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**Executive Compensation and the Recent US Bankruptcy Code Amendments:  
Fundamental Change or an Invitation to Negotiate?<sup>1</sup>**

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On 20 April 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ('BAPCPA'). BAPCPA made substantial amendments to the Bankruptcy Code and Rules, creating significant changes for business and consumer bankruptcy cases. One of the most high-profile corporate issues addressed in BAPCPA is how executive compensation is treated in a chapter 11 case.

Compensation for CEOs in the United States has soared over the past decade, far exceeding inflation and wage gains of ordinary workers. The increasing pay for executives has garnered much attention and led to debates in Congress, front-page headlines, cover stories and stories on television news shows. In addition, federal and state prosecutors have looked into the propriety of executive pay outside of bankruptcy. Notably, the newly appointed Attorney General of the State of New York, Andrew Cuomo, appointed chief trial counsel to handle the case against former New York Stock Exchange chief executive Richard A. Grasso to give back over USD 100 million in compensation.

In an effort to address perceived abuses associated with executive compensation, effective in October 2005, Congress formulated section 503(c) of the Bankruptcy Code to curb bonuses paid to executives in a chapter 11 case. In light of this change to the Bankruptcy Code and recent court rulings, this article will focus on how to craft an executive compensation plan that will withstand scrutiny from the court and not violate the new section 503(c).

**Bankruptcy court authorisation for KERPs pre-BAPCPA**

Companies frequently provide compensation to certain employees as an incentive for the employee to remain with the company during uncertain times, such as a period of downsizing, merger, reorganisation or similar activity. Such payments are designed to compensate the employees for risks associated with remaining with the company for a specified period.

In bankruptcy, management incentives contained in programs known as key employee retention programs or 'KERPs' became an integral part of almost all large chapter 11 cases over the past decade. KERPs typically provided for the payment of bonuses to certain 'key employees' for remaining with the debtor company during the course of its chapter 11

1. The content of this article reflects the sole opinion of the authors and does not necessarily reflect the views of LeBoeuf, Lamb, Greene & MacRae LLP or *International Corporate Rescue*.

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case. The key employees were typically the company's senior management, including the chief executive officer, chief financial officer and chief operating officer. A KERP generally included one or more of the following types of payments: (1) retention payments to eligible employees who remain employed by the debtor through a certain date or event; (2) success payments made to eligible employees upon the occurrence of a specified event; (3) severance payments to eligible employees who are involuntarily terminated; and (4) bonuses payable to eligible employees in the event that their employment is terminated after a change in control of the company.

A debtor company will typically seek approval from the bankruptcy court to implement a KERP shortly after the bankruptcy petition is filed. Prior to BAPCPA, a debtor usually sought approval of a proposed KERP under section 363(b)(1) of the Bankruptcy Code, requiring bankruptcy court approval for use of property of the bankruptcy estate 'other than in the ordinary course of business'.<sup>2</sup> Bankruptcy courts established a two-part test for determining whether to approve a KERP: (1) that there was a sound business purpose for approval of the KERP; and (2) that the KERP was 'fair and reasonable'.<sup>3</sup>

Thus, the decision of whether to approve a KERP depended on the facts and circumstances of each particular case.<sup>4</sup> However, courts generally deferred to the business judgment of the debtors regarding a proposed KERP. This resulted in courts routinely approving sizeable payments to management and employees in most large chapter 11 cases.

## **KERP backlash**

Certain creditors and shareholders became more and more frustrated with the routine approval of substantial payments to executives. They questioned why managers should be rewarded as their company fell into bankruptcy. David McCall of the United Steel Workers of America of the American Federation of Labor and Congress of Industrial Organizations, testified against such programs before the Senate Judiciary Committee in early 2005, referring to KERPs as 'golden parachutes payable to the executives of a reorganizing company and rewarding them handsomely often after they have cut workers' pay, reduced or eliminated retiree benefits, shuttered plants, and sold them off'.<sup>5</sup>

The frustration of those affected by such payments in bankruptcy culminated with the high-profile bankruptcies of Enron,<sup>6</sup> Worldcom,<sup>7</sup> and Adelphia<sup>8</sup> and the generous KERPs authorized in those cases. For example, Bankruptcy Judge Arthur Gonzalez in the Southern District of New York approved USD 140 million in retention bonuses to Enron's key manag-

2. 11 U.S.C. § 363(b)(1).

3. See *In re Aerovox Inc.*, 269 B.R. 74, 80-81 (Bankr. D. Mass. 2002); *Dai-Ichi Kangyo Bank, Ltd. V. Montgomery Ward Holding Corp.* (*In re Montgomery Ward Holding Corp.*), 242 B.R. 147, 154 (D. Del. 1999); *In re America West Airlines, Inc.*, 171 B.R. 674, 678 (Bankr. D. Ariz. 1994); *In re Interco Inc.*, 128 B.R. 229, 234 (Bankr. E.D. Mo. 1991).

4. *Montgomery Ward*, 242 B.R. at 154.

5. See *Bankruptcy Reform: Hearing on S. 256 Before the S. Comm. on Judiciary*, 109th Cong. (2005) (statement of David McCall, Director United Steel Workers of America of the American Federation of Labor and Congress of Industrial Organizations).

6. *In re Enron Corp.*, No. 01-16034 (Bankr. S.D.N.Y.) (AJG).

7. *In re Worldcom, Inc.*, No. 02-13533 (Bankr. S.D.N.Y.) (AJG).

8. *In re Adelphia Comm. Corp.*, No. 02-41729 (Bankr. S.D.N.Y.) (REG).

ers while Enron's rank and file employees suffered substantial losses.<sup>9</sup> Judge Gonzalez also approved a USD 25 million KERP in the WorldCom bankruptcy that was designed to keep employees from leaving the company.<sup>10</sup> In Adelphia, Bankruptcy Judge Robert Gerber, also in the Southern District of New York, approved the payment of retention bonuses to executive vice presidents that were up to 200% of their base salaries.<sup>11</sup>

Reacting to the public perception of a lack of oversight on the part of bankruptcy courts in large chapter 11 cases, Congress enacted section 503(c) of the Bankruptcy Code. Senator Edward Kennedy, who proposed section 503(c), noted the 'glaring abuses of the bankruptcy system by the executives of giant companies like Enron Corp. and WorldCom Inc. and Polaroid Corporation, who lined their own pockets, but left thousands of employees and retirees out in the cold'.<sup>12</sup>

### **The new section 503(c)**

The new section 503(c) of the Bankruptcy Code was enacted for the purpose of placing restrictions on incentives paid to executives in a bankruptcy case. Two components of the traditional KERPs, retention and severance, now must meet high thresholds to be approved.

Section 503(c)(1) prohibits payments to 'insiders' for 'the purpose of inducing such person to remain with the debtor's business', *i.e.*, retention bonuses.<sup>13</sup> This section prohibits retention payments to such persons absent an evidentiary finding that (i) the payment is 'essential to the retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation'<sup>14</sup> and (ii) the services provided by the insider are 'essential to the survival of the business'.<sup>15</sup> In addition, executive retention payments are capped by section 503(c)(1)(C), which limits payments at either (i) ten times the amount of the 'mean transfer or obligation of a similar kind given to non-management employees for any purpose'<sup>16</sup> during the calendar year in which the payment is made, or (ii) if no similar payments were made to non-management employees during the same calendar year, 25% of any similar payment given to the executive in the prior calendar year.<sup>17</sup>

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9. See Eric Berger, 'Enron's Prospects for Surviving Bankruptcy May Be Improving', *Houston Chron.*, 22 Apr. 2002, at A1. Enron argued that the proposed executive compensation was vital to its reorganization because its 'key employees are their most valuable asset'. Debtors' Motion for Approval of Key Employee Retention Program Pursuant to Bankruptcy Code Section 363(b) and to Authorize Administrative Expense Priority for Indemnification Claims Arising from Post-petition Services Of Directors and Officers Pursuant to Sections 503(b) and 507 of the Bankruptcy Code, *In re Enron Corp.*, No. 01-16034 at ¶ 6 (Bankr. S.D.N.Y. 29 Mar. 2002).

10. See Order Pursuant to Sections 363(b) and 105(a) of the Bankruptcy Code Authorizing a Key Employee Retention Plan, *In re Worldcom, Inc.*, No. 02-13533 (Bankr. S.D.N.Y. Oct. 29, 2002).

11. Mike Farrell, "'Definitive' Adelphia Sale Bolsters 2 Top Cable Ops', *Multichannel News*, 25 Apr., at 1.

12. See *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: Hearing on S. 256 Before the S.*, 109th Cong. (2005) (statement of Senator Edward Kennedy).

13. 11 U.S.C. § 503(c)(1).

14. 11 U.S.C. § 503(c)(1)(A).

15. 11 U.S.C. § 503(c)(1)(B).

16. 11 U.S.C. § 503(c)(1)(C)(i).

17. 11 U.S.C. § 503(c)(1)(C)(ii).

Commentators have called this standard 'extraordinarily difficult, if not impossible to meet'.<sup>18</sup> Richard Levin and Alesia Ranney-Marinelli, writing in the summer 2005 issue of *The American Bankruptcy Law Journal*, questioned why an executive that receives a bona fide job offer from a company that is most likely not in bankruptcy, at the same or for more compensation would choose to remain employed with the debtor.<sup>19</sup> A further problem arises if the company did not make any retention payments to non-management employees or to the executive within the same calendar year.<sup>20</sup> In such circumstances, the executive would not be entitled to any payments.<sup>21</sup>

Section 503(c)(2) imposes similar formulaic restrictions on severance payments to insiders: the payment must be 'part of a program that is generally applicable to all full-time employees',<sup>22</sup> and the amount of the payment may not exceed ten times the amount of the mean severance pay given to non-management employees during the same calendar year in which the severance payment is made.<sup>23</sup> This provision limits severance payments that may be made to a debtor's officers and directors by placing a 'cap' on the amount of the severance payments and requires that such payments be available to non-management employees. Commentators have noted that there are similar problems with meeting the standards of this section as with calculation of the amount allowed under section 503(c)(1).<sup>24</sup>

Section 503(c)(3) is a catchall provision that prohibits any other transfers or obligations outside the ordinary course that are 'not justified by the facts and circumstances of the case'.<sup>25</sup>

Notably, the restrictions imposed by section 503(c) affect the debtor's ability to assume the employment agreements of certain of its employees post-petition, if such agreements contain incentive compensation or severance provisions. Section 365(a) of the Bankruptcy Code provides debtors with the right to assume or reject executory contracts, including those employment contracts containing such provisions.<sup>26</sup> However, debtors must now also comply with the new section 503(c), which restricts severance and other payments to insiders that do not meet the stated requirements. Thus, a debtor is not able to assume a pre-petition employment contract if it does not comply with section 503(c).

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18. Richard Levin & Alesia Ranney-Marinelli, "The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005", 79 *Am. Bankr. L. J.* 603, 620 (2005).

19. *Id.* at 621.

20. *Id.*

21. *Id.*

22. 11 U.S.C. § 503(c)(2)(A).

23. 11 U.S.C. § 503(c)(2)(B).

24. See Levin & Ranney-Marinelli, 79 *Am. Bankr. L. J.* at 621.

25. 11 U.S.C. § 503(c)(3). Importantly, section 503(c)(3) is not limited to insiders of the debtors.

26. Courts will permit assumption or rejection upon a showing that assumption or rejection is in the debtor's best interests. Once a contract is assumed, any amounts owed under that contract typically become administrative expenses, payable in full.

## *Who is an 'insider'?*

Sections 503(c)(1), relating to retention payments, and (c)(2), relating to severance payments restrict payments to 'insiders' of the debtors. Section 101(31)(B) of the Bankruptcy Code defines an insider as a director, officer or person in control of the debtor corporation.<sup>27</sup> The term 'officer' is not defined in the Bankruptcy Code.

However, there is case law interpreting who is considered an officer under the Bankruptcy Code. A number of bankruptcy courts have relied on the federal securities law decision of *C.R.A. Realty Corp. v Crotty*<sup>28</sup> as persuasive authority that a person's particular title is not sufficient to consider such individual an officer in the absence of the performance of important executive duties.<sup>29</sup> Rather, courts have recognised that title alone, without evidence of control, is insufficient to confer insider status.<sup>30</sup> For instance, in *In re NMI Systems Inc.*, the court was required to determine whether a regional vice president was an 'officer', and, therefore, an insider for fraudulent conveyance purposes.<sup>31</sup> The *NMI* court reasoned that rather than looking at the title, the analysis must focus on the duties and responsibilities of the employee.<sup>32</sup> The court stated that an officer of a corporation is likely to be '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'.<sup>33</sup> Thus, members of senior management of a company would be considered to be 'insiders' and subject to sections 503(c)(1) and 503(c)(2).

## **Initial interpretation of courts**

The new section 503(c) of the Bankruptcy Code makes it harder for companies in chapter 11 to award executives retention or severance bonuses. However, most of the courts that have been faced with executive bonus requests since the enactment of BAPCPA have been reluctant to be bound by the restrictions of section 503(c) of the Bankruptcy Code. Courts have further worked around the statute by characterising, if appropriate, payments under executive bonus plans, as 'incentives', rather than retention bonuses or severance payments. In addition, if there are no objections to a proposed program awarding executive bonuses, courts have been willing to approve such programs even in the absence of a showing of compliance with section 503(c). Below is a summary of key cases that have analysed the new section 503(c) following its enactment.<sup>34</sup>

27. 11 U.S.C. § 101(31)(B).

28. 878 F.2d 562 (2d Cir. 1989).

29. See, e.g., *NMI Sys., Inc. v Pillard (In re NMI Sys., Inc.)*, 179 B.R. 357, 368 (Bankr. D.D.C. 1995).

30. *Id.* at 369.

31. *Id.* at 369-370.

32. *Id.*

33. *Id.*

34. Some courts have kept their reasons for approving executive bonuses confidential. For example, the Delaware bankruptcy court in the cases of *Nellson Nutraceutical* and *Werner*, approved a management incentive plan and a pre-petition incentive-based bonus plan respectively; however, the hearings approving such plans were conducted in private and the records were sealed so it is not clear what standards were applied in each case.

## *In re Nobex Corp.*

The first reported analysis of a court addressing a proposed executive compensation plan after the amendment to section 503 was the bankruptcy court for the District of Delaware in *In re Nobex Corp.*<sup>35</sup> In this case, the debtors moved the court to authorise a 'sale-related incentive' payment plan to senior management.<sup>36</sup> The debtors planned to sell substantially all of their assets over approximately three months and identified two senior managers who were the 'only personnel with the necessary skill and experience to implement the sale procedure'.<sup>37</sup> The court determined that the costs associated with the sale-related incentive pay were reasonably necessary and justified by the likely benefits of the sale.<sup>38</sup> Specifically, the court authorised the debtors to pay each of the senior managers a percentage of the purchase price of the assets.<sup>39</sup>

Thus, the court took a restrictive view of the application of section 503(c)(1), reasoning that the payments were not designed to retain the affected employees, who agreed to remain in the debtor's employ irrespective of the sale-related payments, but rather as 'incentives' based on future performance.

## *In re Refco, Inc.*

In *Refco*,<sup>40</sup> the debtors filed a motion to approve a retention program designed to retain 32 non-executive employees.<sup>41</sup> The fact that none of the beneficiaries of the plan were executives or directors was used to argue that the proposed payment plan was not subject to the requirements of sections 503(c)(1) and (2).<sup>42</sup> The debtors' retention program was comprised of two parts: (i) a year-end bonus consistent with its historical bonus policy, except that these bonuses would be paid in two installments after 1 January 2006, and (ii) a performance bonus based on the timely and successful sale and wind-down of the debtors' business.<sup>43</sup>

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35. No. 05-20050 (Bankr. D. Del.) (MFW).

36. Motion for Order Authorizing Payment of Sale-Related Incentive Pay to Senior Management Pursuant to 11 U.S.C. §§ 105, 363(b) and 503(c)(3), *In re Nobex Corp.*, No. 05-20050 (Bankr. D. Del. 9 Dec. 2005).

37. *Id.* at ¶ 9.

38. Transcript of Hearing, at 87, *In re Nobex Corp.*, No. 05-20050 (Bankr. D. Del. 12 Jan. 2006).

39. Order Authorizing Payment of Retention Bonuses and Sale-Related Incentive Pay to Senior Management Pursuant to 11 U.S.C. §§ 105 and 363(b) and 503(c)(3), *In re Nobex Corp.*, No. 05-20050 (Bankr. D. Del. 20 Jan. 2006). Notably, Bankruptcy Judge Mary Walrath stated:

*'I think in this case it is clear that from [the] structure of the plan that this is not a retention plan. It is not providing payment to the employees or senior management solely for being retained, staying on the job. In fact, they can stay on the job all they want if the criteria are not met. That is, if the sale does not produce sufficient funds, they will not get anything.'*

Transcript of Hearing, at 87, *In re Nobex Corp.*, No. 05-20050 (Bankr. D. Del. 12 Jan. 2006).

40. No. 05-60006 (Bankr. S.D.N.Y.) (RDD).

41. Debtors' Motion For Order Under 11 U.S.C. §§ 105 and 363 Authorizing Implementation of Key Employee Retention Program, *In re Refco, Inc.*, No. 05-60006 (Bankr. S.D.N.Y. 21 Dec. 2005).

42. Transcript of Hearing, *In re Refco, Inc.*, No. 05-60006, at 5-6 (Bankr. S.D.N.Y. 10 Jan. 2006).

43. Debtors' Motion For Order Under 11 U.S.C. §§ 105 and 363 Authorizing Implementation of Key Employee Retention Program ¶ 9, *In re Refco, Inc.*, No. 05-60006 (Bankr. S.D.N.Y. 21 Dec. 2005).

An objection to the retention program was filed by a group of interested customers of Refco.<sup>44</sup> The court overruled the objection and approved the retention plan pursuant to sections 105 and 363.<sup>45</sup> The court determined that the plan being proposed did not require analysis under section 503(c)(1).<sup>46</sup> The court applied the pre-existing business judgment standard because the case was a liquidation rather than a reorganization, and thus no 'retention' was contemplated.<sup>47</sup> The court also noted that the employees covered by the retention program 'did not have the decision-making authority that was addressed by section 503(c), or that there is a basis to assume that they are being offered this KERF because they are insiders'.<sup>48</sup>

*In re FLYi, Inc.*

The debtors in FLYi filed an emergency motion to approve a wind-down employee plan and the payments of certain severance benefits to key wind-down employees.<sup>49</sup> In their motion, the debtors proposed terminating most of their workforce, except for approximately 180 employees who would remain with the company through the wind-down.<sup>50</sup> The debtors' employment policies for those wind-down employees would remain in place, even after the discontinuation of scheduled flight operations.<sup>51</sup> In addition to their salary, each of the 180 employees would receive bonuses upon the successful completion of their assigned responsibilities.<sup>52</sup>

The debtors' motion was met with several objections, including from the Office of the United States Trustee and from a consortium of flight attendants.<sup>53</sup> Prior to the hearing on the motion, the following compromise was reached, which was approved by the court: of the approximately 180 beneficiaries of the bonus payments, six employees were to be treated

44. See Moving Customer Group's Objection to Debtors' Motion for Order Under 11 U.S.C. §§ 105 and 363 Authorizing Implementation of Key Employee Compensation Program, *In re Refco, Inc.*, No. 05-60006 (Bankr. S.D.N.Y. 9 Jan. 2006).

45. See Order Under 11 U.S.C. §§ 105 and 363 Approving Implementation of Key Employee Compensation Program, *In re Refco, Inc.*, No. 05-60006 (Bankr. S.D.N.Y. 17 Jan. 2006).

46. Transcript of Hearing, *In re Refco, Inc.*, No. 05-60006, at 29-30 (Bankr. S.D.N.Y. 10 Jan. 2006).

47. *Id.*

48. *Id.* at 30.

49. See Emergency Motion of the Debtors for an Order (I) Authorizing Them to Discontinue Their Scheduled Flight Operations and Take Certain Actions in Connection Therewith; (II) Approving a Wind-down Employee Plan; (III) Approving the Payment of Certain Severance, Vacation and Other Benefits and Amounts to Terminated or Furloughed Employees; and (IV) to the Extent Necessary, Authorizing the Modification of Collective Bargaining Agreements Pursuant to Section 1113(e) of the Bankruptcy Code in Connection Therewith, at ¶ 3, *In re FLYi, Inc.*, No. 05-20011 (Bankr. D. Del. 2 Jan. 2006).

50. *Id.* at ¶ 28.

51. *Id.*

52. *Id.*

53. See Objection of the United States Trustee to Debtors' Emergency Motion of the Debtors for an Order (I) Authorizing Them to Discontinue Their Scheduled Flight Operations and Take Certain Actions in Connection Therewith; (II) Approving a Wind-down Employee Plan; (III) Approving the Payment of Certain Severance, Vacation and Other Benefits and Amounts to Terminated or Furloughed Employees; and (IV) to the Extent Necessary, Authorizing the Modification of Collective Bargaining Agreements Pursuant to Section 1113(e) of the Bankruptcy Code in Connection Therewith, *In re FLYi, Inc.*, No. 05-20011 (Bankr. D. Del. 4 Jan. 2006); Objection of Association of Flight Attendants to Emergency Motion of the Debtors for an Order (I) Authorizing Them to Discontinue Their Scheduled Flight Operations and Take Certain Actions in Connection Therewith; (II) Approving a Wind-down Employee Plan; (III) Approving the Payment of Certain Severance, Vacation and Other Benefits and Amounts to Terminated or Furloughed Employees; and (IV) to the Extent Necessary, Authorizing the Modification of Collective Bargaining Agreements Pursuant to Section 1113(e) of the Bankruptcy Code in Connection Therewith, *In re FLYi, Inc.*, No. 05-20011 (Bankr. D. Del. 5 Jan. 2006).

as insiders.<sup>54</sup> The United States Trustee and the debtors calculated the mean payment for the non-insider beneficiaries of the plan, and from that number, were able to calculate a payment cap of approximately USD 118,000 for the six insiders.<sup>55</sup> Of the six insiders, four were already scheduled to receive payments less than the payment cap.<sup>56</sup> The debtors also agreed to limit their payments to the remaining two insiders to the rate cap, however, the debtors reserved the right to pay these two individuals more over time, subject to limitations imposed by section 503(c).<sup>57</sup>

Commentators have noted that the compromise reached did not comply with section 503(c)(1) to the extent that it was applicable. The debtors did not present evidence that any of the insiders who benefited from the wind-down plan had a bona fide job offer from a competing business, as required by section 503(c)(1). Moreover, if the bonus payments were made in order to 'induce' the insiders to remain with the debtor, then the wind-down plan would violate section 503(c)(1) to the extent that it applied. The fact that the court did not find it necessary to apply section 503(c)(1) to the bonus payments is worth noting, as it demonstrates that certain courts have determined to avoid or ignore the restrictions imposed by section 503(c) where the parties to the case do not object or have reached a compromise.

#### *In re Calpine Corp.*

In *Calpine*,<sup>58</sup> the debtors sought the court's approval of a post-petition severance program for all employees without an employment agreement pursuant to sections 363(b) and 503(c)(2).<sup>59</sup> The debtors modified their pre-petition severance program and proposed a plan that provides severance based on years of service ranging from four weeks (2,359 rank-and-file employees eligible) to 39 weeks (33 executive and senior vice presidents eligible).<sup>60</sup> This analysis purportedly showed that the proposed program would, in the aggregate, cost less than that which is permitted by section 503(c)(2) or the debtors' pre-petition severance program.<sup>61</sup>

Judge Burton Lifland of the United States Bankruptcy Court for the Southern District of New York entered an order approving the program<sup>62</sup> and commented from the bench that:

*'Well, based upon this record, and it's certainly clear to the court that these plans and agreements are proposed in good faith and based upon appropriate business judgment. Further, the record before me validates that the focus of the plans and agreement is to maximize value for all the estates; the plans are apparently designed as incentive plans as opposed to retention or KERPs.'*

54. See Order Approving Wind-Down Employee Plan Pursuant to Section 503(c)(2) of the Bankruptcy Code With Respect to Certain Officers of the Debtors, *In re FLYi, Inc.*, No. 05-20011 (Bankr. D. Del. 5 Jan. 2006).

55. *Id.*

56. *Id.*

57. *Id.*

58. No. 05-60200 (Bankr. S.D.N.Y.) (BRL).

59. Debtors' Motion for an Order Authorizing the Implementation of a Severance Program, *In re Calpine Corp.*, No. 05-60200 (Bankr. S.D.N.Y. 16 February 2006)

60. *Id.* at ¶ 19-21.

61. *Id.* at ¶ 22-29.

62. Order Authorizing the Implementation of a Severance Program, *In re Calpine Corp.*, No. 05-60200 (Bankr. S.D.N.Y. 1 March 2006).

*I do find, based upon this record, that the prohibitions of section 503 have, if not been avoided, are not applicable based upon the structure of these plans and the agreements. To the one area where there might be potentially an argument to be made that 503(c) would be applicable, that would be in the supplemental plan, but that does not involve insiders, and I think 503(c)(3) is appropriately analyzed to agree with that. In short, I do agree that these are incentive plans to bring enhanced value into the estate. They are not retention plans, although anyone can always make an argument that if people are made happier than they were before, then they are excited enough to stay with the company, but that's not the focus of these plans. And this would be clearly, based upon this record, not KERPs and they are not in violation of 503(c). And I will approve the appropriate orders submitted.'*<sup>63</sup>

### **Judge Lifland's rulings in Dana**

While Judge Lifland's comments above might indicate a rather benign approach to KERPs, his approach and decision in a contested case proved to be quite the contrary.

#### *The original executive compensation plan*

Given Judge Lifland's approval of the incentive plan in *Calpine*, the debtors in *In re Dana Corp.*<sup>64</sup> were confident that Judge Lifland would approve their compensation program, as it was modelled on the plan approved in *Calpine*. The debtors sought an order for authorisation to enter into employment agreements for six executives based on the debtors' business judgment and their ability to assume contracts pursuant to sections 363(b), 365, and 105 of the Bankruptcy Code, rather than section 503(c).<sup>65</sup> Significantly, all major parties in the case objected to the plan.<sup>66</sup>

In one of the few reported decisions to date addressing the new section 503(c) of the Bankruptcy Code, Judge Lifland refused to approve the compensation plan, which included a USD 6.2 million bonus for Dana Corp.'s Chief Executive, Michael Burns.<sup>67</sup> Judge Lifland ruled that the debtors' simply changing the name of the plan from a KERP and adding an incentive component to the payment plan did not avoid the restrictions of section 503(c).<sup>68</sup> Instead, the court declared that the debtors should have provided the court with an analysis of the requirements under the new section 503(c) rather than relying on their business judgment.<sup>69</sup>

Judge Lifland specifically addressed two provisions of the compensation plan which he identified as having a 'retentive effect'.<sup>70</sup> These two provisions were the 'Completion Bonus' and the 'Severance/Non-Compete Payment'.<sup>71</sup> Judge Lifland found that because the 'Completion Bonus' would entitle executives to obtain 66% of their bonus even if the debtors lost 23% of their value, that it was not a success-based incentive bonus, but was more akin to a retention bonus.<sup>72</sup> For example, under that plan, Burns would earn an

63. Transcript of Hearing, *In re Calpine Corp.*, No. 05-60200, at 84-85 (Bankr. S.D.N.Y. 16 February 2006)

64. No. 06-10354 (Bankr. S.D.N.Y.) (BRL).

65. 2006 WL 2563458 at \*1 (Bankr. S.D.N.Y. 5 Sept. 2006).

66. *Id.*

67. *Id.* at \*5.

68. *Id.*

69. *Id.* at \*3.

70. *Id.* at \*2-3.

71. *Id.*

72. *Id.* at \*5.

added USD 6.2 million if Dana's enterprise value remains at USD 2.6 billion.<sup>73</sup> He would also receive a 'minimum completion bonus' of USD 3.1 million, payable when the company emerges from chapter 11, regardless of the outcome of the case.<sup>74</sup>

With respect to the 'Severance/Non-Compete Payment', the court found that the debtors failed to meet their burden of demonstrating that the 'non-compete' payments were not 'severance' for the purposes of section 503(c)(2).<sup>75</sup>

In explaining why he approved a comparable plan in *Calpine*, but would not do the same here, Judge Lifland remarked:

*'The Debtors also compare the compensation programs brought before other courts, in other cases, including the plan brought before this Court in In re Calpine. If this Court is to analyze the Compensation Motion pursuant to section 503(c), the Court must look to the specific circumstances of these cases, and these Debtors. A significant aspect of these cases, in the context of the Compensation Motion, are the issues raised in the strong objections filed by several parties in interest, including the Creditors' Committee, Equity Committee and United States Trustee and therefore, the Compensation Motion cannot fairly be compared to other compensation motions brought before this Court or other courts. Finding support in this Court's bench ruling in In re Calpine is misplaced as in that case there was a prima facie case and record to support the application for an "incentive" that was largely un rebutted, therefore not raising the issues currently before this Court.'*<sup>76</sup>

Thus, the debtors could not merely assume the change of control agreements, as requested in their motion, pursuant to section 365. Judge Lifland stated that 'the initial Compensation Motion did not provide this Court with analysis of the requirements under the BAPCPA, rather the Debtors proposed to rely solely on sections 105, 363(b), 365 and 101(31) of the Bankruptcy Code as the basis for the relief sought'.<sup>77</sup>

### ***The modified executive compensation plan***

After Judge Lifland's ruling that the proposed bonuses were not incentive bonuses and violated section 503(c)(1), the debtors negotiated with the objecting parties and revised the original executive compensation program.<sup>78</sup> The revised program modified the original program as follows:

- There would be no minimum 'completion bonus' for any executive. Instead, all incentive bonuses are tied to threshold EBITDAR targets.
- A substantial portion of the 2007 incentive payments and all of the 2008 incentive bonuses would be paid in stock of the reorganised debtors.
- If allowed unsecured claims exceed USD 2.85 billion, the incentive bonuses to management would begin to decrease.

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<sup>73</sup>. *Id.* at \*2.

<sup>74</sup>. *Id.*

<sup>75</sup>. *Id.* at \*5

<sup>76</sup>. *Id.* at \*4.

<sup>77</sup>. *Id.* at \*3.

<sup>78</sup>. Motion of Debtor Dana Corporation, Pursuant to Sections 105, 363, 365, 502 and 503 of the Bankruptcy Code, For An Order (A) Authorizing Assumption of Employment Agreements, As Modified, (B) Approving Long-Term Incentive Plan And (C) Granting Related Relief, *In re Dana Corp.*, No. 06-10354 (Bankr. S.D.N.Y.) (6 Nov. 2006).

- As modified and proposed to be assumed, Burns' employment agreement would provide that if he would be terminated prior to the effective date, in consideration for a Non-Disclosure Agreement (and a waiver of all claims under his current pre-petition employment agreement), Burns would have an allowed USD 4 million unsecured claim, with a recovery limited to USD 3 million less any severance actually paid under section 503(c)(2).<sup>79</sup>
- Only 60% of Burns' Supplemental Employee Retirement Plan would be assumed, with 40% remaining outstanding as a general unsecured claim.
- The debtors agreed to allow the creditors' committee to assist in the formulation of metrics and targets contained in the annual short-term incentive plan for 2007.<sup>80</sup>

The only objections to the revised program were from: (1) the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America and United Steelworkers, (2) the United States Trustee and (3) the Official Committee of Non-Union Retirees of Dana Corporation, Inc.<sup>81</sup>

Judge Lifland approved the modified plan and held that its provisions did not violate section 503(c).<sup>82</sup> He noted that '[b]y presenting an executive compensation package that properly incentivises the CEO and Senior Executives to produce and increase the value of the estate, the Debtors have established that section 503(c)(1) does not apply to the Executive Compensation Motion'.<sup>83</sup> However, because the structure of the plan could provide for a duplication of bonuses, the court suggested that a cap be placed on the overall compensation of the executives during the chapter 11 case.<sup>84</sup>

### **Guidance for development of executive bonus plans**

Based on the limited guidance on the application of the new section 503(c) reviewed above, debtors must now seek approval of management incentive plans that are based on 'success' or 'performance' factors rather than for 'the purpose of inducing such person to remain with the debtor's business'. Such management incentive plans would avoid the new thresholds imposed by section 503(c) on traditional KERPs tied to retention and severance and would provide for alternative ways to compensate executives that remain with the debtor to help the debtor meet targets and achieve success in its chapter 11 case. It is also worthwhile to engage restructuring consultants to develop an executive incentive plan so that such consultants are available to testify, if necessary, regarding the purpose of the plan, the calculation of benefits payable under the plan and the overall reasonableness of plan provisions in light of other cases.

79. Interestingly, Judge Lifland noted that 'section 503(c) is clear and unambiguous that *only administrative claims* are subject to section 503(c)'. 2006 WL 3479406 at \*7 (Bankr. S.D.N.Y. 30 Nov. 2006).

80. Motion of Debtor Dana Corporation, Pursuant to Sections 105, 363, 365, 502 and 503 of the Bankruptcy Code, For An Order (A) Authorizing Assumption of Employment Agreements, As Modified, (B) Approving Long-Term Incentive Plan And (C) Granting Related Relief, *In re Dana Corp.*, No. 06-10354 (Bankr. S.D.N.Y.) (6 Nov. 2006).

81. 2006 WL 3479406 at \*1.

82. *Id.* at \*12.

83. *Id.*

84. *Id.* Judge Lifland's ruling approving Dana's revised executive compensation plan has been appealed to the United States District Court for the Southern District of New York.

Any executive compensation plan for employees who would be deemed to be insiders under section 101(31)(B) should be crafted based on performance incentives.<sup>85</sup> For example, a debtor could develop an incentive plan based on the sale of the company, where executives were paid a percentage of the purchase price of assets, as was authorised by Judge Walrath in the *Nobex* case.

A debtor could also develop an incentive-based plan tied to enterprise value. However, such a plan would need to take into account Judge Lifland's rulings in *Dana* and *Calpine*. The bonuses or compensation should be tied to a meaningful increase or maintenance of enterprise value, rather than a guaranteed bonus payable at the end of the chapter 11 cases. Further, as with the bonus plan approved in *Calpine*, the focus of the plans should be to maximise value for the estates, rather than simply the retention of the executives. Courts have also been more willing to approve bonus programs if there are no objections or if such objections have been resolved. Thus, creditors and other relevant constituents should be consulted and, if possible, a consensus among the major constituents should be obtained prior to the filing of a motion for approval of an executive compensation plan.

## **Conclusions**

Prior to the enactment of section 503(c) of the Bankruptcy Code, management incentives contained in KERPs were routinely approved in large chapter 11 cases. As a result, executives were often given large payments for remaining employed by the debtor company during the course of its chapter 11 case. The newly enacted section 503(c) and recent court rulings interpreting this section have put an end to such retention bonuses. In practice, the application of the new section 503(c) in chapter 11 has not ended the payment of significant amounts to senior executives, instead, debtors must now carefully craft executive compensation plans that are tied to performance-based targets and engage in extensive dialogue and negotiations with relevant constituents in order to obtain approval of bonus programs. Debtors must also be prepared to present to the court strong evidence regarding the reasonableness and propriety of any program proposed. It remains to be seen whether and how the new section 503(c) will actually impact the amounts paid to retain executives in major chapter 11 cases.

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<sup>85</sup> A bonus plan for employees who would not be considered 'insiders' under section 101(31)(B) of the Bankruptcy Code would not be subject to the restrictions imposed by section 503(c).