

*Executive Compensation and Employee
Benefits Under the New Code:
More Trouble For Troubled Companies?*

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These materials were not prepared or reviewed by Judge Drain and do not necessarily reflect his views and positions.

Bankruptcy Abuse Prevention Consumer Protection Act

- In 2005, Congress passed the Bankruptcy Abuse Prevention Consumer Protection Act (the “Act”).
 - The Act amended several aspects of the Bankruptcy Code (the “Code”) with the intention of curbing what appeared to be abuse of the vast array of protections that the Code affords debtors.
- With the Enron collapse as the front page example of corporate corruption, abuse and excess by corporate insiders,
 - One of the many provisions that Congress amended was the ability of debtors to offer their key employees, specifically “insiders,” retention bonuses and severance packages (otherwise known as KERPs).

What is a KERP?

- **A KERP is a Key Employee Retention Plan.**
- During times of uncertainty, companies often offer their key employees bonuses to secure continuity of their management.
 - With the exception of insider misconduct, the last thing a company wants to do during times of insecurity is to have a shift in management.
 - Management comprises the people with institutional knowledge who best know the ins and outs of the business.
 - Management also embodies the faith that the other employees, investors, and financiers will have in the ability of the company to rehabilitate itself after a merger or reorganization, or to successfully wind down the company's business in a liquidation.

What is a KERP?

- When a company files for bankruptcy protection, many of the company's most valuable employees may want to test the market, particularly if the filing is not pre-arranged.
- During a chapter 11 reorganization or a chapter 7 liquidation, employee retention programs may appear in various forms:
 - **Retention Bonuses:** An amount intended to incentivize employees to remain with the debtor through a particular date;
 - **Success Bonuses:** An amount or percentage tied to an employee's successful efforts in selling an important asset or to a company's successful emergence from chapter 11;
 - **Severance Bonuses:** An amount tied to the early termination of an employee.
- Historically, a debtor could choose to employ any combination of these techniques in order to retain employees.

KERPs Under the Pre-Act Code

- KERPs were a major part of a chapter 11 reorganization.
 - The more companies came to rely on KERPs as an incentive, the more those in management came to expect that they would be able to pay themselves large bonuses.
 - Approval of KERP motions came under a variety of Code sections.

KERPs Under the Pre-Act Code

- Sections 363(b) and 105(a) were the most commonly cited provisions for the court’s authority to grant KERP motions:
 - **Section 363(b) provides**: “The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate. . . .”
 - **Section 105(a) provides**: “The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”

KERPs Under the Pre-Act Code: Judicial Standards for Authorizing a KERP

■ **Fair & Reasonable:**

- Facts and Circumstances Test
- Expert Testimony

■ **Business Judgment:**

- Usually based on a showing that (1) the debtor risked losing the employees covered under the plan; (2) the program is designed to minimize that risk; and (3) the debtor would suffer a loss if it could not retain employees.

■ **Presumption that debtor acted in good faith and for the benefit of the debtor's estate.**

KERPs Under the Pre-Act Code: Assumption of Pre-Bankruptcy KERPs

- Another possible means for having KERPs approved by the court is for the debtor to assume pre-petition KERP programs under section 365.

KERPs Under the Pre-Act Code: For the Benefit of the Estate

- Once approved, KERP payments were made pursuant to section 503(b) as an Administrative Expense.
 - Section 503(b) provides:
 - After notice and hearing, there shall be allowed, administrative expenses . . . including
 - **(1)(A) the actual, necessary costs of preserving the estate. . . .**
- Payment of KERPs as an Administrative Expense was an indication that the court and the debtor believed that the KERP was a benefit to the estate (i.e., it preserved the estate's value).

Changes to KERPs Under the Act

- **Certain high-profile bankruptcies created an environment in which Congress came to believe that debtors were abusing the ability to pay retention and severance bonuses as a benefit to the estate.**

- **In re Enron, et al.**, Case No. 01-16034 (Bankr. S.D.N.Y.):
 - Pre-filing bonuses equaled \$105 million.
 - Retention bonuses of \$38.2 million in 2002, \$29 million in 2003, and \$36.3 million in 2004.

- **In re WorldCom, et al.**, Case No. 02-13533 (Bankr. S.D.N.Y.):
 - KERP equaled \$25 million.

- **In re Kmart, et al.**, Case No. 02-02474 (Bankr. N.D. Ill.):
 - \$150 million to key employees.
 - \$2.5 million to CEO.

Changes to KERPs Under the Act: Overview

- Amended section 503(c) of the Code was likely a reaction to what may have seemed like abusive and excessive payments to senior management during the bankruptcies of companies that were forced into bankruptcy as a result of “insider” greed and misconduct.
- As a result, amended section 503(c) severely limits the ability of the debtor to pay its management and key employees post-petition retention bonuses and severance packages.

Changes to KERPs Under the Act: “Insiders”

- Newly added sections 503(c)(1) and 503(c)(2) address retention and severance bonuses to “insiders.”
 - Sections 503(c)(1) and 503(c)(2) both look to place a cap on the ultimate amount a company may pay for incentivizing its management and maintaining company loyalty.

Changes to KERPs Under the Act: Definition of an Insider

■ **Who is an insider?**

- Section 101(31) defines the term “insider” for a debtor that is a corporation as a:
 - Director,
 - Officer,
 - Person in Control,
 - Partnership in which the debtor is a general partner,
 - General partner of the debtor, or
 - Relative of a general partner, director, officer, or person in control of the debtor.
- Additionally, the term “insider” includes:
 - affiliates, or insider of an affiliate as if such affiliate were the debtor; and
 - managing agent of the debtor.

Changes to KERPs Under the Act: Section 503(c)(1)

■ Section 503(c)(1) provides:

- (c) Notwithstanding subsection (b), there shall neither be allowed nor paid—
 - (1) a transfer made to, or an obligation incurred for the **benefit of, an insider of the debtor** for the purpose of inducing such person to remain with the debtor's business, absent a finding by the court based on evidence in the record that—
 - (A) the transfer or obligation is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation;
 - (B) the services provided by the person are essential to the survival of the businesses; and
 - (C) either—
 - The amount of the transfer made to, or obligation incurred for the benefit of, the person is not greater than an amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to non-management employees for any purpose during the calendar year in which the transfer is incurred; or
 - If no such similar transfers were made to, or obligations were incurred for the benefit of, such non-management employees during such calendar year, the amount of the transfer obligation is not greater than an amount equal to 25 percent of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider for any purpose during the calendar year in which such transfer is made or obligation is incurred.

Changes to KERPs Under the Act: Section 503(c)(1) Breakdown

- To be allowed to pay an “insider” a retention bonus, the Act requires that the debtor show that:
 - (1) the retention payment is **“essential to” the debtor’s business because**
 - The “insider” has a **bona fide job offer**
 - The bona fide job offer is **for the same or greater amount; AND**
 - (2) the services that the **“insider” provides are essential to the survival of the business, AND**
 - (3) **either**
 - (1) the amount paid is **capped at 10 times the amount paid under a similar program to non-management** employees during that calendar year, **OR**
 - (2) the **obligation is not greater than 25% more** than the amount paid to that insider in the year before the year the bonus payment is made.

Changes to KERPs Under the Act: Section 503(c)(2)

- Section 503(c)(2) provides:
 - (c) Notwithstanding subsection (b), there shall neither be allowed nor paid—
 - (2) **A severance payment to an insider** of the debtor unless
 - (A) the payment is part of a program that is generally applicable to all full-time employees; and
 - (B) the amount of the payment **is not greater than 10 times the amount of the mean severance pay given to non-management employees** during the calendar year in which the payment is made.

Changes to KERPs Under the Act: Section 503(c)(3)

- Section 503(c)(3) provides:
 - (c) Notwithstanding subsection (b), there shall neither be allowed, nor paid—
 - (3) other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers or obligations incurred for the benefit of officers, managers or consultants hired after the filing of the petition.

Recent Cases Applying Sections 503(c)(1)-(3)

- Very few cases that have been filed since the enactment of the Act have attempted to tackle all the potential obstacles to getting a KERP approved under section 503(c)(1) or 503(c)(2).
- The obvious key to avoiding the many likely difficulties that arise in trying to get a KERP approved under sections 503(c)(1) and (c)(2) is to not cover any “insiders” under the KERP.
- We have yet to find a case in which the debtor successfully sought to approve an “insider” KERP pursuant to the terms of section 503(c)(1).

New Standard Under Section 503(c)(3)?

- Section 503(c)(3) could be interpreted as having only one requirement:
 - That a payment not in the “Ordinary Course” can be allowed as an administrative expense only if the “facts and circumstances” of the case permit such a payment.
- Is this standard any different from the former standard under section 363?
 - The Refco KERP order, which allowed the payment of retention bonuses to non-insiders, seems to imply that the standards are the same.
- Is the section 503(c)(3) standard less stringent than the former standard under section 363?
 - What has yet to be determined is whether the debtor’s business judgment and the fairness and reasonableness of a non-insider retention bonus plan will be considerations in deciding whether the facts and circumstances justify a payment under section 503(c)(3).

Other Alternatives

- Some of the interesting ways in which debtors have tried to get around, or not get around, the restrictions under the newly added section 503(c) include:
 - Complying with the caps;
 - Avoiding payments to insiders in the first instance (other employees may ultimately be more valuable to the company); and
 - Re-characterizing retention bonuses and severance packages so as not to risk coming under the definitions of section 503(c)(1) or 503(c)(2).

Other Alternatives:

- Some other alternatives have been raised by debtors:
- In **In re FLYi, Inc., et al.**, Case No. 05-20011 (Bankr. D. Del. Feb. 3, 2006), the debtors argued that if the court found that the Employee Wind-Down Plan did not comply with section 503(c)(1), debtors would seek authority to:
 - enter into post-petition employment agreements with insiders covered by section 503(c)(1) at a base salary equal to the amounts payable under the Employee Wind-Down Plan;
 - terminate the employment of such insiders and enter into consulting agreements with independent contractors;
 - demote the insiders so that they are no longer considered “insiders”; or
 - establish incentive-based bonuses on the assumption that they can meet the requirements of section 503(c).

Other Alternatives:

Compensation Committees

- In In re Musicland Holding Corp., et al., Case No. 06-10064 (Bankr. S.D.N.Y. Jan. 2006), the debtors requested authority to continue paying certain management employees under their pre-petition incentive program (the “Modified Corporate MIP”). The debtors argued that the pre-petition incentive program does not come within the purview of section 503(c) because they are only seeking (a) to continue a pre-existing program and (b) to conform those payments under the pre-existing plan with the company’s current financial condition and to prevent inequities among employees covered under different plans.
- The debtors also proposed forming a compensation committee consisting of the CEO and other members of the Board of Directors for the purpose of determining, on an individualized basis, payments to be made to covered employees.
- The court approved the Modified Corporate MIP in part, ordering a continuance with respect to amounts payable to 5 covered employees, and the debtors subsequently sought a withdrawal of the motion with respect to those 5 employees.

Is Section 503(c) Working?

- What were the actual goals of section 503(c)?
 - One can presume that at least one goal was to cut back on the amounts expended by debtors in order to retain their employees.
- Is this goal being accomplished?
 - Look at a prime example, Enron's first KERP and Refco's first KERP:
 - Dollar for dollar, based on the total number of employees covered and the length of time, Refco is paying more to keep 32 employees on board for 3 months than Enron paid to keep over 1,000 employees happy for one year.

What's Next? Underqualified & Under-Incentivized

- Is management going to stick around?
 - If management does not choose to stay, are we going to end up with an entire industry of part-time management teams entering the field solely to manage a company through bankruptcy? (Who really guides a company through bankruptcy?)
 - Will these management teams have the knowledge and expertise necessary to guide the company through bankruptcy?
 - Will they be sufficiently incentivized to accomplish the goals of their temporary employment?
 - Will the underqualified pinch hitters continue on as management after a successful reorganization?

What's Next? “Bona Fide Job Offers”

- For management teams that do choose to stay with the company through the bankruptcy process, is it possible to implement a successful retention bonus for “insiders”?
 - What company is going to offer the management of a company in bankruptcy a “bona fide job offer” knowing that the employee is simply going to take that offer in order to get his retention bonus with his current company?
 - If a management employee goes to other companies in search of a new job, will those companies only make offers below the employee’s prior compensation in order to ensure that the employee will not be able to use the offer to shop for a higher retention bonus?
 - Will management be forced to quit before looking for new employment?

APPENDIX

- **In re FLYi, Inc., et al.**, Case No. 05-20011 (Bankr. D. Del. Feb. 3, 2006)

Recent Cases Applying Sections 503(c)(1)-(3): FLYi–

- **In re FLYi, Inc., et al.**: Debtors sought approval of a wind-down plan and bonus structure that would have covered insiders as well as non-insiders under section 503(c)(3). The bonus structure was ultimately approved under section 503(c)(3) for non-insiders and under section 503(c)(2) with respect to insiders.
 - Initially debtors argued in their motion that the wind-down compensation plan for the “insiders” fell outside the requirements of section 503(c)(1) and should be governed by section 503(c)(3).

Recent Cases Applying Sections 503(c)(1)-(3)

■ **FLYi’s argument that its wind-down plan complies with new section 503(c)(1):**

- “Section 503(c)(1) only applies to payments that are meant to induce insiders to ‘remain with the [debtors’] business’ by requiring . . . that the insider (a) has a bona fide job offer from another business and (b) is ‘essential to the survival of the business.’” **In re FLYi, Inc., et al.**, Case No. 05-20011 Emergency Motion Of The Debtors For An Order (I) Authorizing Them To Discontinue Their Scheduled Flight Operations And Take Certain Actions In Connection Therewith; (II) Approving A Wind-Down Employee Plan; (III) Approving The Payment Of Certain Severance, Vacation And Other Benefits And Amounts To Terminated Or Furloughed Employees; And (IV) To The Extent Necessary, Authorizing The Modification Of Collective Bargaining Agreements Pursuant To Section 1113(e) Of The Bankruptcy Code In Connection Therewith (“Motion”) ¶ 33, (Bankr. D. Del. Feb. 3, 2006) (quoting 11 U.S.C. § 503(c)(1)(A) and (B)).

Recent Cases Applying Sections 503(c)(1)-(3)

- FLYi argued that the “insider” restrictions of section 503(c)(1) do not apply when there is no “business” to induce such insiders to continue working for the company.
 - “If ‘business’ in section 503 were construed to mean something other than a viable commercial enterprise, no retention payment could ever be made to insiders in a liquidating chapter 11 case.” Motion ¶ 34.
- They further argued that even if debtors are still a business for the purpose of section 503, the Wind-Down Employee Plan is not intended to induce any employee to remain with the debtors’ businesses. Rather it “is intended to create incentives for employees to wind-down the Debtors’ affairs” Motion ¶ 35.
 - According to the debtors, there is a distinction in job function between working as part of a team whose goal is to operate the business and working to shut down the company’s business.

Recent Cases Applying Sections 503(c)(1)-(3)

- The U.S. Trustee argued that there is nothing to suggest that the statute applies only to businesses that are going concerns.
- Furthermore, the debtors did not show that they met the requirements of section 503(c)(1) since nowhere in the debtors' Motion does it mention that the employees have a “bona fide offer from another business at the same or greater rate of compensation.” 11 U.S.C. § 503(c)(1). Rather, the Motion only mentions that without the Wind-Down Employee Plan employees may look for new employment and accept it.
- Finally, the payments to the insiders proposed under the Wind-Down Employee Plan are not severance payments that can satisfy section 503(c)(2) because these employees are not being terminated.

Recent Cases Applying Sections 503(c)(1)-(3): FLYi Compromise

- Ultimately the debtors and the U.S. Trustee reached a compromise:
 - While the U.S. Trustee initially argued that the plan should not be considered a severance package, the debtors and the U.S. Trustee reached an out-of-court agreement whereby the wind-down insider bonuses would be capped and paid pursuant to section 503(c)(2) (the “insider” severance provision).

- **In re Pliant Corp., et al.**, Case No. 06-10001 (Bankr. D. Del. Jan. 3, 2006)

Recent Cases Applying Sections 503(c)(1)-(3): Pliant Corporation

- **In re Pliant Corp., et al.**: As part of their first-day motions, the debtors submitted a motion to continue paying its pre-petition wages and to continue paying their “Salaried Employee Severance Program.” Rather than trying to meet the requirements of section 503(c)(2), the debtors merely noted that to the extent there are “insiders” covered by the “Salaried Employee Severance Program,” the debtors do not seek authority to pay severance to insiders greater than 10 times the amount of mean severance paid to non-management employees.

- **In re Nobex Corp.**, Case No. 05-20050 (Bankr. Del. Dec. 9, 2005)

Recent Cases Applying Sections 503(c)(1)-(3): Nobex

- **In re Nobex Corp.**: Debtor filed a motion for the authorization to make payments based on a “sale-related incentive” program to senior management.
 - Even though the plan included the payment of certain “insiders,” the debtor argued that these payments fall under section 503(c)(3) as opposed to section 503(c)(1).

Recent Cases Applying Sections 503(c)(1)-(3): Nobex

- **Debtor’s argument:** “The additional incentive pay proposed in the motion is designed and intended to ensure complete implementation of the sale procedure. This incentive pay is not intended and is not structured as compensation to induce either to continue their post-petition employment with the debtor, to refuse other offers of employment or to receive severance upon termination of their post-petition employment.” In re Nobex Corp., Case No. 05-20050, Motion for Order Authorizing Payment of Sale-Related Incentive Pay to Senior Management Pursuant to 11 U.S.C. §§ 105, 363(b) and 503(c)(3) (“Motion”) ¶ 21 (Bankr. Del. Dec. 9, 2005).

Recent Cases Applying Sections 503(c)(1)-(3): Nobex

- In other words, debtor argued that there is a cap on “insider” retention bonuses, a cap on “insider” severance payments, and then a general prohibition regarding payments that are outside the ordinary course and not justified by the facts and circumstances of the case.
- Nobex’s motion raises the question of where the common practice of “success bonuses” would fall with respect to the new provisions of section 503(c).
- Is section 503(c)(3) a catch-all provision?

Recent Cases Applying Sections 503(c)(1)-(3): Nobex

- As one can imagine, the U.S. Trustee objected on the grounds that:
 - not only did the debtor's motion on its face show that it intended the bonuses to be retention bonuses,
 - but to allow debtors, generally, to re-characterize bonuses that otherwise are retention or severance bonuses so that they may fall outside the confines of sections 503(c)(1) and 503(c)(2) would render those sections meaningless.
- The U.S. Trustee's arguments were to no avail and the court authorized the sales incentive bonuses under section 503(c)(3).

- **In re Refco, et al.**, Case No. 05-60006 (Bankr. S.D.N.Y.
Dec. 21, 2005)

Recent Cases Applying Sections 503(c)(1)-(3): Refco

- Another way of avoiding the obstacles of the new section 503(c) is to avoid paying insider bonuses in the first instance.
- Refco filed a motion for the authorization of a Key Employee Retention Plan; however, the motion specifically did not cover any “insiders.”
- One of the questions that the Refco KERP raises is whether non-insider employee retention and severance bonuses simply must meet the old requirements of sections 105 and 363 or whether there is an additional requirement under section 503(c).

Recent Cases Applying Sections 503(c)(1)-(3): Refco

- **In re Refco, et al.**,: The order was approved in accordance with the old Code standards under sections 105 and 363, without mention of objections that raised the debtors' lack of reference to section 503(c).
- The order allowed debtors to pay 32 "Key Employees" both a year- end bonus and a performance bonus expected to total \$1.4 million. To receive the bonus employees must be employed on December 31, 2005 and work through the earlier of March 31, 2006 or termination of employment. Voluntary departure before target date forfeits any right to payment of the performance bonus.