Insider's Compensation Claim Capped at Zero Under Section 502(b)(4)

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The Bankruptcy Code treats insiders with increased scrutiny, from longer preference periods to rigorous equitable subordination principles, denial of chapter 7 trustee voting rights, disqualification in some cases of votes on a cram-down chapter 11 plan, and restrictions on postpetition key-employee compensation packages. The treatment of claims by insiders for prebankruptcy services is no exception to this general policy: section 502(b)(4) disallows insider claims for services to the extent the claim exceeds the "reasonable value" of such services.

A former chief financial officer of Delta Air Lines, Inc. ("Delta"), recently discovered the exacting scrutiny that bankruptcy courts often apply to insider claims. In *In re Delta Air Lines, Inc.*, a New York bankruptcy court ruled that the CFO remained an insider of the debtor even after she had submitted a resignation letter and while she was negotiating her subsequent consulting agreement, such that the consulting agreement was subject to the limitations in section 502(b)(4) of the Bankruptcy Code. Based on that insider status, the court held, pursuant to section 502(b)(4), that the former CFO's claim arising from the debtor's rejection of her prepetition consulting agreement should be capped at zero because of compensation she had already received.

Limitations on Insider Compensation Claims

Section 502(b)(4) was designed to prevent overreaching by, or excessive generosity to, an insider or a debtor's lawyer prior to a bankruptcy filing. With this goal in mind, the provision prohibits

claims for compensation by insiders or debtor attorneys that exceed the "reasonable value" of the services rendered:

> (b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if . . . [an] objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that—
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> […] (4) if such claim is for services of an insider or attorney of the debtor, such claim exceeds the reasonable value of such services . . . .

Courts have taken up the mandate in section 502(b)(4) with vigor, applying "rigorous scrutiny" to claims by insiders. As the bankruptcy court in *In re Siller* explained in April 2010,

> the particularized disallowance under § 502(b)(4) of claims . . . is a manifestation and expansion of the rule of *Pepper v. Litton* that insider dealings with a debtor are "subjected to rigorous scrutiny" and that the burden is on the insider "not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the [debtor] and those interested therein."

Delta Air Lines

M. Michele Burns served as Delta's CFO from August 2000 until April 30, 2004, the effective date of her resignation letter. On the same day that her resignation became effective, Burns executed a consulting agreement with Delta, in which she agreed to provide consulting services for five years with respect to "any matter within [her] general area of expertise as developed during [her] employment . . . that may from time to time arise during the consulting period." Burns also agreed that until May 1, 2009, she would not "solicit any person who is at the time an employee of Delta, or its subsidiaries, at the director or officer level" to provide services or accept employment from any other company. In exchange, Delta agreed to provide her with "unlimited positive space travel"—free, virtually unlimited first-class travel for life. During the

course of the ensuing 16 months, Burns utilized her lifetime travel benefit to book 98 flights for destinations in the U.S. and Europe.

Delta filed for chapter 11 protection in New York on September 14, 2005. After Delta received court approval to reject the consulting agreement, Burns filed a claim for damages arising from the rejection. Delta objected to the claim under section 502(b)(4).

The Bankruptcy Court's Ruling

Bankruptcy Judge Cecilia G. Morris initially noted that the consulting agreement was an executory contract that could have been and was in fact rejected by Delta under section 365, because material performance was still required by both parties. Delta, Judge Morris explained, was obligated to provide the free first-class travel for the remainder of Burns' life, and Burns was obligated to provide consulting services for several more years after Delta's chapter 11 filing.

The court then considered whether Burns' claim was based upon services provided by an insider, or whether her status as a consultant exempted her from section 502(b)(4). Under section 101(31)(B) of the Bankruptcy Code, insiders of a corporation include directors, officers, general partners, relatives, and persons in control of the debtor, as well as partnerships in which the debtor is a general partner. As Judge Morris noted, this statutory list is not exhaustive, and courts will also evaluate: (i) the closeness of the relationship between the debtor and the individual; and (ii) whether the transaction in question was performed at arm's length.

Even though Burns was an insider while she was Delta's CFO, she provided services under the consulting agreement after her resignation became effective. Furthermore, the negotiations over

the consulting agreement began after she submitted her letter of resignation, but prior to the effective date of the resignation. Citing the Pennsylvania bankruptcy court's 1992 ruling in *In re Allegheny Int'l, Inc.*, Judge Morris held that the important issue for determining insider status is whether the claimant was an insider when the consulting contract at issue was formed, not necessarily when the services were rendered. Since Burns was still a statutory insider while she was negotiating the contract, section 502(b)(4) applied, Judge Morris concluded.

Finally, Judge Morris valued Burns' unsecured claim for rejection damages. Under section 502(b)(4), her claim was limited to its "reasonable value." Even though Judge Morris acknowledged that Burns' consulting services provided some value, the judge rejected Burns' request for an evidentiary hearing as to the extent of that value. Instead, Judge Morris invoked her power under section 502(c) to estimate the claim and concluded that the 98 tickets Burns had already used sufficiently compensated her for any services that she had provided under the consulting agreement. Thus, her claim was capped at its "reasonable value, which is zero."

The Importance of Specific Facts

Delta demonstrates the role of specific facts in a court's 502(b)(4) analysis. "Unlimited positive space travel" was an enormously valuable benefit that only certain executives received. The scope of the benefit was also lopsided in favor of Burns. Under the consulting agreement, Burns would receive the benefit for the rest of her life even though she had had to provide consulting services for only five years. Burns herself acknowledged that at the time of the bankruptcy filing, any information she provided concerning Delta matters "likely was of little value" and her contact with Delta employees was "*de minimis*." In the meantime, she utilized 98 tickets in approximately 16 months.

Additional facts, although unstated in the court's opinion, may have influenced the court's decision. First, in 2002, while at Delta, Burns helped the company establish bankruptcy-proof pension trusts for about three dozen executives. According to an article published in *The Atlanta Journal-Constitution*, those trusts provided her with at least $1 million that creditors could not reach. She was also one of many Delta executives who received controversial bonuses while the airline was cutting jobs and asking for federal aid: her annual salary prior to her resignation was $560,000, but her bonus during her last year of employment was $846,000. This backdrop of facts may have made Burns' claim appear to be precisely the type of excessive generosity to insiders that section 502(b)(4) was designed to prevent.

Finally, whether to designate Burns as an insider might have been a more difficult decision had she waited to negotiate her consulting agreement until after her resignation was effective.

In re Delta Air Lines, Inc., 2010 WL 423279 (Bankr. S.D.N.Y. Feb. 3, 2010).

In re Siller, 427 B.R. 872 (Bankr. E.D. Cal. 2010).

Pepper v. Litton, 308 U.S. 295 (1939).

In re Allegheny Int'l, Inc., 158 B.R. 332 (Bankr. W.D. Penn. 1992).