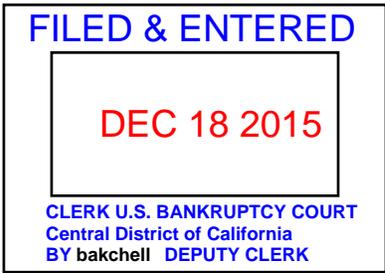


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**UNITED STATES BANKRUPTCY COURT
CENTRAL DISTRICT OF CALIFORNIA
LOS ANGELES DIVISION**

In re:
EcoSmart, Inc.,
Debtor.

Case No. 2:15-bk-27139-RK
Chapter 11

**MEMORANDUM DECISION AND
FURTHER ORDER ON DEBTOR'S
MOTION FOR AN ORDER
AUTHORIZING THE DEBTOR TO PAY
PRE-PETITION WAGES, EMPLOYEE
DEDUCTIONS, AND RELATED RELIEF**

Pending before the court is the Motion for an Order Authorizing the Debtor to Pay Pre-Petition Wages, Employee Deductions, and Related Relief ("Motion"). ECF 6. The Motion was filed by Debtor EcoSmart, Inc., on November 9, 2015 after Debtor filed its voluntary petition for relief under Chapter 11 of the Bankruptcy Code, 11 U.S.C, on November 8, 2015. As a debtor-in-possession, Debtor brings the Motion pursuant to 11 U.S.C. §§ 105(a), 362, 363(b), 507(a), 1107(a) and 1108 and seeks an order authorizing it to immediately pay non-insider employees and independent contractors based on anticipated claims for prepetition wages, salary and commissions, which it says are otherwise entitled to priority unsecured claim status under 11 U.S.C. § 507(a)(4). Motion at 3-5. According to the Motion, as of the petition date, Debtor was a California corporation in the business of designing, manufacturing and selling fireplaces powered by Bioethanol, a renewable energy, which employs 35 full-time and part-time employees, of

1 which 20 are salaried, 11 are individual sales representatives, and four (4) are
2 independent sales representatives that are corporations. *Id.* at 8 and n. 2; *see also*,
3 Declaration of Alexander Eburne, Motion at 17-20. The court granted Debtor's application
4 to hear the motion on shortened notice pursuant to Local Bankruptcy Rule 9075-1, and
5 the initial hearing on the instant motion was conducted on November 12, 2015. Johnny
6 White and Simon Aron, of the law firm of Wolf, Rifkin, Shapiro, Schulman & Rabkin, LLP,
7 appeared for Debtor. Alvin Mar appeared for the United States Trustee. Alexander
8 Eburne, chief executive officer of Debtor, also attended the hearing. No other
9 appearances were made.

10 Local Bankruptcy Rule 2081-1, which provides for consideration of motions for
11 emergency or expedited relief in Chapter 11 cases, applies to the Motion. Rule 2081-
12 1(a)(6) specifically includes motions to pay prepetition payroll and to honor prepetition
13 employment procedures, and with respect to such motions, states:

14 The motion must be supported by evidence that establishes: (A) The
15 employees are still employed; (B) The necessity for payment; (C) The
16 benefit of the procedures; (D) The prospect of reorganization; (E) Whether
17 the employees are insiders; (F) Whether the employees' claims are within
the limits established by 11 U.S.C. §507; and that (G) The payment will not
render the estate administratively insolvent.

18 Local Bankruptcy Rule 2081-1(a)(6).

19 At the initial hearing on the Motion on November 12, 2015, the court considered
20 whether the Motion complied with the standard of Rule 2081-1(a)(6). Based on the
21 evidence submitted in support of the Motion and the offers of proof made by counsel for
22 Debtor at the initial hearing on November 12, 2015, the court partially granted the Motion
23 as to the claims of creditors listed as employees on Debtor's payroll summary attached as
24 Exhibit B to the Motion and reserved ruling on the Motion as to claims of creditors listed
25 as independent contractors (i.e., independent sales representatives) on this document.
26 The payroll summary indicates that 20 workers are listed as "employees" ("Department
27 200") whose wages or salaries are subjected to deduction of federal and state income tax
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1 withholding and employment taxes and that 15 workers are listed as “independent sales
2 representatives” (“Department 300”) whose compensation is not subjected to deduction of
3 federal and state income tax withholding and employment taxes and are issued IRS
4 Forms 1099, Miscellaneous Compensation Statements. Motion, Exhibit B. In this regard,
5 the title of the Motion is somewhat a misnomer because Debtor also seeks authorization
6 to pay prepetition independent contractor compensation claims and not just the
7 prepetition employee wage and employee deduction claims referenced in the title of the
8 Motion.

9 At the hearing on November 12, 2015, the court determined that as to the claims of
10 the 20 workers listed as employees on Debtor’s payroll summary, the Motion was
11 supported by adequate evidence required under Rule 2081-1(a)(6) that established: (A)
12 The employees are still employed; (B) The necessity for payment; (C) The benefit of the
13 procedures; (D) The prospect of reorganization; (E) Whether the employees are insiders;
14 (F) Whether the employees’ claims are within the limits established by 11 U.S.C. § 507;
15 and that (G) The payment will not render the estate administratively insolvent. With
16 respect to item (F) of Rule 2081-1(a)(6), the court relied upon 11 U.S.C. § 507(a)(4) in
17 determining that the employees’ claims were within the limits established by 11 U.S.C. §
18 507 to grant the Motion.

19 11 U.S.C. § 507(a)(4) states:

20 (a) The following expenses and claims have priority in the following order:

21 ****

22 (4) Fourth, allowed unsecured claims, but only to the extent of \$12,475
23 for each individual or corporation, as the case may be, earned within 180
24 days before the date of the filing of the petition or the date of the
cessation of the debtor’s business, whichever occurs first, for---

25 (A) wages, salaries, or commissions, including vacation, severance, and
sick leave pay earned by an individual; or

26 (B) sales commissions earned by an individual or by a corporation with
27 only 1 employee, acting as an independent contractor in the sale of
goods or services for the debtor in the ordinary course of the debtor’s
28 business if, and only if, during the 12 months preceding that date, at

1 least 75 percent of the amount that the individual or corporation earned
2 by acting as an independent contractor in the sale of goods or services
was earned from the debtor.

3 Section 507(a)(4) gives priority in distribution to claims of employees of the debtor for
4 prepetition wages, salaries and commissions under subsection (a)(4)(A), and claims of
5 certain independent contractors for prepetition commissions earned from the debtor under
6 subsection (a)(4)(B). 11 U.S.C. § 507(a)(4); *see also*, 4 Resnick and Sommer, *Collier on*
7 *Bankruptcy*, ¶507.06[3][b] at 507-29 – 507-30 (16th ed. 2015). As to the 20 employees,
8 the court was satisfied that the evidence showed that the claims were for wages or
9 salaries qualifying for priority claim treatment under 11 U.S.C. § 507(a)(4)(A).

10 At the hearing on November 12, 2015, the court determined that as to the claims of
11 the 15 workers listed on Debtor's payroll summary as independent sales representatives
12 or independent contractors, the Motion was not supported by adequate evidence required
13 under Rule 2081-1(a)(6) that established: (A) The employees are still employed; (B) The
14 necessity for payment; (C) The benefit of the procedures; (D) The prospect of
15 reorganization; (E) Whether the employees are insiders; (F) Whether the employees'
16 claims are within the limits established by 11 U.S.C. § 507; and that (G) The payment will
17 not render the estate administratively insolvent. With respect to item (F) of Rule 2081-
18 1(a)(6), the court relied upon 11 U.S.C. § 507(a)(4) in deferring its ruling regarding
19 whether the independent sales representatives' claims were within the limits established
20 by 11 U.S.C. § 507 because the evidence was insufficient to grant the motion.

21 Citing the statutory language of 11 U.S.C. § 507(a)(4)(A) and (B), and the
22 commentary on these provisions in *Collier on Bankruptcy*, the court ruled at the hearing
23 on November 12, 2015 that the evidence was insufficient to show that the Motion should
24 be granted pursuant to Rule 2081-1(a)(6) as to the claims of the independent sales
25 representatives, or independent contractors. The court ruled that the claims of 15
26 independent contractors were not supported by adequate evidence that the claims met
27 the requirements of 11 U.S.C. § 507(a)(4)(B), specifically pertaining to independent
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1 contractors, and that such claims were not entitled to priority claim treatment under 11
2 U.S.C. § 507(a)(4)(A) for the wages, salaries and commissions of employees in order to
3 grant the Motion pursuant to Rule 2081-1(a)(6) as to the independent contractors. In so
4 ruling, the court rejected Debtor's argument that the claims of the independent sales
5 representatives and independent contractors fall under the rubric of commissions
6 pursuant to 11 U.S.C. § 507(a)(4)(A) because there is no restriction in the express
7 language of § 507(a)(4)(A) to employees of the debtor. In its order granting partial relief
8 on the Motion after the hearing on November 12, 2015, the court stated that the claims of
9 the 20 employees may be paid immediately, but that it was reserving a ruling as to the
10 claims of the 15 independent contractors until a further hearing on November 17, 2015,
11 and allowing Debtor to submit supplemental evidence showing that the claims were
12 entitled to priority treatment under 11 U.S.C. § 507(a)(4)(B). ECF 19 at 2.

13 On November 15, 2015, Debtor filed a supplement to the Motion, arguing that
14 payment of prepetition payroll obligations to all "individuals," whether employees or
15 independent contractors, should be authorized under the plain language of 11 U.S.C. §
16 507(a)(4)(A) and applicable case authority. Supplement to Motion, ECF 25 at 2-6. In the
17 Supplement to Motion, Debtor also submitted declarations of two independent
18 contractors, Pau Torruella and Kathleen Lam, and of its chief executive officer, Mr.
19 Eburne, arguing that their claims for prepetition commissions should be paid under either
20 11 U.S.C. § 507(a)(4)(A) or (B). *Id.* at 7-12.

21 Before the scheduled further hearing on November 17, 2015, the court reviewed
22 Debtor's Supplement to Motion and determined that based on the supplemental evidence
23 submitted in support of payment of the claims of Mr. Torruella and Ms. Lam for prepetition
24 commissions that Debtor made a sufficient evidentiary showing that their claims qualified
25 for priority in meeting the requirements of independent contractor claims under 11 U.S.C.
26 § 507(a)(4)(B), specifically, that the sales commissions of these independent contractors
27 were earned in the sale of goods or services for the debtor in the ordinary course of
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1 Debtor's business within 180 days of the petition date and that during the 12 month period
2 preceding the petition date, at least 75 percent of their earnings as an independent
3 contractor in the sale of goods or services was earned from Debtor. Supplement to
4 Motion at 10-12; Supplemental Order on Debtor's Motion for Order to Pay Pre-Petition
5 Wages, Employee Deductions and Related Relief, ECF 26 at 3.

6 As to Debtor's statutory construction argument in the Supplement to Motion, the
7 court, having only reviewed the Supplement on November 16, 2015, which was only the
8 day before the scheduled further hearing on November 17, 2015, decided to continue the
9 November 17, 2015 hearing in order to read and analyze the case authorities cited by
10 Debtor in the Supplement, which included 10 published and unpublished case opinions,
11 most of which were not cited in prior briefing (the Supplement to Motion was filed at 10:30
12 p.m. on the evening of Sunday November 15, 2015, and the earliest opportunity for the
13 court to review it was the next business day, Monday November 16, 2015, the day before
14 the scheduled further hearing on Tuesday November 17, 2015.). After its initial review of
15 the Supplement to Motion, the court entered a further order on the Motion, partially
16 granting the Motion as to the claims of the two independent contractors, Mr. Torruella and
17 Ms. Lam, and continuing the further hearing on the Motion from November 17, 2015 to
18 November 25, 2015 in order for the court to research and consider the Supplement to
19 Motion. *Id.*

20 On November 25, 2015, the court conducted the rescheduled further hearing on
21 the Motion after considering the Supplement to Motion and hearing further oral argument.
22 The court notes that Debtor did not submit further evidence to show that the claims of the
23 independent contractors satisfied the requirements of 11 U.S.C. § 507(a)(4)(B). At the
24 hearing on November 25, 2015, Debtor renewed its argument that the Motion should be
25 granted to allow the immediate payment of the claims of the independent contractors
26 because payment of prepetition payroll obligations to all "individuals" should be
27 authorized under the plain language of 11 U.S.C. § 507(a)(4)(A) and applicable case
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1 authority. In support of this argument, Debtor cited the following cases: *In re Jade West*
2 *Corp., Inc.*, 53 B.R. 16 (Bankr. D. Or. 1985); *In re Hutchison*, 223 B.R. 586 (Bankr. M.D.
3 Fla. 1998); *In re Owen*, 324 B.R. 373 (Bankr. N.D. Fla. 2004); *In re Alroco, Inc.* 92 B.R.
4 523 (Bankr. M.D. Fla. 1988); *In re Konidaris*, 87 B.R. 846 (Bankr. E.D. Pa. 1988); *Matter*
5 *of Dahlman Truck Lines, Inc.*, 59 B.R. 218 (Bankr. W.D. Wis. 1986); *In re Kasson, Inc.*,
6 *U.S.A.*, 109 B.R. 352 (Bankr. E.D. Wis. 1989); *Morton v. Mancari*, 417 U.S. 535 (1974); *In*
7 *re Corcoran*, 2010 WL 5207589 (Bankr. D. Haw. 2010); *In re Qualia Clinical Service, Inc.*,
8 2009 WL 2513820 (Bankr. D. Neb. 2009); *In re Wang Laboratories, Inc.*, 164 B.R. 404
9 (Bankr. D. Mass. 1994). Supplement to Motion at 3-6.

10 As discussed herein, the court does not find Debtor's argument persuasive and
11 finds that Debtor's argument is not supported by applicable statutory and case law. First,
12 the court observes that whether some prepetition claims may be paid before other
13 prepetition claims are paid through a confirmed plan of reorganization in a Chapter 11
14 bankruptcy case raises a general philosophical question of whether it is permissible under
15 the Bankruptcy Code to pay prepetition claims of "critical vendors" before other prepetition
16 claims are paid. *Matter of B & W Enterprises, Inc.*, 713 F.2d 534, 535-538 (9th Cir.
17 1983)(affirming the bankruptcy court's avoidance of certain payments of prepetition
18 claims made by a debtor-in-possession in Chapter 11 proceedings before conversion to
19 Chapter 7, rejecting the defenses of the paid creditors that the payment was proper under
20 the so-called "necessity of payment" rule, stating "[a]bsent compelling reasons, we deem
21 it unwise to tamper with the statutory priority scheme devised by Congress in the 1978
22 Act [the Bankruptcy Code]. See 11 U.S.C. § 507.", and declining to extend any such rule
23 outside railroad reorganization cases); *In re Kmart Corp.*, 359 F.3d 866, 871-874 (7th Cir.
24 2004)(affirming the district court's reversal of a bankruptcy court's "critical vendor"
25 payment order, stating that "[a] 'doctrine of necessity' is a fancy name for a power to
26 depart from the [Bankruptcy] Code."); see also, *In re Adams Apple, Inc.*, 829 F.2d 1484,
27 1486, 1490 (9th Cir. 1987)(appeal of creditors of the bankruptcy court's authorization
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1 without creditor approval of a financing arrangement that includes a cross-collateralization
2 provision dismissed as moot under 11 U.S.C. § 364(e), but noting in dicta that “[c]ases
3 have permitted unequal treatment of pre-petition debts when necessary for rehabilitation,
4 in such contexts as (i) pre-petition wages to key employees; (ii) hospital malpractice
5 premiums incurred prior to filing; (iii) debts to providers of unique and irreplaceable
6 supplies; and (iv) peripheral benefits under labor contracts.”), *citing*, *Ordin, Case*
7 *Comment*, *In re Texlon Corporation*, 596 F.2d 1092 (2d Cir. 1979); *Finality of Order of*
8 *Bankruptcy Court*, 54 Amer. Bankr. L.J. 173, 177 (1980). The answer is generally no on
9 grounds of lack of authority under the Bankruptcy Code to pay claims outside the
10 statutory scheme for payment of prepetition claims. *Matter of B & W Enterprises, Inc.; In*
11 *re Kmart Corp, supra*.

12 The prepetition claims of employees and certain independent contractors are still
13 prepetition claims of creditors, though they may be accorded priority status in payment
14 under the Bankruptcy Code through 11 U.S.C. § 507(a)(4), but 11 U.S.C. § 507(a)(4) only
15 accords priority in payment to such claims when a distribution on claims is authorized,
16 which in a Chapter 11 bankruptcy case is pursuant to a confirmed reorganization plan
17 under 11 U.S.C. § 1129. *See, e.g., In re Air Beds, Inc.*, 92 B.R. 419, 422-424 (9th Cir.
18 BAP 1988)(“The general rule is that a distribution on pre-petition debt in a Chapter 11
19 case should not take place except pursuant to a confirmed plan of reorganization, absent
20 extraordinary circumstances.”), *citing inter alia*, Fed. R. Bankr. P. 3021 (stating generally
21 that after plan confirmation, distributions shall be made to creditors holding allowed
22 claims, interest holders whose interests have not been disallowed and indentured
23 trustees whose claims have been allowed). There is nothing in 11 U.S.C. § 507(a)(4) by
24 itself which authorizes payment of prepetition wage and commission claims in advance of
25 other prepetition claims. There is some case law and some authority in the court’s rules
26 in Rule 2081-1(a)(6), which allows immediate payment of claims, often on first day
27 motions, based on the recognition of the critical need to pay prepetition wage and
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1 commission claims to employees and specified independent contractors so that they
2 continue to work for the debtor and render services to the debtor to help it continue
3 operations as a going concern and to reorganize in a Chapter 11 bankruptcy case.
4 However, the courts which have adopted this practice in their decisions or in their rules
5 have limited the practice to claims entitled to priority in distribution pursuant to the
6 bankruptcy court's equitable powers under 11 U.S.C. § 105(a). See, e.g., Local
7 Bankruptcy Rule 2081-1(a)(6); 2 March, Ahart and Shapiro, *California Practice Guide:
8 Bankruptcy*, ¶ 11:386 at 11-45 (2014) ("Most courts allow payment of prepetition employee
9 wages up to the priority amount under the '*necessity of payment*' doctrine, which permits
10 immediate payment of creditors who will not supply services or material essential to the
11 conduct of the business until their prereorganization claims are paid.") (emphasis in
12 original), citing, *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 175-176 (Bankr. S.D.N.Y.
13 1989) and *In re Gulf Air, Inc.*, 112 B.R. 152, 153-154 (Bankr. W.D. La. 1989). However,
14 the cited statutory justification for such practice is 11 U.S.C. § 105(a) of the Bankruptcy
15 Code, which may be on shaky ground in light of recent Supreme Court precedent, such
16 as *Law v. Siegel*, 134 S.Ct. 1188 (2014), stating that 11 U.S.C. § 105(a) is not a broad
17 mandate to depart from contrary express mandates in the Bankruptcy Code. *Id.* at 1194;
18 see also, *Matter of B & W Enterprises, Inc.*, *supra*; *In re Kmart Corp.*, *supra*. Against this
19 legal backdrop, the court considers Debtor's request for immediate payment of claims of
20 the independent contractors where Debtor has not even demonstrated that such claims
21 are entitled to priority under the Bankruptcy Code, namely, 11 U.S.C. § 507(a)(4).

22 The cases cited by Debtor in its Supplement to Motion are generally inapposite
23 since most of the cases do not raise the issue of whether claims of independent
24 contractors for commissions from a debtor are entitled to priority under 11 U.S.C. §
25 507(a)(4). However, several of Debtor's cited cases are on point regarding the issue of
26 priority claim status of claims of independent contractors, i.e., *In re Wang Labs, Inc.*,
27 *supra*; *In re Corcoran*, *supra*; and *In re Qualia Clinical Service, Inc.*, *supra*.

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1 The first case of *In re Wang Labs, Inc.*, *supra*, was superseded by the Bankruptcy
2 Reform Act of 1994, which added 11 U.S.C. § 507(a)(4)(B) to expressly permit priority
3 claim treatment of claims of certain independent contractors of a debtor under 11 U.S.C.
4 § 507(a)(4) under certain conditions. As *Collier on Bankruptcy* explains:

5 Prior to the Bankruptcy Reform Act of 1994, there was a split among the
6 courts as to whether commissions owed to an independent contractor
7 working for the debtor qualified for a section 507(a)(4) priority. The
8 Bankruptcy Reform Act of 1994 ended the dispute by creating a new clause
9 (B) to section 507(a)(4) providing that commissions owed to independent
10 contractors are eligible for priority if certain conditions are met. For
11 commissions owed to independent contractors to qualify for priority, the
12 independent contractor must have been acting as such for the debtor with
regard to the sale of goods or services in the ordinary course of the debtor's
business. In addition, during the 12 months preceding the earlier of the date
of the filing of the petition or the cessation of the debtor's business, the
independent contractor must have earned from the debtor at least 75
percent of the total amount earned by such independent contractor from the
sale of goods or services.

13 4 Resnick and Sommer, *Collier on Bankruptcy*, ¶507.06[3][c] at 507-29 – 507-30 and n. 3,
14 *citing*, *In re Wang Lab, Inc.*, 164 B.R. 404 (Bankr. D. Mass. 1994) (commissions owed to
15 independent contractors qualified for priority); *In re Lynnwear Corp.*, 28 B.R. 532 (Bankr.
16 S.D.N.Y. 1983) (same); *In re American Shelter Systems, Inc.*, 40 B.R. 793 (Bankr. W.D.
17 La. 1984)(commissions owed to independent contractors did not qualify for priority); *In re*
18 *St. Joseph's Hosp.*, 126 B.R. 37 (Bankr. E.D. Pa. 1991)(same).

19 The legislative history of the Bankruptcy Reform Act of 1994 demonstrates that in
20 enacting 11 U.S.C. § 507(a)(4)(B), Congress intended to resolve the dispute in the case
21 law over whether claims of independent contractors were entitled to priority and to provide
22 for such priority claim status subject to certain conditions as indicated by the floor
23 statements of the bill's sponsor, Representative Jack Brooks, chairman of the House
24 Judiciary Committee, the committee having jurisdiction over the bill:

25 Section 207. Priority for independent sales representatives

26 This section clarifies that independent sales representatives of a bankrupt
27 debtor are entitled to the same priority as the employees of the debtor
28 codifying *In re Wang Laboratories, Inc.*, 164 B.R. 404 (Bankr. D. Mass.
1994). This section modifies section 507 of title 11 to include such

1 representatives in the section's third priority as employees for purposes of
2 claims of a bankruptcy debtor. The section specifies that in order to be
3 treated as an employee for the purposes of priority, at least 75 percent of
4 the income of the independent sales representative must have been earned
5 as an independent contracting entity from the bankrupt debtor.

6 Floor Statements of Rep. Jack Brooks, H.R. 5116, enacted as the Bankruptcy Reform Act
7 of 1994, Pub. L. No. 103-394, 103rd Cong., 2nd Sess., Cong. Rec. H 10767 (October 4,
8 1994).

9 Regarding this legislative history, Debtor argues as follows:

10 In 1994, Congress could have changed the wording of Subsection (a)(4)(A)
11 from "individual" to "employee," but declined to. Rather, it made a very
12 specific change to the law to ensure that a broad application of the provision
13 with respect to one particular group of workers, leaving the broad wording of
14 "individual" undisturbed. While the addition of Subsection (a)(4)(B) did
15 involve a certain degree of superfluity, insofar as "individuals" earning "sales
16 commissions" should already been covered under Subsection (a)(4)(A) as
17 "individuals" earning "commissions," it runs directly counter to the specific
18 congressional purpose in 1994 of expanding the scope of the wage priority if
19 its addition is now construed as impliedly limiting the general purpose and
20 the general wording of "individual" under Subsection (a)(4)(A). *Accord*
21 *Morton v. Mancari*, 417 U.S. 535, 550, 94 S. Ct. 2474, 2482, 41 L. Ed. 2d
22 290 ("In the absence of some affirmative showing of an intention to repeal,
23 the only permissible justification for a repeal by implication is when the
24 earlier and later statutes are irreconcilable."). In addition, any pre-1994
25 case authority construing Subsection (a)(4)(A) broadly to extend to
26 independent contractors was not overruled by the Bankruptcy Reform Act of
27 1994. If anything, it was endorsed.

28 Supplement to Motion at 6.

The court disagrees with Debtor's analysis for several reasons. First, while 11
U.S.C. § 507(a)(4) refers to "individuals," this was a limiting term to exclude artificial
entities, and its pre-1994 language referring to wages, salaries and commissions,
including vacation, severance, and sick leave earned by an individual contain terms
generally applicable to employees only. The only possible exception is the term
"commissions," which may be earned by an employee individual and an independent
contractor individual, as well as an independent contractor who is not an individual. All of
these terms, except commissions, could only refer to compensation of an employee.
Wages and salaries are regular compensation for an employee, and vacation, severance
and sick leave are fringe benefits for employees. Thus, it appears to this court that

1 Congress, in enacting 11 U.S.C. § 507(a)(3), later renumbered (a)(4), was referring to
2 claims for employee compensation, but the addition of commissions which may be earned
3 by both employees and independent contractors made the provision ambiguous, leading
4 to a conflict in the case law as recognized in the legislative history of the Bankruptcy
5 Reform Act of 1994 and by *Collier on Bankruptcy*. In enacting new subsection
6 507(a)(4)(B), Congress intended to resolve the case law conflict by expressly providing
7 for independent contractors under limited conditions. That is, under 11 U.S.C. §
8 507(a)(4)(B), priority status of prepetition claims of independent contractors would be
9 recognized if the claims were for goods or services earned by the contractor in the
10 ordinary course of the debtor's business so long as at least 75 percent of the earnings of
11 the independent contractor were earned from the debtor during the 12-month period
12 before the petition date. If this standard was not met, there was no priority status for the
13 claim of an independent contractor as recognized by the legislative history of the
14 Bankruptcy Reform Act of 1994 in Representative Brooks's floor statements.

15 Debtor argues that Congress could have changed the wording of 11 U.S.C. §
16 507(a)(4) from "individual" to "employee" to support the court's interpretation of the
17 Bankruptcy Reform Act of 1994 that 11 U.S.C. § 507(a)(4) is limited to employees and
18 does not apply to independent contractors. As Debtor reasons, the prepetition claims for
19 independent contractors as "individuals" earning "commissions" were already covered by
20 11 U.S.C. § 507(a)(4) as being entitled to priority status, but Congress just wanted to
21 ensure that a broad application of the provision applies to one particular group of workers,
22 that is, independent sales representatives who provided goods or services in the ordinary
23 course of business of the debtor and whose earnings in the 12 months before the petition
24 date were at least 75 percent from the debtor. Debtor's interpretation of the Bankruptcy
25 Reform Act of 1994 is not supported by the legislative history, nor does it make sense.
26 First, if independent contractors were already covered by 11 U.S.C. § 507(a)(4) and
27 Congress wanted to cover certain workers, it need not have added 11 U.S.C. §
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1 507(a)(4)(B) and could have just added language to expressly include independent
2 contractors. Second, Debtor's interpretation of 11 U.S.C. § 507(a)(4)(B) renders it
3 superfluous as Debtor itself recognizes. See Scalia and Garner, *Reading Law: The*
4 *Interpretation of Legal Texts* at 174-179 (2012). If claims for commissions of independent
5 contractors were already entitled to priority under 11 U.S.C. § 507(a)(4) through 11
6 U.S.C. § 507(a)(4)(A), there is no need for 11 U.S.C. § 507(a)(4)(B). Debtor has no
7 logical explanation for the restrictions on priority status for independent contractor
8 commission claims because under Debtor's view, independent contractor claims that
9 flunk the 11 U.S.C. § 507(a)(4)(B) test are always entitled to priority status under 11
10 U.S.C. § 507(a)(4)(A). Thus, under Debtor's interpretation, only claims of independent
11 contractors for unpaid prepetition sales commissions who earned at least 75 percent of
12 their earnings from the debtor for goods or services during the 12 month period before the
13 petition date qualify for priority under 11 U.S.C. § 507(a)(4)(B), and those that do not
14 meet this standard qualify for priority under the alternative provision of 11 U.S.C. §
15 507(a)(4)(A) since all commissions earned by individual independent contractors qualify
16 for priority status under that provision, which is absurd since this would render the 11
17 U.S.C. § 507(a)(4)(B) meaningless. See, e.g., *Rake v. Wade*, 508 U.S. 464, 471 (1993)
18 ("To avoid deny[ing] effect to a part of a statute we accord significance and effect . . . to
19 every word.") (internal citations and quotations omitted); *Hoffman v. Connecticut*
20 *Department of Income Maintenance*, 492 U.S. 96, 103 (1989) ("It is our duty to give effect,
21 if possible, to every clause and word of a statute . . .") (internal citations and quotations
22 omitted); *United States v. Fisher*, 6 U.S. (2 Cranch) 358, 400 (1805) (stating "if the literal
23 expressions of the law would lead to absurd, unjustified, inconvenient consequences,
24 such a construction should be given as to avoid such consequences, if, from the whole
25 purview of the law, and giving effect to the words used, it may fairly be done.").

26 Aside from being inconsistent with the canon of statutory interpretation that the
27 courts should give meaning to every word in a statute and avoid interpretations that
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1 render statutory language superfluous, Debtor's interpretation also runs afoul of the
2 canon of statutory interpretation that the specific overrides the general. See, e.g., *Law v.*
3 *Siegel*, 134 S.Ct. at 1194 ("a statute's general permission to take actions of a certain type
4 must yield to a specific prohibition found elsewhere."); *RadLAX Gateway Hotel, LLC v.*
5 *Amalgamated Bank*, 132 S.Ct. 2065, 2071 (2012) ("the [general/specific] canon has full
6 application as well to statutes . . . in which a general authorization and a more limited,
7 specific authorization exist side-by-side. There the canon avoids not contradiction but the
8 superfluity of a specific provision that is swallowed by the general one, violat[ing] the
9 cardinal rule that, if possible, effect shall be given to every clause and part of a statute.")
10 (internal citation and quotations omitted); *Morton v. Mancari*, 417 U.S. 535, 550-551
11 (1974) ("Where there is no clear intention otherwise, a specific statute will not be
12 controlled or nullified by a general one, regardless of the priority of enactment."); see also,
13 Scalia and Garner, *Reading Law: The Interpretation of Legal Texts* at 183-188. If 11
14 U.S.C. § 507(a)(4)(A) states the general rule as to "individuals" as Debtor asserts, then
15 the general rule should not override the asserted "specific" rule as to independent sales
16 representatives, which would be the result of Debtor's interpretation.

17 Debtor's reliance on the unpublished opinion of the bankruptcy court in *Corcoran* is
18 misplaced because the court in that case did not examine the legislative history of the
19 Bankruptcy Reform Act of 1994, amending 11 U.S.C. § 507(a)(4), and the canons of
20 statutory interpretation as discussed herein, and thus, the court does not follow *Corcoran*,
21 which does not have precedential effect here.

22 Debtor's reliance on the unpublished opinion of the bankruptcy court in *Qualia*
23 *Clinical Service, Inc.*, is also misplaced because the court in that case interpreted
24 Nebraska law of agency and employment, which is not applicable to this case involving
25 Debtor operating in California and that court, relying upon *Wang Labs*, also as in
26 *Corcoran*, did not examine the legislative history of the Bankruptcy Reform Act of 1994,
27 amending 11 U.S.C. § 507(a)(4), and the canons of statutory interpretation as discussed
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1 herein. Therefore, the court does not follow *Qualia Clinical Service, Inc.*, which does not
2 have precedential effect here.

3 As a factual matter, Debtor treated its independent contractors as Form 1099
4 workers, referring to IRS Forms 1099-MISC, Miscellaneous Income Statements, given to
5 independent contractors to report their compensation from services for Debtor to the
6 Internal Revenue Service for federal income and employment tax purposes as opposed to
7 IRS Forms W-2, Wage and Tax Statements, issued to workers treated as employees for
8 federal income and employment tax purposes. See 26 U.S.C. §§ 6051 and 6041A; IRS
9 Publication 15 (Circular E), *Employer's Tax Guide* (2015)(IRS publications may be viewed
10 online on the IRS's website, www.irs.gov); IRS Publication 1779, *Independent Contractor*
11 *or Employee* (2012). An employer is required to deduct, withhold and pay over federal
12 income and employment taxes from the wages of its employees, but no deductions are
13 made from the compensation paid to independent contractors. 26 U.S.C. §§ 3101 *et*
14 *seq.*, 3401 *et seq.* and 3501 *et seq.*; see also, IRS Publication 15 (Circular E), *Employer's*
15 *Tax Guide* (2015); IRS Publication 1779, *Independent Contractor or Employee* (2012).
16 Thus, the court determines that it would be inconsistent for Debtor to now treat its
17 independent contractors as employees for purposes of 11 U.S.C. § 507(a)(4), having not
18 treated them as employees for federal income and employment tax purposes. There is
19 insufficient evidence on this record to consider the independent contractors as
20 "employees" under California law based on common law factors with control over details
21 of work as the primary factor. See 3 Witkin, *Summary of California Law*, Agency and
22 Employment, § 23 at 62-64 (2005 and 2015 Supp.), citing *inter alia*, *S.G. Borello & Sons*
23 *v. Department of Industrial Relations*, 48 Cal.3d 341, 350-353 (1989) and *Restatement*
24 *(Second) of Agency*, § 220(2)(a)(1958); see also, *Restatement (Third) of Agency*, §
25 7.07(a)(3)(2006).

26 The evidence on this record indicates that these workers were independent
27 contractors who would have to meet the requirements of 11 U.S.C. § 507(a)(4)(B) to be
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1 considered priority claimants. Other than for the claims of Mr. Torruella and Ms. Lam for
2 prepetition commissions which Debtor made a sufficient evidentiary showing that their
3 claims qualified for priority in meeting the requirements of independent contractor claims
4 under 11 U.S.C. § 507(a)(4)(B), specifically, that the sales commissions of these
5 independent contractors were earned in the sale of goods or services for the debtor in the
6 ordinary course of Debtor's business within 180 days of the petition date and that during
7 the 12 month period preceding the petition date, at least 75 percent of their earnings as
8 an independent contractor in the sale of goods or services was earned from Debtor,
9 Debtor has not made a sufficient evidentiary showing that the claims of the other
10 independent contractors met this standard.

11 In enacting 11 U.S.C. § 507(a)(4)(B) in 1994, Congress was aware of the split
12 case law on whether prepetition claims of independent contractors for commissions were
13 entitled to priority under the language of 11 U.S.C. § 507(a)(4) and resolved the conflict
14 by clarifying what the law should be in expressly recognizing such claims as priority
15 claims only under certain conditions. If Congress meant to clarify the law resolving the
16 case law split in recognizing that all prepetition claims of independent contractors for
17 commissions were entitled to priority claim status, it could have and would have done so.
18 Congress did something else, which meant that it did not intend as Debtor argues.
19 Accordingly, the court determines that under 11 U.S.C. § 507(a)(4), prepetition claims of
20 independent contractor individuals are not entitled to priority claim status unless they
21 meet the standards of 11 U.S.C. § 507(a)(4)(B) as the court has previously indicated. In
22 this regard, the court would allow payment of prepetition claims of independent contractor
23 individuals if their claims met the standards of 11 U.S.C. § 507(a)(4)(B), even though the
24 court's local rule, Local Bankruptcy Rule 2081-1(a)(6), only authorizes immediate
25 payment of prepetition wage claims of employees covered under 11 U.S.C. § 507(a)(4)(A)
26 since the rationale for payment of these workers is essentially the same, the statutory
27 recognition of priority status of claims of such workers under 11 U.S.C. § 507(a)(4) and
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1 the case law and rule recognition of a necessity to retain the services of workers to keep
2 a reorganizing debtor business operating.

3 This brings back the first issue raised by the court of whether prepetition claims of
4 Debtor's employees and independent contractors for wages, salaries and commissions
5 may be paid immediately as "critical vendors" in advance of general distributions on
6 prepetition claims of other creditors. The court recognizes that the case law, including
7 circuit authority, is that such payment is generally impermissible based on the so-called
8 "doctrine of necessity." However, a number of lower courts, including this court,
9 recognize that the critical need of Chapter 11 business bankruptcy debtors to retain their
10 workers who might otherwise leave if they were not paid their prepetition wage, salary
11 and commission claims immediately and have justified an exception from the general
12 principle of not allowing advance payment of prepetition claims of so-called "critical
13 vendors" because the Bankruptcy Code confers priority claim status on such claims and
14 would generally have to be paid anyway. However, absent the priority status of claims,
15 the courts have not seen justification to allow payment of prepetition claims of so-called
16 "critical vendors," and this court will follow such examples and require Debtor to
17 demonstrate that the priority status of wage, salary and commission claims of its
18 employees and independent contractors under 11 U.S.C. § 507(a)(4)(A) and (B) to
19 warrant immediate payment in advance of general distribution on prepetition claims.
20 Otherwise, under Debtor's interpretation of the Bankruptcy Code, any prepetition
21 individual creditor is entitled to immediate payment on his or her claim as a priority claim
22 on any contract with the debtor, and such sweeping interpretation is inconsistent with the
23 narrow interpretation given the so-called "doctrine of necessity" in such circuit precedent
24 as *B & W Enterprises* and *Kmart Corp.* discussed above.

25 Having partially granted the Motion to allow immediate payment of prepetition
26 priority claims of Debtor's employees (Department 200) and of independent contractors
27 Torruella and Lam by prior orders, the court specifically denies the Motion as to the
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1 request for authorization of immediate payment of the prepetition commission claims of
2 other independent contractors (Department 300) not entitled to priority under 11 U.S.C. §
3 507(a)(4) for the reasons stated herein. To the extent that Debtor seeks an order to
4 authorize it “to continue to honor existing Employee practices, programs and policies”
5 postpetition and to “continue to pay [its Payroll Administration Obligations] in the ordinary
6 course of business as they come due after the Petition Date” as requested in the Motion
7 at 4-5, the court denies such relief without prejudice because the Motion does not
8 specifically describe such practices and procedures in the Motion in order for the court to
9 meaningfully review such practices and procedures in order to make a ruling.

10 To the extent that the court has not granted relief on the Motion for an Order
11 Authorizing the Debtor to Pay Pre-Petition Wages, Employee Deductions, and Related
12 Relief in its prior orders, it denies the Motion as set forth above.

13 IT IS SO ORDERED.

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23 Date: December 18, 2015



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Robert Kwan
United States Bankruptcy Judge