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WHAT'S INSIDE

TRENDS IN BANKRUPTCY COMPENSATION[1]

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Executives may find little motivation to remain employed at a company as annual bonus plans become compromised and long-term incentive vehicles (e.g. stock options, restricted stock) become virtually worthless. As a result, it is imperative that an organization implement an alternative compensation arrangement to retain key executive talent and incentivize them toward the level of performance necessary to achieve a successful restructuring. We summarize some of the different types of plans below.[1]

Key Employee Retention Plans (KERPs)

In effort to incentivize "non-insider" employees[2] to remain with the company during a bankruptcy period, "stay" bonuses are implemented through a Key Employee Retention Plan ("KERP"). These bonuses are often expressed as a percentage of the employee's base salary and distributed throughout the corporate transition period, generally, with the final (typically largest) payment linked to the process resolution (e.g. emergence, liquidation). Compensation under a KERP is typically in the form of cash.

For "insiders," since BAPCPA prohibits the use of retention programs companies must generally adopt alternative bankruptcy protection plans.

Key Employee Incentive Plans (KEIPs)

The increased restrictions brought forth by the BAPCPA pushed many companies to transition away from KERPs for "insiders" in favor of performance-based incentive plans, known as Key Executive Incentive Plans ("KEIPs"). This approach is not subject to the limitations imposed by Section 503(c)(1) as explained below, and rather, applies more liberal judgment standards to determine if the plan is viable for a debtor company. This determination can generally be made through ordinary business sense, and an evaluation of the facts and circumstances of a given case.

The performance metrics under these plans coincide with the company's goals and objectives and provide incentive payments to key employees who achieve these goals. Generally, these goals tend to be tied to financial metrics, restructuring goals, or a combination

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2 11 U.S.C. section 101(31)(B), defines an insider to be a director, officer, or person in control of the corporation, or a relative of such person. Additionally, parties can be deemed non-statutory insiders if their relationship with the debtor is so close that their conduct should be subject to closer scrutiny than that of those dealing with the debtor at arm's length.

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of both. The performance goals must not be a "lay-up," but instead must be a challenge to achieve.

In 2012, Chapter 11 debtors Hawker Beechcraft, Inc. ("Hawker") and Residential Capital, LLC ("ResCap") each filed motions seeking approval of KEIPs both of which were denied. In each case, the court found that the KEIPs were essentially disguised retention programs. The court in Dana Corporation's bankruptcy case ("Dana II") approved its modified executive compensation plan after finding that the debtors' second attempt at formulating a compensation plan was a true incentivizing plan for senior management and was wholly different than its initial proposed compensation plan.

In *In re Hawker Beechcraft, Inc.*, 479 B.R. 308 (Bankr. S.D.N.Y. 2012), the proposed KEIP offered to pay bonuses of up to 200% of annual base salary ($5.3 million) to 8 senior management employees upon the occurrence of a standalone restructuring or a third-party sale transaction. The judge concluded that while "the KEIP includes elements of incentive compensation, when viewed as a whole, it sets the minimum bonus bar too low to qualify as anything other than a retention program for insiders." It was determined that the minimum financial targets set in the KEIP were based on the current business plan and did not constitute stretch goals. This finding was supported by testimony that Hawker would certainly achieve its business plan projections unless there is a "whoopsie." Additionally, the court concluded that the time-based goals were not challenging, as the debtors were on track to achieve several of the deadlines and the deadlines could be extended with proper consent.

In *In re Residential Capital, LLC*, 478 B.R. 154 (Bankr. S.D.N.Y. 2012), the proposed KEIP would pay up to $7 million in bonuses to 17 members of the senior leadership team. The court denied the debtor's motion to approve the KEIP, finding that the program rewarded work that took place prior to the bankruptcy, and was structured to reward employees for simply remaining in employment instead of incentivizing them to meet performance goals. The judge noted that 63% of the KEIP bonuses were linked solely to closing the sale transactions that had been substantially negotiated pre-petition.

In *In re Dana Corp.*, 358 B.R. 567 (Bankr. S.D.N.Y. 2006), after the debtor had its initial compensation program rejected by the court because it was essentially a retention plan disguised as an incentive plan and could not pass muster under Section 503(c)(3), the program was modified as a true incentive plan. The court approved the revised plan, noting that the compensation plan was similar to incentive programs offered by the debtor prior to filing for bankruptcy, and therefore they were within Dana's ordinary course of business. In order to evaluate whether the revised plan could survive the strict scrutiny necessitated by Section 503(c), the court applied the following factors:

1. Whether there is a reasonable relationship between the plan proposed and the results to be obtained, i.e., will the key employee stay for as long as it takes for the debtor to reorganize or market its assets, or, in the case of a performance incentive, is the plan calculated to achieve the desired performance.
2. Whether the cost of the plan is reasonable within the context of the debtor's assets, liabilities, and earning potential.
3. Whether the scope of the plan is fair and reasonable; does it apply to all employees; does it discriminate unfairly.
4. Whether the plan is consistent with industry standards.
5. Whether the debtor engaged in due diligence related to the need for the plan, the employees that needed to be incentivized, and what types of plans are generally applicable in a particular industry.
6. Whether the debtor received independent counsel in performing due diligence and in creating and authorizing the incentive compensation.

Not surprisingly, bankruptcy courts generally disapprove motions to approve KEIPs where the majority of the work required to earn payments is performed prior to the bankruptcy filing date and the business goals are not difficult to achieve. As a result, companies considering the use of KEIPs should utilize performance metrics that are challenging to attain and that are not disguised KERPs.

Pre-Filing Retention Plans

A recent trend has been the use of a pre-filing retention plan for "insiders" and "non-insiders." The pre-filing retention plan is generally subject to a clawback provision where the employees must repay the amounts if they do not provide certain specified services for the required time period. Although the clawback provision could incorporate certain performance metrics, retention bonuses are typically time-based. The time period for which services must be performed to retain the bonus is typically at least 6 months but is oftentimes multiple years depending on the company's circumstances.

One potential concern is that payments under a pre-filing retention plan are a fraudulent transfer or a preference. The argument for these plans is that the estate is receiving value—the retention of key employees during a time of financial distress.

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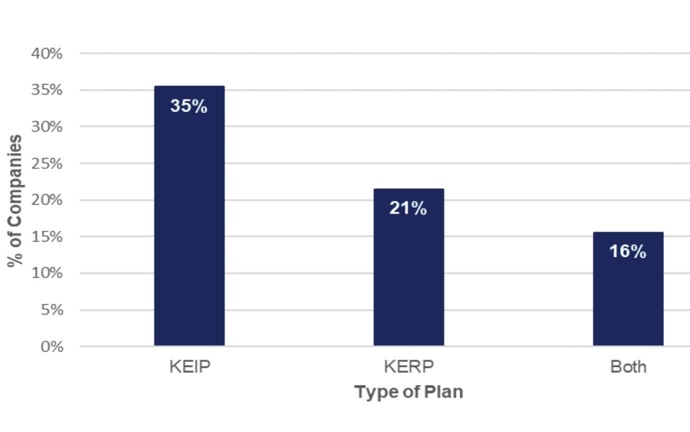
More companies are utilizing such plans due to their many advantages over using plans developed under the watchful eye of bankruptcy courts, and some of those advantages include:

1. Eliminating the need for negotiations with courts and creditors;
2. Focusing on employees who may be contemplating leaving the company; and
3. Having the flexibility to either broadly or narrowly focus plans depending on the organization's needs.

As with all retention plans, companies will need to consider the length of the retention period, the effect on employee pay expectations once the retention period ends and the overall retention award amount. Balancing those concepts effectively can help organizations better deal with employee attrition.

Bankruptcy Compensation Plans Database Observations

The chart below shows the prevalence of approved compensation plans for the bankruptcies reviewed for this article:



Utilization by Industry

We also observed the breakout of compensation plans by industry:

- **KEIPs:** Among the companies we reviewed, the prevalence of KEIPs was highest in the retail industry at 62.5%. The retail industry was followed by manufacturing industry and mining industry at 45% and 38%, respectively.
- **KERPs:** Among the companies we reviewed, the prevalence of KERPs was the highest in the retail industry at 44%, followed by the mining industry at 36% and manufacturing industry at 24%.
- **Both:** The leading industry with both KEIPs and KERPs was the retail industry at 31%, followed by mining industry at 26% and the manufacturing industry at 18%.

As indicated in the chart above, KEIPs were the most common compensation plans implemented during bankruptcy. Among companies that emerged from bankruptcy, the most common performance metrics included in KEIPs were:

- Financial metrics (EBITDA, cash flow, operating income, liquidity);
- Asset sales;
- Confirmation of plan of reorganization/ emergence from bankruptcy (usually by a specified date);
- Creditor recovery; and
- Product sales.

Among companies that liquidated, the most common performance metrics included in KEIPs were:

- Asset sales;
- Cost reduction/expense control; and
- Financial metrics.

Common Objections

The U.S. Trustee, a component of the Department of Justice responsible for overseeing the administration of bankruptcy cases, has increased its scrutiny of bankruptcy plans and has objected to various components of the compensation plans. The most common U.S. Trustee objections we observed were:

- Questioning whether the company "insiders" had been appropriately identified (making sure an "insider" was not a participant in a KERP);
- For KEIPs, was the plan performance based as opposed to a hidden retention plan (not a "lay-up"); and
- Was the plan's potential payout scaled appropriately (i.e., was the plan too rich).

Post-Bankruptcy Incentive and Retention

The battle to retain and motivate key employees does not end simply upon exit from bankruptcy. When emerging from bankruptcy, most pre-bankruptcy company stock, along with unvested equity awards, have lost their value. Lack of meaningful equity ownership in the go-forward entity, coupled with an uncertain company future, can lead to post-bankruptcy retention and motivation difficulties. Post-bankruptcy equity grants ensure that companies retain motivated personnel vital to a successful post-bankruptcy entity.

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Some important considerations for post-bankruptcy grants include:

- What percentage of the new company's equity should be reservedt for employee equity awards?
- What portion of the equity pool should be granted post-bankruptcy?
- Who should be eligible for post-bankruptcy grants (officers, middle management, all employees)?
- How will the post-bankruptcy grants be structured (i.e., size and type of award, vesting, etc.)?

Most companies emerging from bankruptcy will reserve a portion of the new company's shares to provide equity to employees. The typical share reserve depends on the size of the company. Depending on the company's needs post-bankruptcy, awards can be structured as a retention vehicle (full-value equity vehicle with vesting based on time), an incentive vehicle (vesting based on performance) or a combination of the two.

Conclusion

BAPCPA has created a structure by which bankruptcy courts can evaluate compensation plans, however the courts still retain the authority to exercise discretion, especially for incentive plans designed to escape treatment under Section 503(c)(1). Therefore, in designing incentive and retention plans, companies should make every effort to create plans that are "fair and reasonable." Not only is it best practice but doing so demonstrates the company's commitment to management and its accountability to shareholders.

Companies should also be aware of the possible ways to motivate and retain its employees in a distressed environment. Companies should review the plans they have in place and evaluate the impact of those plans should the company enter bankruptcy protection. Lastly, they should carefully examine any compensation plans implemented at or near the time the company files for bankruptcy to ensure it meets the requirements under BAPCPA.

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