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Feature

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The World of Bankruptcy Compensation for Key Employees

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A chapter 11 debtor's executives might 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 in chapter 11 implement an alternative-compensation arrangement in order to retain key executive talent and incentivize them toward the level of performance that is necessary to achieve a successful restructuring.

Overview of Bankruptcy Law

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) imposed the most significant changes to U.S. bankruptcy law in 35 years, affecting both consumer and business bankruptcies. Section 503(c) of the revised law imposed several restrictions on the use of retention plans for insiders in the context of a bankruptcy proceeding. If a company's key employee retention plan (KERP) does not provide for incentive compensation (performance-based) and is solely based on the employee's retention, it is subject to the restrictions under § 503(c)(1). This section prohibits retention payments to "insiders" (defined in more detail below) unless the following criteria are satisfied:

1. The services provided by the employee are vital to sustaining the business;
2. The payment is essential to the retention of the employee due to a *bona fide* job offer from another company of equal or greater compensation (inclusive of commissions, benefits, equity and all wage equivalents or supplements); and
3. The amount of the payment is no greater than 10 times the average payment to similar non-management employees in the same calendar year or (in case the previous, similar payments do not exist) no greater than 25 percent of any similar payment made to the "insider" during the previous calendar year.

Because of these onerous restrictions, retention programs are rarely utilized for "insiders." BAPCPA also placed similar restrictions on severance payments to "insiders." Section 503(c)(2) prohibits severance payments to "insiders" unless the following criteria are met:

1. The severance payment is part of a program that is generally available to all full-time employees; and
2. The severance amount is not greater than 10 times the average severance payment to non-management employees during the same calendar year.

As a result of these limitations, the value of severance programs to "insiders" is extremely limited or nonexistent. Finally, § 503(c)(3) serves as a catch-all provision prohibiting any other payments that are outside the ordinary course of business and are not justified by the facts and circumstances presented in the case. These BAPCPA restrictions apply only to "insiders" and are not imposed on noninsiders.[1]

Key Employee Retention Plans for Noninsiders

The hurdles established by BAPCPA under § 503(c)(1) often render KERPs unworkable as a mechanism to retain insiders. However, KERPs can still be effectively used to incentivize noninsider employees to remain with a company during a bankruptcy period. KERPs for noninsiders usually take

1 11 U.S.C. § 101(31)(B) defines an insider of a corporate debtor to include directors, officers or persons in control of the corporation, or a relative of such person. In addition, parties can be deemed nonstatutory 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. *See, e.g., U.S. Bank NA ex rel. CW Capital Asset Mgmt. LLC v. Vill. at Lakeridge LLC*, 138 S. Ct. 960, 970, 200 L. Ed. 2d 218 (2018).

the form of cash bonuses to employees, are often expressed as a percentage of each relevant employee's base salary, and are distributed throughout the corporate transition period, with the final (and typically largest) payment generally linked to the process resolution (*e.g.*, emergence, liquidation).

Key Employee Incentive Plans for Insiders

While § 503(c)(1) does not prohibit the use of KERPs for insiders altogether, the challenges to and restrictions on use of such plans imposed by BAPCPA generally require that a company that wants to provide incentive compensation to insider employees while in bankruptcy must adopt alternative compensation plans to do so. As a result, many companies entering bankruptcy have had to transition away from KERPs for insiders and toward performance-based incentive plans, commonly known as key employee incentive plans (KEIPs).

Properly implemented KEIPs are not subject to the limitations imposed by § 503(c)(1). Instead, courts analyze these plans under § 503(c)(3), which applies a more liberal judgment standard in order to determine whether a plan is viable for a debtor company. Companies developing KEIPs may do so in the exercise of their business judgment, and courts will then evaluate the KEIP under the specific facts and circumstances of a given case.

Companies developing KEIPs should use performance metrics that coincide with the company's goals and objectives, then provide incentive payments to key employees who achieve these goals. Generally speaking, these goals tend to be tied to financial metrics, restructuring goals, or a combination of the two. The performance metrics and milestones under a KEIP must not be a "lay-up" for employees eligible to participate in the KEIP; they must instead represent an actual challenge for employees to achieve. In other words, KEIPs cannot be disguised retention programs if they are going to pass muster in front of a judge. The following cases illustrate the need for a true incentive program, and that the program cannot be a disguised retention program.

In 2012, chapter 11 debtors Hawker Beechcraft Inc. 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. On the other hand, the court in Dana Corp.'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.*,[2] the proposed KEIP offered to pay bonuses of up to 200 percent of the annual base salary ($5.3 million) to eight 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 was a "whoopsie." In addition, the court concluded that the time-based goals were not challenging, as the debtors were on track to achieve several of the deadlines, and these deadlines could be extended with proper consent.

In *In re Residential Capital LLC*,[3] the proposed KEIP would have paid up to $7 million in bonuses to 17 members of its 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 percent of the KEIP bonuses were linked solely to closing the sale transactions that had been substantially negotiated pre-petition.

In *In re Dana Corp.*,[4] after the debtor had its initial compensation program rejected by the court as an impermissible retention plan disguised as an incentive plan, the program was modified to become 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 § 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 a 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 and applies to all employees, or or whether it discriminates 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; and
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 are not disguised KERPs.

Pre-Filing Retention Plans

A recent trend has been the use of a pre-filing retention plan for "insiders" and "noninsiders." A pre-filing retention plan is a program in which a payment is made to an employee prior to filing for bankruptcy. The pre-filing payment is generally subject to a clawback provision where

2 479 B.R. 308 (Bankr. S.D.N.Y. 2012).

3 478 B.R. 154 (Bankr. S.D.N.Y. 2012).

4 358 B.R. 567 (Bankr. S.D.N.Y. 2006).

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 in order to retain the bonus is typically at least six months, but can also be multiple years, depending on the company's circumstances.

One potential concern in using such a pre-petition program is that payments made under a pre-filing retention plan might be considered fraudulent transfers or preferences. The response to such an argument for these plans is that the estate is receiving meaningful value for these plans: the retention of key employees during a time of financial distress. More companies are utilizing such plans due to their many advantages over using plans developed under the watchful eye of bankruptcy courts: (1) eliminating the need for negotiations with courts and creditors; (2) focusing on employees who might 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 exhibit shows the prevalence of approved compensation plans for the bankruptcies reviewed for this article.

Utilization by Industry

The authors also observed the breakout of compensation plans by industry:

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

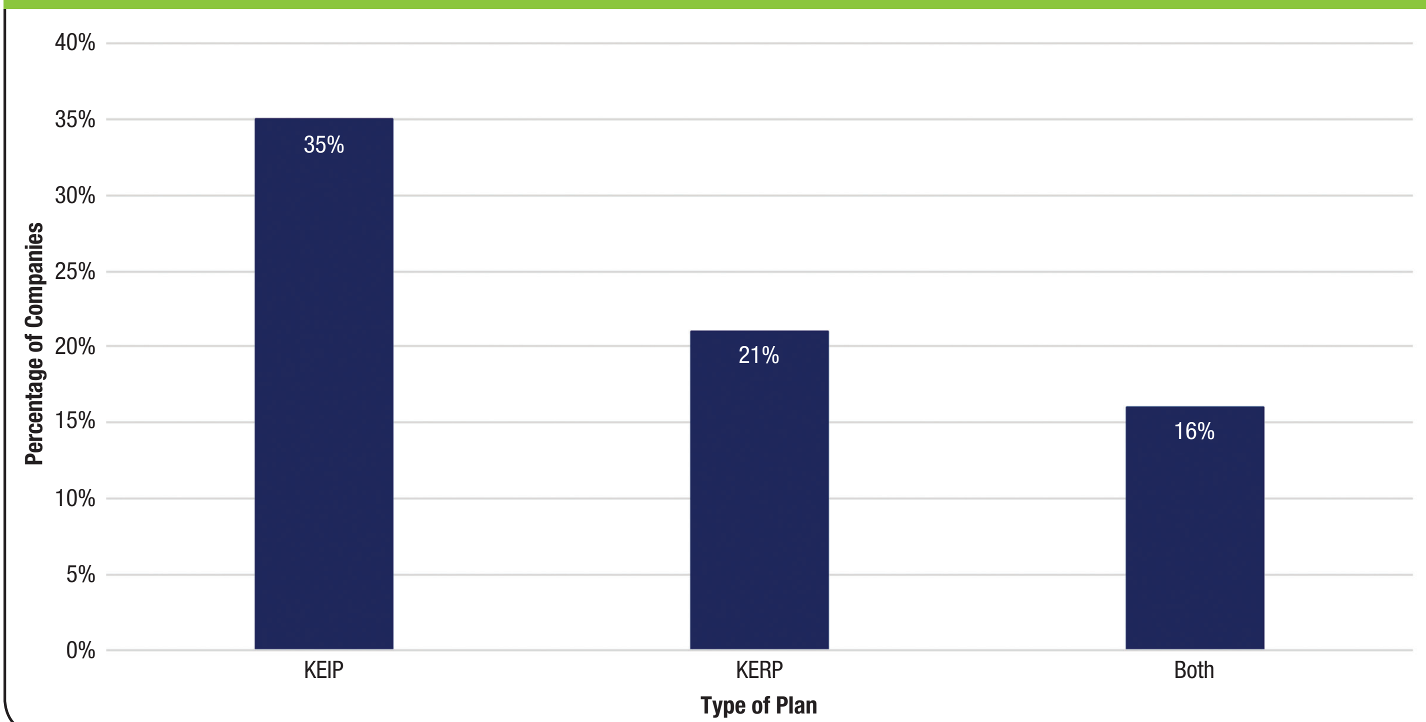
As indicated in the exhibit, KEIPs were the most common compensation plans implemented during bankruptcy. Among companies that emerged from bankruptcy, the most common performance metrics included in KEIPs were financial metrics (EBITDA, cash flow, operating income, liquidity), asset sales, confirmation of a reorganization plan/emergence from bankruptcy (usually by a specified date), creditor recovery and product sales. Among companies that were 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's Office, which is 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 observed were:

- questioning whether the company's "insiders" had been appropriately identified (making sure an "insider" was not a participant in a KERP);
- for KEIPs, whether the plan was performance-based as opposed to a hidden retention plan (not a "lay-up"); and

The Prevalence of Approved Compensation Plans



- whether the plan's potential payout was 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 an exit from bankruptcy. When emerging from bankruptcy, most prebankruptcy company stock, along with unvested equity awards, have lost their value. Lack of meaningful equity ownership in the going-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 that are vital to a successful post-bankruptcy entity. Some important considerations for post-bankruptcy grants include the following questions:

- What percentage of the new company's equity should be reserved 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 thereof.

Conclusion

BAPCPA has created a structure by which bankruptcy courts can evaluate compensation plans, and courts retain authority to exercise discretion, especially for incentive plans designed to escape treatment under § 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 also 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 that they have in place and evaluate the impact of these plans should the company enter bankruptcy protection. Lastly, companies should carefully examine any compensation plan implemented at or near the time the petition date to ensure that such plan meets the requirements under BAPCPA. abi

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