



# Making it a Priority: What Happens to Employee Claims When a Business Declares Bankruptcy?

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Workers are not immune from their employer’s financial difficulties. Troubled companies commonly downsize their workforce, cut wages, and curtail employee benefits. Businesses on the brink of collapse may also lack the funds necessary to pay compensation and benefits that employees have already earned. Companies in particularly dire financial straits may ultimately declare bankruptcy to restructure their obligations or liquidate the business. Individuals employed by such companies face a significant risk of loss of employment or reduced wages or benefits.

In part because of the risks that an employer’s bankruptcy creates for its employees, the federal Bankruptcy Code contains multiple provisions intended to protect a debtor’s workers. For instance, Congress has created statutory protections for collective bargaining agreements and retiree benefits that apply in certain business bankruptcy cases. Of particular relevance here, the Bankruptcy Code also grants certain employee claims “priority” status, thereby entitling covered employees to more favorable treatment than some—but not all—of the other interested parties in the bankruptcy case.

Commentators have debated whether current law “provide[s] too little protection for employees.” Some advocates have encouraged Congress to add additional worker protections to the Bankruptcy Code. Several Members of recent Congresses have introduced legislation proposing to amend the Bankruptcy Code’s priority hierarchy to afford workers more favorable treatment in the bankruptcy process. Others, however, argue that increasing protections for such employees would make it harder for debtors to satisfy the necessary prerequisites for reorganizing their businesses through bankruptcy. Opponents contend that amending the Bankruptcy Code to further favor workers could have the unintended consequence of forcing more companies to shutter their businesses completely—an outcome diametrically opposed to the goal of increasing job security and financial stability.

To provide context to this policy debate, this Sidebar discusses the legal issues implicated by proposals to modify the Bankruptcy Code’s priority scheme with respect to employee claims. After providing a general overview of existing federal law governing bankrupt businesses, the Sidebar then explains how current bankruptcy law treats various categories of creditors. In particular, the Sidebar focuses on (1) the ways in which the Bankruptcy Code affords different levels of priority treatment to certain types of claims

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held by employees; and (2) the legal and economic effect of priority status. The Sidebar concludes by identifying legal issues for Congress to consider as it mulls proposals to reconfigure the existing priority structure.

## Background on Business Bankruptcies

Federal law creates [various types](#) of bankruptcy proceedings, two of which are particularly relevant for business debtors:

- Liquidation proceedings under [Chapter 7](#) of the Bankruptcy Code; and
- Reorganization proceedings under [Chapter 11](#).

A [Chapter 7](#) proceeding liquidates the business’s assets so that it may cease operations. To [effectuate a Chapter 7 liquidation](#), an officer known as the [Chapter 7 trustee](#) collects the debtor’s assets, sells them, and distributes the proceeds to creditors in accordance with a [statutorily defined hierarchy](#) described in greater detail below.

[Chapter 11](#), by contrast, is primarily (but [not exclusively](#)) a means for restructuring a business’s debts so it may continue to operate as a going concern. Chapter 11 bankruptcies ideally result in a reorganization “[plan](#)” that [adjusts the rights and obligations](#) among the debtor and its creditors. Before a plan may become legally binding, a bankruptcy court must first review and [confirm](#) it. The court may not confirm a proposed plan that does not comply with multiple [statutory prerequisites](#), the most relevant of which are discussed below.

## Types and Hierarchy of Claims

A bankrupt business’s debts fall within [several general categories](#). Some creditors hold claims that are [secured](#) by specific property (known as [collateral](#)) that the debtor has pledged against the debt in the event the debtor defaults. For example, a bank might hold a security interest in a [fleet of trailers](#) that the debtor utilizes to operate its business, which the bank could potentially repossess if the debtor fails to satisfy its payment obligations. Because such [secured creditors](#) possess legal rights that are enforceable against particular assets of the debtor, they are generally in a better position than [unsecured creditors](#), who do not enjoy rights against any specific property.

Some unsecured creditors, however, enjoy a [more privileged position](#) than other unsecured creditors. For policy reasons, Congress has singled out several categories of unsecured claims and expenses for [priority](#) treatment. The Bankruptcy Code establishes [the following hierarchy](#) of claims and expenses that are entitled to different levels of priority status.

### Hierarchy of Priority Unsecured Creditors

| Level of Priority           | Description of Claim                           |
|-----------------------------|--|
| First                       | Domestic Support Obligations                   |
| In Between First and Second | “Super-Priority” Claims                        |
| Second                      | Administrative Expenses                        |
| Third                       | Claims Arising in Involuntary Bankruptcy Cases |
| Fourth                      | Unpaid Employee Compensation                   |
| Fifth                       | Employee Benefits                              |
| Sixth to Tenth              | Additional Priority Levels                     |

| Level of Priority | Description of Claim        |
|-------------------|-----------------------------|
| Non-Priority      | General Unsecured Creditors |

**Source:** 11 U.S.C. §§ 364(c), 503(b), 507.

Several priority levels may be particularly significant for employees:

**Second-Level Priority: Administrative Expenses.** Section 507(a)(2) of the Bankruptcy Code grants second-level priority to certain types of “[administrative expenses](#),” which may include claims held by employees. With [limited exceptions](#), administrative expenses are costs that a debtor incurs [during a bankruptcy case](#) to “either [preserve the \[debtor’s assets\]](#) in a reorganization or facilitate the winding-down in a liquidation.” Congress granted administrative expenses a higher priority than most other claims to “encourag[e] lenders and others to [continue or commence doing business](#) with the debtor” during bankruptcy proceedings. As relevant here, [wages, salaries, and commissions](#) for services an employee renders after the commencement of the bankruptcy case may qualify as administrative expenses insofar as they constitute “[actual, necessary](#) costs and expenses of preserving the” debtor’s assets. [Certain back pay](#) awards may also be entitled to administrative expense priority.

**Fourth-Level Priority: Unpaid Employee Compensation.** Section 507(a)(4)’s fourth-level priority tier established is particularly significant for workers, as it confers priority status to certain claims for unpaid wages, salaries, commissions, severance pay, and other forms of employee compensation. To qualify for priority treatment under Section 507(a)(4), the worker must have earned the compensation “within [180 days](#) before the date” on which the debtor filed for bankruptcy “or the date of the cessation of the debtor’s business, whichever occur[red] first.” Thus, [in contrast](#) to Section 507(a)(2), which grants *second*-level priority to administrative expenses incurred *after* the bankruptcy case begins, Section 507(a)(4) grants *fourth*-level priority to certain types of compensation workers earned *before* the case began. Priority status under Section 507(a)(4) is subject to certain [monetary caps](#) that [fluctuate every 3 years](#) to reflect changes in the Consumer Price Index. Thus, as of the date of this Sidebar, to the extent an individual worker’s claim for compensation exceeds [\\$13,650](#), the excess amount is [not entitled](#) to priority status.

**Fifth-Level Priority: Employee Benefits.** Section 507(a)(5)’s fifth-level priority tier—which grants priority status to certain “claims for contributions to an employee benefit plan . . . arising from services rendered within 180 days before” the employer filed for bankruptcy “or the date of the cessation of the debtor’s business, whichever occurs first”—is likewise significant for employees. Like Section 507(a)(4), priority status under Section 507(a)(5) is subject to [monetary caps](#) that periodically adjust to [reflect changes](#) in the Consumer Price Index.

**General Unsecured Claims Not Entitled to Priority.** [Underneath priority creditors](#) are “[general unsecured](#)” claims—that is, claims that are not entitled to priority treatment under the Bankruptcy Code. Generally speaking, to the extent an employee holds a claim against his employer that [does not fall](#) within one of the categories discussed above—such as a [workers’ compensation](#) claim arising from a workplace injury that occurred prior to the bankruptcy—that claim sits at the bottom of the creditor hierarchy.

## The Benefit of Priority Status

Although the *level* of priority that a creditor enjoys generally [remains the same](#) irrespective of which Chapter of the Bankruptcy Code the debtor invokes, the *benefit* of priority status varies depending on whether the debtor has declared bankruptcy under [Chapter 7](#) or [Chapter 11](#).

**Chapter 7.** In Chapter 7 cases, with [limited exceptions](#), secured creditors are generally entitled to be [paid in full](#) out of the proceeds of their collateral before other creditors—including [priority and general unsecured claims](#)—may receive anything. The Chapter 7 trustee then distributes the remaining assets (if any) to the remaining creditors in the order specified in [Section 726](#) of the Bankruptcy Code. Priority

creditors are the **first in line** to receive payment under Section 726, and the Chapter 7 trustee pays those creditors in the order specified in the table above. Lower priority creditors **may not receive anything** until higher priority creditors have been paid in full. If, due to a shortfall of assets, “a priority tier cannot be paid in full, distribution is made **pro rata** among creditors within such tier,” while creditors in lower priority tiers and general unsecured creditors **remain unpaid**.

**Chapter 11.** In Chapter 11 cases, by contrast, the primary benefit of priority status is the entitlement to **cash payments**. As relevant here, administrative expense creditors, employee compensation creditors, and employee benefit creditors are all **entitled to receive cash** equal to the amount of their claims (subject to the **statutory caps** discussed above). Unless these priority creditors agree to be treated otherwise, the court **lacks the authority** to confirm a Chapter 11 plan that does not propose to pay their claims in full.

## Legal Considerations for Congress

As mentioned above, **some commentators** and **several Members of Congress** have advocated **modifying** the **priority hierarchy** to **benefit employee creditors**, such as by creating **new tiers** of priority claims for certain types of employee creditors. If Congress opts to create a new priority tier, it could consider:

- Which types of claims will be eligible for priority treatment;
- **Where to place** the new tier in the **existing creditor hierarchy**;
- **Whether** priority claims in the new tier will be subject to **monetary caps** like those that presently exist in Section 507(a)(4)-(5);
- If so, what those caps will be, and whether they will **adjust automatically for inflation**;
- **Whether**—and under what terms—claimants in the new tier will be entitled to **cash payments** in Chapter 11 cases as a prerequisite to plan confirmation; and
- Whether to impose a temporal limitation on claims entitled to priority treatment akin to Section 507(a)(4)-(5)’s command that priority status only extends to claims accruing “within **180 days** before the date of the filing of the [bankruptcy case] or the date of the cessation of the debtor’s business.”

With regard to the existing priority classes, Congress could also consider:

- Moving claims for wages and benefits earned prior to the bankruptcy case to a different priority level;
- **Altering** or eliminating the **monetary caps** in Section 507(a)(4)-(5); and/or
- **Eliminating** or **modifying** Section 507(a)(4)-(5)’s temporal limitation.

Each of these considerations involves **tradeoffs**. Giving employees a more preferable position in the creditor hierarchy, for example, could potentially “diminish[] the recovery of **other types of creditors**, such as taxing authorities, trade vendors, customers or tort victims.” Prohibiting bankruptcy courts from confirming Chapter 11 plans that do not afford employees preferred treatment might also **make it harder** for some business debtors to successfully reorganize themselves as a going concern, which might in turn **encourage more companies to liquidate** through Chapter 7. Accordingly, adjusting the legal standards governing the hierarchy of creditor claims may implicate a range of policy questions as well.

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