Published on *The National Law Review* https://natlawreview.com

What Happens To Employees When a Company Files for Bankruptcy?

Article By:

Financial Poise Faculty

The employees of a company that files for bankruptcy are creditors of the company for any amount owed but not paid to them prior to the date of the filing. But they are so much more. After all, if all the employees resigned on the same day, there probably would not be much of a company left.

Employees are not just line items on a creditor matrix — they are the people who keep operations running, customers satisfied, and value alive while a company attempts to reorganize or wind down. Bankruptcy law recognizes this dual role, affording employees certain protections and priorities, but the reality is far from simple. From unpaid wages and benefits to retention plans and WARN Act liabilities, this article explores what really happens to employees when their employer heads into Chapter 11.

Will Employees Still Receive Their Wages?

Upon a company's bankruptcy filing, an automatic stay is enacted, halting all creditor collection efforts, including those by employees seeking unpaid wages. To address this, companies typically file 'first-day motions' to request court approval for paying pre-petition wages and benefits. This ensures that employees receive their due compensation without significant delays.

However, the Bankruptcy Code imposes a cap on the priority status of wage claims. As of the current provisions, employees can claim up to $15,150 for wages earned within the 180 days preceding the bankruptcy filing. Any amount exceeding this cap is treated as a general unsecured claim, which may result in partial or delayed payment.

What Happens To Employee Benefits?

Employee benefits, including retirement contributions and health plans, are subject to similar priority caps as wages. The combined total of wages and benefits eligible for priority status cannot exceed the $15,150 limit. For instance, if an employee is owed $12,000 in wages and $5,000 in benefits, only $15,150 of this $17,000 total will receive priority; the remaining $1,850 becomes a general unsecured claim.

It's important to note that funds already vested in retirement accounts, such as 401(k) plans, are generally protected and not considered part of the bankruptcy estate. However, future employer contributions to these plans may be affected during the bankruptcy process.

Employer Obligations During Bankruptcy

Employers must navigate several legal obligations when filing for bankruptcy:

- **Pre-Petition Wages:** Ideally, employers should settle all wages owed before filing. If that's not feasible, they must seek court approval to pay these debts post-petition.
- **Employee Classifications:** Not all workers are treated equally in bankruptcy. W-2 employees typically receive wage priority, whereas 1099 contractors and staffing agency personnel may not.
- **Tax Obligations:** Failure to remit trust fund taxes, such as withheld payroll taxes, can result in personal liability for company officers and directors.

Post-Filing Employee Compensation

After a bankruptcy filing, wages earned are considered administrative expenses and are typically paid in the ordinary course of business. However, any deviations from standard compensation practices, such as salary increases, bonuses, or retention incentives, require court approval, especially if they are outside the ordinary course of business.

Key Employee Retention and Incentive Plans (KERPs and KEIPs)

To retain essential personnel during bankruptcy proceedings, companies may implement:

- **Key Employee Retention Plans (KERPs):** These provide bonuses to employees simply for remaining with the company through the bankruptcy process.
- **Key Employee Incentive Plans (KEIPs):** These are performance-based plans that reward employees for achieving specific financial or operational targets.

Both plans require court approval and must be carefully structured to comply with the Bankruptcy Code's restrictions, especially concerning payments to insiders like officers and directors.

Treatment of Employment Contracts

In bankruptcy, companies have the option to assume or reject executory contracts, including employment agreements:

- **Assumption:** The company continues the contract, provided it cures any defaults and demonstrates the ability to fulfill future obligations.
- **Rejection:** The company opts out of the contract, treating it as breached. Affected employees can file claims for damages, typically capped at one year's compensation.

Collective Bargaining Agreements (CBAs) and Retiree Benefits

CBAs and retiree benefits receive special protection under the Bankruptcy Code:

- **CBAs:** To modify or reject a CBA, the employer must demonstrate that changes are essential for reorganization and must negotiate in good faith with the union. The process is governed by Section 1113 of the Bankruptcy Code.

- **Retiree Benefits:** Similar protections apply under Section 1114, requiring a stringent process to modify or terminate retiree medical benefits. Even if a plan allows unilateral changes, the bankruptcy court may still mandate adherence to Section 1114 procedures.

WARN Act Considerations

The Worker Adjustment and Retraining Notification (WARN) Act mandates that employers provide 60 days' notice before mass layoffs or plant closures. Non-compliance can lead to liabilities, including back pay and benefits for the affected period.

There are exceptions to the WARN Act's notice requirements, such as unforeseeable business circumstances or natural disasters. However, these exceptions are narrowly construed, and employers bear the burden of proof.

State-Specific WARN Laws

Several states have their own versions of the WARN Act with stricter provisions. For example:

- **New Jersey:** Requires 90 days' notice and mandates severance pay for affected employees.
- **California and Illinois:** Have laws with lower thresholds for layoffs and additional administrative requirements, making compliance even more critical for multi-state employers. Employers operating in these jurisdictions must pay careful attention to both federal and state-specific WARN obligations to avoid compounding liabilities during bankruptcy.

Non-Qualified Benefit Plans May Be Vulnerable

While tax-qualified retirement accounts (like 401(k)s) are protected under federal law and excluded from the bankruptcy estate, non-qualified benefit plans — such as deferred compensation arrangements or so-called 'top-hat' or 'rabbi trusts' — do not receive the same treatment.

These non-qualified plans are often used to compensate executives or high earners in excess of IRS contribution limits, but they come with a downside: if the employer files for bankruptcy, those funds may be considered part of the bankruptcy estate and available to satisfy creditor claims.

As Robert Richards, chair of Dentons' global restructuring group, explains, retiree medical benefits can be massive liabilities — especially when a company offers generous long-term coverage. These costs are front and center in large Chapter 11 cases. In many cases, these plans are treated as unsecured obligations, and executives may find their benefits substantially reduced — or even wiped out — if the plan isn't adequately protected by ERISA or contractual safeguards.

The Role of Committees and Watchdogs

Once a company files for Chapter 11, several new players enter the scene. Chief among them are:

- **The US Trustee's Office:** This government office acts as a watchdog to ensure compliance with the Bankruptcy Code. They frequently object to KERP/KEIP plans that appear too generous or not sufficiently tied to performance metrics.

- **Creditors' Committees:** These groups represent the interests of unsecured creditors, including suppliers, vendors, and even unions. Their views often shape how employment-related motions are negotiated and approved by the court.

James Sullivan, partner at Seyfarth Shaw LLP, notes that even if a proposed bonus plan has support from lenders and insiders, the US Trustee or the unsecured creditors' committee might push back. In most cases, these objections lead to negotiation rather than full-blown litigation.

This underscores the importance of building consensus early in the bankruptcy case — especially when proposing compensation structures or employment contract modifications.

Can Individual Employees Reject Their Employment Contracts?

Interestingly, bankruptcy is a two-way street. An employee who files a personal Chapter 7 or Chapter 11 bankruptcy may also reject an executory employment contract. But as Heather Van Meter, partner at Miller Nash, clarifies, rejecting the contract won't necessarily get you out of a non-compete or a confidentiality clause. Those obligations often survive, even if the financial terms of the contract don't.

For example, a former employee might be discharged from any severance repayment obligations, but they could still be bound by restrictions that limit future employment or require them to protect trade secrets.

Lessons for Officers and Directors

Executives navigating a Chapter 11 filing should be mindful of potential personal exposure. Robert Richards warns that certain unpaid debts — like trust fund taxes withheld from employees' paychecks — can trigger personal liability for officers and directors.

This is especially risky when companies handle payroll in-house without a third-party service like ADP. In such cases, if payroll taxes are not remitted to federal or state authorities, individual liability could follow.

To reduce exposure, executives should:

- Ensure trust fund taxes are segregated and paid on time.
- Avoid using withheld taxes to cover operational shortfalls.
- Plan filings around payroll periods to minimize unpaid wage accruals.

Planning Is Everything

Advance planning when a bankruptcy filing is on the horizon is important to both the employer and employee.

- **From the employer's side,** this means carefully timing the filing date to avoid unpaid wage issues, preparing first-day motions, and drafting retention or incentive plans in advance.
- **From the employee's perspective,** knowing your rights under the Bankruptcy Code— and asserting them when necessary — is essential. This might include filing a proof of claim, seeking legal counsel, or working with union representation if applicable.

As Anthony Cali, a bankruptcy specialist at Stinson, observes, skipping one payroll with the assumption that you'll make it up next time rarely works, and most of the time things get worse before they get better.

Final Thoughts

The intersection of bankruptcy law and labor/employment law is complex, but understanding the key principles can help stakeholders manage risk and preserve value. Whether you're a lawyer advising a distressed company, a board member considering whether to approve a bankruptcy filing, a CFO preparing for one, or an employee caught in the middle, it pays to understand how these legal frameworks interact.

To learn more about this topic view Bankruptcy Intersections / Labor/Employment. The quoted remarks referenced in this article were made either during this webinar or shortly thereafter during post-webinar interviews with the panelists. Readers may also be interested to read other articles about distressed business operations.

This article was originally published here.

National Law Review, Volume XV, Number 113