KERP or KEIP: Fireworks Continue on Keeping Key Employees at the Helm in Chapter 11

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Changes made to the Bankruptcy Code in 2005 raised the bar considerably for providing "pay to stay" incentives that had been offered routinely to management and other key employees of a chapter 11 debtor, such as a severance or key employee retention plan ("KERP"). Sections 503(c)(1) and 503(c)(2) now place strict limitations on severance and KERP payments to "insiders." In addition, section 503(c)(3) of the Bankruptcy Code mandates that transfers or obligations outside the ordinary course of business to any person or entity, including officers, managers, or consultants hired post-petition, be "justified by the facts and circumstances of the case."

Several notable court rulings have been handed down already in 2012 concerning the propriety under section 503(c) of—or the application of that subsection to—payments to key employees. Many of these decisions concern the increasing frequency with which chapter 11 debtors have characterized proposed payments to personnel as a key employee *incentive* program ("KEIP") rather than a KERP. Bankruptcy courts, U.S. Trustee watchdogs, and creditor groups have collectively cast a critical eye on these efforts to ensure that payments to key employees do not run afoul of the purpose underlying section 503(c). Other issues that have recently come under scrutiny include the criteria applied under section 503(c)(3) to proposed payments and, further peeling back the onion, whether all KERPs or KEIPs proposed by a chapter 11 debtor are even subject to section 503(c). The latter was addressed by a Delaware bankruptcy court in *In re Blitz U.S.A., Inc.*, 475 B.R. 209 (Bankr. D. Del. 2012).

Limitations on Payments to Key Employees

Section 503(c) was intended to limit the scope of KERPs and similar plans designed to induce management personnel to remain with a company during its bankruptcy case. Prior to the 2005 amendments, key personnel were frequently given bonuses in addition to their regular compensation as part of a KERP, with the resulting obligations treated as administrative-expense priority claims under section 503 of the Bankruptcy Code.

Section 503(c) limits the allowance and payment of such administrative-expense claims, reflecting in part the growing disfavor of giving what some characterized as preferential treatment to a debtor's "insiders" (including, among others, directors, officers, and other controlling individuals or entities) at the expense of the bankruptcy estate. It provides that, notwithstanding the general rule stated in section 503(b) regarding the allowance of administrative expenses:

> 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—
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> (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;
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> (B) the services provided by the person are essential to the survival of the business; and

(C) either—

(i) 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 nonmanagement employees for any purpose during the calendar year in which the transfer is made or the obligation is incurred; or

(ii) if no such similar transfers were made to, or obligations were incurred for the benefit of, such nonmanagement employees during such calendar year, the amount of the transfer or 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 before the year in which such transfer is made or obligation is incurred;

(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 nonmanagement employees during the calendar year in which the payment is made; or

(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 made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition.

Thus, sections 503(c)(1) and 503(c)(2) deal with retention and severance payments, whereas section 503(c)(3) imposes a general catchall limitation with respect to payments or obligations that are both outside the ordinary course of business and not justified by the facts and circumstances of the case. However, unlike with respect to retention and severance payments covered by subsections (c)(1) and (c)(2), lawmakers omitted detailed criteria for payments encompassed by subsection (c)(3) and instead reserved for the bankruptcy courts the discretion to determine whether the provision's conjunctive requirements have been satisfied.

In *In re Dana Corp.*, 358 B.R. 567 (Bankr. S.D.N.Y. 2006), the court ruled that the requirement in section 503(c)(3) for a transaction to be "justified by the facts and circumstances of the case" is the same as the "business judgment" standard applied under section 363(b) to a proposed use, sale, or lease of estate property outside the ordinary course of the debtor's business. According to the court, "[S]ection 503(c)(3) gives the court discretion as to bonus and incentive plans, which are not primarily motivated by retention or in the nature of severance." Other courts have similarly adopted the business-judgment standard as a litmus test for payments governed by section 503(c)(3). *See*, *e.g.*, *In re Dewey & LeBoeuf LLP*, 2012 WL 3065275 (Bankr. S.D.N.Y. July 30, 2012); *In re Global Aviation Holdings Inc.*, 2012 WL 3018064 (Bankr. E.D.N.Y. July 24, 2012); *In re Velo Holdings Inc.*, 472 B.R. 201 (Bankr. S.D.N.Y. 2012); *In re Borders Group, Inc.*, 453 B.R. 459 (Bankr. S.D.N.Y. 2011); *In re Mesa Air Group, Inc.*, 2010 WL 3810899 (Bankr. S.D.N.Y. Sept. 24, 2010); *In re Nobex Corp.*, 2006 WL 4063024 (Bankr. D. Del. Jan. 19, 2006). *But see In re Pilgrim's Pride Corp.*, 401 B.R. 229 (Bankr. N.D. Tex. 2009) (payments under section 503(c)(3) may be granted administrative-expense priority only if the court finds, independent of the debtor's business justification, that the payment is in the best interest of the parties).

In *Dana*, the court listed several factors that courts typically consider when determining whether the structure of a compensation proposal and the process for its development satisfy the business-judgment test:

> — Is there 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?*

— Is the cost of the plan reasonable in the context of the debtor's assets, liabilities and earning potential?

— Is the scope of the plan fair and reasonable; does it apply to all employees; does it discriminate unfairly?

— Is the plan or proposal consistent with industry standards?

— What were the due diligence efforts of the debtor in investigating the need for a plan; analyzing which key employees need to be incentivized; what is available; what is generally applicable in a particular industry?

— Did the debtor receive independent counsel in performing due diligence and in creating and authorizing the incentive compensation?

As noted, several courts have recently addressed whether payment programs denominated as "incentive" rather than "retention" plans should be approved under section 503(c). For example, in *In re Velo Holdings Inc.*, 472 B.R. 201 (Bankr. S.D.N.Y. 2012), the court concluded that the chapter 11 debtors' proposed KEIP established incentive targets which, although tied to the debtors' compliance with their debtor-in-possession budget, required key employees to "stretch" in order to qualify for plan payments, so as not to constitute a retention plan subject to the restrictions set forth in sections 503(c)(1) and (2). The court ruled that the debtors met their burden of proving that the proposed KEIP was primarily incentive-based as it related to key employees and was a valid exercise of sound business judgment under sections 363 and 503(c)(3).

Similarly, in *In re Borders Group, Inc.*, 453 B.R. 459 (Bankr. S.D.N.Y. 2011), the chapter 11 debtor-retailers sought court approval of both a KEIP and a KERP. The employees covered by the proposed KERP were not insiders, but the court determined that the KERP had to be analyzed under section 503(c)(3) because the plan was not an ordinary-course transaction. Applying the *Dana* factors, the court ruled that the debtors exercised sound business judgment in proposing both the KEIP and the KERP. The bankruptcy court also approved incentive payments under section 503(c)(3) as a sound exercise of the debtor's business judgment in *In re Mesa Air Group, Inc.*, 2010 WL 3810899 (Bankr. S.D.N.Y. Sept. 24, 2010).

The bankruptcy court in *Blitz* considered whether a chapter 11 debtor group's EBITDA-based employee bonus plan was subject to the strictures of section 503(c)(3).

Blitz

Blitz U.S.A., Inc., manufactures consumer gasoline containers distributed through various retailers. On November 9, 2011, prompted by rapidly escalating product-liability defense costs, Blitz and several of its affiliates (collectively, "Blitz") filed for chapter 11 protection in Delaware.

In May 2012, Blitz sought court approval of an employee bonus plan for the 2012 fiscal year. The proposed bonus plan, which was substantially similar to bonus plans adopted by Blitz every year since 2008, was calculated on the basis of EBITDA (earnings before interest, taxes, depreciation, and amortization) targets. Prior to 2008, a bonus program based upon net-income targets was in place at Blitz. The EBITDA targets were adjusted by Blitz for the 2012 fiscal year before it filed for chapter 11 protection. Among other things, the adjustments involved lowering the thresholds for bonus payments due to Blitz's pre-bankruptcy spinoff of one of its non-gasoline container businesses.

Blitz argued that the bonus plan was an ordinary-course transaction that did not require court approval. In the alternative, however, Blitz maintained that, even if the bonus plan was outside the ordinary course of its business, the plan should be approved because it satisfied the requirements of section 503(c)(3). The official unsecured creditors' committee objected and argued that the bonus plan was neither ordinary-course nor justified under the facts and circumstances of the case as required by section 503(c)(3). The office of the U.S. Trustee, a division of the U.S. Department of Justice responsible for overseeing the administration of bankruptcy cases and private trustees, also objected, taking issue with the amount of the payments designated for certain insiders.

The bankruptcy court conducted an evidentiary hearing after which it found, among other things, that: (i) the bonus-plan EBITDA targets were set by Blitz's compensation committee so that total employee-compensation levels would, on average, be competitive with the market if the targets were reached; (ii) all Blitz employees were eligible for the bonus plan; (iii) because EBITDA targets were met in 2008, 2009, and 2010, payments were made to employees under the plan amounting to $533,620, $1.60 million, and $1.75 million, respectively; (iv) no payments were made in 2011 due to the failure to meet EBITDA targets; (v) the 2012 targets were lowered due to the spinoff to reflect the loss in sales but account for greater efficiencies and better margins; (vi) if the 2012 targets were met, the total payout to employees would be approximately $427,000; and (vii) Blitz's debtor-in-possession lender did not oppose the bonus plan.

Applying the two-part test adopted by the Third Circuit in *In re Roth American, Inc.*, 975 F.2d 949 (3d Cir. 1992), as well as many other courts, the bankruptcy court in *Blitz* concluded that the bonus plan was an ordinary-course transaction because: (i) Blitz had implemented similar plans for the three years preceding its chapter 11 filing (therefore satisfying the "vertical" element of the test to determine whether a transaction is ordinary-course); and (ii) other manufacturers employed similar plans (satisfying the "horizontal" component). On the basis of its analysis, the court ruled that "the Bonus Plan is an ordinary course transaction that is not subject to the requirements of § 503(c)(3)."

Even so, the court considered whether the plan satisfied the business-judgment standard applied under section 363 of the Bankruptcy Code to proposed non-ordinary-course transactions. The court rejected the committee's arguments that: (i) the bonus-plan approval process was incomplete and the payments were too high; (ii) in light of subsequent projections, the EBITDA targets were "not a stretch and . . . designed only to reward certain insiders before the company is liquidated"; and (iii) the targets should have been revised upward once the bankruptcy filing stayed product-liability suits. The court ultimately ruled that "the Bonus Plan is an ordinary course transaction made with sound business judgment and in good faith," stating that "rewarding [employees] for hard work already done and encouraging them to fill existing orders until operations cease does not smack of bad faith or unsound business judgment."

Outlook

Blitz confirms many practitioners' views that not all employee incentive plans are subject to section 503(c). However, the ruling also demonstrates that a chapter 11 debtor or bankruptcy trustee should be prepared to justify a proposed plan under the business-judgment standard whether or not the plan is within the ordinary course of business.

Post-petition payment programs for key personnel (especially insiders), whether characterized as KEIPs, KERPs, or others, have increasingly come under the microscope since 2005, in keeping with lawmakers' efforts in the Bankruptcy Abuse Prevention and Consumer Protection Act to "trim the fat" from chapter 11. As part of those efforts, the U.S. Trustee is making a concentrated effort to block companies from paying bonuses to the same executives who piloted their companies into chapter 11. For example, during July 2012, chapter 11 debtors Eastman Kodak Co., Hawker Beechcraft Inc., and Residential Capital LLC proposed incentive plans that the companies claim will motivate and reward their top executives and other employees to meet important goals in their restructurings, such as ensuring that creditors recover as much as possible. In each of these cases, the U.S. Trustee urged the bankruptcy court to block the plans on the basis that, rather than providing genuine incentives, the plans, which contain readily achievable goals, are masked ploys to induce insider management to remain on board during a time of great uncertainty—in other words, KERPs dressed up in KEIPs' clothing.

The U.S. Trustee's efforts have been gaining traction. In *In re Hawker Beechcraft, Inc.*, 2012 WL 3637251 (Bankr. S.D.N.Y. Aug. 24, 2012), the court recently denied without prejudice the debtor's motion to implement a KEIP that would have paid bonuses of up to $5.3 million to a "senior leadership team" and concluded that, although the KEIP included elements of incentive compensation, "when viewed as a whole, it set[] the minimum bonus bar too low to qualify as anything other than a retention program for insiders." In *In re Residential Capital, LLC*, 2012 WL 3670700 (Bankr. S.D.N.Y. Aug. 28, 2012), the bankruptcy court denied Residential Capital LLC's bid to pay more than $7 million in bonuses to 17 top executives and ruled that the plan had been improperly structured, to ensure that top management would not leave the company rather than to incentivize them to meet performance goals. "Ultimately, the Debtors have failed to carry their burden," the court wrote, pointing to a provision that 63 percent of the bonus money could be earned simply by the debtor's closing the sales of two loan portfolios that had been substantially negotiated pre-petition.

Bankruptcy professionals and industry commentators, however, are beginning to wonder whether the U.S. Trustee's watchdog mentality is doing more harm than good. A study published on August 8, 2012, entitled "Provision of Management Incentives in Bankrupt Firms," which was coauthored by Vidhan K. Goyal of the Hong Kong University of Science and Technology and Wei Wang of the Queen's School of Business at Queen's University in Kingston, Ontario, concludes that employee retention and incentive plans in bankrupt firms actually improve outcomes for creditors rather than enrich managers at the creditors' expense.

Professors Goyal and Wang assembled a database of 417 large public firms that had filed for chapter 11 protection between 1996 and 2007, 39 percent of which implemented KERPs. In addition to offering bonuses of 30 to 70 percent of employees' base salary, approximately half of the plans offered further incentives tied to resolving the bankruptcy expeditiously and to other specific goals. The study found that incentive plans (i.e., plans that tie bonuses to specific outcomes) "significantly improve outcomes for creditors." When incentive plans were tied to reorganization, the study reports, firms were more likely to reorganize. Conversely, when incentives were contingent upon asset sales, companies were more likely to liquidate. Incentive plans, the study concludes, also resulted in "significantly less time in bankruptcy" and a "significantly lower likelihood" of deviating from the absolute-priority rule.

The authors noted that it is important to distinguish between plans that offer retention bonuses only and plans that provide both retention and incentive bonuses. The study also found that "creditor control of bankruptcies [by means of an official creditors' committee] increases the likelihood that bankrupt firms offer retention and incentive bonuses to managers." Another significant finding was that chief executive officers were more likely to be paid bonuses if they were newly hired turnaround specialists rather than pre-existing managers. A complete copy of the study can be accessed at http://northernfinance.org/2012/openconf/modules/request.php?module=oc_program&action=view.php&id=330 (web sites herein last visited on October 4, 2012).