F.2d 1200 (6th Cir. 1986), *aff'd*, Citicorp Indus. Credit v. Brock, 483 U.S. 27 (1983); *see also* Brock v. Kentucky Ridge Mining Co., 635 F. Supp. 444, 451 (W.D. Ky. 1985).

fact that the only two exceptions provided in the statute did not encompass secured creditors.

The circuit split was settled when the Supreme Court, in the case of *Citicorp Industrial Credit v. Brock*,[103] aligned itself with the "plain meaning" courts which had concluded that secured creditors were indeed subject to the anti-transfer provisions of FLSA. In *Citicorp*, the affected secured creditor challenged two preliminary injunctions obtained in district court by the Department of Labor prohibiting transportation or sale of the secured creditor's collateral in interstate commerce.

The Supreme Court essentially relied on the two statutory interpretation principles that had persuaded a number of lower courts that had come down the same way. The court noted that the language "any person" in section 15 of FLSA must encompass secured creditors, since "any person" is further defined by the Act to include corporations.[104] The court also focused on the statute's specific creation of just two exceptions to the "any person" language, common carriers and good-faith purchasers.[105]

The court rejected the secured creditor's argument that the nature of the two exceptions created by Congress indicated that the Act was intended to cover only culpable parties. The court instead stated that the exemption of only two narrow categories of innocent persons suggests that all others, whether innocent or not, are covered by the statute. The court stressed that specific FLSA exemptions must not be enlarged by implication to include persons not plainly within the exception's terms and spirit.[106]

In addition to relying on statutory interpretation arguments, the Supreme Court also justified its decision on more general policy grounds. The court said that its decision furthered the FLSA's goal of eliminating the competitive advantage enjoyed by producers of goods who maintain substandard labor conditions. The court also noted that its decision will further the statute's goal of ensuring that employers comply with the FLSA's minimum wage and overtime provisions, since its holding will cause potential creditors (even secured) to monitor whether their borrowers are complying with these provisions.[107]

Interestingly, the Supreme Court in *Citicorp* denied that its interpretation of the statute gave the unpaid employees a "lien" on the goods in question. The Court said that creditors' rights vis-a-vis employers were unchanged by its holding, and that the employees did not obtain any possessory interest in the goods as a result of the statute.[108]

If the Court was completely candid, it would have acknowledged that there was little practical difference between its holding and the granting of a lien to the employees on the inventory in question. As long as a secured creditor wishes to get cash for its collateral, it will first need to pay the employees their minimum wage. The only way for a secured creditor to circumvent this lien-like priority for the workers is for the secured creditor to use or consume the inventory itself. By so doing, the secured creditor would

103. 483 U.S. 27 (1983).
104. *Id.* at 33.
105. *Id.* at 33–34.
106. *Id.* at 35.
107. *Id.* at 37–38.
108. *Id.* at 38–39.

not violate the anti-transfer injunction of FLSA. Practically speaking, however, there will be few secured creditors who wish to do anything with their collateral other than transfer it for cash.

C. FLSA Actions and the Automatic Stay

In order to understand the effect of the automatic stay on the ability of the Department of Labor to enforce FLSA provisions against employers who are in bankruptcy, one must first appreciate the range of possible actions that the DOL is empowered to bring under FLSA. There are at least five DOL enforcement functions that have arisen in the context of an employer's bankruptcy: 1.) the assessment or liquidation of FLSA penalties; 2.) the entry of a judgment for monetary damages with respect to such penalties; 3.) the enforcement of such a monetary judgment against the debtor; 4.) the enforcement of FLSA's anti-transfer injunction; and 5.) the enforcement of FLSA's injunction that the debtor currently pay minimum wage and that the debtor pay back wages due employees.[109]

Against the backdrop of these possible DOL enforcement actions, one must also understand the rules surrounding the Bankruptcy Code's automatic stay provisions. For FLSA purposes, the key Code sections are 362(a)(1), (a)(2), (b)(4) and (b)(5). Section 362(a)(1) stays the commencement or continuation of a judicial or administrative action against the debtor that was or could have been commenced pre-bankruptcy.[110] Section 362(a)(2) stays the enforcement, against the debtor or against property of the estate, of any pre-bankruptcy judgment.[111]

Section 362(b) of the Bankruptcy Code contains various exceptions to the usual prohibitions of the automatic stay. Section 362(b)(4) creates an exception to the stay with respect to the commencement or continuation of actions or proceedings by a governmental unit to enforce its police or regulatory powers.[112] Section 362(b)(5) creates a similar exception for the enforcement of pre-petition judgments, other than money judgments, obtained in actions by governmental units to enforce their police or regulatory powers.[113]

Of the five DOL enforcement actions enumerated above, all but one have found protection in bankruptcy from the § 362(b)(4) and (b)(5) exceptions to the automatic stay. Only the actual enforcement of a money judgment obtained by the DOL against a debtor-employer has been stymied by § 362(a)'s automatic stay.[114] In fact, three of the five DOL enforcement actions under FLSA have proven relatively uncontroversial in bankruptcy. As just noted, the enforcement of a money judgment by the DOL is stayed by § 362(a)(2) and is

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109. *See* cases cited *infra* notes 112–24.
110. 11 U.S.C. § 362(a)(1) (1988).
111. 11 U.S.C. § 362(a)(2) (1988).
112. 11 U.S.C. § 362(b)(4) (1988).
113. 11 U.S.C. § 362(b)(5) (1988).
114. *See* Eddleman v. United States Dep't of Labor, 923 F.2d 782, 783 & n.1 (10th Cir. 1991) (DOL concedes that once its claims are liquidated, any collection of such claims must be governed by the bankruptcy proceeding); *see also In re* Perez, 61 B.R. 367, 368 (Bankr. E.D. Cal. 1986) (any attempt by DOL to collect a money judgment under FLSA shall not be pursued except through the debtor's bankruptcy proceeding); *In re* Tauscher, 7 B.R. 918, 920 (Bankr. E.D. Wis. 1981) (enforcement of money judgment by Secretary of Labor would not fit within § 362(b)(4) exception and therefore must be stayed).

specifically excluded from the § 362(b)(5) exception. Equally straightforward has been the conclusion that the mere assessment of penalties by the DOL and the entry of a judgment against a debtor are allowed to proceed in bankruptcy under the § 362(b)(4) exception to the stay.[115]

The more problematic cases under the stay have been those involving the DOL's injunction powers under FLSA. In particular, the DOL's ability to enforce its anti-transfer injunction in bankruptcy has raised the objection that the employees are thereby being granted a "superlien" in bankruptcy that is contrary to the Bankruptcy Code's own set of priorities. Despite this objection, the Eleventh Circuit, in *Brock v. Rusco Industries*,[116] held that the Secretary of Labor could indeed proceed with this administrative action against an employer that was in bankruptcy.

Specifically, the court in *Rusco* stated that such an injunction action by the Secretary was an exception to the automatic stay under §§ 362(b)(4) and (b)(5), since the Secretary "brought the suit to protect legitimate businesses from unfair competition and to enforce the federal law regarding minimum wage."[117] The court noted that *Rusco* was not an action for money damages and that § 362(b)(5)'s legislative history indicated that it was intended to provide an exception to the automatic stay "to permit an injunction and enforcement of an injunction."[118]

Somewhat ironically, courts have also been willing to let the DOL use its injunctive powers to force an employer in bankruptcy to pay its workers minimum wage and even to pay back wages owed to employees who were not paid the appropriate minimum wage in the past.[119] These actions as well have fallen under the shield of § 362(b)(4). The irony is that the DOL's injunction action for back wages is tantamount to forcing the debtor to pay a money judgment from the past. Yet in cases in which the DOL had an actual money judgment against the employer in bankruptcy, courts have held the automatic stay to prevent the collection of such a judgment.[120]

Allowing the DOL to enjoin the employer in bankruptcy from failing to pay current minimum wages is less troublesome. Such an action at least relates to ongoing work for the debtor-in-possession and therefore can be justified as simply an expense of doing business. When the DOL's "injunction," however,

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115. *Tauscher*, 7 B.R. at 920.

116. 842 F.2d 270 (11th Cir. 1988).

117. *Id.* at 273.

118. *Id.* (quoting S. Rep. No. 989, 95th Cong. 2d Sess. 52 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5838).

119. *See* Brock v. Arlmont Services, Inc., 67 B.R. 111 (Bankr. D. Mass. 1986) (§ 362(b)(4) and (5) except from the stay an action by the DOL to enjoin the Chapter 11 debtor from paying its employees less than minimum wage and for failing to pay time-and-a-half for overtime, as well as a demand for back wages stemming from previous violations); Brock v. American Messenger Serv., 65 B.R. 670 (Bankr. D.N.H. 1986) (action by DOL to enforce FLSA, including the seeking of monetary damages for back pay and liquidated damages, is exempt from the stay per § 362(b)(4)); Donovan v. Health Care Resources, Inc., 44 B.R. 546 (Bankr. W.D. Mo. 1984) (DOL's injunction action under FLSA, including payment of minimum wages due to debtor's employees, is exempt from stay per § 362(b)(4)).

120. *See* Eddleman v. United States Dep't of Labor, 923 F.2d 782, 791 (10th Cir. 1991) (although liquidation of DOL's judgment is not prevented by stay, the "[a]ctual collection of the back-pay claims must proceed according to normal bankruptcy procedures"); *In re* Perez, 61 B.R. 367, 368 (Bankr. E.D. Cal. 1986) (same); *In re* Tauscher, 7 B.R. 918, 920 (Bankr. E.D. Wis. 1981).

consists of forcing an employer in bankruptcy to make good on past failures to pay the minimum wage, the DOL's action seems hard to distinguish from the enforcement of a past money judgment. Nevertheless, courts have allowed as an exception to the automatic stay a DOL injunction requiring that the debtor pay money owed from the past, while at the same time refusing to allow the enforcement of a technical "money judgment" received by the DOL against a debtor-employer.

D. Bankruptcy Dischargeability of FLSA Penalties

A couple of issues have arisen under FLSA involving the Bankruptcy Code's non-dischargeability provision, § 523(a). Under FLSA, employers can be assessed civil penalties for violations of the Act's provisions.[121] In one bankruptcy case, the court held that civil penalties assessed against the debtor for child labor violations would be non-dischargeable in bankruptcy pursuant to § 523(a)(7) of the Code.[122] Section 523(a)(7) creates non-dischargeable status for any fines that are payable to a governmental unit and that are not in compensation for actual pecuniary loss.[123]

Civil penalties such as those described above must be distinguished, for dischargeability purposes, from back wage claims that are also recoverable under FLSA. One group of workers unsuccessfully tried to argue that FLSA claims against its employer in bankruptcy should be non-dischargeable under either § 523(a)(7) or (a)(6) of the Bankruptcy Code.[124] The court summarily dismissed both arguments. The § 523(a)(7) argument failed, the court stated, because back wage claims under FLSA do not constitute fines or penalties.[125] The § 523(a)(6) claim was improper, the court held, because the employer's failure to pay the minimum wage did not constitute a "willful and malicious injury by the debtor to another entity or to the property of another entity,"[126] as required by § 523(a)(6).

V. EMPLOYEES' DAMAGE CLAIMS UNDER WARN

In 1988, Congress passed the Worker Adjustment and Retraining Notification Act [hereinafter WARN].[127] Under WARN, an employer's failure to provide its employees with the requisite notice of a plant closing gives rise to employee damages in the form of back pay.[128]

In *In re Cargo, Inc.*,[129] the debtor ceased operations prior to giving its employees the statutorily required notice under WARN. About a month and a half later, the debtor filed for bankruptcy. The employees of the debtor filed a claim in the debtor's bankruptcy for their WARN damages and requested that their claim receive a § 507(a)(3) wage priority. The trustee objected to the

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121. *See supra* text accompanying notes 94–100.
122. *Tauscher*, 7 B.R. at 920.
123. 11 U.S.C. § 523(a)(7) (1988).
124. *See In re* Anderson, 32 B.R. 131 (Bankr. S.D. Fla.), *aff'g* 30 B.R. 229 (Bankr. S.D. Fla. 1983).
125. *Anderson*, 32 B.R. at 132 (quoting 11 U.S.C. § 523(a)(b)).
126. *Anderson*, 30 B.R. at 232.
127. 29 U.S.C. §§ 2101–2109 (1988).
128. 29 U.S.C. § 2104(a) (1988).
129. 138 B.R. 923 (Bankr. N.D. Iowa 1992).

priority that was asserted by the workers for their WARN claims, arguing that WARN damages are more like penalties than they are like wages.[130]

The court held for the workers and concluded that WARN back pay damages were entitled to § 507(a)(3) priority where the WARN violations, as here, took place within ninety days before the employer's bankruptcy filing. First, the court stated that WARN specifically used the term "back pay" to refer to the workers' entitlement to damages, whereas Congress, in the same statute, characterized the employer's liability to a local government unit as a "penalty."[131] Second, the court analogized these WARN damages for employees to an employee's right of severance pay in lieu of notice, in that the right to damages is earned upon termination rather than over time.[132]

In a footnote, the court acknowledged a timing paradox that exists in determining what WARN damages qualify for priority under § 507(a)(3).[133] Section 507(a)(3) requires the wages to be earned within ninety days of the employer's cessation of business or its bankruptcy filing, whichever occurs first. In *Cargo* the cessation of business preceded the bankruptcy, but it was the cessation of business without notice that technically triggered the WARN damages for the workers. In one sense, then, it would be impossible for the WARN claim to have been earned by the workers within ninety days *prior to* cessation of the business.

The court concluded that Congress could not have intended this result, particularly given the reason that the cessation of business alternative in § 507(a)(3) was inserted. That alternative, the court said, was included as a means to ensure that there would be a meaningful ninety-day priority period for workers in the case where the employer first ceased operations and only later filed for bankruptcy. In any event, the court said, it would consider the WARN claim to have arisen on the day that the debtor ordered its close of business without notice, and it would consider the "cessation of business" for § 507(a)(3) purposes to have been the next day—that is, the first day that the debtor did not operate.[134] Under this approach, it could then be said that the WARN claim arose within ninety days *prior to* the debtor's cessation of business.

VI. CONCLUSION

Special priorities for workers have, as discussed above, created a number of vexing issues for both litigants and bankruptcy courts. The time spent discerning just how these priorities fit within bankruptcy's distribution scheme, however, has arguably comprised only part of the cost to these priorities. There are at least two additional potential disadvantages to the creation of special priorities for certain classes of claimants such as workers.

First, bankruptcy is at bottom a zero-sum game. What legislators often forget is that the creation of a priority for one class necessarily implicates the return that will be available for other, equally sympathy-evoking claimants. Tort victims, for example, who in no way choose their association with the

130. *Id.* at 925.
131. *Id.* at 926.
132. *Id.* at 927.
133. *Id.* at 928 n.4.
134. *Id.*

debtor, are merely unsecured creditors whose claims will be subordinated to the priorities of workers. Furthermore, many bankruptcy experts have expressed the fear that the proliferation of bankruptcy priorities will lead to the demise of Chapter 11 as a viable reorganization process.[135] If that is the end result of a rash of special-interest priorities, then workers will suffer at least as much as institutional lenders.

The second problem associated with worker priorities is unique to the type of priorities that operate only in bankruptcy. That problem is one of both logic and perverse incentives: why should a worker whose claim against its employer outside of bankruptcy is a general unsecured claim suddenly enjoy a preferred position merely by the happenstance of its employer filing for bankruptcy? In some instances, a financially struggling employer can be more effectively reorganized outside of bankruptcy than in Chapter 11. Yet if workers enjoy a preferred position only inside of bankruptcy they will have, at least at the margin, a perverse incentive to see their employer reorganize in the manner that is less efficient for the creditor group as a whole.[136]

Perhaps the best solution to the worker-priority issue is to eliminate the formal priorities and simply allow the workers to exercise what may be their best leverage anyway: their ability as valuable employees to affect whether or not their employer will prosper as a viable going-concern.

135. *See Retiree Benefits Protection Act of 1987: Hearing on H.R. 2969 Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 100th Cong., 1st Sess. 160 (1987) (testimony of Nathan B. Feinstein) (indicating that "experience in Europe and elsewhere has been that engrafting welfare priorities into the reorganization process has destroyed the process").

136. *See* Butner v. United States, 440 U.S. 48, 55 (1979) (asserting that an important reason for uniform treatment of property interests inside and outside of bankruptcy is to discourage forum shopping).