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Best of ABI 2022: The Year in Business Bankruptcy

A. Executive Compensation: Need for a Change to the Bankruptcy Code

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Most healthy companies have three tools in their executive compensation toolbox: incentive pay, retention pay and severance pay. For distressed companies, retention pay might be a particularly important tool that can be used to keep senior managers in place to preserve (and hopefully increase) value through the restructuring process. However, Congress, by adding § 503(c) to the Bankruptcy Code through the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), effectively did away with retention and severance pay for companies that have sought bankruptcy protection, leaving incentive pay as the only option during bankruptcy.

BAPCPA's restrictions have led to an unintended consequence: significant retention payments immediately prior to a bankruptcy filing. These "eve of bankruptcy" payments are seemingly inconsistent with the purpose of the BAPCPA executive compensation amendments, which were designed to give creditors and courts the ability to scrutinize these payments as part of the bankruptcy process. To address this problem, the Bankruptcy Code should be amended to balance the need for debtors to have flexibility in designing compensation arrangements with the need for appropriate court and creditor oversight.[2]

Legislative Handcuffs

Prior to BAPCPA, the retention and severance programs of companies in bankruptcy were subject to the general (and debtor-friendly) business-judgment standard, which gave debtors significant flexibility in designing compensation arrangements to motivate key employees to stay with the debtor.[3] However, the addition of § 503(c) as part

1 The authors thank corporate associate Esther Kang for her contribution to this article.

2 A bill was recently introduced in Congress that calls for a flat prohibition of bonuses to any individual earning more than $250,000 annually, and deems any such bonus made within the 180-day period prior to filing a voidable preference (No Bonuses in Bankruptcy Act of 2021, H.R. 5554, 117th Cong. (2021)). A flat prohibition would be counterproductive to the goal of value-maximization for all stakeholders, and accordingly, the proposals described herein would better address concerns with bankruptcy bonuses.

3 *See, e.g., In re Georgetown Steel Co. LLC*, 306 B.R. 549, 555 (Bankr. D.S.C. 2004) (approving retention plan given debtor's demonstration of sound business purpose); *In re Aerovox Inc.*, 269 B.R. 74, 80 (Bankr. D. Mass. 2001) (citing *In re Logical Software*, 66 B.R. 683, 686 (Bankr. D. Mass. 1986) (indicating that court should grant approval absent finding that plan is "so manifestly unreasonable that it could not be based upon sound business judgment").

of the BAPCPA amendments[4] severely limited — and effectively prohibited — certain payments to "insiders," defined as directors, officers and other persons in control of the debtor.[5]

Under § 503(c), retention payments to insiders are (1) limited to employees who both (a) have a "*bona fide*" job offer at the same or higher rate of compensation from another (presumably solvent) business, and (b) are "essential to the survival of the [debtor's] business"; and (2) subject to a cap of either 10 times the average payment to non-management employees made in the current calendar year or, if no such payment exists in the current calendar year, 25 percent of a similar payment in the prior calendar year.[6] Severance payments to insiders are limited to those made as part of programs applicable to all full-time employees and are subject to a cap of 10 times the average payment to non-management employees during the calendar year.[77] In addition, any payments outside the ordinary course of business to insiders, including those who were hired post-petition, must be justified by the "facts and circumstances of the case."[8]

BAPCPA's supporters argued that § 503(c) was necessary "to stop the travesty of high-level corporate insiders walking away with millions of dollars in bankruptcy while workers and retirees are left empty-handed."[9] In particular, legislators railed against the executives at Enron and WorldCom, who paid themselves significant amounts under so-called "golden parachutes" while their employees, investors and creditors suffered massive losses.[10] On the other hand, members of the Association of Insolvency and Restructuring Advisors (AIRA) expressed concern that § 503(c) would "handcuff ... the judiciary and stakeholders" and prevent necessary retention measures such as key employee retention programs (KERPs), which offer compensation to incentivize certain employees to stay with companies throughout the restructuring process.[11]

Section 503(c) has indeed made it nearly impossible for a debtor to put in place executive-retention programs during the bankruptcy process. For retention bonuses, the requirement that the insider be "essential to the survival" of the debtor's business is difficult and costly to prove. In addition, an insider who meets the requirement of having a job offer with equal or higher compensation is likely to take the other offer. Further, both retention and severance pay programs under § 503(c)(1)-(2) are subject to caps benchmarked to non-management pay. Because compensation of top executives can be hundreds of times that of nonexecutives as the result of natural market forces, these limitations can make it effectively impossible to design a retention plan that satisfies the requirements of § 503(c).

Accordingly, the AIRA's concerns appear to be well founded; Congress did impose legislative handcuffs in the area of bankruptcy executive compensation. This observation is borne out by a recent report by the Government Accountability Office (GAO), which found that not a single one of the approximately 7,300 companies that filed for bankruptcy in 2020 attempted to get an executive KERP plan approved.[12]

4 11 U.S.C. § 101, *et seq*.

5 11 U.S.C. § 101(31)(B).

6 11 U.S.C. § 503(c)(1).

7 11 U.S.C. § 503(c)(2).

8 11 U.S.C. § 503(c)(3).

9 151 Cong. Rec. S1991 (daily ed. March 3, 2005) (statement of Sen. John Kennedy).

10 151 Cong. Rec. S1987 (daily ed. March 3, 2005) (statement of Sen. Richard Durbin).

11 151 Cong. Rec. S2341 (daily ed. March 3, 2005) (statement of board and management of AIRA).

12 U.S. Gov't Accountability Office, GAO-21-104617, Bankruptcy: Enhanced Authority Could Strengthen Oversight of Executive Bonuses Awarded Before a Bankruptcy Filing 26 (2021)

Tensions Arising from Executive Pay in the Bankruptcy Setting

Unlike the insolvency regimes in many other countries, in a chapter 11 case existing management (rather than a trustee) continues to run the business. This is a policy choice; Congress adopted the "debtor-in-possession" model because it believed the model to be the best mechanism for successful reorganization. Congress determined that absent fraud, dishonesty or gross mismanagement,[13] existing management is best positioned to preserve value and steer the company through the bankruptcy process.

However, there is a real tension between the need to make significant payments to retain these executives and the large losses often faced by creditors and employees in a bankruptcy proceeding. Moreover, the circumstances of the bankruptcy process, including the inability to use stock-based compensation and the high likelihood of a change of ownership post-bankruptcy, create special challenges for management retention.

The § 503(c) Workaround: Pre-Bankruptcy Bonuses

In response to these challenges, many companies approaching bankruptcy have employed a workaround to avoid the § 503(c) issue: prepaid retention-bonus payments in the period leading up to the bankruptcy filing, or the so-called "payday before mayday." This phenomenon appears to be significant. According to the GAO, in 2020 42 companies awarded 223 executives close to $165 million before filing for bankruptcy, ranging from five months before to as few as two days before filing.[14]

The main problem with these pre-petition retention bonuses is that they are being made outside the bankruptcy framework. The foundation of U.S. bankruptcy is a bargaining system in which various constituents are given tools to negotiate an acceptable outcome. While public companies must disclose pre-bankruptcy bonus payments in a Form 8-K or other filing, there is no creditor or court supervision of pre-bankruptcy payments.[15]

Even if the amounts are entirely appropriate, there is a significant negative-perception issue with pre-bankruptcy bonus payments, which may undermine public confidence in the bankruptcy system. In fact, companies like Hertz, JC Penney and Whiting Petroleum received significant negative media attention for their pre-petition bonuses, which have been criticized as unseemly, given the companies' layoffs and losses.[16] While these payments are typically subject to a repayment requirement if the executive does not remain in place throughout the restructuring process, that is an imperfect tool for regulating payments over which creditors have no oversight or control. To address this problem and balance the interests of companies and creditors, the Bankruptcy Code should be amended to give distressed companies more leeway in adopting retention plans while under bankruptcy court supervision.

13 11 U.S.C. § 1104(a)(1).

14 U.S. Gov't Accountability Office, GAO-21-104617, Bankruptcy: Enhanced Authority Could Strengthen Oversight of Executive Bonuses Awarded Before a Bankruptcy Filing 31 (2021).

15 A pre-bankruptcy bonus payment could be subject to clawback post-bankruptcy as a preference or as a fraudulent transfer, but that is not as effective a governance mechanism as having prepayment creditor and court scrutiny. 11 U.S.C. §§ 547-548.

16 Abha Bhattarai & Daniela Santamariña, "Bonuses Before Bankruptcy: Companies Doled Out Millions to Executives Before Filing for Chapter 11," *Wash. Post* (Oct. 26, 2020), *available at* washingtonpost.com/business/2020/10/26/chapter-11-bankruptcy-executive-bonuses (last visited Dec. 20, 2021).

Proposed Solutions

Proposal 1: Subject All Executive Compensation Programs to Review Under a Single Heightened Business-Judgment Standard

The first step is to remove § 503(c)(1)-(2). This would leave only § 503(c)(3), which requires justification based on the facts and circumstances of the particular case as the test for all executive compensation plans. Courts have interpreted § 503(c)(3) as the standard by which to approve key employee incentive plans (KEIPs), as no other provisions in § 503(c) set limitations applicable to KEIPs. Per the widely adopted *In re Dana* factor test, courts have scrutinized KEIPs under a heightened business-judgment standard. The factors include the reasonableness of the plan in light of the debtor's needs and financial situation, as well as the fairness of the debtor's process in creating the KEIP.[17]

Section 503(c) should be amended to apply a similar heightened business-judgment standard when evaluating all executive compensation plans and arrangements. This would provide a consistent standard based on widely accepted precedent. Ultimately, judges should determine whether a plan is fair and reasonable, but a list of factors in § 503(c) (or at the very least, in the committee notes) should be included to guide judges on how to evaluate retention and severance plans under the amended Code.[18] Section 503(c) should also explicitly state that the debtor bears the burden of proving that the compensation plan meets the heightened business-judgment standard.

Judges should evaluate both the substance of the plan and process used to create and internally approve the plan. Factors used to evaluate the substance should include whether the plan is consistent with industry benchmarks, and whether there are reasonable rights to recover compensation under the plan for early termination or fraudulent behavior. Factors used to evaluate the process should include whether, if applicable, the plan has received approval by independent directors unaffiliated with the executives to be compensated, and whether independent counsel or compensation consultants were hired to perform due diligence. These factors should not be dispositive, and judges should be free to determine fairness based on the case's specific facts. However, given the potential conflict of interest inherent in executive-compensation arrangements, courts should be required to make specific findings that the relevant criteria have been satisfied in approving an executive-compensation plan or arrangement.

Proposal 2: Require Debtors to Seek Court Approval of Bonuses Made Within a Certain Period Pre-Petition

With loosened restrictions under Proposal 1 alone, debtors may still choose to make pre-petition bonuses rather than be subject to court scrutiny under the heightened business-judgment standard post-petition. Thus, § 503(c) needs to have a provision added that requires debtors to bring pre-petition bonuses into the bankruptcy process.

This provision would require debtors to make a motion for court approval of any retention payments, incentive-based payments or severance payments made within a specified period of time before the bankruptcy filing — say, nine months or one year. The official committee of unsecured creditors would be granted automatic standing to pursue preference or fraudulent-transfer claims to claw back pre-petition bonuses paid within the specified time frame unless and until the debtor seeks and obtains such court approval. This framework would allow creditors to make objections, parties to negotiate for an appropriate compensation structure in light of the debtor's business and industry, and the court to ultimately decide whether the compensation is appropriate. Payments that are not

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17 *In re Dana Corp.*, 358 B.R. 567, 576-77 (Bankr. S.D.N.Y. 2006).

18 While the removal of §§ 503(c)(1)-(2) should be interpreted by judges as intentional, there is some danger that a judge would continue to look to the previous version of the statute and related case law for guidance on the elements of a reasonable retention plan or severance agreement. To avoid this, the statute or the advisory committee notes should make explicit that these programs should not be subject to any specific cap, and — although described as a "heightened" business-judgment standard — the standard does not require the insider to be "essential to the survival" of the business.

approved would be required to be promptly returned, without the need for costly and time-consuming preference or fraudulent-transfer litigation.

Proposal 3: Include "Executive Compensation" in § 503(b) as a Specific Category of Administrative Expenses

Section 503(b) currently expressly includes wages, salaries and commissions that are necessary to preserving the estate and earned post-petition as categories of allowable administrative expenses.[19] This part of the Bankruptcy Code should be amended to specifically reference payments made or committed to be made under executive compensation programs approved under amended § 503(c) as allowable administrative expenses. This will give debtors (and their executives) additional incentive to obtain approval of retention programs and payments. If approved, the executive will have additional comfort that the payments will have administrative expense priority, thereby reducing the need to structure the payments as pre-paid bonuses subject to contractual clawback. Instead, the payments can be made only if and when the specified retention target has been met.

Conclusion

These proposals would bring executive-compensation plans designed to retain key management talent back into the bankruptcy process, where they belong. Paying big bonuses on the eve of bankruptcy sends the wrong message to important constituents, including employees and vendors, and upsets the careful balance between creditors and debtors. Retention payments should not be effectively outlawed as they currently are, which has the unintended consequence of forcing companies to make these payments outside the bankruptcy process. Appropriate retention plans can be in the best interests of all constituents, but the current workaround introduces unnecessary tension in the system. It is time to acknowledge that the BAPCPA approach to executive compensation in bankruptcy has not worked, and for Congress to fix it with something that does.

19 11 U.S.C. §503(b)(1)(A)(i). Administrative expenses are paid before priority and general unsecured claims. 11 U.S.C. §§ 507(a)(2), 726(a)(1), 1129(a)(9).