OF KERPs AND BONUSES:
LET THE REVOLUTION BEGIN![©]

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Representative Experience

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"In general, the art of government consists in taking as much money as possible from one class of citizens to give it to the other."

Voltaire
Money (1764)

I. Introduction.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("***BAPCPA***") arrived in October 2005 with predictions of major changes to commercial Chapter 11 practice notwithstanding the unmistakable aim of BAPCPA to further disenfranchise the politically weak financially distressed consumer debtor at the behest of the monolithic credit card companies.[1] The uncertainty was, in itself, enough to propel some major Chapter 11 filings before the mid-October 2005 effective date (for most provisions)—a notable example being Delta Airlines.

These materials will focus on BAPCPA's impact on Key Employee Retention Plans ("***KERPs***") and bonuses for management of the financially distressed business enterprise. It is a fair characterization of the BAPCPA changes in this area that they amount to thinly veiled "class warfare" against the perceived "robber barons" of the Chapter 11 process—executives who purportedly profit from the distress of their businesses at the expense of creditors.

 The authors gratefully acknowledge the contributions of Andrew Banas, Squire, Sanders & Dempsey L.L.P., to these materials.

[1] If it weren't such a tragic scenario, the irony would be delightful. Credit card companies deluge the consuming public with indiscriminate credit in the guise of high interest credit cards. The public, not surprisingly, take the "bait," and also not surprisingly run up high interest credit card debt that they have trouble paying off. Personal bankruptcies are the foreseeable consequence, with credit card debt being discharged. Credit card companies cry "foul," and have well-connected lobbyists push Congress to amend the bankruptcy law to make, among other things, credit card debt hard to discharge. To further add to the irony, the stampede by consumers to file personal bankruptcies prior to the effective date of BAPCPA in mid-October caused huge fourth quarter 2005 write-offs by credit card companies. *See* "Rush to file bankruptcy causes loan problems," *International Herald Tribune* at 21 (1/18/06). This is only temporary "justice," as profits will regain their historical vigor in time.

As usual, Congress used a meat cleaver for delicate surgery, resulting in foreseeable consequences—*i.e.* clever lawyers finding ways through the new legislation. But I digress…

II. <u>What Was Congress Thinking?</u>

Background: To successfully reorganize under Chapter 11, a debtor-in-possession typically needs to retain key employees during the interim period between the petition date and plan confirmation. Similarly, the reorganized debtor may need key employees to remain with the company post-confirmation for purposes of stability and continuity. However, for several reasons, management-level employees may be compelled to "jump ship" and leave the company just when they are needed most. The solution is to obtain court approval of KERPs, which provide critical employees with incentives to remain with the company. KERPs can include a variety of incentives such as compensation during the interim period, severance payments if the employee is involuntarily terminated, indemnity for post-bankruptcy actions, and bonus payments tied to a successful reorganization. Most importantly, payments under a KERP receive administrative priority under §§503(b)(1)(A) and 507(a)(2).[2]

The Kennedy Amendment: Bankruptcy Code §503(c)[3] is the result of a last minute amendment that was added to the bankruptcy bill by Senator Kennedy during the Judiciary Committee mark-up. Its purpose was "to prevent unfair and unnecessary retention bonuses to insiders in [C]hapter 11 companies."[4] A copy of BAPCPA §503 is attached hereto as Appendix "2."

Legislative History: There is little to no legislative history with regard to Kennedy's amendment. From the limited history, it appears to have been adopted in response to the anti-corporate abuse sentiment that was voiced to and by Congress during the period before the Judiciary Committee mark-up. More specifically, the Kennedy amendment seems to be motivated by "a desire to combat KERPS in Chapter 11 cases where employee-related fraud substantially contributed to the bankruptcy of the company."[5] It also appears to be aimed at preventing abuses of the system, where creditors', employees' and retirees' monies are unnecessarily expended for the enrichment of management."[6] Although the amendment's detractors were concerned that it would prevent responsible companies from successfully reorganizing, and advanced that §503(c) should only prevent payments to insiders in the event of fraud, mismanagement or conduct contributing to insolvency, the amendment was adopted in its original, broad-brush form.

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[2] Under §503(b)(1)(A), allowed administrative expenses include "the actual, necessary costs and expenses of preserving the estate, including—(i) wages, salaries, or commissions for services rendered after the commencement of the case." Under §507(a)(2), administrative expenses allowed under §503(b) receive priority status.

[3] §503(c) of the Bankruptcy Code is the codified version of Senator Kennedy's amendment.

[4] *See* 151 Cong Rec S 2306, 2340 (March 9, 2005).

[5] *See AIRA Letter to Senator Arlen Specter* (March 1, 2005) (attached as Appendix "1").

[6] *Id.*

- ***Employee Abuse Prevention Act of 2002:*** On July 25, 2002, Representative Delahunt introduced the "Employee Abuse Prevention Act of 2002" to the House of Representatives. Its purpose was to protect employees and retirees from corporate practices that deprive them of their earnings and retirement savings when a business files for bankruptcy.[7] Although this bill never passed, § 104 of the "Employee Abuse Prevention Act of 2002" was almost identical in language and structure to Kennedy's amendment.[8]

- **2/10/05 *Statement of Dave McCall, Senate Judiciary Committee Hearing:*** Dave McCall, on behalf of the United Steel Workers of America, testified that the bill was not comprehensive enough in terms of preventing corporate bankruptcy abuse. He suggested the Committee consider adding a provision about KERPs. He criticized KERPs as being "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 plans, and sold them off."[9]

- **2/17/05 *Statement of Senator Kennedy, Judiciary Committee Meeting on Bankruptcy:*** Senator Kennedy emphasized that we have recently witnessed the worst corporate misconduct in decades (Enron, Worldcom, Adelphia, and Polaroid), yet the current bankruptcy bill does nothing to prevent corporate abuse. He demanded that the new bankruptcy bill correct this oversight by "crack[ing] down on corporate executives who loot their companies at the expense of workers, retirees, creditors, and stockholders."[10]

- **3/1/05 *Statement of Senator Durbin, Senate:*** Senator Durbin voiced concern that the bankruptcy bill overlooks corporate abuse. He asked, "Wouldn't one think in a bankruptcy bill we would go after some of these corporate bankrupt cheaters? Wouldn't one think we would go after these CEOs and officers who got hundreds of millions of dollars from these corporations they never paid back? . . . There is not a word here about the corporate crooks who are milking these corporations at the expense of employees and retirees."[11]

- **3/1/05 *Statement of Senator Kennedy on the Bankruptcy Bill:*** Senator Kennedy spoke about how it is Congress' duty to improve the bankruptcy bill for its constituents. He stated, "If this were a bill that dealt with the truly incredible abuses

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[7] *See* 2002 H.R. 5221; 107 H.R. 5221; Retrieve Bill Tracking Report (July 25, 2002).

[8] The major differences are in numbering and that § 104 does not use the word "including" to define what transfers or obligations should be considered outside of the ordinary course of business. Otherwise, there are no material differences.

[9] *See BANKRUPTCY REVISION*, Federal Document Clearing House Congressional Testimony (February 10, 2005).

[10] *See Senator Edward M. Kennedy Fights to Protect Americans from a Flawed Bankruptcy Bill* (February 17, 2005) at: http://kennedy.senate.gov./~kennedy/statements/05/02/2005217D47.html

[11] *See* 151 Cong Rec S 1818 (March 1, 2005).

of the bankruptcy system that we have seen in the Enron case, in the Worldcom case, in the Adelphia case and the Polaroid case in my own state, then maybe there would be a reason to be spending out time working on this bill...But this bill…is not about corporate executives who have exploited the system to line their own pockets."[12]

- **3/8/05 *Kennedy Statement on Bankruptcy Cloture Vote:*** In speaking about why the Senator cloture vote must be defeated, Senator Kennedy declared, "It [the bankruptcy bill] does absolutely nothing about the glaring abuses of the bankruptcy system by the executives of giant companies like Enron and Worldcom and Polaroid, who lined their own pockets, but left thousands of employees and retirees out in the cold."[13]

- **3/9/05 *Statement of Senator Hatch, Senate:*** In expressing his concerns about Senator Kennedy's amendment, Senator Hatch maintained, "Kennedy, seeks to prevent unfair and unnecessary retention bonuses to insiders in [C]hapter 11 companies…The goal here is certainly laudable and I agree with the desire to try to do that, but it has come to light since our markup that this amendment may act to effectively prohibit responsible companies undergoing reorganization, in other words, trying to save themselves, from keeping key employees who may best be able to steer the company back into solvency."[14] Senator Hatch then read a letter from the Association of Insolvency and Restructuring Advisors ("AIRA") in which a number of professionals expressed their concerns about the scope of Kennedy's amendment.[15]

    - ***AIRA Letter to Senator Specter, Chairman, Committee on the Judiciary:*** AIRA warned that "by painting with such a broad brush, the Kennedy amendment will, if enacted, effectively eliminate all companies' ability to ever receive court approval for a KERP" and that "this result will cause considerable harm to companies in bankruptcy, their employees, and their creditors." AIRA finally suggested that "there must be an approach better than handcuffing the judiciary and stakeholders in bankruptcy cases by essentially precluding all KERPs."[16]

After reading the AIRA letter, Senator Hatch informed the Senate that "[w]e have language in this issue which would mitigate what I believe are unintended effects of this amendment. Under the modified language, all payments where 'misconduct, fraud, or mismanagement' is present are prohibited. The language also keeps the burden on [C]hapter 11 companies to prove that retention bonuses are 'necessary, fair,

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[12] *See Statement of Senator Edward Kennedy on the Bankruptcy Bill* (March 1, 2005) at: http://kennedy.senate.gov./~kennedy/statements/05/03/2005301821.html

[13] *See Kennedy Statement on Bankruptcy Cloture Vote* (March 8, 2005) at: http://kennedy.senate.gov./~kennedy/statements/05/03/2005310710.html

[14] *See* 151 Cong Rec S 2306, 2340 (March 9, 2005).

[15] See *AIRA Letter to Senator Arlen Specter* (March 1, 2005).

[16] *Id.*

and reasonable,' and 'likely to enhance a successful reorganization.'"[17] However, this modified language was never included in the final bankruptcy bill, which was approved by Congress. The fact that Senator Hatch's recommendation was ignored suggests that the actual effects of §503(c) on companies in bankruptcy may be significantly broader than what Congress had originally intended.

- **4/14/05** ***Statement of Representative Cannon, House of Representatives:*** Representative Cannon voiced his concern that the KERP provision "should not be construed to invalidate all key employee retention programs for companies that may someday wind up in Chapter 11." Representative Cannon also discussed the importance of being able to retain key management post-petition and suggested that Kennedy's amendment "should not be applied to invalidate such programs when there is no evidence of insider negligence, mismanagement, or fraudulent conduct contributed to a company's insolvency in whole or in part." Representative Cannon also recognized the "possibility that the intent of the Congress with respect to this provision and the interpretation of [s]ection 331's[18] text may not be consistent."[19] However, like the similar proposal made by Senator Hatch, Representative Cannon's suggestion was never incorporated into §503(c).

III. <u>What Did Congress Do?</u>

In the end, Congress adopted Senator Kennedy's amendment in its original, broad-brush form, despite the concerns of some of its prominent detractors such as Senator Hatch, Representative Cannon, and the AIRA. Kennedy's amendment was codified as §503(c) of the Bankruptcy Code and is effective in cases that were filed on or after October 17, 2005.[20] §503(c) severely limits the scope and flexibility of KERPs by (1) prohibiting retention payments to insiders except under certain conditions, (2) prohibiting severance payments to insiders except under certain conditions, and (3) prohibiting payments outside the ordinary course of business except under certain conditions.

- ***Restrictions on Retention Payments to Insiders***: Under §503(c)(1), transfers to an insider[21] that are made "for the purpose of inducing [the insider] to remain with the debtor's business" are prohibited unless the court finds that three conditions are satisfied:[22]

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[17] *See* 151 Cong Rec S 2306, 2340 (March 9, 2005).

[18] The Kennedy amendment was section 331 of the bankruptcy bill.

[19] *See* 151 Cong Rec H 1993 (April 14, 2005).

[20] *See Collier on Bankruptcy,* 15th Edition, P 503.17 at Footnote 1.

[21] The definition of "insider" in §101 was not changed by BAPCPA.

[22] In addition to transfers to insiders, section 503(c)(1) also prohibits "obligations incurred for the benefit of" insiders.

A. The insider has a bona fide job offer from another business at the same or greater rate of compensation[23];

B. The insider's services are essential to the survival of the business; and,

C. The amount of the transfer is capped at:

(i) 10 times the average[24] of similar transfers[25] made to nonmanagement employees for any purpose[26] during the calendar year of the proposed transfer; or,

(ii) if no such transfers were made to nonmanagement employees, 25% of any similar transfer made to the insider for any purpose in the year preceding the proposed transfer.

- ***Restrictions on Severance Payments to Insiders***: Under §503(c)(2), severance payments to insiders are prohibited unless two conditions are satisfied:

A. The payment is part of a severance program that is "generally applicable" to all full-time employees; and,

B. The payment is capped at 10 times the average severance payment made to nonmanagement employees during the calendar year of the proposed payment.

- ***Restrictions on Payments Outside the Ordinary Course of Business***: §503(c)(3), which is a catch-all provision, prohibits all transfers and obligations "that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including[27] transfers made to, or obligations incurred for the benefit of officers, managers, or consultants hired after the date of the filing of the petition."

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[23] Since the reference is to "compensation," rather than "salary," all components of compensation should be taken into account, including benefits and the potential for incentive compensation.

[24] *I.e.*, mean value.

[25] The expression "similar transfers" in this (and the next) subsection suggests that the insider-transfer must be measured against transfers of the same kind. For example, if the insider will receive a monthly salary, then the salary can not be greater than 10 times the average monthly salary paid to nonmanagement employees. Likewise, if the insider will receive a performance bonus, then the bonus cannot be greater than 10 times the average performance bonus paid to nonmanagement employees.

[26] The expression "for any purpose" in this (and the next) subsection suggests that the insider-transfer must be measured against all similar transfers, including transfers made in the ordinary course of business (as opposed to transfers made "for the purpose of inducing such person to remain with the debtor's business").

[27] According to the rules of construction in §103(c), the term "including" is not limiting. Accordingly, §503(c)(3) is not limited to such persons and is a general restriction on post-petition transactions. *See Collier on Bankruptcy,* 15th Edition, P 503.17.

IV. Bankruptcy Code §503(c)—A Real Limitation?

The language of §503(c) is not well drafted, and it is difficult to discern the exact scope of the exceptions to the restrictions placed on insider retention and severance payments. These exceptions seem to be so narrowly drawn that very few (if any) insider retention or severance plans will be able to meet the necessary qualifications. The likely result is that these types of plans will be eliminated altogether from Chapter 11 cases that were filed on or after October 17, 2005.[28] Accordingly, only a few cases have addressed §503(c) since its effective date and no case to date has been decided under §503(c)(1).[29]

§503(c)(1)—Retention Payments, An Impossible Standard: One reason why no case has been decided under this subsection is because of the onerous requirements of §503(c)(1). In fact, a number of professionals have suggested that these requirements "will likely eliminate the possibility of [insider][30] retention plans being approved (or even proposed) in the vast majority of cases."[31] This is because §503(c)(1) only allows transfers to insiders for the "purpose of inducing such person to remain with the debtor's business" if the court is able to make a series of three findings, all of which are nearly impossible to satisfy.

- ***First***, the insider must have "a bona fide job offer from another business at the same or greater rate of compensation."[32] This finding is self-defeating in that once a key executive is forced to search for alternate employment, it is unlikely that they will decline an offer from a more financially stable company at the same or greater rate of compensation.[33] Ironically, the bona fide job offer provision is "likely to encourage the very kind of key employee flight that retention benefits under a KERP are intended to discourage."[34]

- ***Second***, the court must find that the services provided by the key executive "are essential to the survival of the business." This finding is highly subjective. The reference to "survival" suggests that the person seeking to justify such payment will have a heavy burden. It will not be enough for the moving party merely to show that the insider's continued retention is valuable or

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[28] *See Collier on Bankruptcy.*

[29] In *Musicland*, the judge has yet to rule on the Supplemental Incentive Plan. It is possible that this plan may fall under §503(c)(1). See page 10 for more on this topic.

[30] §503(c)(1) only applies to "insiders" of a company.

[31] *See* "What does an insider have to do to make a buck?" *BCD News and Comment* (October 25, 2005). *See also Collier on Bankruptcy,* (stating, retention plans falling under §503(c)(1) are "likely to be eliminated as a common feature of [C]hapter 11 cases").

[32] This requirement cannot be met by simply threatening to quit or retire.

[33] A key executive might be more likely to decline an alternate job offer if the proposed retention benefit is large enough to compensate him for foregoing the current and future benefits of a better job offer. However, it is highly unlikely that the retention benefit will be large enough considering the benefit's amount is subject to the caps under §503(c)(1)(C)(i) or (ii).

[34] *See* "Not So Fast: Asset Sales under the New §363," *24-7 American Bankruptcy Institute Journal* 12 (Sept. 2005).

beneficial to creditors. Rather, the moving party must show that continued employment is necessary for the business to survive. As a practical matter, this will be a nearly impossible standard to meet for companies that are not founder dominated and that are run by professional managers. There are very few people, who by themselves are absolutely essential to the survival of a business.[35]

- ***Third***, if a retention program is put in place during a calendar year that covers nonmanagement employees, the amount awarded to the insider cannot be greater than 10 times the mean award to nonmanagement employees. If no such program for nonmanagement employees is in effect, the award to the insider cannot exceed 25 percent of any retention award granted to the insider during the previous year.[36] One obvious problem with these caps is that neither of them may apply in every case. Not every debtor will have a retention plan for nonmanagement employees in the same year that a retention plan is proposed for insiders in a bankruptcy case. Likewise, not every insider will have received a similar type of retention payment for any purpose during the prior year. In the event that neither cap applies, it is unclear from the drafting of §503(c)(1) how a court should proceed. It is plausible that a court could decide that no cap should be imposed on the KERP. Alternatively, a court could decide that since one of the requisites for approval of retention plan could not be met, the KERP accordingly must be denied. In the latter situation, a debtor will actually be incentivized to propose a retention plan for nonmanagement employees during the current year just so that insiders will have a retention plan that can then be evaluated and capped consistent with §503(c)(1).[37]

As a practical matter, these three requirements will likely eliminate the possibility of retention plans being approved under §503(c)(1). The requisite factual findings for approval and the associated caps on the amounts that may be paid may simply prove too onerous.

§ 503(c)(2)—Severance Payments, A Possible Limitation: §503(c)(2) seems to be more workable in practice than §503(c)(1). In fact, Judge Mary Walrath of the United States Bankruptcy Court for the District of Delaware approved a KERP under §503(c)(2) in *In re FLYi Inc.*[38] Under §503(c)(2), severance payments to insiders[39] are allowed only if two tests are satisfied.

- ***First***, the severance payment must be a "part of a program that is generally applicable to all full-time employees." This requirement at first appears to be extremely difficult to fulfill in a debtor of any size. It is a rare severance plan that will apply to all full-time employees of a large company. The purpose of the limitation, however, is to ensure that the insider severance is not specially created for those insiders and that a severance program is in effect for all full-time

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[35] *See Collier on Bankruptcy.*

[36] *Id.*

[37] *See* "What does an insider have to do to make a buck?" *BCD News and Comment* (October 25, 2005).

[38] *See* "A Fresh Obstacle to Retaining Key Employees," *The National Law Journal* (March, 7, 2006).

[39] §503(c)(2) only applies to "insiders" of a company.

employees. Accordingly, it would make sense to interpret the reference to severance "program" to mean a series of plans so long as the series covers all full-time employees of the debtor.[40]

- ***Second***, the amount of the severance payment to the insider must not be "greater than 10 times the amount of the mean severance pay given[41] to nonmanagement employees during the calendar year in which the payment is made." If read literally, this requirement would preclude any payment of severance to an insider until the end of the calendar year in which the insider's employment was terminated. Only at the end of the year would it be possible to determine the mean severance pay given to nonmanagement employees during the year.[42] However, the analysis in *In re FLYi Inc.* suggests that courts may interpret the language to mean the period then elapsed during the calendar year. In calculating the mean severance pay given to nonmanagement employees, the court accepted the Debtor's calculations, which were solely based on the number of days that had elapsed between the start of the calendar year and the day of the KERP hearing.[43] Another potential issue may arise from the fact that the language of §503(c)(2) makes no distinction between the period before and the period after the filing of the petition.[44] Accordingly, it seems that both pre-petition and post-petition layoffs will need to be taken into account if the payment to the insider is proposed to be made during the year in which the petition is filed.[45]

§ 503(c)(3)—Other Transfers, The "Catch-All" Provision: §503(c)(3) also may assist in retaining insiders. Unlike both §§503(c)(1) and 503(c)(2), this subsection does not have a formulaic approach to compensation and does not expressly mention "insiders." Accordingly, if a compensation plan cannot be properly characterized as a retention or severance plan, which is governed by §§503(c)(1) and §503(c)(2) respectively, then it will be governed by §503(c)(3). However, it is unclear from its drafting how broad Congress intended this subsection to reach. For example, does §503(c)(3) apply only to "officers, managers, or consultants hired after the date of the filing of the petition" or does it also cover "officers, managers, or consultants" hired

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40 *See Collier on Bankruptcy.* This treatise also notes that §503(c)(2) does not distinguish between severance programs enacted before bankruptcy and those enacted after the commencement of the case. *Collier* predicts that this subsection would probably limit severance payments to insiders under programs that are in place before bankruptcy and either assumed or followed during the bankruptcy case. Additionally, *Collier* notes that "it is not clear, however, whether it would apply to a payment that is in the nature of severance but that arises under an employment contract rather than a severance plan."

41 The use of the word "given" suggests that the calculation will be made with respect to the actual amount paid as severance to such employees as opposed to a calculation based on the mean payment for which employees are eligible.

42 *See Collier on Bankruptcy.*

43 In *FLYi Inc.,* the KERP hearing took place on January 12, 2006. Debtor calculated mean severance pay for nonmanagement employees over the course of 11 days, from January 1, 2006, through January 11, 2006. *See* Transcript of Hearing on January 12, 2006 at pages 13-14.

44 This issue was not addressed in *FLYi* because debtor's petition was filed in the year before the KERP was proposed.

45 *See Collier on Bankruptcy.*

prior to the filing of the petition?[46] The court's decision in *In re Nobex Corp.* suggests the latter because it held that §503(c)(3) applied to payments to insiders who were hired pre-petition.[47] However, the court's decision in *In re Refco Inc.* seems to suggest the opposite result in holding that §503(c) did not apply to payments to certain employees who had formerly been insiders pre-petition, but who no longer had any decision-making authority post-petition.[48] Another question that arises from the poor drafting of §503(c)(3) is whether it applies exclusively to officers [insiders], managers, and/or consultants.[49] It is permissible that §503(c)(3) may even cover transfers made to non-insider employees under an incentive plan. This subsection prohibits administrative expense status to any obligation that is both outside the ordinary course of business and not justified by the facts and circumstances of the case. Assuming the transaction is outside the ordinary course of business, the standard under this subsection is whether the incurring of the obligation can be justified by the facts and circumstances of the case.

- If a transaction is entered into in the ordinary course of the debtor's business, it would not be proscribed by §503(c)(3).[50]

- If a transaction is outside the ordinary course of business, but is nonetheless justified by the facts and circumstances of the case, it would likewise not be proscribed by §503(c)(3).

It is not clear whether this provision makes any substantive difference in practice, because even under existing law, no administrative claim can be approved that is not justified by the facts and circumstances of the case.[51] Additionally, it appears that §503(c)(3) may just be a reiteration of the "business judgment" test under §363(b).[52]

Post-BAPCPA Cases—Insight into Actual and Foreseeable Loopholes in §503(c): Since the effective date of §503(c), a handful of cases have involved, in one way or another, the new KERP provision. Each case illustrates a different means by which a company can potentially get around the onerous provisions of §503(c)(1).

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[46] I am assuming that the words "hired after the date of the filing of the petition" modify not only "consultants," but also "officers or managers." See last clause of 503(c)(3).

[47] *See In re Nobex Corp.,* 2006 Bankr. Lexis 417.

[48] *See* "A Fresh Obstacle to Retaining Key Employees," *The National Law Journal* (March, 7, 2006).

[49] See Footnote 26. *Collier on Bankruptcy.* Some even argue that §03(c)(3) may not apply to insiders since "insiders" are not expressly mentioned in the language of §503(c)(3) as opposed to the language of §§503(c)(1) and 503(c)(2).

[50] If a transaction with any such person is within the ordinary course of business, such transaction is not implicated by the beginning language of §503(c)(3), which reads, "Such transfer or obligations that are outside the ordinary course of business…"

[51] Under §503(b)(1), the bankruptcy court will ask whether the non-ordinary course transfer consists of "actual, necessary costs and expenses of preserving the estate."

[52] See page 16 for more on this topic.

- ***In re Refco Inc.***[53] was the first bankruptcy case filed to address §503(c) after the new law became effective. This case involved a liquidating Ch. 11 Debtor, who was trying to wind-down its business operations. The Debtor was seeking an order permitting it to implement a KERP pursuant to §§105 and 363. Although the KERP was overtly "designed [to] retain certain employees key to the successful wind-down of the Debtors' business operations,"[54] the Debtor argued that §503(c) did not apply because none of the employees in the program were currently insiders.[55] The court agreed with the Debtor's analysis and granted the Debtor's motion for implementation of a KERP.[56] This holding suggests that there likely will be future litigation over whether an employee fits within the definition of "insider" as well as over possibly expanding the definition of "insider"[57] and/or the definition of the term "person in control of the debtor" under §101(31)(b)(iii).[58]

- ***In re Musicland Holding Corp.***[59] is another case to address §503(c). In this case, the Debtor, which operates the Sam Goody retail chain, asked the court to approve a modified Corporate Management Incentive Plan ("MIP") and a Supplemental Incentive Plan ("SIP").

Under the original MIP, if certain target metrics were met at the end of the year, individualized bonuses would be paid out based on a percentage of the key employee's salary. Under the modified version, the debtor sought to pay 25 percent of the current MIP to eligible employees from a discretionary pool.[60] The modified MIP payments would based on (1) the employee's contribution to the Debtor's operating and financial results, (2) the extent of the employee's increased responsibility due to the Debtor's financial situation, and (3) the employee's value to the business on a forward-looking basis.[61] Although the court decided to

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[53] Refco Inc. filed a petition for bankruptcy on October 17, 2005.

[54] *See* "Debtor's Motion for Order under 11 U.S.C §§105 and 363 Authorizing Implementation of Key Employee Compensation Program" (December 21, 2005).

[55] However, some of the employees covered by the plan may have been considered "insiders" pre-petition, but they no longer had any decision making authority post-petition. *See* "A Fresh Obstacle to Retaining Key Employees," *The National Law Journal* (March, 7, 2006).

[56] *See* "Order Under 11 U.S.C. §§105 and 363 Approving Implementation of Key Employee Compensation Program" (January 17, 2006).

[57] Under §101(31) the definition of "insider" is non-exclusive because it states, "The term 'insider' includes." According to the rules of construction in § 103(c), the term "including" is not limiting.

[58] "New KERP Payment Restrictions Show Democrat's Influence," *Daily Bankruptcy Review* (April 25, 2005).

[59] Musicland Holding Corp. filed a petition for bankruptcy on January 12, 2006.

[60] Without the modified MIP, it was highly likely that eligible employees would receive nothing under the regular MIP for fiscal year 2006 and that this would create a compensation misalignment between the corporate eligible employees and the store employees, who would be receiving fiscal year 2006 bonuses under a different plan.

[61] *See* "Motion for Order Authorizing, But Not Directing, Debtors to Pay Certain Pre-Petition Employee Obligations and Related Claims, to Continue Providing Employee Benefits in the Ordinary Course of Business, to Continue and Modify Severance Programs and Incentive Plans, And Granting Related Relief" (January 12, 2006).

grant the Debtor's motion with respect to the modified MIP,[62] it is not entirely clear from the record whether it was granted pursuant to §§§363(b), 363(c), or 503(c).[63] In its motion, the Debtor posited that §503(c)(1) did not apply because the modified MIP "did not resemble a retention program for employees" and because the Debtor was "merely seek[ing] to continue their pre-petition practice of rewarding employee's performance." The Debtor also argued that "503(c) was not intended to foreclose a Chapter 11 Debtor from reasonably compensating employees for their contribution to the Debtor's reorganization." In terms of §503(c)(3), the Debtor argued that this section should not proscribe the modified MIP because it was an ordinary course transaction and the proposed payouts were justified by the facts and circumstances of the Chapter 11 case.[64]

Unlike the modified MIP, the SIP is still pending court approval. Under this plan, the Debtor's seek to further incentivize five senior management employees, including the CEO and CFO, "to maximize value for the parties with the most at stake." The payments will be conditioned upon the earlier of (1) the closing of substantially all of the Debtor's assets, or (2) on consummation of a plan or reorganization. According to the Debtor, §503(c)(1) does not apply because the SIP "does not resemble a retention program or make severance payments" because it is "designed to motivate personnel to maximize value and specifically is not designed to induce insiders to remains with the Debtors." The Debtor also claims that §503(c)(3) would not proscribe any payments made under the SIP because the proposed SIP is justified by the facts and circumstances of the Chapter 11 case.[65] However, the creditor's committee has filed an objection to this plan and has specifically questioned whether "the SIP is in fact a disguised KERP governed by §503(c)."[66] It should be interesting to see how the judge rules on this issue.

- ***In re FLYi Inc.***[67] is another case involving §503(c). The Debtor, a regional airline, decided to cease operations and implement a wind-down plan (the "Wind-Down Employee Plan") in its Chapter 11 proceedings after a failed sale process. The Wind-Down Employee Plan was "designed to ensure that the Debtors can wind down their operations properly, prudently, and as efficiently as possible by encouraging individuals to complete

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[62] *See* "Order Authorizing, But Not Directing, Debtors to Pay Certain Pre-Petition Employee Obligations and Related Claims, to Continue Providing Employee Benefits in the Ordinary Course of Business, to Continue and Modify Severance Programs and Incentive Plans, And Granting Related Relief" (February 22, 2006).

[63] Under §363(c), the debtor argued that the modified MIP was in the ordinary course of business because incentive programs are commonplace within the Debtor's industry and the Debtor had had the MIP in place pre-petition. Under §363(b), Debtor argued, "in an abundance of caution," that the court should authorized the modified MIP if the Debtor's had exercised sound business judgment. *See* Debtor's Motion for Order (January 12, 2006).

[64] *Id.*

[65] *See* "Motion for Order Approving Debtors' Supplemental Incentive Plan" (January 20, 2006).

[66] *See* "Objection of the Official Committee of Unsecured Creditors to the Motion to Approve the Debtors' Supplemental Incentive Plan" (February 2, 2006).

[67] FLYi Inc. filed a petition for bankruptcy on November 7, 2005.

specified wind-down tasks."[68] The 171 employees who were part of the wind-down employee plan were grouped by length of task and were entitled to a specified "completion bonus" upon completing their assigned task.[69] Only 6 of these participating employees were insiders.[70]

The Debtor advanced two reasons why §503(c)(1) did not apply to the Wind-Down Employee Plan. First, "as of January 6, 2006, there will not be a 'business' of the Debtors, as that term is used in section 503(c)(1)". Under §503(c)(1)(B), retention payments may be permissible only if the services provided by the insider are "essential to the survival of the *business"* [emphasis added]. The Debtors posited that if "business" in §503 were construed to mean something other than a viable commercial enterprise, no retention payments could ever be made to insiders in a liquidating Chapter 11 case. Debtors alleged, "A liquidation, by definition, means the 'business' will not survive, and hence the employee's service cannot be essential to the survival of the business." The Debtors then concluded that "for purposes of section 503(c), a business should mean a viable commercial enterprise." Second, the Debtor argued that even if a "business" existed after cessation of operations, the Wind-Down Employee Plan was not intended to "induce" anyone "to remain with the Debtors' business." The Debtor maintained that there was a fundamental difference between being paid to continue to work as a part of a team in a growing business, and being rewarded for performing non-operational tasks designed to wind-down the business.[71] In essence, FLYi argued, the insiders were working themselves out of a job.

Ultimately, the court did not have to rule on this issue. After discussions with the U.S. Trustee, the Debtor determined that all but two of the insiders would fall under the §503(c)(2) cap and the parties agreed to characterize the Wind-Down Employee Plan as a severance program. As to the two insiders who would fall above the cap, FLYi and the U.S. Trustee agreed that they would be paid the maximum severance allowed, with the right to seek more in the future. However, in approving the severance plan, Judge Walrath rejected the argument that under §503(c)(2) the Debtors had to include in their calculation severance paid (or not) to employees who previously had been severed. Rather, the court ruled that §503(c)(2) contemplated a new severance program for employees remaining after a debtor has gone through initial cost-cutting measures. Thus, in making the requisite calculations under the §503(c)(2)(B) cap, the Debtor only had to calculate ten times the "mean severance pay given to the [165] nonmanagement employees" under the Wind-Down Employee Plan.[72]

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68 *See* "Emergency Motion of the Debtors for an Order (II) Approving a Wind-Down Employee Plan…" (January 2, 2006).

69 The Wind-Down Employee Plan for non-insiders was approved by the court in an order dated 1/5/06 pursuant to §363.

70 *See FLYi* Transcript of Hearing on January 12, 2006.

71 *See* "Emergency Motion of the Debtors for an Order (II) Approving a Wind-Down Employee Plan…" (January 2, 2006).

72 *See FLYi* Transcript of Hearing on January 12, 2006; "A Fresh Obstacle to Retaining Key Employees," *The National Law Journal* (March, 7, 2006).

- ***In re Nobex Corp.***[73] is a case in which an incentive plan was approved pursuant to § 503(c)(3) by Judge Walrath. In this case, the Debtor, a biopharmaceutical company, entered bankruptcy to pursue a §363 sale of substantially all of its assets. After the court had approved the sale procedure, the Debtor filed a motion seeking authorization to pay "sale-related incentive pay" to two of its senior management officials[74] under §§§105, 363(b), and 503(c)(3).[75] The compensation was couched as a percentage of the sale proceeds over the proposed stalking horse bid amount.[76] The Debtor sought permission to pay each of the executives up to the amount approved by the court subject to the "board's ultimate conclusions about the post-petition contributions of each to successful implementation of the sale procedure, including obtaining approval of and closing a Sale." Nobex took the position that the incentive plan was not intended or structured as either a retention plan or a severance plan under §§503(c)(1) or 503(c)(2), respectively, because it was "designed and intended to ensure complete implementation of the sale procedure."[77]

At the hearing, the U.S. Trustee made multiple arguments in opposition to the Debtor's presumed authority under §503(c)(3). First, he made a strictly textual argument that §503(c)(3) applies only in the narrow situation in which insiders are hired after the petition date. Alternatively, he argued that semantics should not govern, and asserted that the compensation plan was nothing more than a disguised retention program under §503(c)(1). The U.S Trustee supported this assertion with evidence from the Debtor's application for order shortening time in which the Debtor voiced concern about potentially losing senior management if the issue pertaining to its proposed compensation plan was not decided on an expedited basis. Judge Walrath rejected both of the U.S. Trustee's arguments. With regard to his textual argument, Judge Walrath held that §503(c)(3) is a "catch-all" that applies to insiders hired pre-petition, as well as post-petition. Accordingly, the court held that §503(c)(3) applied in the Debtor's situation in which it was proposing to make incentive payments to two insiders, who had both been hired pre-petition. With regard to the latter argument, Judge Walrath noted that "the structure of the compensation is not similar to retention motions…this is not you're getting paid to stay a certain period of time.[78] The structure's based on not just being here, but getting a successful conclusion to the sale; that is, an upside price…It is not providing payment to the employees or senior management *solely* for being retained, staying on the job" [emphasis added].[79] Walrath's analysis suggests that a proposed compensation plan will only fall under the onerous §503(c)(1) if the *sole* purpose of the plan is to retain an insider or insiders.

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[73] Nobex Corp. filed a petition for bankruptcy on December 1, 2005.

[74] One of the officials was the chairman of the board of directors and CEO of the company.

[75] *See* 2006 Bankr. LEXIS 417.

[76] The two officials would receive no incentive compensation unless the gross sale price achieved exceeded the proposed stalking horse bid.

[77] *See* "A Fresh Obstacle to Retaining Key Employees," *The National Law Journal* (March, 7, 2006).

[78] Walrath also noted that the officials are committed to continue their employment with Nobex Corp. even if no incentive pay is authorized.

[79] *See Nobex* Transcript of Hearing on January 12, 2006.

Other Loopholes: There are number of loopholes that potentially may assist a debtor in implementing a compensation program outside of §503(c)(1). Some of these loopholes have already been advanced by the Debtors in *Refco, Musicland, FLYi,* and *Nobex*, while other loopholes have yet to be tested.

- ***Incentive Bonus Plans Based on Clear Performance Targets:*** One popular option is to steer clear of traditional KERPs and instead offer bonuses for achieving certain goals to key employees.[80] In *Nobex,* the court approved an incentive plan for insiders in which the insiders' bonuses were tied to the amount of the sale price over the stalking horse bid pursuant to §503(c)(3). Steve Kortanek, who represents Nobex creditors, said, "Congress closed one door by prohibiting retention bonuses, but left the door wide open for incentive bonuses."[81] Likewise, in *Musicland,* the court approved the modified Corporate Management Incentive Plan in which the corporate executives' bonuses were based on (1) the employee's contribution to the Debtor's operating and financial results, (2) the extent of the employee's increased responsibility due to the Debtor's financial situation, and (3) the employee's value to the business on a forward-looking basis.

- ***Demote Insiders to Non-Insider Status:*** Another option is to demote key employees to a non-insider status pre-petition. According to the court in *Refco*, only current insiders under a post-petition KERP would be subject to the limitations imposed by §503(c).

- ***Insiders Resign Pre-Petition and Rehired as Consultants or Advisors:*** This option is a way for a Debtor to avoid having a key employee fit within the definition of "insider" under either §§ 503(c)(1) or 503(c)(2). However, if a consultant is hired post-petition, any transfer made to them will most likely be subject to approval under §503(c)(3).

- ***Insiders Resign Pre-Petition and Rehired Under Richer Employment Contract:*** Under this option, a debtor could essentially retain an insider by terminating them pre-petition and then rehiring them post-petition under a new employment contract at an increased salary point.[82] However, it is possible that a party may object to this "new" obligation being incurred as a KERP in disguise under §503(c)(1). One possible way to get around this objection may be to reinstate the executive's pre-petition salary, but offer them extra compensation for meeting particular performance targets under the new employment contract. It is also foreseeable that the new employment contract would be subject to approval under §503(c)(3) since it is an "obligation incurred for the benefit of" an "officer…hired after the date of the filing of the petition."

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[80] *See* "Limits Set on Key Executive's Pay, But Door is Wide Open on Bonuses Linked to Achieving Certain Goals," *Wall Street Journal* (March 27, 2006). Additionally, in lieu of proposing an incentive plan tied to specific targets, a Debtor should consider revising the terms of an executive's contract so that it offers extra compensation for meeting particular performance targets.

[81] *See id.*

[82] Judge Wedoff of the U.S. Bankruptcy Court for the Northern District of Illinois suggested this at the American Bar Association Annual Conference for 2005.

- ***Implement KERPs Pre-Petition:*** Another option is to implement a KERP pre-petition in order to avoid having to seek bankruptcy court approval. However, this option may be futile in that creditors may be able to later object to the pre-petition KERP on fraudulent transfer grounds under §548(a)(1)(B)(ii)(IV).[83] Under this provision, "the trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor…if the debtor…[1] received less than a reasonably equivalent value in exchange for such transfer or obligation; and [2] made such transfer to or for the benefit of an insider, under an employment contract and not in the ordinary course of business." The likely resulting debate will be over (1) the value the Debtor received in exchange for the KERP payment and (2) if the KERP payment was in the ordinary course of business.[84]

- ***Business Liquidation Exception to § 503(c)(1):*** This option is only available to liquidating debtors. Under this option, the liquidating debtor would claim that §503(c)(1) is inapplicable to their proposed KERP because the term "business" in that subsection must be construed to refer only to a viable commercial business, and that a liquidation by definition is not a "business." This argument was raised by the Debtor in *FLYi.* FLYi also argued that even if a "business" existed after cessation of operations, the KERP was not designed to induce the insiders to remain with the Debtor's nearly non-existent business.

- ***Reconfiguring a Retention Bonus into a Severance Bonus:*** In certain situations, debtors may be able to reconfigure a retention bonus into a severance payment in order to avoid the onerous §503(c)(1). For instance, where the debtor needs to incentivize insiders to consummate a going-concern sale of the debtor's business, the debtor can propose a severance (rather than retention) plan that contemplates the payment of bonuses to such insiders upon termination, which shall necessarily occur within a specified period of time after or upon the closing of the sale.[85]

V. ***"Ah, The Good Old Days…"***

Background: Bankruptcy courts derive their authority to approve a debtor's request to implement a KERP from §363(b) of the Bankruptcy Code. This section gives a trustee or debtor-in-possession the authority to use, sell, or lease property of the estate, "other than in the ordinary course of business," only upon court approval. Prior to BAPCPA, bankruptcy judges traditionally employed a two-part test when asked to approve a proposed KERP. First, they looked at whether the debtor exercised proper business judgment in formulating its KERP. Second, they considered whether the proposed KERP was fair and reasonable.[86] Given the inherently discretionary nature of these tests, the judge's ultimate decision to approve a KERP

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[83] This provision was added to the Code under the BAPCPA.

[84] *See* "Bankruptcy Bill Fails to Close Loophole on Executive Payouts," *Daily Bankruptcy Review* (April 27, 2005).

[85] *See* "What does an insider have to do to make a buck?" *BCD News and Comment* (October 25, 2005).

[86] This second test is not always used by bankruptcy courts.

always depended on the facts and circumstances of each individual case. Additionally, there was a presumption in the debtor's favor that the proposed KERP was fair and reasonable and that it was formulated for a sound business purpose.[87]

- ***In re Interco Inc.,* 128 B.R. 229 (Bankr. E.D. Mo. 1991):** Pre-BAPCPA debtors often cited this case as precedent for approval of their KERP motions. In this case, the Debtor proposed a retention plan for "critical executives." Interco argued that because its executives' stock options were worth very little, their compensation was not commensurate with that of the rest of the industry. As a result, it feared that the executives essential to its reorganization efforts would seek work opportunities elsewhere. It estimated the annual cost of its retention program between about $1.9-$5.7 million, based on the level of EBITDA at the end of each fiscal quarter. In finding that the Debtor had a sound business purpose in developing its KERP , the judge emphasized that each Chapter 11 case "must be determined on its own in the circumstances which are presented to the Court."[88]

- ***In re Montgomery Ward Holding Corp.,* 242 B.R. 147 (D. Del. 1999):** This case was an appeal from a bankruptcy court's approval of a KERP. The district court looked at the facts and circumstances specific to the Debtor's case in affirming that the plan was fair and reasonable. The court found that, even though the plan provided higher than average benefits, they were "reasonable in light of the circumstances surrounding the Debtor's bankruptcy…"[89] In reaching this conclusion, the court first reviewed the Debtor's decision-making procedures, which included hiring an outside company to create the KERP and the fact that the outside company had compared the Debtors' pay structure to those of similar companies. Second, the court recognized the Debtor's reasons for adopting its retention plan, which were to "(1) motivate people to stay with the company and (2) mitigate the total loss of incentive compensation."[90]

- ***In re America West Airlines, Inc.,* 171 B.R. 674 (Bankr. D. Ariz. 1994):** In this case, the Debtor sought to award various individuals and employee groups with bonuses for helping to propel the Debtor through the confirmation process. The court considered the particular facts and circumstances of the Debtor's case in ultimately holding that the success bonuses were "fair and reasonable under the history of the case and a valid exercise of the Debtor's business judgment in these matters."[91] More specifically, in approving the Debtor's request to pay a success bonus in the form of stock to its CEO, the court noted that the "proposed success bonus follows a trend in large successful companies within and out of [b]ankruptcy. The size of the bonus relates to the success of the company…"[92] In approving the proposed success

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[87] *See* "Approving Employee Retention and Severance Programs: Judicial Discretion Run Amuck?" 11 *Am. Bankr.Inst. L. Rev.*93.

[88] *See In the Matter of Interco Inc.,* 128 B.R. at 233.

[89] *See In re Montgomery Ward Holding Corp.,* 242 B.R. at 155.

[90] *Id.* at 150-51.

[91] *See In re America West Airlines, Inc.,* 171 B.R at 678.

[92] *Id.* at 677.

bonus to its recently hired COO, the court considered the fact that the "Debtor needed to properly compensate the COO in order to urge him to make a career move to an organization operating under Chapter 11."[93] In approving the proposed success bonuses to 28 other officers and managers, the court was persuaded by a compensation consultant's testimony that "the proposed management bonuses are common in large reorganizations" and that "the amounts of the proposed bonuses were in line with bonuses given by other large reorganized companies."[94]

- ***In re UAL Corp* (Bankr. N.D. Ill):** In this case, the Debtor sought permission to implement a KERP. In support of its KERP motion, the Debtor attached the affidavit of Douglas J. Friske, who was responsible for developing the KERP. In his affidavit, Mr. Friske stated that he developed UAL's KERP after examining the compensation programs used in over 35 similar bankruptcy cases. He found that retention plans normally included bonuses in the amount of 50%-100% of current salary for senior executives and 20%-50% of current salary for other employees. Mr. Friske also noted that the typical retention program covered 1.5% of a company's overall population. According to Mr. Friske, the Debtor's KERP "as a whole is consistent with similar plans in other industries. The size and expense of the plan are made necessary by the size of UAL, the average compensation of executives and other key employees in this industry, and the risk to the company should these individuals leave."[95] In the end, the court approved the KERP and entered the appropriate order after considering the facts and circumstances of UAL's Chapter 11 case.[96]

- ***In re Allied Holdings, Inc.,* 2005 WL 3754087 (Bankr. N.D. Ga.):** In this case, the court granted the Debtor's KERP motion, subject to certain conditions that would make the plan both fair and reasonable. Based on the facts and circumstances of the Debtor's case, the court found that the amount of the bonuses being paid to upper level employees was not fair because these employees' compensation was already "equivalent, if not higher than, the direct compensation paid to executives of similar-size trucking companies" and that "at this time in the Debtor's reorganization, it is not reasonable to pay the Debtor's executives such large cash bonuses that are not directly tied to the Debtor's financial performance."[97] The court also found that the timing of the first of the four proposed payments to be made under the KERP was not fair under the circumstances. The court insisted that the date of the first payment be pushed back so that the purpose of the KERP, which was "to retain the employees" could be better fulfilled. Additionally, the court determined that the Debtor had satisfied the "business judgment" test after considering the facts and circumstances of the case. The court found that the process by

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[93] *Id.*

[94] *Id.*

[95] Under UAL's KERP, corporate officers were to receive an award of between 75%-125% of their salary and the program was expected to cover only 0.7% of UAL's employee population.

[96] *See* "Affidavit of Douglas J. Friske", which is attached to Debtor's "Motion for Entry of an Order Pursuant to Sections 105(a), 363(b) And 365 of the Bankruptcy Code Authorizing the Debtors to Continue their Key Employee Program in the Ordinary Course of Business" (December 9, 2002).

[97] *See In the Matter of Allied Holdings, Inc* at 8.

which the Debtor had created the KERP was reasonable because "the Debtors sought the advice of an outside consultant and they sought the [Teamsters] Committee's participation in the formulation of the KERP." The court also found that the implementation of the KERP was necessary because the Debtor persuaded the court that its current work environment was "not conducive to maintaining employee loyalty" and that there was a real risk of employee flight without a KERP.[98]

Is the "Business Judgment" Test only of Historical Significance for KERP Cases Filed On or After October 17, 2005? Assuming the KERP is outside the ordinary course of business,[99] the KERP must at least satisfy the "business judgment" test of §363(b) in order to obtain court approval.[100] It may also have to comply with the limitations set forth in either §§503(c)(1) or 503(c)(2) or be justifiable under the facts and circumstances of the case under §503(c)(3), depending on the purpose and nature of the KERP.[101] For example, in *Nobex,* the court entered an order authorizing payment of sale-related incentive pay to senior management pursuant to both §§ 363(b) and 503(c)(3).[102]

Bankruptcy Code §503(c)(3)—A Reiteration of § 363(b)? Both *Collier on Bankruptcy*[103] and Judge Mary Walrath in *Nobex* have suggested that the standard under §503(c)(3) is the same as the standard under §363(b). Intuitively, this makes sense because both the "business judgment" test and the standard under §503(c)(3) focus on whether a transaction can be justified by the particular facts and circumstance of a case. At the KERP hearing in *Nobex,* Judge Mary Walrath stated:

> "So I do read [§503](c)(3) to be the catch-all and the standard under (c)(3) for any transfers or obligations made outside the ordinary course of business are those that are justified by the facts and circumstances of the case. Nothing more – no further guidance being provide to the Court by Congress, *I find it [§503(c)(3)] quite frankly nothing more than a reiteration of the*

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98 *Id.* at 9.

99 If the KERP is somehow within the ordinary course of business, then it will be governed by §363(c). This subsection does not require court approval of ordinary course transactions.

100 The decision to enter into an agreement out of the ordinary course of a debtor's business is to be based on the reasonable business judgment of the debtor. *In re Continental Air Lines, Inc.,* 780 F.2d 1223, 1226 (5th Cir. 1986); *In re Lionel Corp.,* 722 F.2d 1063, 1070 (2d Cir. 1983) (concluding that "there must be some articulated business justification, other than appeasement of major creditors, for using, selling or leasing property out of the ordinary course of business before the bankruptcy judge may order such disposition under section 363(b)").

101 In some situations, like in *Refco*, the proposed plan may only be governed by §363(b).

102 For KERP cases filed on or after October 17, 2005, it is unclear if bankruptcy courts will continue to determine if the KERP is fair and reasonable under the facts and circumstances of the case in its analysis under §363.

103 *Collier on Bankruptcy* states, "If any such transaction is outside the scope of the ordinary course of business, court approval would be necessary in any event and the standard for approval to be employed under section 503(c)(3) is unlikely to be much different than the standard for approval that would otherwise be applied by the court.

> *standard under §363* and – well, 363 under which courts have previously authorized transfers outside the ordinary course of business and that is, based on the business judgment of the debtor, the court always considered the facts and circumstances of the case to determine whether it was justified. And I'll do the same in this case" [Emphasis Added].

In ultimately approving Nobex's plan under §§363(b) and 503(c)(3), Judge Walrath focused on the particular facts and circumstances of Nobex's Chapter 11 case. She placed great weight on the support of the creditors' committee, and the fact that the formula gave senior management incentives to improve upon a stalking-horse bid. She also found that the plan was designed to maximize recoveries to unsecured creditors.

<u>APPENDIX "1"</u>

AIRA Letter To Senator Arlen Specter

(March 1, 2005)

AIRA Letter to Senator Arlen Specter

Association of Insolvency and

Restructuring Advisors,

March 1, 2005.

Sen. Arlen Specter,

Chairman, Committee on the Judiciary, U.S. Senate, Washington, DC.

Dear Mr. Chairman: The undersigned are financial and legal professionals who serve as the Board of Directors of the Association of Insolvency and Restructuring Advisors (AIRA). As board members we work to further the AIRA's goal of increasing industry awareness of the organization as an important educational and technical resource for professionals in business turnaround, restructuring, and bankruptcy practice, and of the Certified Insolvency and Restructuring Advisor (CIRA) designation as an assurance of expertise in this area.

We write to make you aware of serious concerns we have regarding a provision contained in S. 256, the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005" The provision in question effectively prohibits the use of key employee retention plans in Chapter 11 reorganizations. It was added during the Judiciary Committee mark-up of the bill and elicited little attention at the time. However, we believe this provision will cause considerable harm to a number of companies that will become subject to bankruptcy proceedings, and, most importantly, to their employees, customers, and creditors.

When a company is operating in Chapter 11, a primary responsibility of management is to maintain and grow the company's value for the benefit of all of its stakeholders. A company that is well-managed through its restructuring benefits its creditors, employees, retirees, unions and the local communities of which the company is a part. Companies that fail to successfully reorganize in Chapter 11 are liquidated. Creditors receive pennies on the dollar and employees see their jobs and retirement savings destroyed.

When companies enter Chapter 11, it is critical that they attract and retain top management talent. But Chapter 11 is also the most difficult time to attract and retain such talent. Managers of Chapter 11 companies are faced with intense scrutiny, stress, insecurity, and an enormously complex process. Compensation and incentive tools used by non-bankrupt companies such as equity compensation programs are not available to assist with attracting and retaining the type of management talent necessary to bring the company successfully through the Chapter 11 process-this is because the pre-petition equity is almost always without value. Key employee retention plans ("KERPs") have become common practice since the early 1990's and have been viewed by courts, debtors, and creditors alike as an important and useful way to help reorganization by retaining key employees.

Bankruptcy courts have agreed with this reasoning, and many judges have used their judicial discretion to approve KERPs. For a court to approve a KERP under existing law, however, a debtor must use proper business judgment in formulating the program, and the court must find the program to be reasonable and fair. Creditors have the right to object to proposed KERPs, and judges are presented with a full evidentiary record upon which to make a determination. If a KERP is not appropriate or if it is not in the best interest of the company's creditors, the judge can refuse to approve it.

In the last few years, there has been a trend, with which we agree, towards stricter judicial scrutiny of proposed KERPs by bankruptcy judges. Such a trend seems appropriate in the wake of numerous high profile bankruptcy filings where management's misconduct or mismanagement has led to the Chapter 11 filing. Judges have discretion to deny KERPs in these circumstances, and they do so when the facts and circumstances warrant.

Unfortunately, S. 256 as reported by the Senate Judiciary Committee includes an amendment authored by Senator Edward M. Kennedy (the Kennedy amendment) that places significant limits on retention bonuses and severance payments to employees of companies in Chapter 11. It would prohibit a bankruptcy judge from approving retention bonuses in every Chapter 11 case unless he or she finds that the company in question has proven that the employee has a bona fide job offer at the same or greater rate of compensation; was prepared to accept the job offer; and the services of that employee are "essential to the survival of the business". The amendment also places significant caps on the amount of such bonus and payments.

The Kennedy amendment appears to be motivated by a desire to combat KERPs in Chapter i t cases where employee-related fraud substantially contributed to the bankruptcy of the company. Yet, by painting with such a broad brush, the Kennedy amendment will, if enacted, effectively eliminate all companies' ability to ever receive court approval for a KERP. Federal bankruptcy judges would have little or no discretion to approve KERPs. In turn, bankrupt companies would have less flexibility in trying to retain or attract necessary employees. This result will cause considerable harm to companies in bankruptcy, their employees, and their creditors.

It is apparent that the Kennedy amendment is designed to prevent abuses of the system, where creditors' employees' and retirees' monies are unnecessarily expended for the enrichment of management. Whether there currently is or is not sufficient judicial scrutiny of KERPs is a valid question, insofar as the overall bankruptcy system allows debtors a fair amount of flexibility in exercising reasonable judgment, but there must be an approach better than handcuffing the judiciary and stakeholders in bankruptcy cases by essentially precluding all use of KERPs. The proper use of KERPs requires an analysis of all facts and circumstances of the case, and not what is essentially a blanket proscription of these tools.

Senator Kennedy has advanced an important public policy discussion with his amendment. Managers who have had responsibility for driving a company into bankruptcy should not be paid a bonus to remain. Similarly, if the retention of an employee would not enhance a company's value for its stakeholders, they should not be paid a bonus to stay. Current law provides bankruptcy judges with the discretion necessary to deny a KERP in such circumstances and bankruptcy judges do deny KERP payments in these circumstances. Still, if the Congress wishes to improve the operation of current law while still safeguarding the ability of the courts to approve legitimate KERPs, we would welcome a discussion on how best to achieve that end. Unfortunately, S. 256, as reported by the Committee, goes too far and should be amended so as not to unnecessarily limit the bankruptcy court's ability to determine what is in the best interest of each individual bankruptcy estate.

Mr. Chairman, we thank you for considering our views on this important matter. We would be pleased to address any questions you or other members of the Committee on the Judiciary may have.

Sincerely,

The members of the board and management of the Association of Insolvency and Restructuring Advisors.

APPENDIX "2"

BAPCPA §503(c)

BAPCPA §503(c)

§ 503. Allowance of administrative expenses

…

(c) Notwithstanding subsection (b), 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—

(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;

(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.