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Identifying Insiders for Purposes of §503(c)

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Section 503(c) of the Bankruptcy Code, added to the Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, governs retention and severance payments to an insider of a debtor.[1] This article examines case law interpreting what constitutes an insider for purposes of §503(c) and discusses the Delaware bankruptcy court's recent decision in *In re Foothills Texas Inc.*

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Background on §503(c)


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Section 503(c)(1) prohibits payments and obligations to insiders for the purpose of inducing insiders to remain with the debtor's business absent a showing that (1) the insider has a bona fide job offer from another business at the same or greater rate of compensation, (2) the services provided by the insider are essential to the survival of the business and (3) the payment or obligation falls within statutory limits (meaning that the amount does not exceed 10 times the amount of a similar obligation to nonmanagement employees).[2] Section 503(c)(2) prohibits severance payments to an insider unless the payment (1) is part of a program that is generally applicable to full-time employees and (2) falls within statutory limits (meaning that the amount does not exceed 10 times the mean severance payment given to nonmanagement employees in the same calendar year).[3] Finally, §503(c)(3) is a "catch-all" provision that prohibits "other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case."[4] Section 503(c) was enacted to "limit a debtor's ability to favor powerful insiders economically and at estate expense during a chapter 11 case."[5]

Practice & Procedure

Definition of an Insider


Patrick J. Reilley

Section 101(31) of the Code contains a nonexhaustive definition of an "insider." If a debtor is a corporation, §101(31)(B) defines an "insider" to include: "(i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor."[6] The legislative history of §101(31)(B) states that "an insider is one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arms length with the debtor."[7] At least one court has recognized that this statement "begs the question [of] *when* and *under what circumstances* the court should find such a 'sufficiently close relationship.'"[8]

The term "officer" is not defined in the Bankruptcy Code. The seminal case defining an officer under §101(31)(B) is *In re NMI Systems Inc.*, which was decided prior to the enactment of §503(c).[9] In *NMI Systems,* the court considered whether a regional vice president of the debtor was an insider at the time he received preferential transfers before the petition date. The court reasoned that the employee's "title of vice president and mid-management responsibilities of running the company's consulting division ought not suffice to make him an officer if he did not enjoy the elements of being an officer that would per se put him in a position of advantage as against other creditors."[10] Ultimately, the court ruled that the appropriate test for whether an employee was an officer was whether he occupied a high position within the corporation, making him active in setting overall corporate policy or performing other important executive duties of such a character that it is likely he would be accorded less than arm's-length treatment in the payment

1 11 U.S.C. §503(c)(1).
2 *Id.*
3 11 U.S.C. §503(c)(2).
4 11 U.S.C. §503(c)(3).
5 *In re Pilgram's Pride Corp., et al.,* 401 B.R. 229, 234 (Bankr. N.D. Tex. 2009). *See also In re Airway Industries Inc.,* 354 B.R. 82, 87 n. 12 (Bankr. W.D. Pa. 2006) (amendment was "designed to stop the travesty of high-level corporate insiders who walk away with millions while the company's workers and retirees are left empty-handed"), citing a statement by Sen. Edward Kennedy, quoted in the July 24, 2005, edition of *The Kansas City Star*; H.R.Rep. No. 109-031, pt. 1 at 84 (2005).
6 11 U.S.C. §101(31)(B).
7 *In re CEP Holdings LLC, et al.,* 2006 WL 3422665, *2 (Bankr. N.D. Ohio Nov. 28, 2006), citing S. Rep. 95-989, 95th Cong. 2d Sess., reprinted in 1978 U.S. Code Cong. & Admin. News 5787, 5810.
8 *In re CEP Holdings,* 2006 WL 3422665 at *2 (emphasis in original).
9 *In re NMI Systems Inc.,* 179 B.R. 357 (Bankr. D. D.C. 1995).
10 *Id.* at 368.

of his antecedent claim against the debtor.[11] The court further found that the employee was not an officer because he "was not one in the inner circle making the company's critical financial decisions."[12] In *NMI Systems,* the court set forth a test to determine whether a person was an officer based on the purposes of the Code's preference statute. The court observed that the "test ought to be one that takes account of the bankruptcy policies behind the use of the term 'insider' in the preference statute and that is best designed to further those policies."[13]

Who Is an Insider under §503?

Since the enactment of §503(c) in 2005, there has been very little case law interpreting the term "officer," and therefore "insider," under that Code section. A survey of written opinions and oral rulings suggests that some courts apply the plain language of the statute and do not look beyond the title of "officer" in determining the applicability of §503(c)(1) and (2) to insiders. For example, in *In re Pilgram's Pride Corp.,* the U.S. Bankruptcy Court for the North District of Texas held that "for purposes of §503(c), anyone who was an officer or director of a debtor as of the commencement of the debtor's bankruptcy case is an insider."[14]

However, some courts have ruled that the "insider" title is not determinative of officer status. For example, in *Three A's Holdings LLC,* the court held that two individuals who held the title of vice president were not officers within the meaning of §101(31) because, under the company's bylaws, officers of the corporation were appointed by the board of directors, and since those individuals did not occupy such positions as defined under the bylaws, they were not officers of the corporation within the meaning of the statute.[15]

Likewise, in *In re CEP Holdings LLC, et al.,* the U.S. Bankruptcy Court for the Northern District of Ohio found that titles listed in the plan's schedules were not determinative of whether an employee was an "officer" when there was nothing in the company's books and records electing the employee to officer status.[16] In that case, the court adopted the reasoning in *NMI Systems* and focused on the employee's influence over the specific transaction at issue to determine whether a person is "in control" of the debtor under §101(31)(B)(iii).[17] The court observed that in the context of §503(c)(3), insider status under the "control provision of §101(31)(B)(iii) should be determined by reference to the payment recipient's control of the specific transaction under consideration and the impact of the transaction upon other creditors."

Other courts have also examined the responsibilities of the proposed participant and his or her control over the governance of the debtor. In *In re Refco Inc.,*[18] the court found that based on the liquidation status of the debtors, the participants did not have the type of decision-making authority to render them insiders. Similarly, in *L.G. Philips Displays USA Inc.,* the court, considering the definition of an insider for purposes of a severance program, found that the fact that individuals may have "important responsibilities in the operation of the business does not necessarily confer insider status on them."[19] In that case, the court noted that "considerable expertise does not...necessarily reflect" insider status.[20] The court observed that "insider status typically goes to those who control the governance and strategic direction of a corporate enterprise."[21]

The Foothills *Decision*

Recently, the U.S. Bankruptcy Court for the District of Delaware addressed whether certain employees, holding the title of vice president of the debtors, were insiders for purposes of determining whether retention bonus payments were prohibited by §503(c)(1).[22] In *Foothills Texas Inc.,* the debtors, independent energy companies engaged in the acquisition, exploration and development of oil and natural gas properties, sought to assume certain employment agreements and authorization to pay retention bonuses to certain employees pursuant to the employment agreements.[23] The debtors had 10 employees and sought to pay retention bonuses to three of those employees, including the "Vice President, Land and Legal" and "Vice President, Engineering."[24] The debtors contended, in part, that the two vice presidents were not officers of the debtors, and therefore, were not insiders. Consequently, the debtors argued that the criteria set forth in §503(c) were satisfied and the debtors should be authorized to make the retention bonus payments.

In deciding whether a person is an insider under §503(c)(1), the court observed that it must first determine whether a person is an officer. The court disagreed "that the meaning of 'officer' should vary according to the context in which the word is used."[25] Rather, the court held that "a person holding the title of an officer, including a vice president, is presumptively what he or she appears to be—an officer and thus, an insider."[26] The court, however, explained that the presumption that a person is an officer, and therefore an insider, can be rebutted by evidence sufficient to establish that the "officer" does not participate in the management of the debtor company. Specifically, the court suggested that a "flexible approach should be taken in considering what evidence might rebut the presumption that a person who holds the title of an officer is, in fact, an officer."[27] To overcome that presumption, a debtor is required to submit evidence sufficient to establish that the officer did not participate in the management of the debtor.[28]

The court examined the job responsibilities of the two vice presidents, both of whom were in charge of important aspects of the debtors' business—the acquisition, exploration, exploitation and development of oil and natural gas properties.[29] One employee was in charge of the debtors' oil and gas leases and communications with landlords regarding those leases, and was also responsible for ensuring the debtors' compliance with state and federal laws and regulation.[30] The other employee was in charge of the debtors' oil and gas production, evaluation of reserves, technical reporting and development of capital-spending projections.[31] Neither employee supervised other employees; however, the court considered this fact of little importance.[32] The court found that

11 *Id.* at 369.
12 *Id.* at 370.
13 *Id.* at 369.
14 *In re Pilgram's Pride Corp.,* 401 B.R. at 236, fn. 11;. *See also In re Calpine Corp., et al.,* Bankr. 05-60200 (BRL) Lifland, J. (Bankr. S.D.N.Y. March 1, 2006) ("§503(c)(1) only applies to transfers to 'insiders,' which includes the directors and officers of the Debtors.").
15 *In re Three A's Holdings LLC,* Case No. 06-10886 (BLS) (Bankr. D. Del. 2006); Transcript of Nov. 16, 2006, Hearing, pp. 81-82.
16 *CEP Holdings,* 2006 WL 3422665 at *1.
17 *Id.* at *2.
18 *In re Refco Inc.,* Case No. 05-60006, Drain, J. (RDD) (Bankr. S.D.N.Y. Jan. 10, 2006); Transcript of Jan. 10, 2006, Hearing, pp. 29-32.
19 *In re L. G. Philips Displays USA Inc.,* Case No. 06-10245 (BLS) (Bankr. D. Del. 2006); Transcript of April 13, 2006, Hearing, pp. 71-72.
20 *Id.* at 72.
21 *Id.*
22 *See In re Foothills Texas Inc.,* 408 B.R. 573 (Bankr. D. Del. July 28, 2009).
23 *Id.*
24 *Id.*
25 *Id.*
26 *Id.*
27 *Id.,* citing *Public Access Technologies Co.,* 307 B.R. 500, 506 (Bankr. E.D. Va. 2004).
28 *Id.*
29 *Id.*
30 *Id.*
31 *Id.*
32 *Id.*

the employees' "broad responsibilities over significant aspects of the debtors' business," and the fact that they reported directly to the debtors' president, demonstrated they were "participating in the management" of the debtors.[33] In sum, the court held that there was insufficient evidence to rebut the presumption that the employees were officers, and therefore concluded that they were insiders.[34]

Conclusion

The *Foothills* decision provides much-needed guidance for determining whether an officer is an insider for purposes of §503(c). The court's analysis of the job responsibilities of the officers also provides useful insight into the evidence necessary to rebut the presumption that an officer is an insider. ■

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33 *Id.*
34 *Id.*