Management compensation and incentive programmes after bankruptcy reform

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The basic model for US corporate bankruptcy is to leave the debtor in possession during a Chapter 11 to achieve a successful reorganisation, or in some instances a successful liquidation. Senior management and officers – those most knowledgeable about the business – continue to oversee the company, thereby ensuring continuity throughout the Chapter 11 process. However, when a company is in financial difficulty and may need respite from its creditors, there is a significant risk that key employees will jump ship and seek more reliable employment. How does a company in distress retain its senior executives and key personnel when their personal futures are as uncertain as that of the company? Moreover, it is widely recognised that distressed companies need to incentivise key employees properly to induce them to work with the company during the Chapter 11 to maximise value and hopefully turn the company around.

The law of senior management retention and incentives before reform: the impact of Enron

In the past, incentivising key employees and senior management to remain with the company in return for a staying bonus was routine in a Chapter 11. Key employee retention programmes (KERPs) were used to maximise employee buy-in to a company's turnaround and recovery and became commonplace in modern Chapter 11 cases. A KERP often required a debtor's use of property of its estate (ie, money) outside the ordinary course of its business, and therefore also required bankruptcy court approval under Section 363(b) of the US Bankruptcy Code. In order to have a KERP approved by the bankruptcy court, the debtor had to demonstrate that there was a "sound business reason" for the programme and that it was fair and reasonable. This sort of corporate decision-making is usually supported by "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was in the best interests of the company" (*Brehm v Eisner*, 746 A 2d 244, 264 n 66 (Del 2000)). Generally, bankruptcy courts did not and do not want to micromanage the company's use of its property outside the ordinary course of its business, and therefore will defer to a debtor's business judgement so long as there is a sound business purpose to justify the use in question.

Before the Bankruptcy Abuse Prevention and Consumer Protection Act (the 'Bankruptcy Reform Act') became effective in October 2005, KERPs complemented, modified or even replaced severance programmes, annual incentive plans, consulting deals, pension plan modifications and bonus provisions in employment contracts for senior management, including insiders. KERPs enhanced ordinary compensation and bonus levels to those identified as key employees – arguably so that they would accept aligning their professional futures and reputations with a distressed company that had a higher-than-usual chance of failure. Not infrequently, KERPs were negotiated and proposed on the eve of the filing of a bankruptcy or promptly after the bankruptcy commenced. The bonuses were promised to senior management to induce them to stay with the company with assurance that the company's officers would promptly seek court approval of the programme. In reliance on the company's promises, most key employees would work through the Chapter 11, anticipating a bonus for their loyalty.

Prior to the enactment of the Bankruptcy Reform Act, organised labour and creditors often argued that KERPs were unnecessary for senior management and officers and inequitable for a debtor's total workforce given the sacrifices required of such workers in bankruptcy (eg, job losses and pension and wage concessions). It could be argued that, once the case is filed, senior management owed the debtor and its creditors a fiduciary duty to attempt to reorganise successfully without the inducement of enhanced compensation. Many contended that it was senior management's failures that caused the company to file Chapter 11, and there was no justification for rewarding their actions.

Nevertheless, in the years running up to bankruptcy reform, KERPs became common in complex Chapter 11 cases in the United States and were almost a market feature of executive compensation in a distressed context. More often than not, courts deferred to the debtor's business judgement and the argument that without a retention plan employees would resign in droves, putting the future of the company in grave peril and the recoveries to creditors at risk. While some may have questioned the intent and merit of a bonus programme that was proposed by the very insiders who would benefit personally from the programme, the courts upheld companies' decisions unless there was evidence that it was "so manifestly unreasonable that it could not be based upon sound business judgment, but only on bad faith, or whim or caprice" (*In re Aerovox*, 269 BR 74 (Bankr D Mass 2001)).

Then, in the early part of this decade corporate executives in the high-profile cases *WorldCom* and *Enron* were found to have engaged in self dealing and criminal conduct, decimating companies, jobs and pensions – to the grave detriment of rank-and-file employees. At the same time, mainly because of the various renowned corruption cases involving corporate officers, KERPs were characterised, fairly or unfairly, as a licence to enable senior managers to cash in on corporate and labour market disasters for which they bore substantial responsibility. This perceived inequity caused Congress to enact Section 503(c) of the Bankruptcy Code, which places significant restrictions on KERPs.

The Bankruptcy Code now severely restricts the ability to make retention or severance payments to insiders

The three subsections of Section 503(c) of the Bankruptcy Code:

- effectively prohibit retention programmes for insiders in Chapter 11 reorganisations outside a plan;
- place limitations on severance payments to insiders; and
- establish standards for benefits for non-insider employees, provided that the transfers or obligations are outside the ordinary course of the company's business and justified by the facts and circumstances of the case.

Section 503(c) makes it almost impossible to create a KERP that directly pays stay or retention bonuses to insiders. Indeed, there are no reported decisions approving any such KERP after October 2005 (eg, see *In re Dana Corp ('Dana I')*, 358 BR 567, 576 n 11 (Bankr SDNY 2006).

In order to offer a retention bonus to an insider, the requirements of Section 503(c)(1) must be met and applied strictly. First, the debtor has to show that an insider has a pending job offer that exceeds the insider's existing compensation package (inclusive of commissions, benefits, stock options and all wage equivalents or supplements). It then has to prove that the company would fail without the insider's continued employment. Finally, no insider KERP can be approved unless non-management employees have benefited from a KERP in the same year, or unless the debtor has in place a KERP that benefited the insider in question in the previous calendar year. If the first two hurdles are overcome, the court must then apply a formulaic and conservative approach to ensure that the benefits for insiders are not substantially in excess of those provided to non-managerial employees.

In effect, as a threshold matter an insider must have in hand a better paid job offer, presumably with a financially sound company. If that is the case, why would the insider choose the uncertainty of staying with a Chapter 11 debtor that may or may not reorganise, for a stay bonus that is subject to a formulaic cap and is likely to be less valuable than incentives available to the executive pre-petition. The company then has to demonstrate that the insider's exit will cause the company to fail –

that is, that the insider is irreplaceable. This is an impossible burden for any company that uses professional managers for which a relevant labour market exists. These provisions of the Bankruptcy Reform Act accomplish Section 503(c)(1)'s intended objective, effectively precluding any debtor from making retention benefits available to insiders in a Chapter 11 case.

In addition, Section 503(c)(2) of the Bankruptcy Code appears to prohibit severance payments to insiders unless the severance is part of an overall programme applicable to the general workforce and the various plans relating to severance covering that workforce. In that case, the severance payments to insiders are capped at 10 times the amount actually paid to non-management employees in a given calendar year.

Section 503(c)(3) of the Bankruptcy Code is a catch-all clause, intended to cover plans and programmes that are outside the ordinary course of a debtor's business and are not formally designed to retain insiders. While the section primarily seems to restate the old "sound business judgment" standard (*Dana I*, supra at 576-77; *In re Nobex Corporation*, Case No 05-20500 (MFW), nt at 86-87 (Bankr D Del, Jan 12, 2006)), it has been suggested that under Section 503(c) all compensation programmes that can have a retentive effect with respect to insiders are subject to stricter scrutiny under Section 503(c)(3) than the pre-Bankruptcy Reform Act sound business judgement test (*In re CEP Holdings, LLC*, slip op, 2006 LEXIS 3305 at *2 (Bankr ND Ohio, Nov 28, 2006)).

Overall, Section 503(c) of the Bankruptcy Code makes it much more difficult for a debtor to provide key employees with retention and performance incentives. Indeed, the only programmes characterised as KERPs for insiders since the Bankruptcy Reform Act came into force have been some modest Section 503(c)(2) severance programmes in middle-market debtor cases. In those instances the disparity between historical severance payments to insiders and the general workforce are not so excessive as to prohibit meeting the formula set out in Section 503(c)(2) (eg, see *In re Flyi, Inc*, Case No 05-20011 (MFW), nt at 14 (Bankr D Del, Jan 12 2006)).

Incentive plans versus retention plans: fact-sensitive distinctions

Due to the undoubted importance to a distressed company of incentivising key employees to remain with the company and maximising enterprise value or accomplishing a successful turnaround, debtors have been very creative in structuring programmes that fall within the ambit of Section 503(c). The most common approach to tackling the business problem posed to debtors by Section 503(c) is to develop post-petition compensation programmes that offer insiders and other key employees incentives to create value (or to continue pre-petition programmes that incentivise insiders and other senior managers). The basic concept is to require the creation of value for the estate as a condition to payment of compensation enhancements. Milestones have to be identified, including for example increased asset sale prices or enterprise value, increased cash and operating sales levels coupled with expense reductions, or successful negotiation and compromise of certain controversies.

It has been argued that the existence of incentive programmes creates an environment that is retentive in nature. Nevertheless, courts have consistently found that the prohibitions in Section 503(c)(1) are inapplicable to true incentive programmes, irrespective of the retentive effect of such programmes (*Dana I*, 351 BR at 103 – "I do not find that incentivizing plans which may have some components that arguably have a retentive effect, necessarily violate Section 503(c)'s requirements"; also see *In re Calpine Corporation*, Case No 05-60200 (BRL), nt at 84-85 (Bankr SDNY, Apr 26 2006) – incentives only paid where enterprise value increases and thus are not retention bonuses, but are performance based).

The following are examples of incentive plans that have been approved by bankruptcy courts since the Bankruptcy Reform Act, irrespective of retentive effects and insider eligibility to participate in bonuses:

- As a result of a negotiation between the debtor and the creditors' committee to resolve the committee's objection to the debtor's incentive programme as originally proposed, the debtor compromised and agreed to pay its chief executive officer and vice president for finance and administration a percentage of sale proceeds realised, but only if the sale proceeds exceeded a floor established by an already negotiated stalking horse bid for the debtor's assets (*Nobex*, slip op, 2006 Bankr LEXIS 417 at *6-8 (Bankr D Del, Jan 19 2006).
- Senior executives were permitted to receive a long-term incentive bonus if the debtor reached specific earnings before interest, taxes, depreciation and amortisation (EBITDA) levels up to an annual cap. The plan covered three

years and was payable in a mix of currencies, including company stock over the term of the plan *(In re Dana Corporation ('Dana II')*, 358 BR 567, 574, 584 (Bankr SDNY 2006)).
- Senior management and other tiers of key employee received bonuses equal to a sliding percentage of their base compensation if the debtor achieved certain levels of EBITDA for certain periods (*In re Nellson Neutraceutical, Inc*, 369 BR 787, 801-03 (Bankr D Del 2007)).
- Senior management was eligible to receive a rateable share of all or of 50 per cent of a quarterly bonus pool depending on the achievement on a quarter by quarter basis of:
  - EBITDA levels, and
  - certain other cash-flow benchmarks. Further, senior sales managers can receive bonuses based on percentages of base compensation if sales goals are met in a given quarter (*In re Global Home Products, LLC*, 369 BR 778, 785-86 (Bankr D Del 2007)).
- In the *American Home Mortgage Case* the Delaware Bankruptcy Court approved a plan offering critical employees (including an insider) familiar with the debtor's construction and mortgage loan business incentive bonuses to negotiate and compromise certain loans successfully. The plan was properly characterised as a sale-related incentive plan and not a retention or severance plan for insiders. Accordingly, it was not governed by Sections 503(c)(1) or (c)(2). Since the stay or retention bonus provisions applied only to non-insiders, it was authorised under the catch-all Section 503(c)(3), as it was justified by a sound business purpose.

However, the courts have refused to approve artificially low target completion bonuses and non-compete compensation for a chief executive officer as being effective retention bonuses prohibited by Section 503(c)(1) (see *Dana I*, 351 BR at 102).

Ordinary course benefit and performance plans

Some debtors have argued that longstanding bonus or pension plans are ordinary course business programmes that are excluded from the ambit of Section 503(c)(3) because the goal and purpose of the plan is not the retention of insiders. Further, debtors have caused pension plans to be modified and assumed in ways that are favourable to senior management, claiming that the modifications are ordinary course and not in the nature of severance, and were neither conceived nor modified for a primarily retentive purpose. These approaches have met with some success:
- The Delaware court in *Nellson Nutraceutical* found that a longstanding bonus programme based on driving EBITDA was in the ordinary course of the debtor's business. Although the programme, which was actually modified post-petition to lower EBITDA triggers to ensure payment of some bonus pool, was available to senior management, the court found that the programme was not designed to retain senior management in bankruptcy, but rather was designed, consistent with industry standards and the reasonable expectations of the debtor's stakeholders regarding the debtor's ordinary conduct of its business, to drive debtor cash flow. In this context, the court found both Sections 503(c)(1) and (3) inapplicable and the programme, as modified, was supported by the debtor's good-faith, reasonable business judgement (*Nellson Nutraceutical*, 369 BR at 801-04).
- In *Global Home Products* the court held that a sales performance incentive programme was an ordinary course business mechanism designed to incentivise performance in or out of bankruptcy, and therefore was not subject to the limits of Section 503(c) (*Global Home Products*, 369 BR at 786).
- Similarly, the court in *Dana II* (358 BR at 579-80) found that an annual incentive programme was ordinary course and non-retentive, even though it had been modified just prior to bankruptcy. The court said that the programme had "been a common component of compensation plans at Dana for the past fifty years and [did] not differ significantly from Dana's prepetition practice" (*id*).
- The *Dana II* court also held that the assumption of pension plans for senior management upon emergence from bankruptcy was not governed by Section 503(c). Focusing on the facts that the senior employees had already vested pension benefits under relevant plans in part and that the pension plan assumption was tied to the company's exit from bankruptcy and not to the employees' retention by the firm, the court found that the purpose behind the pension assumption was not retentive in nature and that the pension modifications were customary and ordinary plan adjustments and not in the nature of severance (*Dana II*, 358 BR at 577-78).

Other key issues relating to management incentives: insider status and source and effect of retentive benefits

The threshold question in evaluating an employee compensation enhancement programme is how to define an 'insider'. Courts have been fairly conservative in finding insider status (see *CEP Holdings*, slip op, 2006 LEXIS 3305 at *4 – insider status indicated where control is not indicated by title, but by organisational authority; *In re Refco Inc*, Case No 05-60006 (RDD), order approving implementation of key employee compensation programme, at 1-2 (Bankr SDNY, Jan 18 2006) – focusing on level of control exercised by senior employees in a liquidation and determining that in light of the course of the liquidation and its requirements, such employees were no longer insiders and the compensation programme could be evaluated under a business judgement test). Other courts have addressed whether the title of an employee is enough to deem him or her an insider. For example, many companies freely designate employees as vice presidents. In a recent case the court required an evidentiary hearing to determine if the title of vice president connoted control and decision-making authority or whether the employee was properly included in a stay bonus plan as a non-insider.

In limited situations insiders have received retention bonuses since the enactment of the Bankruptcy Reform Act. Some courts have approved contracting with former officers and insiders as consultants in capacities where those officers are providing strategic leadership and related services in exchange for a fee – even over objections that such consulting arrangements effectively deliver an insider a retention bonus (see *In re LG Philips Display USA, Inc*, Case No 06-10245 (BLS), nt at 38 (Bankr D Del, Apr 13 2006) – the court suggested, without holding, that agreement to provide consulting services for fee is not akin to agreement to be employed and to be paid a retention bonus).

Other courts have refused to upset pre-petition KERP planning where the bonuses are paid by a third party and where that third party is not seeking reimbursement from the estate. In *In re Airway Indus Inc* (354 BR 82 (Bankr WD Pa 2006)) the court approved retention bonuses for senior management that had been negotiated with the debtor's senior secured creditor pre-petition as part of the terms of a sale under Section 363 of the Bankruptcy Code. The court permitted the retention bonuses to be paid because the secured creditor and not the estate was the source of the payment, and importantly the bonuses were not added to the secured creditor's claim, thereby depleting estate recoveries.

Final notes

Section 503(c) of the Bankruptcy Code attempts to restrict severely transfers or obligations that have the effect of paying insiders merely to stay with distressed companies. It has largely succeeded in ending retention bonuses for insiders and other key employees. But the law has evolved sensibly in reaction to this prohibition. Retentive programmes can be approved that benefit senior management. However, debtors must diligently ensure that such bonus programmes are equitably structured to benefit non-management workers as well as officers and managers. Debtors must act to ensure that retentive incentive programmes:

- are cost-effective;
- derive from historical practice;
- are consistent with industry standards; and
- drive business performance or strategic success.

Post-Bankruptcy Reform Act incentive and bonus programmes for key employees must also be structured carefully and professionally so as not to deplete estate resources. Finally, debtors must be transparent regarding such programmes with key stakeholders (eg, official and *ad hoc* committees, lenders, key executory contract counter parties) to build support and consensus for these plans.