Schulte Roth&Zabel

Alert

Fifth Circuit Treats Severance Payments to Insider as Fraudulent Transfers Under 2005 Bankruptcy Code Amendment

March 5, 2010

The U.S. Court of Appeals for the Fifth Circuit held on Feb. 10, 2010, that a corporate debtor's pre-bankruptcy severance payments to its former chief executive officer ("CEO") were fraudulent transfers. *In re Transtexas Gas Corp.*, ____ F.3d _____, 2010 BL 28145 (5th Cir. 2/10/10). Because of its holding "that the payments were fraudulent under the Bankruptcy Code," the court did "not consider other possible violations, including [the Texas Uniform Fraudulent Transfer Act] or [Bankruptcy Code] Section 547(b) [preferences]." *Id.* at *5. More important, the court relied on a rarely discussed 2005 amendment to Bankruptcy Code ("Code") § 548 enabling a bankruptcy trustee to avoid a transfer for "less than a reasonably equivalent value . . .to or for the benefit of an insider, under an employment contract and not in the ordinary course of business." § 548(a)(1)(B)(ii)(IV). In doing so, the court avoided having to deal with the defendant CEO's challenge to the debtor's insolvency, thus facilitating the trustee's recovery from the insider defendant.

This case is the first appellate ruling under the new Code provision, intended by Congress "to enhance the recovery of avoidable transfers and excessive [pre-bankruptcy] compensation, such as bonuses, paid to insiders of a debtor." H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 154 (2005). Because of this 2005 amendment, the Code's fraudulent transfer provision now applies "to transactions undertaken during periods[when] the debtor was *not* financially distressed." 5 Collier, *Bankruptcy* ¶ 548.05 [5], at 548-52.3 (15th rev. ed. 2005) (emphasis added).

Facts
The CEO, the debtor's founder, had a three-year employment contract, entitling him to severance if the debtor terminated him within the first two years. If the debtor dismissed the CEO "for reasons other than cause, he would receive" $3 million. *Id.*, at *2. But if the debtor dismissed him for cause, the CEO would receive $1.5 million. *Id*. And if "he voluntarily resigned, he would be paid no severance." *Id.*

The corporate debtor became financially troubled in 2001. When the five-person board of directors met in January 2002, four of the five directors other than the CEO agreed that the "severance option" in the CEO's employment agreement should be invoked, but the "cursory" board minutes said nothing about a termination "for cause." *Id.,* at *3. Two months later, the CEO remained in office and still was a director when he negotiated the terms of his departure. *Id.* He and the debtor signed a "separation agreement" superseding the CEO's employment agreement and providing for the payment of $3 million "in installments" to the CEO. *Id.* He received $2.27 million before the debtor filed a Chapter 11 petition in November 2002.

The Lower Courts
The confirmed reorganization plan's liquidating trustee later sued the CEO, claiming the severance payments were preferences and fraudulent transfers. The bankruptcy court agreed and ordered the CEO to repay the $2.27 million plus attorneys' fees and costs. On the first round of appeal, the district court held the severance

payments were fraudulent transfers, but not preferences, still leaving the CEO's repayment liability "unaffected." *Id.*, at *4.

The Court of Appeals
Affirming the lower courts, the Fifth Circuit based it holding on (a) the debtor's payments on "obligations incurred by [the debtor] within two years of [bankruptcy]; (b) the CEO's being "indisputably an insider at the time he entered into the relevant obligation; and (c) the lack of any "reasonable equivalency." *Id.*, at *8-*9. This holding tracks the precise elements of Code § 548 (a)(1)(B)(ii)(IV).

The bankruptcy court found, as a fact, that the debtor had not received reasonably equivalent value "in exchange for its severance payments" to the CEO. *Id.*, at *9. Finding no fault with the bankruptcy court's methodology, the Fifth Circuit stressed that "reasonable equivalence" is a fact issue and must be judged "from the standpoint of creditors". *Id.* "The proper focus is on the net effect of the transfers on the debtor's estate, [and] the funds available to the unsecured creditors." *In re Hensley,* 201 F.3d 638, 644 (5th Cir. 2000). Here, the CEO had essentially removed "more than $2 million from the debtor's estate, making the funds inaccessible to its creditors." 2010 BL 28145, at *9.

Moreover, the court found the following fact findings by the bankruptcy court "not clearly erroneous":

- the CEO "used overreaching tactics, abusing his position of authority to obtain favorable," unjustified terms in the separation agreement;
- whatever concessions the CEO made did not "reasonably equate in value to the payments" he received;
- "there was no value to the 2002 agreement to pay [the CEO] three million dollars";
- "at least for a year prior to the termination, there had been . . . good cause" to terminate the CEO, reducing "by half the severance payment";
- the CEO had "actually resigned, which under the Employment Agreement would have entitled the [debtor] to pay him nothing";
- the CEO's "departure was a voluntary resignation"; and
- "the [Board's] decision not to terminate [the CEO] for cause (in fact, he resigned) was in effect a self-fulfilling prophesy to justify paying three million dollars instead of half that amount if he were terminated for cause." *Id.*, at *10-*12.

Because the relevant language in Code § 548 (a)(1)(B)(ii)(IV) also contained no requirement of the debtor's insolvency, the court rejected the CEO's solvency defense. *Id.*, at *13.

Comments

1. ***Questionable reliance on 2005 amendment.*** Congress made its amendment to Code § 548 effective in cases commenced on or after Oct.17, 2005. The *Transtexas* case commenced in 2002. It is unclear from the opinion whether the defendant ever raised the issue.

2. ***The CEO's resignation was fatal.*** Regardless of the applicable law (fraudulent transfer, preference), the CEO's resignation here deprived him of any right to payment under his employment agreement. Had he not resigned, the satisfaction of his claim (termination damages) arguably might avoid the fraudulent transfer problem, but probably not the preference problem.

3. ***Alternative grounds for relief.*** If the 2005 amendment (§ 548 (a)(1)(B)(ii)(IV)) did not apply, the trustee would have to prove the debtor's insolvency in addition to the lack of reasonably equivalent value in order to recover under Code § 548 (a)(1) (B)(i)-(ii)(I), (II) or (III). *See In re Teligent*, 380 B.R. 324, 336 (Bankr. S.D.N.Y. 2008) (*held*, former CEO liable for fraudulent transfer after insolvent debtor

Copyright © 2010 Schulte Roth & Zabel LLP. All Rights Reserved.

released him from $12 million obligation for no reasonably equivalent value; despite separation agreement with debtor terminating CEO's obligation, his prior resignation made "the termination . . . a $12 million gift.").

Authored by Michael L. Cook.

If you have any questions concerning this Alert, please contact:

Michael L. Cook	**+1 212.756.2150**	**michael.cook@srz.com**
Lawrence V. Gelber	**+1 212.756.2460**	**lawrence.gelber@srz.com**
Adam C. Harris	**+1 212.756.2253**	**adam.harris@srz.com**
David M. Hillman	**+1 212.756.2174**	**david.hillman@srz.com**
Brian D. Pfeiffer	**+1 212.756.2157**	**brian.pfeiffer@srz.com**

New York
Schulte Roth & Zabel LLP
919 Third Avenue
New York, NY 10022
+1 212.756.2000
+1 212.593.5955 fax

Washington, DC
Schulte Roth & Zabel LLP
1152 Fifteenth Street, NW, Suite 850
Washington, DC 20005
+1 202.729.7470
+1 202.730.4520 fax

London
Schulte Roth & Zabel International LLP
Heathcoat House
20 Savile Row, London W1S 3PR
+44 (0) 20 7081 8000
+44 (0) 20 7081 8010 fax

www.srz.com

U.S. Treasury Circular 230 Notice: Any U.S. federal tax advice included in this communication was not intended or written to be used, and cannot be used, for the purpose of avoiding U.S. federal tax penalties.

This information has been prepared by Schulte Roth & Zabel LLP ("SRZ") for general informational purposes only. It does not constitute legal advice, and is presented without any representation or warranty as to its accuracy, completeness or timeliness. Transmission or receipt of this information does not create an attorney-client relationship with SRZ. Electronic mail or other communications with SRZ cannot be guaranteed to be confidential and will not (without SRZ agreement) create an attorney-client relationship with SRZ. Parties seeking advice should consult with legal counsel familiar with their particular circumstances. The contents of these materials may constitute attorney advertising under the regulations of various jurisdictions.

Copyright © 2010 Schulte Roth & Zabel LLP. All Rights Reserved.