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Severance Payments May be Recoverable in a Company's Bankruptcy

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Working for the Queen of Hearts is a tough gig. A disappointing quarter and she's quick to the chopping block. And the 'severance' she offers - "Off with their heads!" - no thanks.

While (non-Wonderland) corporate layoffs are often less animated, former employees receiving severance payments have their own concerns if the company subsequently files for bankruptcy: some or all of those payments may be recouped by the bankruptcy estate. A recent Tenth Circuit decision addressed this issue, finding that a company's severance payments to its former president and board member were not recoverable, at least not under the particular facts of the case. The Court did, however, highlight potential pitfalls that could lead to an alternate result.

In ***Weinman v. Walker***, the board of Adam Aircraft Industries (AAI) decided to replace its president and board member (Walker). To avoid potentially disrupting ongoing negotiations for debt financing, the board asked Walker to resign. Walker agreed and the two parties subsequently negotiated a severance package which included the refund of Walker's airplane deposit and stock investment (apprx. $200,000) and consultant retainer payments for 18 months ($375,000). In return, Walker entered into a non-compete agreement and released all potential claims against AAI. A year later AAI declared bankruptcy and the bankruptcy trustee sued to recover transfers made to Walker under the severance agreement.

Walker not an Insider when Severance Agreement Negotiated

The trustee's initial argument was that the severance payments could be recovered because they occurred within 2 years of the petition date, Walker was an insider when the package was negotiated or when the payments were made, the package was part of an employment contract, AAI did not receive reasonably equivalent value and the payments were made outside the ordinary course of business. Notably, under this argument the trustee was not required to prove AAI's insolvency. The Court, however, was not convinced that Walker was an insider at any relevant time.

An insider is an officer, director or person in control of a debtor (a statutory insider), or a person with a sufficiently close relationship with the debtor that their actions require closer scrutiny than arm's length dealings (non-statutory insider). The Court concluded that Walker made a "clean break" from AAI as of his termination date and at no other point had a sufficiently close relationship with AAI to be considered an insider (despite his continued consultant role). Further - and importantly - the severance agreement was negotiated after this clean break; Walker had neither a written employment contract nor a severance agreement at any other time during his AAI employment. Accordingly, the Court found that Walker was neither a statutory nor non-statutory insider when the agreement was negotiated or when payments were made.

AAI Received Reasonably Equivalent Value for Severance Payments

The trustee also argued that, even if Walker was not an insider, the payments were recoverable because AAI did not receive reasonably equivalent value for the payments and AAI was insolvent when the payments were made. The Court analyzed the three transfers under the severance agreement (airplane deposit, equity investment, consultant payments) separately, concluding each was made for reasonably equivalent value.

First, the refund of the airplane deposit was authorized under the airplane contract. Second, there was no evidence that the AAI shares Walker 'returned' had declined in value since he purchased them months earlier (i.e., the shares = apprx. $100,000). Third, the consultant payments were made in exchange for the non-compete agreement, the waiver of potential lawsuit (e.g., wrongful termination) and the assurance that Walker's firing did not disrupt AAI's $80 million debt negotiations.

Because the Court found reasonably equivalent value was provided as to each transfer under the severance agreement, AAI's solvency was immaterial. Note, this 'reasonably equivalent value' determination likely would have prevented the Trustee from recovering the payments even if Walker was found to be an insider under the previous analysis.

Takeaway

While the *Weinman* Court ultimately allowed Walker to keep the severance payments, the decision outlines potential pitfalls which could lead to a less favorable result for the terminated employee. For instance, the Court distinguished this case from others holding that non-compete agreements did not constitute reasonably equivalent value (Walker did not already have a fiduciary duty not to compete with AAI); some executives have a fiduciary duty not to compete with their former companies. Also, the Court referenced the negotiation process by which the board (comprised mostly of outside investors, not company insiders) agreed to the severance payments (clearly not a "sweetheart deal just to do right by Walker"); the more insider board members, the more likely a court may find the severance package was not negotiated in good faith. Finally, the Court highlighted that Walker did not have an employment and/or severance agreement while he was president (thus did not negotiate the agreement while he was an insider); many company executives have agreements in place during their tenure.

In sum, considering the already heightened emotions, understanding the subtleties surrounding severance situations (say that five times) is important; as is, of course, keeping your head - lest the Queen of Hearts gets her way.

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Eric R. Blythe is a Mintz attorney with deep capabilities in commercial litigation and lending, debt restructuring and workouts, distressed debt advising, and corporate and municipal reorganization. His clients have included lenders, secured and unsecured creditors, corporate borrowers, and bondholders.