LAMSON, DUGAN AND MURRAY, LLP
ATTORNEYS AT LAW

BUSINESS COUNSELING UPDATE

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A SAFE HARBOR?

Lamson, Dugan and Murray, LLP, was recently involved on behalf of clients in a significant case interpreting a little-known provision of the United States Bankruptcy Code. *Contemporary Industries Corporation v. Frost*, 564 F.3d 981 (8th Cir. 2009), arose in the context of the attempted avoidance by the debtor, Contemporary Industries Corporation ("CIC"), of an alleged constructive fraudulent transfer. CIC, a privately-held corporation, had filed a voluntary Chapter 11 bankruptcy petition and then instituted a proceeding within the bankruptcy seeking to recover payments that the former shareholders of CIC had received in exchange for their stock during a "leveraged buyout," claiming that the payments were voidable as fraudulent transfers under the Bankruptcy Code and the Nebraska Uniform Fraudulent Transfer Act. Put simply, section 548 of the Bankruptcy Code permits the avoidance of a "fraudulent transfer" where the debtor had received less than a reasonably equivalent value in exchange for such transfer or obligation and was insolvent on the date of the transfer or was engaged in a business or transaction or about to engage in a business or transaction for which property remaining with the debtor was an unreasonably small capital.

This section of the Bankruptcy Code has frequently been applied to "leveraged buyouts" where selling shareholders sell all or substantially all of their interest in an entity to a third-party purchaser which in turn borrows the funds with which to make the purchase, pledging the assets of the purchased entity to the lender, and thereby highly leveraging the entity. The typical scenario is that the shareholders of company A sell their interest in A to investors X, Y and Z who in turn pledge the assets of A to the lending institution. The theory is that the selling shareholders have removed substantially all of the value from the corporation, leaving it with inadequate capital to continue operations post-sale. There is considerable debate about the wisdom or fairness of such an application of section 548, but that was not the issue on which the CIC case ultimately turned.

There is an often overlooked exception to the avoidability of a constructive fraudulent transfer as described above. Specifically, section 546(e) of the Bankruptcy Code provides that "the trustee may not avoid a transfer that is a … settlement payment, as defined in section … 741 of this title, made by or to a … financial institution … that is made before the commencement of the case, except under section 548(a)(1)(A) of this title [this section pertains to actual fraudulent transfers, not here relevant]."

In the CIC case, the selling shareholders moved for summary judgment in the bankruptcy court, contending that the payments that they received for their stock were "settlement payments" within the meaning of section 546(e). The bankruptcy court had concluded that the payments were settlement payments within the plain language

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of the applicable statute, and granted the selling shareholders' motion for summary judgment. This decision was affirmed by the U.S. District Court for the District of Nebraska, which decision was then appealed to the United States Court of Appeals for the Eighth Circuit.

The shareholders contended on appeal, and the bankruptcy and district courts had held that the payments they received in exchange for their privately-held CIC stock were exempt from avoidance within the plain meaning of the language quoted above. CIC contended, however, that the payments could not be settlement payments under section 546(e) because that section was enacted to protect the stability of financial markets and only intended to protect payments made to settle public securities transactions. CIC also contended that the payments were not made "by or to" a financial institution within the meaning of section 546, because the bank which had handled the escrow, First National Bank of Omaha, never obtained a beneficial interest in the funds.

The Court of Appeals began by looking at the statutory language itself, considering first whether the payments at issue were settlement payments within the meaning of section 546(e), and quoting the definition of settlement payment in section 741(a): "Settlement payment is defined as 'a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade.'" The Eighth Circuit, noting that it had not had occasion to decide this question before, observed that three other U.S. courts of appeal have concluded that the quoted language is extremely broad, and intended to encompass most payments that can be considered settlement payments. The Tenth Circuit, the Third Circuit, and the Ninth Circuit all have so held.

The Court of Appeals also rejected CIC's argument that because the bank did not ever obtain a beneficial interest in the funds at issue, the case did not fit within the requirement that the payments be made "by or to a '…financial institution'." The court conceded that a divided panel of the Eleventh Circuit Court of Appeals had endorsed that argument in refusing to apply section 546(e) to protect similar payments to selling shareholders. *In re Munford, Inc.*, 98 F.3d 604 (11th Cir. 1996). However, the Eighth Circuit concluded that because section 546(e) protects settlement payments "made by or to a … financial institution" and does not expressly require that the financial institution obtain a beneficial interest in the funds, the Eleventh Circuit's holding in *Munford* does not square with the plain language of the statute.

The court thus concluded that the payments at issue were "settlement payments" made "by or to a … financial institution," and that the payments therefore satisfied both requirements necessary to invoke the protections of section 546(e): where statutory language is plain and does not lead to an absurd result, a court's duty is to enforce the language as written.

This case is important because it places the Eighth Circuit Court of Appeals, which is, after the U.S. Supreme Court, the ultimate interpreter of federal law in seven Midwestern states, including Nebraska and Iowa, on record as holding that the broader, selling-shareholder-friendly interpretation of the applicable statutory sections is the appropriate reading of the law.[1] This could be significant for entities and shareholders contemplating stock or asset sales, and should at least reduce the risk of the application of the controversial constructive fraudulent transfer principles to arms-length sales of businesses, given proper planning.

Frank M. Schepers

E-MAILS CAN MODIFY CONTRACTS

We send e-mails so casually and with such informality, even in the business environment, that it is easy to forget that they may carry significant legal consequences. It is only prudent to bear in mind that even e-mails written in the most conversational style may create legal obligations no less binding than a more conventional written agreement laden with legalese and signed with all the formalities.

If a business wants to entirely avoid the possibility of having e-mails treated as binding amendments to existing contracts, the best approach is to be as clear and direct as possible on the subject by including language in contracts to the effect that e-mails do not count as signed writings for purposes of any contract amendments.

Cautionary Case

A recent cautionary case on point involved an individual who sold his

[1] On July 6, 2009, as this newsletter was going to print, the U.S. Court of Appeals for the 6th Circuit (encompassing the federal court districts located in Michigan, Ohio, Kentucky and Tennessee), adopted the Eighth Circuit's approach as articulated in the *CIC* case discussed in this article, applying a broad interpretation to the terms "settlement payment" and "by or to a ...financial institution." In *In re QSI Holdings, Inc.,* a case somewhat similar to our *CIC* case, the Sixth Circuit held that the settlement payment exception was not limited to public securities transactions, and that the financial institution involved was not required to have a beneficial interest in the funds transferred, citing *CIC* with approval on both points.

public relations firm to a global communications company. The deal included an employment contract under which the seller was to continue as chairman and CEO of the new company for three years. Soon, the new company was losing money and the seller was presented with the option of either leaving or taking on new responsibilities.

E-mail then entered the picture when an employee of the communications company sent yet another option to the seller in an e-mail that spelled out how the seller would allocate his time. The seller replied by e-mail that he enthusiastically accepted that proposal. For his part, the representative of the communications company replied by e-mail that he was thrilled with the seller's decision to accept the new offer. In both e-mails the sender had typed his name after the message.

The seller later had a change of heart and sued to enforce the terms of the original employment agreement. An appellate court ruled against him on the ground that the exchange of e-mails on the new employment proposal constituted a binding amendment to the employment agreement. This was so even though the original agreement required that any changes had to be in the form of signed writings.

The court reasoned that the e-mails effectively were signed writings because the parties' names appeared at the end of the e-mails, signifying an intent to authenticate the preceding contents of the messages. Likewise, the e-mails also were signed writings for purposes of the Statute of Frauds, which requires certain contracts to be in writing in order to be enforceable. In short, when the seller and his e-mail correspondent clicked "send" and "reply," they were sealing a new deal that the seller could not avoid even though it was in an electronic form.

AGE DISCRIMINATION IN EMPLOYMENT

When the federal government required one of its defense contractors to reduce its workforce, the contractor first evaluated its employees based on the criteria of "performance," "flexibility" and "critical skills." After adding points to scores for years of service, the employer arrived at a list of 31 employees to be laid off. On their face, the criteria were age-neutral, but all but one of the employees chosen to receive a pink slip were at least 40 years old, within the age group protected by the federal Age Discrimination in Employment Act ("ADEA").

The laid-off employees sued their former employer under the ADEA, alleging the disparate impact form of age discrimination. Disparate impact refers to the use of policies or criteria by an employer in making employment decisions that are not overtly based on age, but which, when applied, allegedly have a disproportionate impact on older individuals. (The other type of employment discrimination, known as "disparate treatment," asserts that the employer intentionally treated applicants or employees differently because of their age.)

The plaintiffs first established, using statistical experts, that such a skewed result against older workers under the layoff criteria would rarely happen by chance, and that the same factors that were most closely linked statistically to the older employees–flexibility and critical skills–were also the factors most influenced by the discretion of the contractor's supervisors.

The contractor countered that it was not liable because the ADEA provides that an employer action is not unlawful if differentiation among employees is based on "reasonable factors other than age" ("RFOA"). A jury returned a multimillion-dollar verdict for the plaintiffs. Ultimately, the case reached the United States Supreme Court, which upheld the judgment for the plaintiffs.

The critical issue determined by the Supreme Court was whether the RFOA element needed to be proven by the plaintiffs or by the defendant employer. In other words, did the plaintiffs have to prove that there were no reasonable factors other than age underlying the employer's decision, or did it fall to the employer to present an "affirmative defense" and prove the existence of the other reasonable factors? Examining the language of the ADEA and taking note of a previous ruling where a similar provision in the law was in the nature of an affirmative defense, the Court ruled that RFOA is an affirmative defense that the employer must prove and, in this case, had not.

The Court's opinion anticipated criticism, which, in fact, was forthcoming, that its decision could open the floodgates for similar claims and make it too easy for plaintiffs to prevail. It pointed out that, even before the RFOA affirmative defense comes into play, the plaintiff in an ADEA disparate impact case must isolate and identify specific

performance practices by the employer that are responsible for statistical disparities disfavoring older workers. As the Court put it, "[t]his is not a trivial burden."

However, concerns about tilting the scales too far against employers should be directed at Congress, according to the Court, since it created the RFOA concept and made it a defense to be proven by employers.

ESTATE PLANNING: A GIFT OF DEBT

If you inherit property, of course you should be grateful and count your blessings. Still, consider the possibility that the gift may come with a big string attached–a debt linked to the property, such as is particularly common with real estate or a car. In that event, the question arises as to whether the debt must be satisfied from the particular asset or from the decedent's estate more generally. How this question is answered can cause a big swing in the respective gift amounts for beneficiaries of an estate.

Historically, the law presumed that the debt was *not* to be paid from the property that was connected to it. The reasoning was that a true gift should not come laden with such a burden. Over time, as taking on debt became commonplace, this thinking changed and statutes flipped the conventional assumption. Increasingly, these laws start from the premise that the property left to someone includes the debt on the property, unless the decedent in his or her will clearly indicated a different intent. That is where careful estate planning, with professional guidance, comes in.

It is best to leave no doubt for the ordinary lay reader of a will. A general directive in the will to pay all debts of the testator is too nebulous. Instead, if the intent is not to keep the asset joined to the debt, language something like this should be used in a will: "If [the specific asset] is subject to a mortgage, security interest, or other lien, I direct that my executor pay the debt from other property of my estate which is not given to a specific person or entity."

This scenario was played out recently in a case in which a farmer left to his (favored?) son three different farms, each of which was encumbered by debt. To his other son he left the residue of the estate. When the father died, the executor used part of the estate proceeds to pay off the loans to the farms, so that the first son would receive them debt-free. Not surprisingly, the second son, whose inheritance was thereby diminished, brought the matter to court.

The second son prevailed, forcing payment of the debts for the farms to come from the farms themselves. The father's will directed in a general way that debts were to be paid from the estate. However, under the relevant state statute, that was not a sufficiently explicit indication of intent to satisfy the debts on the farms from the residuary estate. In other words, the will had not clearly shown an intent that the first son was to receive the farms debt-free. As a result, the first son got the three farms, but he, not the second son, also got the responsibility for paying off the attached encumbrances, which totaled almost a quarter of a million dollars.

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