Fifth Circuit Allows Debtor to Avoid Insider Severance Payment as a Fraudulent Transfer

September/October 2010

John H. Chase
Mark G. Douglas

In keeping with the careful scrutiny that the Bankruptcy Code directs toward claims asserted by corporate insiders due to the heightened risk of overgenerosity or overreaching, severance payments made (or promised) to an executive terminated during the period leading up to a bankruptcy filing by the company may be challenged if the amount of the payment is later deemed to be excessive and/or unsupported by adequate consideration. Changes made to the Bankruptcy Code as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") have made it easier for a bankruptcy trustee or chapter 11 debtor in possession ("DIP") to recover these payments or to avoid the underlying payment obligation. In such actions, which most commonly arise under section 548(a) of the Bankruptcy Code, the focus becomes the value of the concessions or other consideration that the executive granted in exchange for the severance payments and whether the value of such consideration is "reasonably equivalent" to the value of the severance payments. A three-judge panel of the Fifth Circuit Court of Appeals recently applied section 548(a) in this context. In *In re TransTexas Gas Corp.*, the court affirmed a ruling below authorizing a DIP to avoid prepetition severance payments made to an executive as fraudulent transfers.

Avoidance of Fraudulent Transfers in Bankruptcy

Among the powers conferred upon a bankruptcy trustee (or DIP) under the Bankruptcy Code is the ability to avoid asset transfers that are either actually or constructively fraudulent. Section

548(a)(1)(A) of the Bankruptcy Code provides that the trustee can avoid any transfer made, or obligation incurred, by the debtor in the two years preceding a bankruptcy filing if it is effected with the "actual intent to hinder, delay, or defraud" creditors. Section 548 also authorizes avoidance of transfers made or obligations incurred in the absence of fraudulent intent. Specifically, section 548(a)(1)(B) provides that the trustee may avoid any transfer made or obligation incurred by a debtor in the two years preceding bankruptcy if the debtor received "less than a reasonably equivalent value in exchange" and: (a) was, or became as a result of the transaction, (i) insolvent, (ii) undercapitalized, or (iii) unable to pay its debts generally as they matured; or (b) regardless of solvency, made, or obligated itself to make, nonordinary-course payments to insiders under an employment agreement.

Fraudulent transfers may also be avoided under applicable state law by operation of section 544(b) of the Bankruptcy Code. Section 544(b) allows a DIP or trustee to "avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim" against the debtor. The primary advantage of this provision over section 548 is that section 548 bears a two-year reach-back period. By contrast, many state fraudulent conveyance laws (generally a version of the Uniform Fraudulent Transfer Act ("UFTA")) provide for a longer statutory reach-back period to avoid fraudulent transfers.

Amendments to Section 548 in BAPCPA

BAPCPA amended section 548 to enhance the trustee's ability to recover excessive prepetition compensation paid or promised to a debtor's insiders. Specifically, section 548(a) was amended

to clarify that it permits a trustee to avoid transfers 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." According to the legislative history, the intent of the amendment was "to enhance the recovery of avoidable transfers and excessive [prebankruptcy] compensation, such as bonuses, paid to insiders of a debtor." The 2005 amendment removed the requirement that the debtor be insolvent at the time of any challenged transaction involving nonordinary-course payments under employment agreements to insiders. As a consequence, insiders are now precluded from claiming solvency as a defense, thereby significantly simplifying the trustee's ability to avoid a transfer or obligation to an insider under section 548.

Consequences of Avoidance

If the trustee successfully avoids a severance payment as a fraudulent transfer, the recipient of the avoided transfer is required to return the funds actually received to the bankruptcy estate. However, if the DIP or trustee succeeds in avoiding the severance payment but does not seek to avoid the underlying payment obligation as reflected in the severance agreement, the insider may have a claim against the bankruptcy estate. That claim would most likely be an unsecured prepetition claim, possibly with partial priority under section 507(a)(4), provided the claim is not invalidated in whole or in part under section 502(b)(4), which disallows any insider claim for services to the extent the claim exceeds the "reasonable value" of such services, or section 502(b)(7), which caps employee claims for "damages resulting from the termination of an employment contract" at an amount equal to approximately one year's compensation.

The Fifth Circuit applied section 548 to insider severance claims in *TransTexas Gas*.

TransTexas Gas

TransTexas Gas Corporation ("TransTexas") was engaged in the exploration, production, and transmission of oil and natural gas. TransTexas filed the first of two chapter 11 petitions in April 1999 in Texas. The company's chapter 11 plan provided that the company's founder, John Stanley, Sr. ("Stanley"), would serve as chief executive officer of the company and as one of the five directors on the board.

As part of TransTexas' chapter 11 plan, Stanley and TransTexas entered into an employment agreement effective in 2000 providing that Stanley could be terminated beginning two years after its execution. At termination, Stanley could be entitled to severance pay, depending on the circumstances of his termination. If he were dismissed for reasons other than cause, he would receive $3 million. If terminated for cause, his payment would be $1.5 million. If he voluntarily resigned, he would not be entitled to any severance.

Despite confirmation of a chapter 11 plan in March 2000, TransTexas continued to struggle financially. On January 30, 2002, all five members of the board met. The four directors other than Stanley agreed that "the severance option" under Stanley's employment agreement should be invoked. There was no indication that the directors discussed whether Stanley would be terminated for cause or the effect that such a termination would have on the payment.

Between January and March 2002, Stanley remained with TransTexas as CEO and a member of the board as he negotiated the terms of his departure. In March 2002, Stanley and TransTexas agreed that he would resign. The board then executed a "separation agreement," which explicitly

superseded Stanley's employment agreement. Under the separation agreement, Stanley was to be paid $3 million in installments, nearly $2.3 million of which Stanley received before the payments ceased.

TransTexas filed a second chapter 11 petition in November 2002. The Texas bankruptcy court confirmed a chapter 11 plan proposed by TransTexas' creditors in August 2003. The plan established a liquidating trust for TransTexas' remaining assets. The liquidating trustee sued Stanley, seeking to avoid the severance payments as preferential and fraudulent transfers under sections 547 and 548 of the Bankruptcy Code as well as the Texas UFTA. The bankruptcy court ruled in favor of the liquidating trustee on all counts, ordering Stanley to repay the $2.3 million he had received, plus attorneys' fees and costs. Among other things, the bankruptcy court found that Stanley used overreaching tactics, abusing his position of authority to obtain favorable terms in the separation agreement to which he was not entitled. The bankruptcy court also concluded that: (i) Stanley was an "insider" of TransTexas for the purpose of determining whether he was the recipient of a preferential transfer (such that the one-year reach-back period in section 547 applied); (ii) the severance payments to Stanley were both actually and constructively fraudulent under section 548; and (iii) TransTexas was insolvent at the time of the payments.

Stanley appealed to the district court, which affirmed the bankruptcy court's determination that the payments were voidable under section 548 and the UFTA but reversed the preference ruling on the basis of its conclusion that the bankruptcy court erred in holding that Stanley was an insider. Stanley then appealed to the Fifth Circuit Court of Appeals.

The Fifth Circuit's Opinion

A three-judge panel of the Fifth Circuit affirmed the ruling. Writing for the panel, circuit judge Leslie H. Southwick cited to the post-BAPCPA version of section 548, observing that "[t]wo elements [of section 548] are clearly satisfied" because "[t]he severance payments made to Stanley after his dismissal were obligations incurred by TransTexas within two years of its petition date." The judge then examined whether Stanley qualified as an "insider" of TransTexas within the meaning of section 548(a)(1). Under section 548, Judge Southwick wrote, "it is enough that Stanley was an insider either at the time of the transfer of the funds or at the time the company incurred such obligation." According to the judge, "[T]here is no textual limitation of insider status to the time in which the transfer is made."

Judge Southwick then addressed whether TransTexas received reasonably equivalent value in exchange for the severance payments made to Stanley. According to Stanley, he provided reasonably equivalent value because the payments were "a dollar-for-dollar satisfaction of a debt" that arose under his employment agreement and were merely memorialized in his separation agreement. He also contended that his employment agreement was specifically approved as part of the chapter 11 plan in TransTexas' first bankruptcy and that "there is a *res judicata* effect from the earlier bankruptcy court's approval of the contract itself, making the payment incontestable." Finally, Stanley suggested that by agreeing to "go quietly," he provided benefit to the company.

The Fifth Circuit rejected these arguments. Judge Southwick wrote that "[t]he problem factually for each court that has examined the early 2002 Separation Agreement is that at least for a year prior to the termination, there had been evidence of good cause for which Stanley could be

terminated." Such a termination would have reduced by half the severance payment. Moreover, the judge explained, Stanley actually resigned, which under the employment agreement would have entitled the company to pay him nothing. Even under the most favorable circumstances, he emphasized, Stanley could have been entitled to no more than $1.5 million under the employment agreement, rather than the $2.3 million he was actually paid.

Stanley argued that the release and covenant not to sue that he signed as part of the separation agreement provided a benefit to the company, an argument that led the district court below to assign some value to Stanley's concessions, but not enough to prevent the payment from being avoided as a fraudulent transfer. The Fifth Circuit agreed with the district court, concluding that any such value paled in comparison to the severance payment and could not make up the $1.5 million difference between what TransTexas may have owed Stanley (assuming it owed him anything at all) and the amount actually paid.

Turning to the issue of whether TransTexas was insolvent or had become insolvent by virtue of the financial obligations incurred by the separation agreement, Judge Southwick concluded that "the insolvency issue only applies to preferential transfers under section 547(b)." Under post-BAPCPA section 548, she explained, a debtor either must have made a transfer that resulted in insolvency or when the debtor was insolvent, or must have made the transfer "to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business." According to the judge, "That latter provision applies," and Stanley was an insider at the time the obligation was incurred.

Ramifications

TransTexas Gas represents the first time that the post-BAPCPA version of section 548 was applied in the federal circuit courts of appeal. Unfortunately, it would appear that the *pre-*BAPCPA version of the provision actually applied to the dispute. TransTexas filed both of its chapter 11 cases prior to the October 17, 2005, effective date of most BAPCPA provisions, as well as the April 20, 2005, effective date of the changes to section 548 regarding transfers or obligations to insiders under employment contracts, and the April 21, 2006, effective date of the expanded two-year look-back period. The Fifth Circuit's reliance on the post-BAPCPA version of section 548 may have been a consequence of the bankruptcy court's findings of fact and conclusions of law, which cite to a version of the provision that contains subsection 548(a)(1)(B)(IV), which was added as part of BAPCPA. In addition, one of the appellate briefs filed in the Fifth Circuit refers to the amended version of section 548. Interestingly, although Stanley asked the Fifth Circuit to reconsider its ruling on February 24, 2010, he did not raise this issue in his petition for rehearing, which the court denied on April 12, nor did he appeal the ruling to the U.S. Supreme Court.

Because the post-BAPCPA version of section 548 will apply to bankruptcy cases filed after the dates described above, *TransTexas Gas* demonstrates the importance of proving reasonably equivalent value if an insider is to retain payments under or enforce a severance agreement. The question then arises regarding what forms of reasonably equivalent value (under section 548) or "adequate consideration" (under the UFTA) the insider can provide. Unfortunately, the answer to that question is unclear.

Courts have determined, in the context of actions commenced under section 544(b) to avoid fraudulent transfers under the UFTA, that one form of adequate consideration involves an employee accepting an obligation of continuing performance in exchange for a future severance payment. This was the situation, for example, in the Eleventh Circuit's 1996 ruling in *In re Munford*, where several essential officers agreed to stay with the company during a leveraged buyout transaction in exchange for additional severance pay. The court found that the obligation of continued employment constituted adequate consideration and that the severance payments were therefore not fraudulent transfers.

An obligation of continuing performance may not help, however, if the debtor enters into a severance agreement simultaneously with an employee's termination, which is a common scenario in which a severance payment is later challenged by a trustee or DIP as being a fraudulent transfer. Also, as in *TransTexas Gas*, a contingent obligation to make a severance payment may result in a fraudulent transfer if the necessary contingency (*i.e.*, lack of cause for the termination) is not satisfied. In these cases, the insider may need to rely on the value of a release and covenant not to sue, a noncompete clause, or another ongoing obligation created by the severance agreement in order to establish the necessary value to withstand a challenge under section 544(b) or 548.

Unfortunately, case law provides little guidance on how to value releases, noncompete clauses, or similar obligations created by severance agreements. Both the district court and the Fifth Circuit in *TransTexas Gas* agreed with Stanley that such releases provide some measure of value. Both also found, however, that the potential value was not reasonably equivalent to the

challenged $3 million severance obligation. There was no analysis of how the courts reached that conclusion, nor was there any suggestion of how a court should calculate value in a similar situation. This uncertainty creates a potential minefield for executives who are terminated as part of the prebankruptcy process.

In re TransTexas Gas Corp., 597 F.3d 298 (5th Cir. 2010), *aff'g Stanley v. U.S. Bank Nat'l Assoc., as Liquidating Trustee*, Case No. 2:07-CV-00398 (S.D. Tex. Sept. 23, 2008).

In re Munford, Inc., 98 F.3d 604 (11th Cir. 1996).