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Alert

Tenth Circuit Saves Insider's Severance Payments

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A terminated officer of a corporate debtor, who bargained for "18 months of severance (… $375,000 …) to ensure that his firing not disrupt [the debtor's] negotiations for $80 million" of financing gave the debtor "reasonably equivalent value," held the U.S. Court of Appeals for the Tenth Circuit on Oct. 15, 2015. *In re Adam Aircraft Industries, Inc.*, 2015 U.S. App. LEXIS 17930, at *27 (10th Cir. Oct. 15, 2015). Affirming the lower courts' dismissal of a Chapter 7 trustee's fraudulent transfer claims against the officer as a purported insider, the Tenth Circuit stressed that the officer ("W") was not an insider and "did not end up getting what he bargained for," but the debtor did get the entire benefit of "a pretty good trade." Indeed, although W "presented the initial terms of his departure, the [debtor's] Board[,] after a negotiation," only agreed on "less favorable terms" for W.

Relevance

The debtor's Chapter 7 trustee ("Trustee") had sued W for having received cash payments from the debtor under pre-bankruptcy separation agreements, claiming they were preferences and fraudulent transfers. Only the fraudulent transfer claims were the subject of the appeal. The first of the two claims was based on the debtor's extraordinary payment to an insider "under an employment contract" for less than "reasonably equivalent value" (Bankruptcy Code ("Code") § 548(a)(1)(B)(ii)(IV)). The second, alternative claim was based on an insolvent debtor's payment for less than reasonably equivalent value (Code § 548(a)(1)(B)(i), (ii)(I)).

The Trustee stated that W had been an insider when he negotiated his separation agreements with the debtor, relying on a Code amendment that was part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. In the Trustee's view, this amendment was intended to "enhance … the ability to recover avoidable transfers and excessive prepetition compensation … paid to corporate insiders of the debtor." *Id.* at *9-10. To support his argument, he relied on *In re TransTexas Gas Corp.*, 597 F.3d 298 (5th Cir. 2010) (former chief executive officer's severance payments held to be insider fraudulent transfers); and *In re TSIC, Inc.*, 428 B.R. 103 (Bankr. D. Del. 2010) (same).

Facts

In *Adam Aircraft*, W had been an officer of the debtor. He served as its president and as a member of its board of directors between 2004 and 2007. He had *no* employment agreement and *no* severance agreement with the debtor. When the board replaced W as president and board member on Feb. 1, 2007, it did not want his termination to disrupt its ongoing negotiations for debt financing. It suggested that W voluntarily "resign" in lieu of termination and continue to support the debtor publicly. He later agreed, signing a memorandum of understanding outlining the terms of his separation, and then

embodied these terms into separation agreements and releases signed by the parties on Feb. 13 and May 18, 2007.

W first learned of the board's decision to terminate him on Feb. 1, 2007, promptly collected his belongings and never returned to the debtor's facilities after Feb. 2. In the meantime, he offered the board his terms for a voluntary resignation. Although the board's minutes showed that W had resigned "effective February 2, 2007," it discussed the terms of W's proposed severance package and later negotiated with him. "While [W] requested two years of consultant work, the Board proposed 18 months with [W's] pay between months 12 and 18 contingent on his helping to maintain [the debtor's] sales backlog," terms that W accepted. *Id.* at *5. The debtor also agreed to provide W with severance payments, stating that his employment had "terminated effective March 1, 2007." *Id.* at *6. Under the terms of the separation agreement, the debtor also returned, with interest, W's $100,000 deposit made for the purchase of an airplane; repurchased shares of stock that he had bought for $100,000; and made $250,000 in severance payments over the next year.

The debtor filed a Chapter 7 petition on Feb. 15, 2008. W filed a claim in the bankruptcy case for roughly $135,000, including a priority-employee wage claim for $10,950 under the terms of his separation agreements.

The bankruptcy court, after trial, found that W was neither a de facto nor a statutory insider; the debtor's payments to W were not made under an employment contract; and W had given "reasonably equivalent value for the transfers he received from" the debtor. *Id.* at *8. The Bankruptcy Appellate Panel affirmed, agreeing that W "had ceased being [an] insider after February 1, 2007," finding that the debtor "was solvent when it incurred the obligations to [W], and that [the debtor] received reasonably equivalent value for the transfers to [W]." *Id.*

Analysis

No Insider Status

The Tenth Circuit stressed that the Trustee had to prove "all of the" statutory elements of his claims (e.g., insider, less than reasonably equivalent value and insolvency), and that "in the absence of even one of the [statutory factors]," the Trustee "cannot prevail." *Id.* at *11. It first dealt with W's purported insider status, an essential element of the Trustee's claim, noting that the statutory definition contained in Code Section 101 (31)(B) is not limited to "an officer, director, or a person in control of a debtor." Thus, "even someone not specifically listed in the statute can be considered an insider if he or she 'has a "sufficiently close relationship with the debtor that … [his or her] conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor."'" *Id.*, citing *In re U.S. Med. Inc.*, 531 F.3d 1272, 1276 (10th Cir. 2008) (internal citation omitted). In other words, a person would be an insider per se if his title fell within the terms of the Code, but could also be a de facto insider if he had a "close" relationship with the debtor.

"[T]here was more than sufficient evidence to support the [bankruptcy] court's finding that [W] 'made a clean break' as an insider on" Feb. 1, 2007, reasoned the court. *Id.* at *13. Aside from this "clean break," W's successor started "as president immediately on February 2"; "[W] never returned to [the debtor's] premises after February 2; and … the minutes of the Board's February 5 meeting … not[ed] [W's] resignation as a director of the Company, effective February 2, 2007."

Nor could W "qualify as a non-statutory [i.e., de facto] insider on this record," reasoned the court. In its view, "an employee negotiating the terms of his termination soon after learning that the company intended to fire him cannot be considered to possess either the type of control of — or relation to — a company necessary to constitute a non-statutory [i.e., de facto] insider." *Id.* at *14.

The court then distinguished the Trustee's main authorities. In *TransTexas*, for example, the defendant officer "remained CEO and a member of the board as he negotiated the terms of his departure over two months." *Id.* at *15. In contrast, W "negotiated the terms of his departure in a little over a week after having already been stripped of his titles, removed all of his personal effects from his previous office, and while performing none of the duties of his previous positions." *Id.*

The second of the Trustee's authorities, *TSIC*, was also distinguishable. In that case, "the officer in question … had an employment agreement with the employer that provided for a severance package upon his termination regardless of cause." *Id.* at *15-16. "Once the board decided to terminate [him], it then negotiated with him a separate Settlement Agreement requiring that he waive any claim to the previously agreed-upon severance package, as well as any other claims against the company … . The court found that the operative date for considering whether [the defendant] was an insider was the date of his original employment agreement, presumably because this agreement contained the promise of a severance package … [that] led to the negotiation of [the] Eventual Settlement Agreement." *Id.* at *16. Here, however, "[W] had no employment agreement with [the debtor]." *Id.*

The debtor in *Adam Aircraft* also got the benefit of W's agreeing to a "resignation so that the [debtor's] decision to fire him would not imperil the critical $80 million debt financing that [the debtor] was negotiating with [an investment bank]." *Id.* at *17. Not only did W agree to limit "his conduct after his resignation" as the result of an "arm's-length negotiation," but he also "fulfilled the terms of this agreement," when the debtor was, in effect, reneging "on its responsibilities by asking [the] court to retroactively term [W] an insider." *Id.* In short, explained the Tenth Circuit, W "ceased to be an insider on February 1, 2007." *Id.* at *18.

Reasonably Equivalent Value

For the balance of its decision, the court focused on whether W provided the debtor with "reasonably equivalent value." If so, then the Trustee's claims would fail entirely.

According to the Tenth Circuit, the bankruptcy court correctly found that the debtor's "satisfaction of the 'antecedent debt' created [by W's separation agreements] constituted 'reasonably equivalent value' to preclude avoidance." *Id.* at *19. Still, the "bankruptcy court's ruling on this statutory basis was too limited." *Id.* First, no party denied the debtor's receiving "reasonably equivalent value when it transferred money to [W] because these transfers resulted in the lessening of [the debtor's] legitimate antecedent debts." *Id.* at *20. The bankruptcy court also "failed to consider reasonably equivalent value on dates occurring in later February, March and May, 2007," when the debtor's obligations to W were incurred under the separation agreements. *Id.* "Reasonably equivalent," the court explained, means "approximately equivalent," or "roughly equivalent." *Id.* at *21, quoting *B.F.P. v. Resolution Trust Corporation*, 511 U.S. 531, 538 n.4 (1994).

The Tenth Circuit stressed that "no court could reasonably support a finding that [the debtor] failed to receive reasonably equivalent value" for (1) the refund of W's airplane-purchase deposit; (2) the refund of W's stock purchase; and (3) W's severance payments. *Id.* at *24. When W asked for a refund of his

airplane deposit, he was relying on "a contractual requirement entered into when he made the initial deposit[,] … [a] transaction [made] for reasonably equivalent value." *Id.* As for the refund of W's stock purchase payment, reasoned the court, "absent any evidence to the contrary[,] the amount [W] paid for it months before seems a fair estimated value." *Id.* As for the debtor's severance payments, the board negotiated with W, leading to "less favorable terms to [W]." *Id.* at *25. Nor was there any evidence to suggest that the board had "agreed to a sweetheart deal just to do right by [W]. The Board fired [W] without providing him any notice and after having had him unwittingly give a tour of the [debtor's] facility to the man the Board had already decided would replace him … . [C]ompany insiders did not principally comprise the Board; rather, outside investors filled eight of its ten positions — including the position of lead director. These individuals … would not have agreed to part with a significant amount of money just to placate [W]. The bankruptcy court is correct that the directors seemed willing to grant [W's] requests in return for noncompetition, goodwill, and waiver of claims." *Id.* at *26.

Moreover, the debtor "did not want anything to disrupt [its] financing and … some members of the Board worried that terminating [W] would do just that. In this context, paying [W] 18 months of severance [$375,000] … to ensure that his firing not disrupt negotiations for $80 million of capital probably looked like a pretty good trade. In fact, especially since he did not end up getting what he bargained for, [W] could make a better argument that he did not get reasonably equivalent value for what he gave up — a job in the aviation industry he could easily have gotten because of his high reputation … and any right to sue for his termination." *Id.* at *27.

The court finally rejected the Trustee's authorities for the proposition that "non-compete agreements have no value." In the cases relied on by the Trustee, former officers and owners of the company had negotiated non-competes with their companies at a time when they "already owed a fiduciary duty to" their employers not to compete with them "before" entering into their agreements. *Id.* at *28-29. Here, however, W owed no "such duty to not compete with [the debtor] before entering" into the separation agreements. The debtor had fired him months before.

It was "obvious that [the debtor] did not give [W] 'free money' or the like," reasoned the Tenth Circuit, "but compensated him for money he otherwise could have earned." *Id.* at *30. In return, the debtor "got the benefit of avoiding a possible lawsuit and an unhelpful, high-profile mess as it sought the needed $80 million in outside financing." *Id.* Because it found the debtor received reasonably equivalent value, the court did not have to consider the debtor's solvency. In a footnote, however, it noted that the bankruptcy court's solvency finding at the time of the separation agreements with W "was not clearly erroneous." *Id.* at *30 n.8.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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