IN THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
CORPUS CHRISTI DIVISION

In re:	)	Jointly Administered
	)	
SCOTIA DEVELOPMENT LLC, *et al.*,[1]	)	**Case No. 07-20027-C-11**
	)	
Debtor.	)	Chapter 11

OPPOSITION OF THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS TO DEBTORS' MOTION TO PAY PRE-PETITION SEVERANCE CLAIMS

Introduction

The Official Committee of Unsecured Creditors (the "Committee") is sympathetic to the position of the Debtors' former employees. It is both regrettable and unfortunate that the Debtors filed these bankruptcy cases before the expiration of the 60-day waiting period the Debtors built into their severance promises. However, it is also regrettable and equally unfortunate that the Debtors' businesses are unprofitable enterprises that cannot support their existing secured debt.

While the Committee favors a global payment in full solution for unsecured creditors in these cases, none has been presented. Indeed, almost five months into this case, the Debtors: (1) have no DIP financing in place; (2) apparently lack secured lender consent to make the requested severance payments; (3) are unprofitable when debt service is taken into account; (4) have no announced reorganization strategy; and (5) have no announced plans to provide incentives to remaining employees and management. Since the claims of the former employees are

[1] The Debtors are the following entities: Scotia Development LLC; The Pacific Lumber Company; Britt Lumber Co., Inc.; Salmon Creek LLC; Scotia Inn, Inc.; and Scotia Pacific Company.

unquestionably "pre-petition," the foregoing facts make payment of those claims both impossible and imprudent at this time.

Statement of Facts

In early December 2006, debtors The Pacific Lumber Company ("Palco") and Scotia Pacific Company LLC ("Scopac") (together, the "Debtors") decided that they had too many employees to be profitable and implemented a reduction in force ("RIF"). At that same time, the Debtors surely knew that Scopac (a) had a bi-annual installment payment due to the Timber Noteholders on January 20, 2007 (the "Timber Note Payment Date"), and (b) did not have the funds to make the payment. Nevertheless, the Debtors instituted a RIF that promised an additional 60 days' wages to each terminated employee. In addition to the 60 days' wages, the Debtors promised severance payments to employees with more than five years of service. The "catch" in the Debtors' severance promise was that the payments would be made 60 days later – after the Timber Note Payment Date passed.

Scopac was unable to gather the funds necessary to pay the Noteholders on the Timber Note Payment Date. Thus, these bankruptcy cases were filed on January 18, 2007 to forestall the risk of foreclosure by the Debtors' secured creditors.

Almost immediately after the cases were filed, the Debtors sought court authority to pay the "priority" wage and benefit claims of its current employees. The Debtors also sought permission to pay the pre-petition debt of certain company vendors whose services after bankruptcy were deemed "critical" by the Debtors. As a result, the Debtors obtained court authority to pay more than $2,400,000 to providers of pre-petition goods and services who were

also going to provide consideration to the Debtors post-petition (all but $160,000 of this authority has since been used to pay such vendors).

On February 16, 2007, the Debtors advised the Committee that they intended to file a motion for permission to pay severance to the Terminated Employees. In response, the Committee suggested the Debtors develop a cohesive, top-to-bottom retention and incentive strategy for those who remained employed with the companies. Thereafter, roughly three months passed, at which point the instant motion was filed without any explanation of whether or when the Debtors will seek to institute some sort of key employee retention plan or management incentive plan, or even a rank and file retention plan.

Five months into this bankruptcy case, the Debtors' operations remain unprofitable. Indeed, at this time, neither Scopac nor Palco are in a position to make all of the payments due to their various bank and noteholder creditors using the cash flow that their businesses generate. Scopac has neither a ten-year harvest plan, nor a reorganization business plan. Palco has no DIP financing and may run out of cash without one later this summer. Nevertheless, Palco seeks to pay $843,890.78, and Scopac seeks to pay $102,996 to the Terminated Employees on account of the voluntary severance program instituted in December 2006 as part of a pre-petition RIF.

Argument

The Debtors justify their requests to pay severance benefits to the Terminated Employees on two ostensibly inter-related grounds. First, the Debtors suggest that paying the Terminated Employees is a proper exercise of business judgment that will benefit the estates by fostering the loyalty and commitment of the company's remaining employees. Second; the Debtors claim that paying these severance obligations is vital to the reorganization because continuing employees

are "very sensitive" to the issue of whether the Debtors will fulfill their commitment to pay severance benefits to long-term employees. As addressed below, neither of these grounds meet the applicable legal standards.

A. <u>The Terminated Employees' Severance Claims Are Not Postpetition Administrative Claims</u>

In essence, Palco and Scopac have asked the Bankruptcy Court to elevate the severance claims of the Terminated Employees to the level of administrative expenses. It is only under that standard (or under the so-called "doctrine of necessity," addressed below) that such claims can be paid at this time. *See In re American Plumbing & Mechanical, Inc.*, 323 B.R. 442, 458 (Bankr. W.D. Tex. 2005) (J. Clark) (regardless of whether bonuses may be owed by the debtor, "in order to be eligible for payment in full from the estate, the bonuses must first qualify as allowed administrative claims under section 503(b)(1)(A) of the Bankruptcy Code.").

Section 503(b)(1) of the Bankruptcy Code provides, in relevant part, as follows:

> After notice and a hearing, there shall be allowed administrative expenses, . . . : including, --
>
> (1)(A) the actual, necessary costs and expenses of preserving the estate, including (i) wages, salaries, and commissions for services rendered after the commencement of the case . . . .

11 U.S.C. § 503(b)(1).

Under Fifth Circuit law, severance claims arising under a prepetition agreement are *not* entitled to administrative expense status. This rule was enunciated by Judge Felsenthal in *In re Phones for All, Inc.*, 249 B.R. 426 (Bankr. N.D. Tex. 2000) and then affirmed by the Fifth Circuit Court of Appeal in *In the Matter of Phones for All, Inc.*, 288 F.3d 730 (5th Cir. 2002). To

be perfectly clear, the Fifth Circuit has previously examined an even more compelling case for immediate payment (involving post-petition termination rather than the pre-petition termination at issue here), and rejected it. There, the debtor entered into a prepetition employment agreement with an individual who was to become the president of the company. 249 B.R. at 427-28. The agreement provided certain severance benefits to such employee in the event of termination without cause. *Id*. The debtor subsequently filed for bankruptcy and a few weeks later terminated the employee, who then sought an administrative expense claim for the entirety of the severance benefit owed to him under the contract. *Id*. The bankruptcy court rejected the claim, and the Fifth Circuit affirmed this decision, on the following three grounds:

First, section 503(b)(1) does not include severance pay within wages, salaries and commissions entitled to an administrative expense. Unlike section 507(a)(4) of the Bankruptcy Code, which specifically contemplates that severance claims may be entitled to prepetition priority status, section 503(b)(1) only refers to wages, salaries, and commissions earned after the commencement of the case. *Id*. at 428-29.

Second, the employee in *Phones for All* earned his rights to severance prepetition when he entered into his employment contract, rather than as compensation for postpetition services or in lieu of other benefits or rights arising postpetition.[2] *Id*. at 429-30.

Third, regardless of whether severance could fit within the definition of wages or salaries, section 503(b)(1) also requires that the payment of severance compensation be of benefit to the estate. *Id*. at 430. In *Phones for All*, the bankruptcy court concluded that the debtor derived no

[2] There is authority in other Circuits for the proposition that severance benefits earned postpetition "in lieu of notice of termination" are entitled to administrative status. *See, e.g., In re Roth Amer., Inc.*, 975 F.2d 949, 957 (3d Cir. 1992). In this case, however, the Terminated Employees received 60 days' notice and regular wages and benefits throughout such notice period. So such authority has no bearing here.

benefit from having the employee be paid more than what was owed for the services he provided before his termination. *Id*. Severance pay was simply not part of the equation in terms of postpetition compensation.

Based on the foregoing analysis by the bankruptcy court, the Fifth Circuit agreed that "a prepetition severance agreement is not entitled to post-petition administrative priority status." 288 F.3d at 732. In order to attain such status, "a severance claim must have arisen from a transaction with the debtor in possession and must then confer a benefit on the debtor's estate." *Id*. (citations omitted).

In the instant case, the severance claims of the Terminated Employees do not meet this standard. Palco and Scopac committed to pay the severance *prior to* their respective bankruptcy filings. Although the Debtors now seek to affirm that decision and argue that *Phones for All* is distinguishable on this basis, the Debtors fail to take into account that they are essentially offering to pay the Terminated Employees for *no postpetition consideration whatsoever*. *See American Plumbing*, 323 B.R. at 463 ("What is crucial is what consideration supports the bonus, and whether such consideration, or a portion of it, was pre-petition services.") (citations omitted).

The Debtors base their position on the allegation that the loyalty and commitment of continuing employees will improve if severance is paid, but section 503(b)(1) requires that an administrative expense claim for wages must be for services *rendered after* the commencement of the case (not before). *See* 11 U.S.C. § 503(b)(1)(A); *American Plumbing*, 323 B.R. at 458-59 ("With regard to wage claims, the claim must be for services rendered after the commencement

of the case, not before.”).[3] The severance claims of the Terminated Employees have nothing to do with postpetition services. They are entirely based on prior service to the company (*i.e.*, prepetition service).

In sum, it appears that by paying them out of turn, the Debtors are proposing to make a “gift” to the Terminated Employees on the basis that there may be certain tangential benefits to the estates in the form of improved employee morale. Clearly, the Terminated Employees are not themselves providing this benefit. They are in fact providing no benefit at all because they are already gone. Accordingly, the severance claims of the Terminated Employees should not be elevated to the status of administrative claims under section 503(b)(1) of the Bankruptcy Code.

B. <u>Immediate Payment of the Severance Claims is Not Critical for the Reorganization</u>

The Debtors also take the position that payment of the severance claims of the Terminated Employees should be permitted under the “doctrine of necessity” and section 105(a) of the Bankruptcy Code. The Debtors analogize this situation to one involving critical vendors because payment of severance obligations, they say, is necessary to facilitate the loyalty and commitment of the company’s remaining employees. This is essentially the same rationale as the one used by the Debtors for justifying allowance of the severance claims as administrative expenses, except that the “doctrine of necessity” only applies to prepetition claims.

Section 105(a) of the Bankruptcy Code provides that “[t]he court may issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title.” 11

[3] It also bears mention that the fact that a severance claim becomes due at a point that happens to be postpetition does not make it an administrative claim. The relevant inquiry is whether such severance claim is compensation for services actually rendered to the estate postpetition.

U.S.C. § 105(a). Section 105(a) essentially "authorizes a bankruptcy court to fashion such orders as are necessary to further the substantive provisions of the Bankruptcy Code." *In the Matter of Oxford Management, Inc.*, 4 F.3d 1329, 1333-34 (5th Cir. 1993). However, section 105(a) is not a license for the court to issue any order that it sees fit. The powers granted by section 105(a) "must be exercised in a manner that is consistent with the Bankruptcy Code." *Id*. at 1334. "The statue does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity." *Id*. (citations omitted). In *Oxford*, for instance, the Fifth Circuit overruled the decision of the bankruptcy court to allow the payment of postpetition funds to satisfy prepetition claims because neither the parties nor the bankruptcy court cited a specific provision of the Bankruptcy Code that would allow such payment. *Id*.

Although *Oxford* did not arise in the context of a critical vendor payment and did not absolutely prohibit payment of prepetition claims outside of a plan, the Fifth Circuit made clear that any such payment must be otherwise expressly justified by the Bankruptcy Code. *See, e.g., In re Equalnet Communications Corp.*, 258 B.R. 368, 369-370 (Bankr. S.D. Tex. 2000) (J. Greendyke) (noting that, in most instances, "the payment of prepetition claims prior to confirmation of a plan in a Chapter 11 case has been proscribed by the 5th Circuit in [*Oxford*].").

In *In re CoServ, L.L.C.*, 273 B.R. 487 (Bankr. N.D. Tex. 2002) (J. Lynn), the court struggled with the propriety of permitting critical vendor payments given the decision in *Oxford* and what standard to apply in the event that such payments were permitted. The court concluded that debtors may be authorized to pay prepetition debt outside of a plan, but "only under extraordinary circumstances." *Id*. at 492. The court also felt that the "doctrine of necessity" is

"a device to be used only in rare instances." *Id*. Nonetheless, the court found a link between section 105(a) and the "doctrine of necessity" in section 1107(a) of the Bankruptcy Code, which designates the debtor in possession as the equivalent of a trustee. *Id*. at 497. The court reasoned that a trustee is a fiduciary charged with the task of maximizing the value of the estate. *Id*. "There are occasions when this duty can only be fulfilled by the preplan satisfaction of a prepetition claim." *Id*. This power, however, must be used "sparingly." *Id.*

The court then proceeded to outline three elements to consider in making the determination of whether to allow advance payment of a prepetition claim. *Id*. at 498. First, it must be critical that the debtor deal with the claimant. Second, unless it deals with the claimant, the debtor risks the probability or harm, or, alternatively, loss of economic advantage to the estate or the debtor's going concern value, which is disproportionate to the amount of the claimant's prepetition claim. Third, there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim. *Id*. The focus of this standard is on the critical need for the debtor to continue to conduct business with the claimant who is to be paid.

With regard to the Terminated Employees in this case, they no longer contribute to the Debtors' economic operations. They have not worked for the Debtors in nearly four months. By definition, therefore, the Debtors do not need to pay the Terminated Employees for continued service. There is also no evidence that failure to pay severance to the Terminated Employees would cause any harm to the Debtors' estates disproportionate to the approximately $950,000 that the Debtors propose to pay. Moreover, the Debtors certainly could put this money to better

use (for instance, incentivizing existing employees to confirm a plan that provides a significant recovery to all unsecured creditors).

Conclusion

From a legal perspective, the Debtors' request to pay severance to the Terminated Employees is unwarranted. The employees were let go prior to the filing of these bankruptcy cases, and they were promised severance prior to the petition date. Moreover, the type of severance promised by the company to employees is entirely based upon service to the companies that took place in the past. The severance claims of the Terminated Employees are therefore clearly prepetition claims.

It also stretches credibility for the Debtors to argue that payment of such claims (almost five months into these cases) is now critical to the reorganization. The Terminated Employees are no longer involved with the company. Courts within the Fifth Circuit recognize that critical vendor payments are extraordinary and only allow such payments in the rare instance when the debtor has no choice but to deal with a particular creditor post-petition.

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As unfortunate as it may seem, this is just not a case with a legal or business basis for paying the Terminated Employees ahead of other general unsecured creditors. At this time, the money would be better used in the ongoing operations of these troubled companies.

Dated: June 6, 2007

PACHULSKI STANG ZIEHL YOUNG JONES & WEINTRAUB LLP

By */s/ John D. Fiero*

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PROOF OF SERVICE

STATE OF CALIFORNIA)
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I, Adriana Zaragoza, am employed in the city and county of San Francisco, State of California. I am over the age of 18 and not a party to the within action; my business address is 150 California Street, 15th Floor, San Francisco, California 94111-4500.

On June 6, 2007, I caused to be served the **OPPOSITION OF THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS TO DEBTORS' MOTION TO PAY PRE-PETITION SEVERANCE CLAIMS** in this action by placing a true and correct copy of said document in sealed envelopes addressed as follows:

SEE ATTACHED SERVICE LIST

☑ (BY MAIL) I am readily familiar with the firm's practice of collection and processing correspondence for mailing. Under that practice it would be deposited with the U.S. Postal Service on that same day with postage thereon fully prepaid at San Francisco, California, in the ordinary course of business. I am aware that on motion of the party served, service is presumed invalid if postal cancellation date or postage meter date is more than one day after date of deposit for mailing in affidavit.

☐ (BY FAX) I caused to be transmitted the above-described document by facsimile machine to the fax number(s) as shown. The transmission was reported as complete and without error. (Service by Facsimile Transmission to those parties on the attached List with fax numbers indicated.)

☐ (BY PERSONAL SERVICE) By causing to be delivered by hand to the offices of the addressee(s).

☐ (BY OVERNIGHT DELIVERY) By sending by _____________ to the addressee(s) as indicated on the attached list.

I declare under penalty of perjury, under the laws of the State of California and the United States of America that the foregoing is true and correct.

Executed on June 6, 2007, at San Francisco, California.

/s/ Adriana Zaragoza
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