

# **BANKRUPTCY, WAGES, AND EMPLOYMENT ISSUES**

Richard K. McPartlin & Ryan M. Borden  
Ford & McPartlin, P.A.  
Portsmouth, NH

It's not an uncommon scenario in good times and bad: An employee reports to work as usual in the morning only to be informed that the employer has filed for bankruptcy. Whether or not the employee was aware things weren't going well, this is an event bound to create concern and uncertainty. The world of corporate bankruptcy is often dominated by institutional creditors but the bankruptcy code does provide some protection for the average employee.

## *Priority of Wages Claims in Bankruptcy – Because the Bills Won't Pay Themselves...*

When an employer reorganizes under Chapter 11, it will generally have obtained authority from the bankruptcy court to pay its employees for their work after the date of the bankruptcy and identified a source of cash to fund payroll. Additionally, under 11 U.S.C. §503(b)(1)(A)(i), post-petition salary and wage expenses are afforded administrative claim priority against the bankruptcy estate. In the bankruptcy payment scheme, these administrative claims are behind only domestic support orders (unlikely in most employer cases) and the chapter 7 or 11 trustee, if one is appointed. 11 U.S.C. §507(a)(2).

Whether the employer intends to reorganize under Chapter 11 or liquidate under Chapter 7, employees likely wonder whether they will ever see payment for their pre-bankruptcy services. Their ability to be paid is enhanced by their bankruptcy priority. The bankruptcy code provides fourth priority status to employees for "wages, salaries or commissions, including vacation, severance and sick leave pay earned by an individual." 11 U.S.C. §507(a)(4)(A). The priority portion of such claims is currently limited to \$12,475. 11 U.S.C. §507(a)(4). So the fear

of non-payment is ameliorated if sufficient unencumbered funds exist to satisfy priority claims under Section 507(a)(1), (2) and (3), and employees can expect some payment.

But unencumbered funds in bankruptcy are rare. Many times a lender has a lien on all assets and there is nothing left over for any other party. Is all hope lost? Surprisingly, no. There is some hope if there is also a federal tax lien.

*Subordination of Tax Liens for the Benefit of Wage Claims – The IRS to the Rescue?*

In the face of a federal tax lien, 11 U.S.C. 724(b) provides a possible vehicle for payment. Section 724(b) provides a vehicle for payment to wage claims because it shares the tax lien held by the IRS with all other priority claims. When a tax lien exists in a Chapter 7 bankruptcy, the benefit of the lien is distributed to all priority claims under 11 U.S.C. § 507, up to the lesser of the tax lien or the amount of the claims with priorities senior to tax claims. 11 U.S.C. 724(b)(2). Tax Claims have an eighth priority. 11 U.S.C. § 507(a)(8). Wage claims have a fourth priority. §507(a)(4). If there is a tax lien, then employees will get paid before the IRS gets paid.

The IRS has magic powers (doctrine of choateness) that sometimes allow its lien to get paid even though a secured claim in an amount greater than the value of all assets exists and was recorded first. Those magic powers grant the IRS a growing senior position in accounts receivable and inventory acquired forty-five days after the IRS records its tax lien against the employer. 26 U.S.C. §6323(d). Where a lender secured by receivables and inventory has not been diligent, 11 U.S.C. §724(b) allows a Chapter 7 trustee to use those magic powers to make some payment to employees even in the otherwise hopeless case. The bankruptcy code thus ensures that when a tax lien exists, employees stand a greater chance of receiving wages they are owed.

*Trust Fund Tax Liability, Discharge and Employee Liability – Doth the Taxman Cometh?*

When an employer files for bankruptcy, and it failed to withhold or pay federal income, social security and Medicare taxes, who is responsible for nonpayment? The employer's principals? The employee? Can that obligation be discharged?

Generally speaking, a discharge in Chapter 7, 11, 12, or 13 does not discharge an individual from any debt for an employment tax on wage, salaries or commissions. 11 U.S.C. §523(a)(1)(A). If an employer withholds federal income and FICA taxes from an employee's paycheck, but fails to remit the funds to the IRS, the employee is credited with the payment and will not be liable for the employer portion. *See In re Bourque*, 153 B.R. 87, 92 (Bankr. D. Mass. 1993).

Not all employees enjoy this general protection as there are certain scenarios where an employee could be held liable for the non-payment. The Internal Revenue Code provides that a "responsible party" of the employer-debtor can be held 100% responsible for the employment taxes. *See In re McAdam*, 402 B.R. 473 (Bankr D.N.H. 2009); 26 U.S.C. § 6672(a). Typically, a responsible party is an officer of a corporation, partner of a partnership, member of an LLC, a corporate director or shareholder or other person responsible for determining to pay creditors other than the IRS. But, responsible party status does not require ownership/senior management level authority and a "just following orders" argument is likely no defense. *See In re Bourque*, 153 B.R. at 92 (controller/staff accountant employee with no ownership stake in employer was a responsible person). Simply put, if the employee was the person responsible for withholding and transmitting employment taxes to the IRS and failed to do so, the employee could be liable for the unpaid withholding taxes.

*Conclusion:*

For any employee, the filing of a bankruptcy by their employer is likely to be disconcerting and disruptive. Few pulled into the bankruptcy world are likely to see all of the funds due from a debtor. However, the bankruptcy code does provide some advantages and protections to employees.

Ryan M. Borden is an associate at Ford & McPartlin, P.A. in Portsmouth, New Hampshire whose practice focuses on bankruptcy representation of creditors, trustees and debtors, foreclosure and related matters.

Richard K. McPartlin is an associate at Ford & McPartlin, P.A. in Portsmouth, New Hampshire whose practice focuses on bankruptcy representation of creditors, trustees and debtors, foreclosure and related matters. Prior to entering law school, Mr. McPartlin enjoyed a 13 year career in commercial lending.

