The Priority of Severance Pay Claims Under the Bankruptcy Reform Act

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It is inevitable that the expectations of many individuals and business entities will be frustrated when a company with which they do business goes through bankruptcy. When the individuals involved are the employees of the failing company, however, their claims may center on employment benefits of considerable personal value, guaranteed to them by a collective bargaining agreement. The author examines the status of such claims under the recently revised federal bankruptcy statute, analyzing the judicial background, statutory language, and policy considerations which define the rights and obligations of the parties involved in such a dispute.

I

INTRODUCTION

The practice and study of labor law, although most frequently concerned with the relationships between employees, unions, and prosperous employers, must occasionally overlap the field of bankruptcy law. The relationship between employer and employee may be more strained when a business is on the verge of failure than at any other time in the employment relationship. Furthermore, when a business is in serious financial trouble and is being operated under the auspices of a bankruptcy court, the status of the employee and the employment contract is extremely ambiguous. Difficult questions of statutory interpretation and complex policy choices are presented when the goals of labor law and of bankruptcy law clash. This article examines one such area of conflict: the priority of claims for severance pay under the Bankruptcy Reform Act of 1978.†

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† Pub. L. No. 95-598, 92 Stat. 2549 (1978) [hereinafter called the Reform Act]. This Act became effective in October 1979, replacing the old Bankruptcy Act, codified beginning at 11 U.S.C. § 1 (1976) [hereinafter called the Old Act]. Because of the important relationships between the complementary sections of the Reform Act and the Old Act, parallel citations will frequently be used. Chapters of the Old Act are designated by Roman numerals (e.g., Chapter X), while Chapters of the New Act bear Arabic numbers (e.g., Chapter 10). Section 64(a)(1) & (2) of the Old Act is particularly important, for it was the section dealing with severance pay priority. Thus,
The need for bankruptcy regulation usually arises when the assets of a business are insufficient to pay its accrued debts. Without statutory regulation the creditors of the business would hurry to levy against its assets in an effort to satisfy the debts owed to them. Since there are usually insufficient assets to pay every creditor, the quicker creditors would be satisfied to a much greater extent than their slower associates. A failing business with a substantial possibility of rehabilitation would be dismantled asset-by-asset by worried creditors before the business could be reorganized. Bankruptcy legislation was passed to avoid these results.

The Reform Act continues the general mechanism provided in the Old Act through which a business unable to meet its obligation may be either liquidated or reorganized. The Reform Act provides special rules for liquidation of the business (straight bankruptcy) and for reorganization and continuation of the business under court supervision.

The liquidation section of the Reform Act provides rules under which the assets of the business are collected and sold and the proceeds distributed to the creditors. These rules eliminate the need to win the race of diligence to receive payment on debts owed. Chapter 11 of the Reform Act sets up a mechanism through which the business debtor, in conjunction with its creditors and investors, may develop a plan to adjust its debt obligations and equity interests. The plan may establish virtually any method of repayment and equity adjustment, including partial payment in full satisfaction of a debt and reduction of an equity interest. The purpose of Chapter 11 is to aid the financially distressed but potentially profitable business through this difficult period, with the hope that after rehabilitation it will once again become a prosperous enterprise.

Rather than consolidate all creditors into one group, the Reform Act, like the Old Act, sets up a system of priorities whereby creditors within certain classifications are paid prior to creditors falling within lower classifications. The Reform Act requires that liquidation payments from the business' assets must be made in the order specified in section 726. In a reorganization, the plan must provide for payment in full of the first two priority classes before the plan may be confirmed.

cases of severance pay priority decided prior to the passage of the Reform Act will generally contain references to that section of the Old Act.

2. The unregulated rush to file claims against a debtor in which the quickest creditor receives the most satisfaction is sometimes called the "race of diligence."
5. Consequently, these rules aid the slow creditor at the expense of the faster one, as the latter must now share what would otherwise have been undivided.
Among the many different creditors affected by liquidation or reorganization are the employees of the debtor. Should the business debtor voluntarily⁸ or involuntarily⁹ come within the jurisdiction of the bankruptcy court, the employees' right to wages and benefits is partially protected by the priorities in section 507. Specifically, section 507(a)(3) gives third priority to allowed unsecured claims for "wages, salaries, or commissions, including vacation, severance and sick leave pay" earned within 90 days before the filing of the petition or the date of cessation of the debtor's business, whichever occurred first. Recovery is limited to $2000 per individual. Section 507(a)(4) grants fourth priority to unsecured claims for contributions to employee benefit plans arising from services rendered 180 days before the earlier of the two dates specified above.¹¹

Section 507(a)(1) provides security for the employees of a business that continues to operate after the commencement of proceedings in bankruptcy. Most frequently, this continued operation occurs because the debtor has filed for a reorganization of the business under Chapter 11. Section 507(a)(1) states that during the reorganization first priority for the repayment of debts shall be given to "administrative expenses allowed under section 503(b). . . ." Section 503(b)¹² includes among

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⁸. Section 1129(a)(9) states:
(a) The court shall confirm a plan only if all of the following requirements are met:
  * * *  
  (9) Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that—
  (A) with respect to a claim of a kind specified in section 507(a)(1) or 507(a)(2) of this title, on the effective date of the plan, the holder of such claim will receive on account of such claim cash equal to the allowed amount of such claim . . . .

¹¹. Recovery under § 507(a)(4) is limited to:
  (i) the number of employees covered by such plan multiplied by $2,000; less
  (ii) the aggregate amount paid to such employees under paragraph (3) of this subsection [§ 507(a)(3)] plus the aggregate amount paid by the estate on behalf of such employees to any other employee benefit plan.

These sections of the Reform Act eliminate a source of confusion that existed under the Old Act. Section 64(a)(2) gave second priority to "wages and commissions." The question arose whether severance pay, vacation pay, and contributions to employee benefit plans fell within this language. The courts held that "wages and commissions" included: vacation pay (Division of Labor Law Enforcement v. Sampsell, 172 F.2d 400 (9th Cir. 1949); In re Wil-low Cafeterias, 111 F.2d 429 (2d Cir. 1940)), back pay awards from National Labor Relations Board actions (Nathanson v. NLRB, 344 U.S. 25 (1952)), and severance pay (McCloskey v. Division of Labor, 200 F.2d 402 (9th Cir. 1952)), but did not include contributions to employee benefit plans (United States v. Embassy Restaurants, Inc., 359 U.S. 29 (1959)). In § 507(a)(3) of the Reform Act, Congress has codified the holdings in Sampsell, Nathanson, and McCloskey. Congress rendered Embassy Restaurant moot by including payments to employee benefit plans in § 507(a)(4).

¹². This language is slightly different than the relevant language of the Old Act. Section 64(a)(1) did not specifically refer to "wages, salaries, or commissions," stating only:
allowable administrative expenses:

(1)(A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case; . . . .

It is unclear what priority, if any, severance pay owed to employees who are terminated after the reorganization begins is to have under sections 503 and 507. Interpreting the language of the Old Act, the courts have reached conflicting conclusions as to whether (and to what extent) severance pay should constitute an “administrative” expense entitled to first payment priority. These conflicting results have been reached by different courts because of an underlying conflict between the goals of bankruptcy law and labor law. At least with respect to the priority for severance pay, the Reform Act fails to reconcile these goals.

II

THE CONFLICT BETWEEN THE CIRCUITS

The severance pay priority problem arises when the debtor-in-possession begins to conduct the business and, in an effort to reorganize the business, discharges employees. Are these employees entitled to section 507(a)(1) priority for their severance pay claims because the severance pay claim is an administrative expense of the debtor’s estate? Interpreting the payment priority provision of the Old Act, the Sec-

a. The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment shall be (1) the costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition . . . .

13. Because of the Reform Act’s specific reference to “vacation, severance and sick leave pay” in connection with wages in § 507, it may be argued that vacation, severance and sick leave pay should not be included in the “costs of administration” priority of § 503. However, the language of § 507(a)(3) does not state that vacation, severance and sick leave pay are not included within wages, salaries or commissions without specific reference. The language in § 507 merely codified what the courts have held for over thirty years, i.e., that these benefits are actually included within the phrase “wages, salaries and commissions.” See cases cited at note 11 supra. Thus, it would seem that Congress’ specific reference to wages, salaries and commissions as allowable expenses in § 503 should include what employers and employees alike would include in that terminology: vacation, severance and sick leave pay earned during the period of estate administration. While Congress gave those payments fourth priority in § 507(a)(4), it did not overrule the Supreme Court’s position in Embassy Restaurant that these payments should not be considered wages, salaries or commissions. The language of § 507(a)(4) renders Embassy Restaurant moot, but it does not destroy its logic.

14. “Debtor-in-possession” is a term of art used in bankruptcy law when a business is in a Chapter 11 reorganization. The bankrupt company, the “debtor,” remains in possession of its assets and continues doing business while it tries to reorganize and become profitable. § 1101(1) of the Reform Act, 11 U.S.C. § 1101(1) (1978). The operation of the business and the reorganization are supervised by the Bankruptcy Court.

15. Severance pay priority may also be an issue if the reorganization fails and the business is completely liquidated under Chapter 7 of the Reform Act.

ond Circuit in *Straus-Duparquet, Inc. v. IBEW Local 3* \(^{17}\) answered affirmatively. The First Circuit in *In re Mammoth Mart, Inc.* \(^{18}\) expressly rejected the Second Circuit's approach and said no.

In *Straus-Duparquet* the debtor filed for arrangement under Chapter XI of the Old Act, but later was converted into straight bankruptcy. Rule 11-42 of the Rules of Bankruptcy Procedure \(^{19}\) detailed the procedures that controlled this conversion. \(^{20}\) The debtor had a collective bargaining agreement with the union; based on the terms of this agreement, the employees' union made a claim against the estate for vacation and and severance pay. The severance pay was designed as a "variable rate" system: one to three years of work entitled the employee to two week's pay upon dismissal; more than three years of work entitle the employee to two weeks pay upon dismissal. The Second Circuit held that by its nature severance pay was compensation for the loss of a job and was earned by the employee only at the time of discharge. \(^{21}\) Although the amount of severance pay was affected by the employee's length of service, the pay did not accrue over time. Based on this theory, the court held that since the jobs had been terminated as an incident of estate administration, the entire "compensation" was payable by the debtor-in-possession and entitled to section 64a(1) priority as a cost of administration.

In *Mammoth* the debtor also filed a Chapter XI case. There was no union or collective bargaining agreement, but the court found that the employees were entitled to severance pay. The debtor-in-possession had discharged certain employees and paid them one week's salary for every year worked, with a maximum of four weeks' pay. Some of the discharged employees, who had been with the debtor more than four years, filed claims for additional severance pay. These employees argued that the debtor's consistent policy had been to pay one week's pay for each year worked with no maximum limit. The bankruptcy court agreed with these employees and allowed the claim, but rejected their further contention that this additional severance pay should be given section 64a(1) priority. \(^{22}\) The bankruptcy court instead held that the claims were unsecured claims against the debtor, entitled to no priority. \(^{23}\) Furthermore, any claim for severance pay that may have arisen from the operation by the debtor-in-possession was held paid in full by

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17. 386 F.2d 649 (2nd Cir. 1964).
18. 536 F.2d 950 (1st Cir. 1976).
21. In contrast, the court decided that vacation pay did accrue over time and consequently constituted a first payment priority "administrative cost" only to the extent that it accrued during the arrangement period. 386 F.2d at 651.
22. 536 F.2d at 952.
23. The bankruptcy court also held that § 64a(2) priority was unavailable, since each em-
the payment of four week’s pay at the time of discharge. Thus, the bankruptcy court concluded that this claim for additional severance pay was for payment fully earned prior to filing of the Chapter XI petition and was not entitled to section 64a(1) priority. This conclusion was accepted by the district court without a published opinion.

The First Circuit affirmed the district court despite the Second Circuit’s earlier holding in Straus-Duparquet. The Court discussed the problem at greater length and in more depth than did the Straus-Duparquet court, concluding that different types of severance pay systems warrant different payment priority. When the contract calls for a set amount of severance pay, regardless of length of service (flat rate), then the Straus-Duparquet result—that all severance pay is accorded first priority—is appropriate. But when the contract provides for varying rates of severance pay for varying lengths of service (variable rate)—as did the two contracts in Straus-Duparquet and Mammoth—only that portion of the severance pay earned while the debtor-in-possession conducted the business should be granted first payment priority. The portion entitled to priority is determined by prorating the total amount due over the period the employee was employed by the debtor-in-possession.

The Second Circuit was given an opportunity in Matter of Uni-shops, Inc. to reexamine its holding in Straus-Duparquet in light of the distinction made in Mammoth. The court, citing Mammoth, stated that if the debtor-in-possession received benefits from a contract the debt arising out of that contract is entitled to first payment priority as an administrative expense. At the same time, it reaffirmed Straus-Duparquet as “correctly defining severance pay as compensation for termination of employment and hence usually an expense of administration. . . ." The court may have retreated from its absolute

24. These employees had worked for the debtor-in-possession for 11 days before they were discharged.

25. The court did not address the fact that the employees were given four weeks severance pay as a § 64(a)(1) priority, even though consistency within the opinion would seem to require that only 11 days of severance pay be allowed first payment priority. The court apparently was concerned only with the claim for additional payment of severance pay and chose not to question the propriety of the debtor-in-possession’s earlier distribution.

26. 553 F.2d 305 (2nd Cir. 1977).

27. 553 F.2d at 308 n. 1. After affirming the holding of Straus-Duparquet, the Unishops court distinguished that case in order to avoid prohibitions of a local bankruptcy rule. The court stated no reason for the distinction other than that Straus-Duparquet involved a collective bargaining contract. This is an inadequate distinction; whether the severance pay provisions were collectively or individually bargained does not affect the nature of those provisions as compensation for termination of employment. Once the Unishops court affirmed the characterization of severance pay in Straus-Duparquet, it should have accepted the district court’s denial of § 64(a)(1) priority rather than adjusting its decision to avoid the local rule.
stance in *Straus-Duparquet* by its use of the adverb "usually," but its express affirmation of the position that severance pay equals compensation for termination, without more, certainly suggests that the Second Circuit still does not accept *Mammoth*'s flat rate/variable rate distinction.

### III

**The Flat Rate/Variable Rate Distinction, Examined**

A majority of cases characterize severance pay as compensation for job termination. These cases hold that severance pay is "earned" at the time notice is due under the contract, or at the time the employee is actually discharged, rather than from the beginning of employment. The holdings accept by implication the argument that severance pay is paid primarily to help the discharged employee through the difficult period between jobs. It would not be logical to base that help on the length of employment. Instead, it should be measured by the size of the employee's family, the extent of his financial obligations, the reemployment opportunities for that employee, and other economic considerations.

This position is acceptable in the context of those cases that deal exclusively with flat rate systems of severance pay. In *McCloskey v. Division of Labor* severance pay was paid only if notice of termination was not given (one week's pay given in lieu of one week's notice); the severance pay system at issue in *In re Elliott Wholesale Grocery Co.* was similar. Both of these cases dealt with claims for section 64a(2) wage priority, but the logic of the decisions carries over into the section 64a(1) area. In both cases the courts found severance pay to be "earned" at the time that the employees were discharged. The amount of severance pay received remained the same regardless of how long the employee had worked for the debtor; it did not accrue during the period of employment.

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28. See *McCloskey v. Division of Lab.*, 200 F.2d 402 (9th Cir. 1952); *In re Public Ledger, Inc.*, 161 F.2d 762 (3rd Cir. 1947); *In re Elliott Wholesale Grocery Co.*, 98 F. Supp. 1017 (S.D. Cal. 1951); *In re Men's Clothing Code Auth.*, 71 F. Supp. 469 (S.D.N.Y. 1937); Matter of Colum. Toy Prods., Inc., 10 *COLLIER BANKRUPTCY CAS.* 707 (W.D. Mo. 1976). Although some of these cases dealt with the issue as a § 64(a)(2) wage priority claim, the reasoning is applicable to the § 64(a)(1) issue.

29. 200 F.2d 402 (9th Cir. 1952).


31. See note 1 *supra*.

32. In such systems it might be argued that the right to receive the severance pay "vests" upon employment and is due when the employer fails to give the specified notice of termination. *McCloskey v. Division of Lab.*, 200 F.2d 402 (9th Cir. 1952) (argument of trustee). This approach fails to take account of the situation where an employee quits and collects no severance pay. In such a situation, it cannot be said that the employee has a vested right to receive the severance pay. The better view is the one the courts have taken; the severance pay is earned at the time...
If, however, the severance pay is based on a variable rate system, the "earned at discharge" argument does not fit. Under the variable rate system each worker gets a different amount of severance pay based on his length of employment; if the pay were "earned" at the time of discharge, the payments would be equal for all. The variable rate severance pay system simply does not fit within the theory that severance pay is earned at one sudden point.

Under the *Mammoth* reasoning severance pay is indeed compensation. The bankruptcy case law suggests that a creditor's right to payment will be given section 507(a)(1) priority only if the consideration supporting that right to payment was both supplied to and beneficial to the debtor-in-possession who is conducting the business. Based on that position it follows that the extent of the severance pay awarded section 507(a)(1) priority is that portion that was supported by consideration during the arrangement. Under the flat rate system the consideration demanded by the employer is the employee's presence on the notice should have been given, thus giving rise to an "in lieu of" payment, or it is earned at the time of discharge if the contract does not require any advance notice.

This begins to sound like an argument for damages rather than one for wages. Arguably, severance pay can be viewed as a damages claim against the employer, with the employee alleging an implied warranty of continued solvency and employment. The Sixth Circuit held in *In re Ad Serv. Engraving Co.*, 338 F.2d 41 (6th Cir. 1964), that severance pay was a damages measure not entitled to § 64(a)(2) wage priority. The contract between union and employer called for one week's notice by the superintendent or foreman prior to any discharge. The shop was closed on the same day the decision to declare bankruptcy was made but two weeks before the bankruptcy petition was filed. The employees filed for one week's pay for failure to receive the required advance notice. Holding that the employees' claim was for damages, the court denied the plaintiff's petition, stating that "no amount of construction can make this damage claim one for wages 'earned' on the day of termination or within three months prior thereto." 338 F.2d at 44.

The contrary, and better, view was taken in *In re Public Ledger*, 161 F.2d 762 (3rd Cir. 1947), where the court held that severance pay was not a damage payment for the employer's breach of the employment contract, but rather was compensation under the contract. Public Ledger had filed under the Chapter X reorganization provisions, which are exempted from § 64 priorities unless the proceedings are ordered into straight bankruptcy. 11 U.S.C. § 502 (1976). Public Ledger was subsequently ordered into straight bankruptcy so the § 64 provisions attached. The court held that these claims had accrued under the contract, whether over time or when notice of layoff became due. *See also* Straus-Duparquet, Inc. v. IBEW Local 3, 386 F.2d 649 (2nd Cir. 1967); McCloskey v. Division of Lab., 200 F.2d 402 (9th Cir. 1952); *In re Elliott Wholesale Grocery Co.*, 98 F. Supp. 1017 (S.D. Cal. 1951); Matter of Colum. Toy Prods., Inc., 10 COLIER BANKRUPTCY CAS. 707 (W.D. Mo. 1976).

When the court feels severance pay is earned over time, only that portion earned during the three months prior to commencement of bankruptcy or reorganization proceedings will be entitled to § 507(a)(3) priority. In any case, the purpose of the severance pay is to soften the impact of losing a job and to help sustain the employee and his family until a new job can be found. This approach, rather than the "damage caused by the employer" notion, is codified in the Reform Act by the inclusion of severance pay in the wage priority enumeration of § 507(a)(3).

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payroll at the time of discharge. This condition can be fully performed while the debtor-in-possession conducts the business. Thus, the full amount owed under a flat rate system is entitled to section 507(a)(1) priority. Under a variable rate system the consideration for severance pay is spread over the entire period of employment; since only a portion of that consideration is completed within the arrangement period, only that portion is entitled to section 507(a)(1) priority. It has been settled that a debt does not receive such priority simply because the debt falls due during the period of arrangement; there must also have been a benefit to the debtor-in-possession.

The importance of the distinction between flat and variable rate severance pay systems is clearly illustrated in In re Public Ledger, where the debtor had two collective bargaining agreements. One agreement contained a flat rate severance pay system and the other a variable rate system. Both unions brought actions for severance pay when the debtor was adjudicated a bankrupt after a short period in Chapter X. The trustee had discharged the employees whose contract contained the flat rate provision without giving them the required two days notice; the court found the estate liable for severance pay, concluding that since the severance pay was not based on any length-of-service formula it was wholly "earned" under the trustee's management and was entitled to first payment priority. The second contract called for severance pay based on length of service with the bankrupt; the court held that this claim was accrued over time, and that only the pro rata portion that had accrued while the trustees conducted the business was entitled to section 64a(1) priority. The remainder was given section 64a(2) priority, within its limits, and unsecured claim status.

The flat rate/variable rate distinction for payment priority is supported not only by the logic that variable rates are earned over time rather than all at once, but also by the basic policy underlying the section 507(a)(3) priority and the Bankruptcy Act in general. Nathanson v. NLRB stated that the theme of the Bankruptcy Act was equality of distribution among creditors. An unlimited priority for severance pay under 507(a)(1) very well could consume all the assets of the debtor before any non-employee creditors received any payments and even before some employees could collect under section 507(a)(3) priority for unpaid wages earned prior to the filing of the petition for reorganization. While Congress recognized that wages should receive a high

35. In re Mammoth Mart, Inc., 536 F.2d 950, 955 (1st Cir. 1976).
37. 161 F.2d 762 (3rd Cir. 1947).
priority, they limited recovery to a $2000 maximum. In contrast, the Straus-Duparquet court seemed to give unlimited scope to claims for severance pay. Employees who may have been employed by the debtor-in-possession for only a few days before they were dismissed can receive large amounts as section 507(a)(1) claimants without jeopardizing their ability to collect additional amounts as section 507(a)(3) claimants.

A further policy problem with the Straus-Duparquet approach is the large increase in 507(a)(1) claims that arise in a case that goes briefly into Chapter 11 and then is converted to straight bankruptcy. In that situation, under Straus-Duparquet, all severance pay would be given section 507(a)(1) priority and quite possibly could consume all the assets of the bankrupt in satisfying the costs of administration. Had the debtor gone directly into straight bankruptcy, the discharge of the employees would have most likely occurred prior to or at the time of the adjudication, and the employees would therefore not be entitled to section 507(a)(1) priority. The Straus-Duparquet approach could lead to very unfair effects on creditors if employees, merely by working for the debtor-in-possession for a few days, could elevate their standing to receive severance pay to a first payment priority as an administrative cost, and then apply that priority to their many years of accumulated severance pay. The flat rate system does not give the employee this unfair advantage over other creditors, since the amount of severance pay earned by each employee remains the same regardless of the length of time employed.

A difficult question remains whether the estate should be saddled with this possibly high section 507(a)(1) priority at all. As indicated in the last paragraph, creditors may suffer greatly if a short venture into Chapter 11 prior to an adjudication of bankruptcy could divert a substantial amount of the assets from creditors to pay the expenses of administration. Under the Mammoth approach a variable rate severance pay system will add very little to the section 507(a)(1) priority, since only the amount earned during the administration would be included. The largest amount that could be added to the cost of administration would be under the flat rate system, since severance pay would receive priority in full. While the Mammoth position concerning the flat rate system leads to some conflict with the bankruptcy policy of equality of distribution to all creditors, the conflict is unavoidable and is properly decided in favor of priority for the severance pay. By the very nature of the flat rate system, as discussed above, the severance pay is earned at the date of termination of employment. When termination is ef-

39. See text accompanying note 11 supra.
40. See text accompanying notes 29-32 supra.
fected by the debtor-in-possession, the total amount of severance pay owed under the flat rate system comes due and is entitled to section 507(a)(1) priority. Furthermore, under the flat rate system there is no way to calculate a figure less than the full amount owed without being totally arbitrary; if the employee is entitled to severance pay under this system, the only logical amount is the full amount specified in the contract.

The flat rate/variable rate distinction made in Mammoth and Public Ledger is the most equitable system for all interested individuals—all classes of employees and the unsecured creditors. Under the Strauss-Duparquet approach all severance pay would receive the section 507(a)(1) priority regardless of when it was “earned”; by contrast, the flat rate/variable rate distinction permits the form of the severance pay provision in the contract to control its priority. If the parties agree on language that is interpreted as a flat rate system, the entire claim is entitled to priority as a cost of administration; if variable rate language is used, the employee will be entitled to priority on that portion of the total severance pay earned while employed by the debtor-in-possession.

IV

THE EFFECT OF REJECTION OF THE COLLECTIVE BARGAINING AGREEMENT ON SEVERANCE PAY PRIORITY

Even when the severance pay priority is determined by the form the severance pay provision takes in the collective bargaining agreement, priority problems will arise if the collective bargaining agreement is rejected by the debtor-in-possession as an executory contract, pursuant to section 365 of the Reform Act, or as part of a plan for reorganization under section 1123(b)(2). Section 365 provides, in pertinent part:

(a) . . . [T]he trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.

Section 1123(b)(2) provides:

(b) . . . [A] plan may—

(2) subject to section 315 of this title, provide for the assumption or rejection of any executory contract or unexpired lease of the debtor not previously rejected under section 365 of this title; . . .

41. At this point, for convenience, the employment contract will be assumed to be a collective bargaining agreement, negotiated by the debtor and a union. Although a great many employment contracts are not collective agreements, the analysis in this Part should apply with equal force to those other contracts as well.


44. Under the Old Act, which contained essentially the same provisions, the court was re-
Under these sections the debtor-in-possession may after court approval reject a contract that has not yet been fully performed. Recent cases have held that collective bargaining agreements are executory contracts that may be rejected under the predecessors to sections 365 and 1123(b)(2). These decisions capped a slow development toward this position beginning in 1959. The basic statement of the position that collective bargaining agreements are executory contracts is found in Iron Workers' Local 455 v. Kevin Steel Products, Inc. The court of appeals rejected the NLRB's argument that the Bankruptcy Act and the National Labor Relations Act were in conflict and that, in order to preserve industrial peace, Congressional policy called for resolution in favor of the Labor Act. The court felt that the two statutes could be reconciled. It concluded that Congress was fully aware of the relationship between collective bargaining agreements and executory contracts. This awareness is evidenced by Congress' refusal to sanction the rejection of collective bargaining agreements during railroad reorganizations. By failing to similarly limit section 313(1) [section 365 of the New Act], the court continued, Congress intended to include collective bargaining agreements within the realm of rejectable executory contracts.

The NLRB had argued that section 313(1) of the Bankruptcy Act directly conflicted with section 8(a)(5) and -(d) of the Labor Act. Section 8(a)(5) makes failure to bargain collectively an unfair labor practice; section 8(d) defines collective bargaining and prohibits the unilateral termination or modification of the collective bargaining agreement while it is in effect. The NLRB also argued that public pol-
icy proscribed rejection of a valid collective bargaining agreement. The court short-circuited the Board's argument by considering the debtor-in-possession to be a new entity and, therefore, not a party to the existing collective bargaining agreement. Until the debtor-in-possession assumes the collective bargaining agreement or signs a new one, "it is not a 'party' under § 8(d) to any labor agreement with the Union and is simply not subject to the termination restrictions of the section."52 The court reconciled its holding with the labor policy mandating collective bargaining by requiring that bankruptcy courts consider a variety of factors when balancing the need for rejection (measured by its necessity for achieving a viable arrangement) against general labor policy.53

Determining whether or not Kevin Steel was decided correctly is not within the scope of this article.54 Assuming that a collective bargaining agreement has been rejected under section 365 and Kevin Steel, the question addressed here is: what will determine the priority of severance pay? As concluded in Part III of this paper, the payment priority should be determined by the severance pay provisions in the contract. Will rejection of the contract destroy the right to severance pay or will the employees still be able to make a claim? If they may make the claim, is it entitled to priority?

The questions asked above were left unanswered in Mammoth.55 In fact, except for one recent non-bankruptcy case, Nolde Brothers, Inc. v. Bakery Workers Local 358,56 the courts have never considered the

52. 519 F.2d at 704.
53. Id. at 707:
In In re Overseas Nat'l Airways, 238 F. Supp. 359, 361-62 (E.D.N.Y. 1965), the court emphasized that a bankruptcy court should permit rejection of a collective bargaining agreement only after thorough scrutiny, and a careful balancing of the equities on both sides, for, in relieving a debtor from its obligations under a collective bargaining agreement, it may be depriving the employees affected of their seniority, welfare, and pension rights, as well as other valuable benefits which are incapable of forming the basis of a provable claim for money damages. That would leave the employees without compensation for their losses, at the same time enabling the debtor, at the expense of the employees, to consummate what may be a more favorable plan of arrangement with its other creditors.

55. 536 F.2d at 954 n.3.
contract rejection issue in conjunction with the priority for severance pay. *Nolde* will be discussed in more detail below.\(^\text{57}\)

**A. Assumption of the Contract by the Debtor-in-Possession**

If the collective bargaining agreement is actually assumed by the debtor-in-possession, or a new one is negotiated and signed with the union, all the obligations and duties in that document are placed on the debtor-in-possession.\(^\text{58}\) Thus, if the debtor-in-possession assumes the old collective bargaining agreement, severance pay will be given section 507(a)(1) priority in accordance with the agreement’s terms. If the debtor-in-possession negotiates and signs a new agreement, all severance pay awarded under this new agreement will receive section 507(a)(1) priority, as it will have all accrued under the administration of the debtor-in-possession.

**B. Rejection of the Contract by the Debtor-in-Possession**

Under the Old Act most executory contracts could be rejected or assumed only by some affirmative act on the part of the trustee. Rejection had to be approved by the bankruptcy court.\(^\text{59}\) Collier stated the basic position on rejection: “The failure to assume affirmatively an executory contract does not result at any time in a rejection of the contract. . . . Unless so rejected, the contract continues in effect.”\(^\text{60}\) He also stated the widely accepted position on assumption that “the denial of an application made under § 313(1) to reject an executory contract does not mean that the contract is assumed.” Rather, “[a]ssumption requires approval of the Court.”\(^\text{61}\) However, these statements were not

\(^{57}\) See note 92 infra.

\(^{58}\) “An assumption carries with it all of the burdens as well as all the benefits of the contract.” *8 COLLIER ON BANKRUPTCY* § 3.15[6] (14th ed. 1978).


\(^{60}\) *8 COLLIER ON BANKRUPTCY* § 3.15[6] (14th ed. 1978).

\(^{61}\) *Id.* at 208 and n.14 (citations omitted). These statements are supported by cases outside the employment context. *See, e.g.*, In re American Nat’l Trust, 426 F.2d 1059 (7th Cir. 1970) (judicial action required to affirm building contract); In re Northern Ind. Oil Co., 65 F. Supp. 167 (N.D. Ind. 1946) (trustee cannot assume lease on his own responsibility); In re Rochester Shipbuilding Corp., 32 F. Supp. 98 (W.D.N.Y. 1940) (must indicate intention to adopt charter on a vessel). A few supporting cases deal with collective bargaining agreements. *See Local Joint Exec. Bd., AFL-CIO v. Hotel Circle, Inc.*, 419 F. Supp. 778 (S.D. Cal. 1976) (no affirmation of collective bargaining agreement with hotel employees); In re Schenectady Ry. Co., 93 F. Supp. 67 (N.D.N.Y. 1950) (no affirmation of collective bargaining agreement simply because continued to contribute to pension fund according to such agreement). The most cogent judicial statement came from the court in *In re American Nat’l Trust*, 426 F.2d at 1064:

And, rejection or assumption of an executory contract in a Chapter X proceeding requires judicial action by the judge and not merely administrative action and decision by the trustee. *Texas Importing Company v. Banco Popular de Puerto Rico*, 5th Cir., 360 F.2d 582, 584.

The court continued that the trustee is entitled to “a reasonable time within which to decide
accepted without dissent due to the ambiguity of the statutory language. Old section 313(1) stated: "Upon the filing of a petition, the court may . . . (1) permit the rejection of executory contracts of the debtor. . . ." Congress' failure to require court action for the assumption of executory contracts made it possible for the courts in *In re Public Ledger, Inc.* and in *Brotherhood of Railway Workers v. REA Express, Inc.* to decide that an executory employment contract had been assumed without requiring proof of an affirmative act by the trustee and without approval by the bankruptcy court.\(^6^2\)

Under the *Public Ledger* and *REA Express* holdings, there was no distinction drawn between an express assumption of the collective bargaining agreement and inaction by the debtor-in-possession. In both instances the debtor-in-possession was required to fulfill all the obligations of the agreement. But there should be a difference, and in this respect *Public Ledger* and *REA Express* were wrongly decided. The debtor-in-possession should be able to reject the agreement (after ade-

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\(^6^2\) The court in *In re Public Ledger, Inc.*, 161 F.2d 762 (3d Cir. 1947), held that the collective bargaining agreement remained effective throughout the administration of the estate, even though not expressly assumed by the trustee. The court stated: "It is thus seen that the labor contract continued to be effective throughout the administration of the estate by the trustee, and that the doctrine of experimental assumption is inapplicable." 161 F.2d at 767. This was a new step taken by the *Public Ledger* court, as it conflicted with the mass of bankruptcy authority. However, it was relied upon by other courts. In *Brotherhood of Railway Workers v. REA Express, Inc.*, 523 F.2d 164 (2d Cir., 1975), the court said in dictum that if the employees were led to believe by the successor employer (the debtor-in-possession) that they would have continued employment at the old terms, the debtor-in-possession would have to follow those old terms until a new agreement was negotiated and signed. 523 F.2d at 171. While the court actually did not say that the collective bargaining agreement had been assumed, significant burdens were placed on the debtor-in-possession without the need for acts of affirmance. More importantly, earlier in the opinion the *REA Express* court stated that a collective bargaining agreement could be assumed without the traditional acts of express assumption. The court said, citing *Public Ledger*:

> It [the debtor-in-possession] was not a party to and was not bound by the terms of the collective bargaining agreement entered into by REA as debtor, [citations omitted] unless and until the contract should be assumed, either expressly or conforming to its terms without disaffirmance . . . .

523 F.2d at 170 (emphasis added). In another recent case, *Matter of Unishops, Inc.*, 553 F.2d 305 (2d Cir. 1977), the debtor-in-possession was required to pay severance pay according to an employment contract it never expressly affirmed because it had accepted the continued services of the employee and no attempt had been made to disaffirm the contract.

These cases developed an exception to the basic rule that there must be an affirmative act to assume an executory contract. The *Public Ledger* court stated its position with no bankruptcy authority to support it. Both the *REA Express* and *Public Ledger* courts overstated their positions when they said to conform to the contract was to assume it. If these two courts had allowed the debtor-in-possession to conform to the agreement for a short time, in an attempt to gauge the effects of the agreement and then to decide knowledgably whether to affirm or reject, the basic bankruptcy position would have remained intact. That had been the procedure under Old Act § 706, which gave the trustee 60 days within which to reject or assume the contract. After that time, if no action had been taken, the contract was deemed to have been rejected. 11 U.S.C. § 110b (1976).
quate cause for rejection is shown) at any time prior to its express assumption. Inaction while the debtor-in-possession gauges the impact on the arrangement attempt should not be equated with express assumption.

The position taken by bankruptcy scholars such as Collier ("unless so rejected the contract continues in effect") and Remington ("an executory contract remains in full force and effect unless the plan expressly rejects it") may pertain to executory contracts in general, but should not be applicable to the special case of an employment agreement. Because the particular executory contract being considered by the trustee or debtor-in-possession is a collective bargaining agreement, labor law policies must be considered in determining the procedures for accepting or rejecting the contract.

The courts enter an area of great uncertainty when they confront apparent conflicts between the bankruptcy and labor laws. Bankruptcy laws are given a high degree of national importance, as evidenced by the specific provision made for such laws in the Constitution. At the same time, the labor laws manifest a strong national policy to preserve labor peace through the collective strength of employees working with employers. It appears that the courts, in cases such as Public Ledger and REA Express, have given a preference to bankruptcy law in their position on assumption of the collective bargaining agreement. The underlying reason for such a preference appears to be the courts' desire to attain a viable reorganization. Ironically, if the courts were to continue to hold that the collective bargaining agreements remained in full force until rejected, essentially adhering to principles of bankruptcy law, the viability of the reorganization effort would be jeopardized rather than strengthened. If, however, the courts apply principles derived from labor law to this question, the debtor-in-possession would be free to deal with employees as a successor employer; the debtor-in-possession would not be bound to an older collective bargaining agreement to which it was not a party. This approach strengthens the viability of a reorganization effort by avoiding financially onerous clauses in the collective bargaining agreement.

This position is supported by a well-established line of cases be-

63. 8 COLLIER ON BANKRUPTCY § 3.15 (14th ed. 1978).
67. See note 62 supra.
68. The court in Kevin Steel stated that the debtor-in-possession was a new entity, separate and distinct from the original debtor. 519 F.2d at 704.
ginning with *NLRB v. Burns Security Services*, which held that the successor employer (analogous to the debtor-in-possession) did not violate section 8(d) of the Labor Act by unilaterally changing the terms of employment. The continuing employer is required to continue existing conditions of employment during periods of renegotiation; for the successor employer, however, there are no such existing conditions. The successor employer must bargain in good faith with the union; until the new bargain is struck, the employer may determine those terms unilaterally, although it is limited to action that does not discriminate against employees for their union activities. This gives the debtor-in-possession the flexibility to make immediate changes if such changes are required to save the reorganization attempt. Typically, however, the debtor-in-possession will only infrequently change the terms and conditions of employment without some discussion with the union. The union always has the right to call a strike; for a distressed company already in Chapter 11, that action could destroy any hope of reorganization and send the business into straight bankruptcy.

The Reform Act has embraced the position argued above and has overruled *Public Ledger*, *REA Express*, and their progeny. The Reform Act expressly requires that court action be taken before assumption or rejection of an executory contract. Section 365(a) states: "(a) . . . [T]he trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." This clarification is especially valuable when applied to the assumption or rejection of a collective bargaining agreement. Intelligent decisions concerning the effect of the agreement on the debtor during reorganization cannot be made on short notice. It takes time to determine if the contract is unduly burdensome to the reorganization effort. At the same time, since the trustee cannot immediately reject the agreement there will be continuity for the employees at the beginning of a difficult period of uncertainty. When, and if, the agreement is found to be onerous, it can then be rejected and a new contract negotiated.

Under the Old Act, as interpreted by *Public Ledger* and *REA Express*, the debtor-in-possession had to make the decision to assume or reject immediately upon commencing operation of the business or risk impliedly assuming a very burdensome collective bargaining agreement. Under Chapter 3 of the Reform Act, the trustee in straight bankruptcy has sixty days within which to assume the contract. Under the provisions of Chapter 11, the debtor-in-possession is not so restricted in its ability to reject; it can reject an executory contract at any time prior

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to approval of the reorganization plan by the court.\textsuperscript{73} Under either chapter, if the contract is assumed its provisions remain in effect as if no proceeding had been initiated.\textsuperscript{74} Conversely, if the contract is rejected, it is rejected as of the date of initiation of bankruptcy proceedings.\textsuperscript{75} During this period, while the debtor-in-possession gauges the overall effect of the current agreement, it can operate the business according to the terms it feels are appropriate.

\textbf{C. Severance Pay Priority of a Rejected Collective Bargaining Agreement Under the Reform Act}

Assuming that the collective bargaining agreement is expressly rejected by the debtor-in-possession and employees are then discharged, the question of the payment priority status of severance pay remains unanswered. Section 365(g) of the Reform Act, succeeding section 353 of the Old Act, states:

\textit{T}he rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease—

(1) if such contract or lease has not been assumed under this section or under a plan confirmed under chapter 9, 11, or 13 of this title, immediately before the date of the filing of the petition;

Claims for breach of contract against the estate are allowed by section 502(g).\textsuperscript{76} If the collective bargaining agreement has not been expressly assumed, these two sections place the employee in the same position as an unsecured creditor, which is not as good as the section 507(a)(1) priority the employee hopes to get for the severance pay claim.\textsuperscript{77} Removal from section 507(a)(1) priority to unsecured creditor status


\textsuperscript{74} See text accompanying note 58 \textit{supra}.


\textsuperscript{76} Reform Act § 502(g) states:

A claim arising from the rejection, under section 365 of this title or under a plan under chapter 9, 11, or 13 of this title, of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed . . . the same as if such claim had arisen before the date of the filing of the petition.


\textsuperscript{77} The allowable amount of a claim for breach of an employment contract is limited by § 502(b)(8), which states:

(b) . . . \textit{T}he court . . . shall allow such claim in such amount, except to the extent that—

\begin{itemize}
  \item[(8)] if such claim is for damages resulting from the termination of an employment contract, such claim exceeds—
    \begin{itemize}
      \item[(A)] the compensation provided by such contract, without acceleration, for one year following the earlier of—
        \begin{itemize}
          \item[(i)] the date of the filing of the petition, and
          \item[(ii)] the date on which the employer directed the employee to terminate, or such employee terminated, performance under such contract; plus
        \end{itemize}
      \item[(B)] the unpaid compensation due under such contract without acceleration, on the earlier of such dates . . .
    \end{itemize}
\end{itemize}

means, in most cases, that the employee will receive nothing on the claim. The basis of the claim will be determined by the contract amount of severance pay not received due to the rejection of the contract.\(^7\) Thus, while the court in \textit{REA Express} suggested that after rejection the collective bargaining agreement had no force,\(^7\) it does remain as the source for determination of damages.

The position that rejection of the collective bargaining agreement nullifies the entire agreement has not gone unchallenged. In \textit{Bohack Corp. v. Truck Drivers' Local 807},\(^8\) the court held that even though the debtor-in-possession could validly reject the collective bargaining agreement, the provisions within that agreement detailing grievance and arbitration machinery remained in force against the debtor-in-possession. This suggests that the severance pay provisions of a collective bargaining agreement also may be found to have continued life beyond the rejection of the collective bargaining agreement. This extension of \textit{Bohack} would give section 507(a)(1) treatment to all severance pay, notwithstanding the logic of the analysis suggested in the first part of this article.

In \textit{Bohack} the court considered whether the employer validly could reject the collective bargaining agreement and, if it could, whether the bankruptcy judge could still order arbitration of certain disputes according to the arbitration and grievance procedures of the rejected agreement. This case had come up on appeal from the decision of the bankruptcy judge, who, in turn, had had these issues remanded to him by the Second Circuit.\(^8\) The court held that Bohack's compliance with the collective bargaining agreement was not an assumption of the agreement. The conduct of Bohack was not considered consistent with assumption of the labor agreement because its financial deterioration, concomitant with the Chapter XI proceeding and the discharging of large numbers of union drivers, should have put the union on notice that changes would have to be made to prevent collapse of the company. While the court reconciled its position with \textit{Public Ledger}, it would have been more appropriate simply to state that the debtor-in-possession was not bound to the collective bargaining agreement until it was \textit{expressly} assumed, unless the debtor-in-possession failed to act within a reasonable time.\(^8\)

On the question of arbitration, Bohack argued that upon the rejection of the collective bargaining agreement the question became moot. The union contended that the contract provisions should apply rather

\(^7\) Reform Act § 502(g), 11 U.S.C. § 502(g) (Supp. 1978).
\(^7\) 523 F.2d at 170-71.
\(^8\) Truck Drivers' Local 807 v. Bohack Corp., 541 F.2d 312 (2d Cir. 1976).
\(^8\) See text accompanying notes 58-69 \textit{supra}. 
than the Old Act arbitration provision\textsuperscript{83} which the bankruptcy judge had decided was controlling.\textsuperscript{84} That section laid out a rather simple structure for arbitration, much less detailed than the basic grievance and arbitration provision of a collective bargaining agreement and certainly not individually tailored. The court held that the rejection of the collective bargaining agreement did not “obviate the need for arbitration.”\textsuperscript{85} Building upon the emphasis placed on arbitration as a tool for preserving labor peace,\textsuperscript{86} the court stated that issues should be turned over to the arbitrator for decision if the arbitration would “preserve labor peace, bring to bear the expertise of the arbitrator on issues such as working conditions or shop practices, and at the same time, avoid usurpation of the bankruptcy court’s critical role in the re-organization proceeding.”\textsuperscript{87} The general bankruptcy view toward arbitration seems

84. Section 105 of the Reform Act simply gives the bankruptcy court the power to issue any appropriate order. Section 105(a) concerning the power of the court, states that “the bankruptcy court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.” 11 U.S.C. § 105(a) (Supp. 1978).

An earlier Supreme Court case relied on in the Second Circuit’s decision in \textit{Bohack} held that the arbitration clause of the collective bargaining agreement continued in force even after the expiration date of the agreement. In \textit{Nolde Bros., Inc. v. Bakery Workers Local 358}, 430 U.S. 243 (1977), the union exercised its right to terminate the collective bargaining agreement and subsequent to that action the employer closed its plant. \textit{See Payne, Enjoining Employers Pending Arbitration: From M-K-T to Greyhound and Beyond}, 3 INDUS. REL. L.J. 167 (1978). The union asked the employer to go to arbitration to decide whether the workers were entitled to severance pay under the old agreement. The employer refused, arguing that the termination of the agreement had ended its obligation to arbitrate disputes arising under that agreement. The Supreme Court disagreed with the employer, stating:

\begin{quote}
Adherence to these principles [that the duty to arbitrate arises strictly from contractual agreement], however, does not require us to hold that termination of a collective bargaining agreement automatically extinguishes a party’s duty to arbitrate grievances arising under the contract.
\end{quote}

430 U.S. at 251. The court found that the language of the arbitration clause was so broad that the parties had intended it to cover all grievances arising under the collective bargaining agreement. It was clear that the union’s claim for severance pay arose under the agreement, so the court held that it should be decided by an arbitrator, as provided in the agreement. The court noted the parties preference for an arbitral rather than a judicial interpretation of the agreement and gave great weight to this preference because the parties had drafted the clause “against a backdrop of well-established federal labor policy favoring arbitration as the means of resolving disputes over the meaning and effect of collective bargaining agreements.” Such a broad grant of power presumably includes the power to order arbitration where appropriate.

85. 431 F. Supp. at 653.
87. 431 F. Supp. at 653. \textit{See also} L.O. Koven & Brother, Inc. v. United Steelworkers Local 5767, 381 F.2d 196, 205 (3d Cir. 1967):

\begin{quote}
In summary, we hold that questions involving an interpretation of the Bankruptcy Act should be decided by the court, while questions involving an interpretation of the collective bargaining agreement should if feasible be decided by the arbitrator, unless they involve special bankruptcy interests. If such interest are present, then the proper
to be neutral. Bankruptcy Rule 919(b) reads: "(b) Arbitration. On stipulation of the parties to any controversy affecting the estate the court may authorize the matter to be submitted to final and binding arbitration." 88 Section 26 of the Old Act stated: "a. The receiver or trustee may, pursuant to the direction of the court, submit to arbitration any controversy arising in the settlement of the estate." 89 These provisions gave the court discretion as to when to authorize arbitration but did not provide any guidelines concerning what should be arbitrated. 90 The Bohack court laid down these guidelines, at least where a collective bargaining agreement is involved. The court felt that arbitration was necessary, arguing that maintaining labor peace was enough justification since the consequences of a strike on the business in Chapter 11 would be disastrous to the arrangement effort. 91 The court also held that the contractual provisions, rather than section 26 of the Old Act, controlled, citing Tobin v. Plein. 92

Case authority clearly holds that the arbitration clause of the collective bargaining agreement will be given effect, if at all possible. 93 If the arbitration clause is broad enough, it will send to arbitration the question of whether employees are entitled to severance pay. Upon that determination the bankruptcy court can decide, by looking at the forum should be dictated by the needs of the particular case, and this matter is best left with the discretion of the trial court.

90. Furthermore, these provisions did not require the debtor-in-possession to arbitrate when the non-assumed contract required arbitration at some point; they simply empowered the debtor-in-possession to go to arbitration if the court found it to be appropriate. The court in Bohack, however, held that arbitration was required when included in a rejected collective bargaining agreement.
91. 431 F. Supp. at 654.
92. Id. at 655. The Tobin court held that § 26 was not required for all Bankruptcy Court-ordered arbitration because "this section is clearly drawn to provide arbitration machinery where no contractual arrangements exist. It does not supersede explicit contractual provisions." 301 F.2d 378, 381 (2d Cir. 1962). The court supported its position by quoting from United Steelworkers of America v. Warrior & Gulf Navigation Co., 363 U.S. 574, 582-83 (1960):

[T]o be consistent with the Congressional policy in favor of settlement of disputes by the parties through the machinery of arbitration, . . . [a]n order to arbitrate the particular grievance should not be denied unless it may be said with positive assurance that the arbitration clause is not susceptible of an interpretation that covers the asserted dispute. Doubts should be resolved in favor of coverage.

The Nolde court concluded by saying: "In short, where the dispute is over a provision of the expired agreement, the presumptions favoring arbitrability must be negated expressly or by clear implication." 430 U.S. at 255. This position is broad enough that most grievances would be seen as arising from the old contract, especially grievances about the right to receive severance pay.
93. The term "arbitration clause" can be construed to include any grievance machinery specified within the collective bargaining agreement. Grievance procedures are usually preliminary rounds, which, if they do not lead to settlement, lead to arbitration. The court in Bohack recognized the interrelationship of the two: "If the contractual duty to arbitrate survives rejection, there is no reason why the grievance procedures established by the parties should not also survive." 431 F. Supp. at 655.
contract terms and the arbitrator's award, whether the claim is entitled to a section 507(a)(1) priority. An example of part of this procedure is illustrated in *H.K. Porter Co.* The arbitrator found severance pay to be a vested right earned by the employee after a specified period of time. The arbitrator held: "In the absence of any language providing for divestment of this vested right, I am unable to... conclude [that the right to severance pay dies with the agreement]."

The *Bohack* court was correct in extending this strong preference for arbitration into the area of bankruptcy law. The labor law preference for arbitration has developed, essentially, since the *Steelworkers' Trilogy* of 1960, and is firmly grounded in the desire to avoid economic labor struggle. It has been an effective force in reducing the amount of economic action taken by both the union and the employer. This is certainly important for the Chapter 11 business, which can ill afford to be hit by labor strife, especially a strike. In contrast, the only bankruptcy principle that argues against the carryover of the arbitration clause is the principle that executory contracts must be assumed or rejected *in toto*—a policy meant to prevent the debtor-in-possession from taking unfair advantage by rejecting only those portions of an executory contract that are unfavorable to the business. The arbitration and grievance provisions of a collective bargaining agreement seem to be neutral provisions dealing only with procedure; on a day-to-day basis arbitration provisions might be used to process grievances more often by the union than by the employer, but this would hardly promote unfair advantage by the debtor-in-possession. Thus, the policy reasons behind refusing to allow partial assumption are simply inapplicable in the case of grievance and arbitration provisions of a collective bargaining agreement.

The ultimate question remains: should the severance pay provisions of the contract carry over after contract rejection as do the arbitration and grievance provisions? The labor law policies supporting the carryover of an arbitration clause do not exist similarly in support of carryover of severance pay provisions. Thus, the decision whether or not to give effect to the severance pay provision turns on the intentions of the parties as discerned from interpretation of the contract. In *Nolde* 94. 49 Lab. Arb. 147 (1967) (Cahn, Arb.).

95. *Id.* at 151.


97. "An executory contract cannot be rejected in part and assumed in part. The debtor, or the trustee, is not free to retain the favorable features of the contract and reject only the unfavorable ones." 8 *COLLIERS ON BANKRUPTCY* ¶ 3.16[7] (14th ed. 1978).
the arbitration clause was very broad and encompassed the issue of severance pay; consequently, the arbitrator was the appropriate party to determine whether the contract meant to continue the severance pay obligation beyond the contract expiration. In the case of a more narrowly drawn arbitration clause the court would be the proper forum in which to decide that question. In this determination the court or arbitrator should not defer toward continued existence of the severance pay clause, as is done for arbitration clauses. As was stated previously, there is no well-established federal policy in support of severance pay as there is for arbitration. Furthermore, under the holdings in *Kevin Steel* and *REA Express*, the debtor-in-possession must show real need to reject the collective bargaining agreement before the bankruptcy court can allow the rejection. If the debtor-in-possession can show that need, it would be counterproductive to permit the severance pay provision to continue in effect after the contract has been rejected; doing so would create a large claim for severance pay which would then be given section 507(a)(1) payment priority. Such a decision could destroy any hope of a successful reorganization, which is the major purpose of Chapter 11.

V

Conclusion

The decision as to whether or not severance pay should receive payment priority as a cost of administration under section 507(a)(1) of the Reform Act has become in essence a contract interpretation problem. If the contract provides for a flat rate of severance pay that is payable on discharge, the entire amount should receive section 507(a)(1) priority. If the contract provides for a variable rate of severance pay, then only the pro rata share earned while the debtor-in-possession administered the business should be given section 507(a)(1) priority. Knowing these rules, the parties to the contract might make all the positions clear in the agreement, thus informing the employees of their position at the outset of their employment. Realistically, however, it would only be the very rare case in which employer and union would contemplate future bankruptcy while they negotiate present severance pay and arbitration provisions. Thus, it seems it will be left to the courts, or the arbitrator, to decide in each case if severance pay for the employee discharged by the debtor-in-possession is entitled to section 507(a)(1) priority.

When considering whether or not the provisions of a rejected collective bargaining agreement should continue in force, the courts have

98. See note 92 *supra*.
99. See text accompanying notes 86-97 *supra*. 
followed neither bankruptcy nor labor law principles consistently. On one hand, the courts have permitted rejection of the collective bargaining agreement in violation of the duty to bargain collectively which is so highly valued in labor law. On the other hand, the courts have required a very strong showing of need in order to reject the bargaining agreement, in violation of basic bankruptcy principles that require a simple showing of burden on the estate. When asked to enforce arbitration clauses after rejection of an employment contract, however, the courts have acted in harmony with labor law's high deference to arbitration and have rejected the bankruptcy law principle that executory contracts should be accepted or rejected in toto. In essence, the courts have been making fine distinctions and have modified both bankruptcy and labor law slightly, in order to avoid a head-on collision between these two important and autonomous branches of federal law.