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New Section 503(c) of the Bankruptcy Code — Who Is an 'Officer' Under the KERP Amendment?

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On April 20 President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which established significant changes to the U.S. Bankruptcy Code. While much of the media attention focused on changes relevant to individuals, significant changes also were made to provisions applicable to corporate reorganizations. One of the most significant changes in the law is new Section 503(c) of the Bankruptcy Code. This section, among other things, for the first time places stringent limits on the ability of a court to approve "key employee retention plans" and severance payments in a bankruptcy case. KERP programs have become common in Chapter 11 cases to incentivize management to remain in the employ of the debtor during bankruptcy and help effectuate a successful reorganization or sale of the debtor.

The KERP limitations of new Section 503(c) are highly technical and no doubt will become subject to dispute after the effective date of the new legislation, Oct. 17. Nonetheless, one key feature of Section 503(c), other than subsection (3) of Section 503(c), is that it applies only to "insiders" of a debtor, as defined in Section 101(31) of the Bankruptcy Code.

If a debtor is a corporation, Section 101(31) defines an "insider" to include, among other parties, a director of the corporation, an officer of the corporation, the person in control of the corporation, a relative of any of the foregoing and an insider of any "affiliate" of the corporation.[1] Because Section 101(31) uses the term "includes" to enumerate the parties who are insiders of a debtor, such list is not exclusive, as Section 102(3) of the Bankruptcy Code states that the term "includes" is not limiting. Nonetheless, absent unusual circumstances, a court is likely to limit the application of the term "insider" in the Bankruptcy Code to those parties actually listed in Section 101(31).

For a corporation contemplating the filing of a Chapter 11 reorganization case after Oct. 17, a key issue will be who exactly is an "insider" of the company under the Bankruptcy Code to whom the new KERP amendments apply. That issue quickly will focus on the question of who is an officer under Section 101(31), since that is the only undefined term in Section 101(31) that is not subject to clear interpretation and is likely relevant in all proposed KERP plans.

Unfortunately for companies seeking answers to this question, the existing case law under the Bankruptcy Code gives little guidance. Since the KERP amendments have yet to go into existence, there is no case law on the issue in the KERP context itself. The one context in which there does exist some case law is the preference context. Under Section 547 of the Bankruptcy Code, insiders under Section 101(31) are subject to a one-year preference period, while all other parties are subject only to a 90-day preference period. As a result, courts have on occasion been required to determine whether a person was an officer, and therefore an insider, of the debtor at the time when that person received a potentially preferential payment more than 90 days prior to the date when a debtor filed for bankruptcy.

The leading case in this area is *In re NMI Systems Inc.*, 179 B.R. 357 (Bankr. D.D.C. 1995). In that case, the court was required to determine whether a regional vice president was an insider of the debtor at the time he received various potentially preferential payments before the bankruptcy. The relevant facts presented a mixed picture. Facts used to support the notion that the employee was an insider included:

- Correspondence at the time he was hired referred to his position as an "officer-level position";
- The compensation committee of the company's board of directors reviewed his compensation;
- The employee reported directly to the company's CEO;
- The employee was a member of the company's "strategy team," which reported to the board of directors; and
- The company's income tax returns listed 17 individuals as officers of the company, including the employee.

By contrast, facts used to support the notion that the employee was not an insider included:

- By the time the employee received the payments in question, his title had changed to "vice president-technical services," with a corresponding reduction in salary and responsibilities;
- Other employees in the company had the title of vice president, but were never considered officers;
- No one ever told the employee that he was an officer of the company or discussed with him the duties of an officer;
- The employee had responsibilities to manage a business line, rather than the company as whole; and
- The employee had no authority to control the timing of his compensation.

In analyzing these facts, the court in *NMI* said the employee's "title of vice president and mid-management responsibilities of running the company's consulting division ought not suffice to make him an officer if he did not enjoy the elements of being an officer that would *per se* put him in a position of advantage as against other creditors." *Id.* at 368. As such, the court focused on the power of the employee to benefit himself, rather than any technical title.

Finding almost no pre-existing relevant case law, the court reviewed the meaning of the term "officer" in the federal securities laws and common law governing the fiduciary duties of officers. In particular, the court relied on *C.R.A. Realty Corp. v. Crotty*, 878 F.2d 562 (2d Cir. 1989), a case interpreting who is an officer for purposes of Section 16(b) of the Securities Act of 1934. That case concluded that the test for whether an employee is an officer should focus not on the employee's title but whether the employee had access to confidential information that could permit the employee to take actions that Section 16(b) seeks to prohibit. *NMI*, 179 B.R. at 369.

The *NMI* court also relied on state fiduciary duty law that considered only those employees who are "active in setting corporate policy" to be officers of a company and therefore to have fiduciary duties to the company's shareholders. *Id.*

Ultimately, the *NMI* court ruled as follows:

> The court believes the appropriate test for whether [defendant Edward M.] Pillard was an officer is whether Pillard occupied a high position within the corporation making him active in setting overall corporate policy or performing other important executive duties of such a character that it is likely that he would be accorded less than arm's-length treatment in the payment of his antecedent claim against the debtor. The term "officer" obviously includes anyone holding a position in which that person controls the decision whether to pay an antecedent claim. But it is broader and includes, for example, those in the collective group exercising overall authority regarding the debtor's corporate decisions who, as members of that insider group, are in a position to exert undue influence over corporate decisions regarding payment of their claims in tight financial times including those who are privy to critical information regarding the debtor's financial stability and able to act to their advantage on the basis of such information.

Id. at 369-70.

The *NMI* court, therefore, set forth a test to determine who is an officer based on the purposes of the underlying statute at issue, in this case the Bankruptcy Code's preference statute. Based on that purpose, the court found that the employee was not an officer because, among other things, he "was not one in the inner circle making the company's critical financial decisions." *Id.* at 370.

It should be noted, however, that by the time the employee received the payments at issue, he was effectively an assistant vice president of the company, rather than a full vice president reporting to the board of directors, as was the case when he was hired by the company. As such, the *NMI* court also noted that at the time of the payments, the employee clearly was not an elected officer of the company and therefore did not "enjoy that prestigious affinity that exists among elected officers that in

appropriate circumstances may *per se* threaten preferential treatment vis-à-vis other creditors." *Id.* at 371.[2]

Other than the *NMI* case, there is little case law under the Bankruptcy Code discussing who is an officer for purposes of Section 101(31).[3] As a result of the dearth of this case law, a bankruptcy court attempting to determine who is an officer, and therefore an insider, for the purposes of Section 503(c) might, as did the court in *NMI*, look to other federal laws for guidance.

In particular, a court might look to the law under Section 16 of the 1934 Securities Act. Section 16 was enacted by Congress after the stock market crash of 1929 based on the perception that corporate insiders had helped precipitate the market crash through trading securities of their employer while in possession of material non-public information. Section 16 requires corporate "insiders" to file reports with the Securities and Exchange Commission disclosing transactions in the securities of their employer.

It also limits insiders' ability to trade in such securities by providing that "short-swing" profits earned through the purchase and sale, or sale and purchase, of the employer's securities within a six-month period are subject to disgorgement (and that such short-swing transactions are themselves prohibited). As such, Section 16 was designed, in part, to guard against at least the perception that managers of publicly traded corporations were improperly using their position to obtain monetary benefits for themselves. Arguably, the new KERP amendment has a similar intended purpose.

Section 16 applies only to officers and directors of a company. Therefore, not surprisingly, there has been litigation as to who exactly is an officer of a company for purposes of Section 16. Originally, the rules under Section 16 contained a fairly broad definition of "officer," including, for instance, arguably all vice presidents. The definition, in fact, was so broad that the courts often tended to ignore its literal language, instead taking a functional approach to the issue such as that utilized in *Crotty*.

Ultimately, in 1991 the definition of "officer" for purposes of Section 16 was revised in Rule 16a-1(f) under Section 16. The current definition provides that the following parties are officers for purposes of the rule, regardless of their actual access to confidential information: the president; the principal financial officer; the principal accounting officer (unless there is no such person, in which case the controller); any vice president in charge of a principal business unit, division or function; any other officer who performs a policy-making function; and any other person who performs similar policy-making functions.

The definition was based on, and is substantially similar to, Rule 3b-7 under the 1934 Securities Act, which sets forth the new definition of "executive officer" for purposes of determining the executive officers required to be included in a public company's annual report on Form 10-K.[4]

Courts, however, are not likely simply to adopt the definition of "officer" in Rule 16a-1(f) for purposes of determining who is an officer under the Bankruptcy Code under Section 503(c). Among other things, a functional approach to determining the contours of the definition requires that a court look to the purpose of Section 503(c), which differs from the purpose of Section 16 of the Securities Act. Section 16 focuses on the use of non-public information in the trading of securities of an employer. As a result, the definition of "officer" tends to focus on those parties likely to have significant access to such information.

By contrast, new Section 503(c) seems to focus on senior management of a company. In fact, there appears to be little, if any, legislative history to Section 503(c). It is generally understood that the provision was introduced by Sen. Edward Kennedy (D-Mass.) just before the passage of the 2005 bankruptcy bill in response to the perceived abuses of the KERP program in the 2001 bankruptcy case of Polaroid, which was headquartered in Kennedy's home state.

In the Polaroid case, senior management sought what some considered to be a very rich KERP while at the same time the company was terminating pension and other benefits for its workers and retirees. These events created, among other things, a letter-writing campaign to the bankruptcy court and Kennedy by retirees and others that focused attention on that case, as well as on KERP programs generally. The resulting KERP amendment introduced by Kennedy, then, might be seen as a reaction to what some perceived as abuse of power by senior management at Polaroid.

Based on this background to Section 503(c), a court may determine that officers of a debtor for purposes of new Section 503(c) are only those senior employees of the debtor who have significant influence or input with respect to the design of the debtor's KERP program, so long as such employees otherwise would be officers of the debtor under a definition such as that contained in Rule 16a-1(f) or are elected officers of the debtor.

For instance, the CEO of the debtor clearly would be an officer of the debtor, as likely would be the CFO. However, a vice president of human resources, even if involved in the design of the KERP program, would not necessarily be an officer solely based on that involvement, unless perhaps the vice president was otherwise an elected officer of the debtor or was otherwise an officer

under a definition similar to that contained in Rule 16a-1(f). The same principle would apply to other employees who might be involved in the design of the KERP, such as the general counsel of the debtor.

One final question under Section 503(c) that courts may need to address is the fact that most Chapter 11 cases involve the bankruptcy filing of multiple legal entities within a corporate family. As noted above, Section 101(31) defines the term "insider" of a debtor to include the insider of any affiliate of a debtor, which likely will include insiders of all Chapter 11-filing entities.

As such, if with the Chapter 11 filing of a parent there also are Chapter 11 filings for numerous subsidiaries, an employee of the parent who happens to be a director or elected officer of one of the subsidiaries might be considered to be an insider for purposes of Section 503(c), even though that employee would not otherwise be considered an officer of the parent.

As such, it will be prudent for companies contemplating Chapter 11 filings to ensure that, unless business needs dictate otherwise, the only officers and directors of subsidiary companies filing for Chapter 11 are employees who already are directors, or would in any case be considered officers, of the parent. This will ensure that employees who are not truly officers within the spirit of new Section 503(c) are not unintentionally placed within the ambit of the term "insider" under Section 101(31) of the Bankruptcy Code and, therefore, made subject the KERP limitations of Section 503(c).

Notes

[1] Section 101(2) of the Bankruptcy Code defines an "affiliate" of a debtor to mean, among other things, an entity that owns 20 percent or more of the voting securities of the debtor, or for which the debtor owns 20 percent of more of the entity's voting securities.

[2] As a result, under new Section 503(c), there may be litigation with respect to whether an employee is an officer for purposes of that section when, upon the filing of Chapter 11, the employee has less senior duties than during an earlier time not long before the filing.

[3] The Delaware bankruptcy court did face the issue in *In re Total Technical Services Inc.*, 150 B.R. 893 (Bankr. D. Del. 1993), and concluded, without much discussion, that the chief operating officer of a debtor subsidiary was an insider because he was "a person in control" of the debtor under Section 101(31) of the Bankruptcy Code.

[4] Section 16 also applies to an employee for a period of six months after the employee is no longer an insider, so that the issue raised in *NMI* of no longer being an officer at the time of the relevant transaction generally does not arise under Section 16.

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