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Executive Compensation in Bankruptcy: Motivating Key Employees through Corporate Financial Distress

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When a company falls into financial distress, maintaining senior leadership can be one of the board's primary worries; facing uncertain futures, lackluster bonuses, and dwindling long-term equity values, key employees may be tempted to "abandon ship" to work for a more stable employer.

While retention may be key to maintaining ongoing business and shareholder values, some of the most common retention tools, such as management retention bonuses and severance benefits, can be severely restricted for "insiders" of companies filing and reorganizing under Chapter 11 of the Bankruptcy Code as a result of the addition of Section 503(c) to the Code. Both pre-filing and post-filing pay decisions are riddled with obstacles. Adjusting the pay of corporate insiders pre-filing requires less oversight, but in turbulent times it may be met with heavy skepticism by creditors and the general public and could be clawed back into the bankruptcy estate. Post-filing changes will be heavily scrutinized and subject to specific bankruptcy court oversight.

Given the many executive pay landmines, boards of financially troubled entities should become well versed in the underlying concepts governing key employee pay of bankrupt companies. Below we provide a background on some of the key elements, concepts, and rules underlying key employee pay packages of financially distressed companies.

Key Employee Retention Plans (KERPS) and Severance For Executives: The Impact of Section 503(c)

The landscape for employees of companies filing for bankruptcy changed dramatically with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), which amended the Bankruptcy Code by adding Section 503(c). The following sections discuss practices before and after this important amendment.

Pre-BAPCA (before 2005)

Before 2005, Key Employee Retention Plans (KERPs) were central to most chapter 11 bankruptcy compensation packages of senior management—complementing, modifying, or in some cases replacing severance programs, annual incentive plans, and pension modifications. KERPs typically provide for the payment of cash lump sums (on a one-time basis or a fixed, regular basis) to a set group of key employees for remaining with the company through a reorganization. In order to be eligible to receive payments, participants must stay employed by the debtor through a date certain, or through an event certain.

While KERPs were mainstream in bankruptcies, not everyone was a fan of the plans. Organized labor and creditors felt KERPs were unnecessary for senior management given their ongoing fiduciary obligations to the corporation. The programs were viewed as inequitable given the sacrifices often asked of the rank-and-file, such as workforce reductions and wage and benefit concessions. Many viewed KERPs as enriching the very managers that should be held responsible for the business failures that led to bankruptcy.

Prior to 2005, obligations for KERPs also had the benefit of being treated as administrative expense priority claims under Section 503 of the Bankruptcy Code. Administrative status gave these claims a great deal of leverage, particularly because a Chapter 11 plan cannot be confirmed unless the claims are paid in full or the claimant agrees otherwise. This priority status essentially guaranteed retention payments determined in the discretion of the company, no matter how big or in what format.

Post-BAPCA (2005 and beyond)

Implemented by Congress in the wake of headline grabbing bankruptcies such as Enron, World-Com, and K-Mart, BAPCA added Section 503(c) to the Bankruptcy Code, imposing significant restrictions on the use of retention plans and severance payments for "insiders."[1]

Section 503(c) limits the allowance and payment of certain priority administrative expense claims. It effectively:

- Prohibits retention or KERP payments for insiders (Section 503(c)(1));
- Places limitations on severance payments to insiders (Section 503(c)(2)); and
- Establishes standards for benefits that are not neatly characterized as retention or severance benefits to insiders, provided 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)(3)).

Under Section 503(c)(1), a company in bankruptcy may not make a payment or incur an obligation to (or for the benefit of) an insider for the purpose of inducing that person to remain with the company's business, unless the following narrow requirements are met:

- The proposed payment or obligation to the insider is essential to retention of the insider because he or she has a bona fide job offer from another business at the same or greater rate of compensation;
- The services provided by the insider are essential to the survival of the business; and
- Either (i) the proposed payment or obligation to the insider is not greater than ten times the amount of the average payments or obligations of a similar kind given to non-management employees during the same calendar year, or (ii) if no similar payment or obligation of a similar kind was provided to non-management employees during the same calendar year, the proposed payment or obligation to the insider is not more than 25 percent of the amount of any similar payment or obligation made to that insider during the previous calendar year.

Section 503(c)(2) provides similar limitations for severance payments made to insiders of a debtor. It essentially prohibits severance to an insider unless:

- Severance is part of a program that is generally applicable to all full-time employees of the debtor; and
- The severance amount is not more than 10 times the average non-management

severance payment given during the same calendar year.

Also included in BAPCA is the catch-all clause found in Section 503(c)(3), which applies to proposed payments or obligations outside the ordinary course of business. This rule can apply to payments outside the ordinary course of business made to non-insiders as well as to insiders. Under Section 503(c)(3), a company needs to demonstrate that the proposed payments or obligations are "justified by the facts and circumstances of the case."

Not surprisingly, given difficult—if not impossible—restrictions that must be met (e.g., the requirement that an executive must have an offer in-hand with another employer to qualify for a KERP), time-based retention payments are now rarely used for bankruptcy insiders. In addition, in our experience, insider severance payments, when provided, are very modest.

KERPs for Non-Executives (or Insiders): Still Market Practice

While Section 503(c) has curbed the use of KERPs for insiders, retention plans are still standard for non-insider employees critical to an ongoing business. Awards are most often structured as cash payments tied to a percentage of each participant's base salary, with payments distributed over the restructuring period. To demonstrate the reasonableness of these non-insider awards to the courts, awards can be compared with retention plans of comparable employers that were previously approved by bankruptcy courts.

The Emergence of Key Employee Incentive Plans (KEIP)

Following adoption of Section 503(c), as an alternative to KERPs, financially distressed companies began implementing performance-based incentive compensation plans, tied to specific financial achievements or bankruptcy case events (commonly referred to as Key Employee Incentive Plans (KEIPs)). In sum, a KEIP focuses on performance whereas its predecessor, the KERP, focuses on retention regardless of performance.

When designed properly, KEIPs avoid the stringent restrictions found in Section 503(c)(1). Instead, these plans are governed by more general provisions found in Section 363(b)(1) and Section 503(c)(3) of the Bankruptcy Code. Section 363(b)(1) allows a debtor to transact outside the ordinary course of business with court approval. Courts generally apply the "business-judgment" standard for this review, determining whether the debtor has provided a legitimate business justification for the payments (a fairly low threshold). But KEIP payments must also satisfy Section 503(c)(3) (as outlined above), which prohibits transfers to officers and managers that are outside the ordinary course of business and not justified by the facts and circumstances of the case. Different courts apply different tests to determine whether a KEIP is justified by the facts and circumstances, and some courts hold that the facts and circumstances test of Section 503(c)(3) is identical to the business-judgement test under Section 363(b)(1).

In *In re Dana Corp.*, 358 B.R. 567 (Bankr. S.D.N.Y. 2006) the court listed several factors that bankruptcy courts now commonly refer to when determining whether the structure of a compensation proposal and the process for its development satisfy the business-judgment test. These factors, known as the *Dana* factors, are:

- Whether a reasonable relationship existed between the proposed plan and the desired results;

- Whether the cost of the plan was reasonable in light of the overall facts of the case;
- Whether the scope of the plan was fair and reasonable;
- Whether the plan was consistent with industry standards;
- Whether the debtor had put forth sufficient due diligence efforts in formulating the plan; and
- Whether the debtor received sufficient independent counsel in performing any due diligence and formulating the plan.

Courts will also focus on whether the performance factors are so easily attainable that the KEIP is really a KERP in disguise. For example, in at least two Chapter 11 cases, the US Trustee urged the bankruptcy court to block the plans, arguing that instead of providing genuine incentives, the plans contained readily achievable goals that they were essentially retention plans rather than incentive plans. In each of these cases, the bankruptcy courts denied the companies' motions to implement the KEIPs, despite the fact that they were supported by the major creditors of those companies.

In *In re Residential Capital, LLC*, No. 12-12020 (Bankr. S.D.N.Y. Aug. 28,2012) the company proposed a KEIP that would have awarded between $4.1 million and $7 million in the aggregate to 17 of its top 20 employees. In denying the plan, the court noted that 63% of the bonus could have been earned simply by the debtor's closing the sales of two loan portfolios that had been substantially negotiated pre-petition.

In *In re Hawker Beechcraft,* Inc. No. 12-11873 (Bankr. S.D.N.Y. August 24, 2012), the company proposed a KEIP that would award cash payments up to $5.3 million in the aggregate to eight members of its senior management team upon the consummation of either a standalone restructuring plan or a transaction with a third party.

In denying the company's motion to approve the KEIP, the Hawker court noted that:

- The company failed to identify the efforts each key employee would make, either individually or as part of a team, to achieve the proposed targets;
- The lowest levels of the incentive targets were "well within reach"; and
- The employees could earn half of their awards under the proposed KEIP for consummating a transaction under an indefinite deadline, without having to achieve any of the net cash flow targets.

In *Hawker*, the Court ultimately concluded that the KEIP should be denied given the likelihood that the key employees would "earn some bonus under the KEIP merely by remaining with the Debtors and regardless of the road the Debtors take."

Pre-Petition Retention Plans and Pay Adjustments: Be Careful!

Increasingly, we have found that financially distressed companies are establishing retention plans for insiders and non-insiders prior to the bankruptcy filing, with the programs designed to withstand court scrutiny if a petition is finally made. In many of these programs, part or all of the awards are structured to be paid to employees prior to the bankruptcy filing, with payments subject to repayment if the participant does not remain employed for the requisite time period.

There are advantages for companies implementing the programs prior to bankruptcy since payments can be directed immediately to target the employees most at-risk of terminating; doing so also bypasses negotiations with courts and creditors. However, there is a risk that these payments may be subject to clawback under Section 548 of the Bankruptcy Code as fraudulent transfers.

Similarly, adjusting pay packages of key employees prior to a bankruptcy filing can, with the wrong facts, lead to creditor mistrust and bad press. For example, in 2011, Hostess Brands raised the salary of its CEO from $750,000 to $2,550,000 (approximately 300%) and gave large raises to nine other key executives six months prior to filing its bankruptcy petition. When creditors discovered these facts, they raised formal objections in court filings and alerted the press. Hostess claimed the executive's salaries were increased at a routine compensation review long before it decided to file for bankruptcy, but ultimately the company retracted the salary increases.

Post-Bankruptcy Equity Emergence Grants: Things to Consider

In most bankruptcies, formerly granted equity awards will likely be worthless and have no retention value. Because of this, companies emerging from bankruptcy commonly reserve a portion of their post-emergence equity to use for long-term incentives ("LTI") after the bankruptcy has been settled.

Developing the pool of shares reserved for post-bankruptcy issuance along with other key details surrounding emergence grants will be a subject of discussions and negotiations with creditors. To develop a starting point for negotiations with creditors, companies should work through the following key LTI design questions:

- What percentage of the equity pool should be granted as initial emergence grants?
- What percentage should be reserved for future equity grants?
- How will the initial equity grants and future equity grants be allocated (e.g., executive insiders versus non-executive insiders)?
- How will the initial and post-bankruptcy awards be structured (e.g., time-based, performance-based, or a mix of time- and performance-based awards)?

Understanding how other companies (particularly comparable firms) emerging from bankruptcy have chosen to structure emergence grants will be helpful in developing a reasonable starting point for negotiating with creditors.

Conclusions

Developing the right compensation pay package for key employees is critical when a company is in financial distress and its executives are tempted to leave and find more stable employers. KEIPs (for insiders), KERPs (for non-insiders), and post -bankruptcy LTI grants often form the basis of pay programs designed to ensure that critical employees remain through following the turbulent times. Pearl Meyer has experience working with companies to retain critical employees through turbulent times and extensive knowledge of performance-measures that are likely to be considered reasonable in these circumstances. We are available to assist with development of programs that fit each particular company through such cycles on a case-by-case basis.

[1] Section 101(31) of the Bankruptcy Code generally provides that if a debtor is a corporation, "insider" includes directors, officers, persons in control of the debtor, and general partners of the debtor, as well as their respective relatives. The term "insider" also includes affiliates and insiders of affiliates of the debtor. In addition, because the definition is non-exclusive certain individuals can still be considered "insiders" even if they do not fall within the categories enumerated in Section 101(31). Courts generally determine insider status based on the totality of the circumstances. Employees with certain titles (e.g., VP and above) may be presumptively considered to be insiders, but the presumption can be rebutted through submission of evidence.

About the Author

Margaret Black is a managing director at Pearl Meyer and a member of the firm's Technical Services team. She has consulted for over 25 years in the field of tax and over 20 years on all aspects of compensation and benefits matters. Margaret has extensive experience in issues related to corporate acquisitions, divestitures and restructurings, as well as with change-in-control provisions, IRC Sections 280G, 409A, and 162(m) compliance.

About Pearl Meyer

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