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Employee Compensation Programs: A Study of Judicial Interpretation Under BAPCPA (Part 1 of 2)

BY STEPHEN B. GERALD

When I decided to write an article regarding the judicial interpretation, thus far, of Congress's 2005 amendments to the U.S. Bankruptcy Code (known affectionately to bankruptcy lawyers as BAPCPA), affecting key employee retention programs (or KERPs), I did what any diligent researcher would do: I read other articles, written by some of the finest, astute bankruptcy lawyers in the country. Most of the articles I read on the subject provide an excellent, well rounded synopsis of pre-BAPCPA law (statutory and judicial interpretation), the initiatives to amend pre-BAPCPA law, BAPCPA itself, including the infamous, somewhat newly enacted Section 503(c), and finally, a summary of the judicial interpretation thus far.

This article is not intended to provide such a broad scope of Section 503(c) and its affect on KERPs. Rather, this article assumes that the reader is familiar with pre-BAPCPA law, the initiatives to amend pre-BAPCPA law, and BAPCPA itself. This article focuses solely on the judicial interpretation of BAPCPA that has taken place thus far and attempts to go beyond a review of the relief requested, granted and denied, and attempts to get inside the minds of the courts by additionally examining the comments and dialogue that took place at the hearings on the pleadings, but which did not necessarily make it into an order or written opinion. Such comments and dialogue, I believe, in these uncharted waters, is invaluable to today's commercial bankruptcy lawyer.

Stephen B. Gerald is a senior associate in the Bankruptcy section of Whiteford, Taylor & Preston LLP, Baltimore. He represents debtors, trustees, creditors' committees, and individual creditors in various complex Chapter 11 and Chapter 7 cases and related litigation. Questions about this article may be addressed to Mr. Gerald at 410-347-8700 or SGerald@wtplaw.com.

Keep in mind, the terms "key employee retention program" and "KERP" are, for all intents and purposes, terms of the past. In our post-BAPCPA world, no bankruptcy attorney in his or her right mind, who has studied the opinions and transcripts interpreting Section 503(c) thus far, would include such terms in their filing papers or even utter such words out loud (at least not in public). Rather, as a review of the cases below shows, bankruptcy lawyers have been quite creative and savvy in not only crafting new names for employee compensation programs, but in arguing the inapplicability of Section 503(c) and its strict requirements, all with one final goal: to obtain the relief that their clients require. The bankruptcy judges are listening.

This article examines cases before the U.S. Bankruptcy Courts for the District of Delaware and the Southern District of New York. Although other jurisdictions have considered employee compensation programs under BAPCPA, the cases decided in the District of Delaware and the Southern District of New York provide a fair representation of the issues considered nationwide. This article is broken into two parts, with the first part studying cases decided in the District of Delaware. The second part, to be published in next week's issue of BNA's *Bankruptcy Law Reporter,* studies the cases decided in the Southern District of New York. The format of this article is simple. First, this article summarizes the relief sought by the respective debtors to give the reader an understanding of the types of programs that have been proposed to courts under BAPCPA. Sec-

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ond, this article summarizes the orders entered by the courts, providing the reader with an understanding of the precedent that is being created. Third, this article provides a summary of the hearings on the pleadings, to the extent that hearing transcripts are available. Lastly, through a comprehensive review of the pleadings, the orders, and the hearing transcripts, this article provides comments and insight regarding the ramifications of the cases studied herein. Hopefully the information provided herein is helpful the next time you are filing, or faced with an employee compensation program in Chapter 11.

With that introduction, let's begin.

THE DELAWARE CASES

In re Nobex Corporation, No. 05-20050 (Bankr. D. Del. 2005)(J. Walrath).

***The Program*:**

Retention Plan

***The Motion*:**

On Dec. 9, 2005, the debtor filed a *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)*, pursuant to which the debtor requested authority to make incentive payments to two officers during the implementation of its sale procedures. The debtor argued that during the efforts to sell its assets, it was imperative for senior management to undertake every effort to support the due diligence process and the marketing of the debtor's assets. The debtor further argued that such sale efforts were essential to meet the burden imposed pursuant to Section 363 of the Bankruptcy Code.

The requested payments were contingent upon the total gross price received in a sale of substantially all of the debtor's assets. In support of the motion, the debtor relied upon Sections 105 and 363(b) of the Bankruptcy Code and argued that Section 503(c) was satisfied to the extent that the participants were deemed insiders.

***The Order*:**

On Jan. 20, 2006, the court entered an *Order Authorizing Payment of Sale-Related Incentive Pay to Senior Management Pursuant to 11 U.S.C. §§ 105, 363(b) and 503(c)(3)*.

***The Hearing*:**

At the Jan. 12, 2006, hearing, the court noted that the program was not just a retention program. In fact, the court noted that ''the structure's based on not just being here, but getting a successful conclusion to the sale; that is, an upside price.'' The court further noted,

> I think in this case it is clear that from structure [sic] 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 meant [sic]. That is, if the sale does not produce sufficient funds, they will not get anything. Similarly, they can leave the day after the sale and get the incentive if in fact the sale produces more than the minimums required under this. So I see it as not a retention plan and therefore not subject to the (c)(1) strictures.

(Transcript at p. 87.)

In distinguishing the program before her from the traditional retention programs that perhaps offended Congress and caused it to enact Section 503(c), the court noted that ''an incentive program that is based on a sale, an increase in sale price, does not seem to be or to fit in with what 503(c)(1) was meant to do . . . .'' It is worth noting, however, that the court did state that such a program could fit into Section 503(c) if the debtor had been selling its assets prepetition and there were plans in place to provide payments based on that sale.

In approving the compensation program before her, the court applied Section 503(c)(3) and stated as follows:

> So I do read (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 provided to the Court by Congress, I find it quite frankly nothing more than a reiteration of the standard under 363 and—well, 363 under which courts had 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.

(Transcript at p. 86).

In discussing the requirements of Section 503(c)(3), the court addressed the debate regarding whether the language, ''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,'' is inclusive or exclusive, i.e., whether ''hired after the petition date'' applies to officers, managers, and consultants, or only consultants. In respect thereof, the court noted, ''I agree that the including transfers made to officers, managers or consultants hired after the petition date is not exclusive. That's clear from other provisions in the Bankruptcy Code.'' (Transcript at p. 86).

Finally, it is noteworthy that the court placed ''great weight'' on the fact that the program was presented and negotiated with the creditors' committee, who as well as the debtor, has a fiduciary duty to all creditors, but has a particular interest in assuring that general unsecured creditors get some recovery.

***Author's Comment*:** This case makes clear that there is a real distinction between retention programs and incentive programs, with Section 503(c)(1) and its strict requirements, applying solely to the former and Section 503(c)(3) applying to the latter. Section 503(c)(3) allows employee compensation outside of the ordinary course if it is ''justified by the facts and circumstances of the case.'' As this court noted, in drafting (c)(3), Congress did not provide any guidance as to what facts or circumstances would justify approval of compensation under this subsection. This case provides some clarity in this regard through the court's application of the business judgment standard set forth in Section 363 of the Bankruptcy Code. Congress has made approval of retention programs to insiders so difficult,

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vis-a-vis Section 503(c)(1), that compensation programs will likely take the form, more often than not, of incentive programs, rather than retention programs, in which case the debtor need only satisfy the business judgment rule, to the extent that courts agree with Judge Walrath's interpretation.

In re FLYi Inc., et al., No. 05-20011 (Bankr. D. Del. 2005)(J. Walrath).

***The Program*:**
Wind-Down Employee Plan

***The Motion*:**
On Jan. 2, 2006, the debtors filed an *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*. By the motion, the debtors requested authority to pay termination benefits to certain terminated and furloughed employees, as well as to compensate employees that would remain with the debtors to assist in the wind down.

Under the program, the debtors provided each participant with a wind-down task. The length of time required to complete such task determined the amount of additional compensation to such employee. The debtors argued that the program should be approved pursuant to Section 363(b). In addressing Section 503(c), the debtors asserted that the program did not conflict with Section 503(c)(1) because that section only applies to entities continuing as a viable commercial enterprise. The debtors, however, were in the process of liquidating their estates, and as such, there would be no business remaining. Hence, the employees' services would not be essential to the survival of a business. In the alternative, the debtors argued that the program was not intended to induce the participants to stay in their employ; but rather it was intended to create incentives to wind down the debtors' affairs.

In the motion, the debtors noted that if the court found that the program contravened Section 503(c) with respect to participating insiders, the debtors intended to either: (i) seek authority to enter into post-petition employment agreements with such insiders otherwise covered by Section 503(c)(1) at base salaries equal to the amount payable under the program; (ii) terminate the employment of such insiders and enter into consulting agreements with such employees as independent contractors; (iii) demote such employees so that they were no longer insiders; or (iv) establish incentive based bonuses on the assumption that they would not fall within the ambit of Section 503(c) that would be satisfied by such insiders.

The debtors also sought authority to pay, among other things, severance to employees terminated or furloughed as a result of the discontinuation of scheduled flight operations. With respect to non-union employees, the debtors sought to modify their prepetition severance plan to provide a flat severance payment of two weeks pay to such employees and asserted that such payments would create administrative expenses of the estate. The debtors estimated that the total cost of compensation for non-union employees, including severance, would be $6,040,000.

With respect to union employees, the debtors sought to honor the respective collective bargaining agreements (CBA) in place prior to the bankruptcy filing. The CBAs provided one week severance payments for full time employees with at least one full year of service and two weeks for full time employees with at least two full years of service. The debtors estimated that the total cost of compensation to union members, including severance, would be $5,260,000.

The Orders:
On Jan. 5, 2006, the court entered an *Order (I) Authorizing the Debtors 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 this order, the court found that the debtors articulated a sound business purpose for the approval and implementation of the wind-down employee plan and payment of termination benefits pursuant to Section 363 and approved the program with respect to non-insiders only. The court found that the debtors could, in consultation with the creditors committee, modify the program, provided that total compensation would not exceed $4.4 million.

On Feb. 6, 2006, the court entered an *Order Approving Wind-Down Employee Plan Pursuant to Section 503(c)(2) of the Bankruptcy Code With Respect to Certain Officers of the Debtors*, pursuant to which the court approved the program, under Sections 363(b) and 503(c)(2), with respect to the six respective insiders. The court approved an agreement between the debtors and the U.S. Trustee (UST) that no bonus would be paid to any officer exceeding $118,385.96, such that the order complied with the requirements of Section 503(c)(2).

***The Hearing*:**
As the Jan. 6, 2006, order approved the program with respect to non-insiders, the Jan. 12, 2006, hearing pertained solely to the approval of payments to the participating insiders. At the hearing, the debtors and the UST presented an agreement to the court to treat the proposed payments to the insiders as severance payments pursuant to Section 503(c)(2). Accordingly, such payments could not be more than 10 times the severance payments to non-insiders. The parties reserved their rights with respect to any incentive payments for which the debtor may seek future approval.

At the hearing, counsel for the Association of Flight Attendants (AFA) argued that the debtors misinterpreted Section 503(c)(2)(B), specifically the language requiring that "the amount of the payment [to insiders] 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." Counsel for the AFA argued that the debtors' calculation was based on the 171 non-insider employees participating in the program and erroneously failed to include employees that were not terminated. Counsel for the AFA argued that under the debtors' interpretation, a debtor could implement a wind-down plan with one non-insider receiving severance and multiply that number by 10 to calculate the amount of severance payable to insiders, with everybody else receiving no compensation.

In response, the court stated,

> I think the prior (c)(1)(C) talks about payments being equal to ten times amounts made during the prior calendar year or the calendar year in which it was made and then applicable to a prior period. But this doesn't have any of that prior language, and I think that it does contemplate creating a severance payment for remaining employees after the debtor has gone through its cost cutting and does not mean that because you're now proposing to do severance payments for employees you have to go back . . . and retroactively give severance payments for terminated employees . . . I think this contemplates a new severance program, if you will.

(Transcript at p. 11).

***Author's Comment*:** This case is insightful in that it explains how Section 503(c)(2) severance payments to insiders should be calculated. Furthermore, this case provides some options to consider when seeking approval of employee compensation programs for insiders. In the motion, the debtors noted that if the court found that the program contravened Section 503(c) with respect to the insiders they would either: (i) seek authority to enter into post-petition employment agreements with such insiders otherwise covered by Section 503(c)(1) at base salaries equal to the amount payable under the program; (ii) terminate the employment of such insiders and enter into consulting agreements with such employees as independent contractors; (iii) demote such employees so that they were no longer insiders; or (iv) establish incentive based bonuses on the assumption that they would not fall within the ambit of Section 503(c) that could be satisfied by such insiders. The extent to which any of these options would pass muster with the courts is uncertain. Nevertheless, these are options that should at least be considered.

In re Aphton Corporation, No. 06-10510 (Bankr. D. Del. 2006)(J. Sontchi).

***The Program*:**

Sale-Related Incentive Pay

***The Motion*:**

On June 9, 2006, the debtor and the creditors committee filed a *Joint Motion of Debtor and of Official Committee of Unsecured Creditors for Order Authorizing Payment of Salary Deferral and Sale-Related Incentive Pay to Debtor's Employees Pursuant to 11 U.S.C. §§ 105, 363(b) and 503(c)(3)*. Prior to the filing of the motion, the debtor began efforts to sell substantially all of its assets and was having liquidity problems. The committee proposed to all of the debtor's employees, and certain employees accepted, an arrangement whereby the employees would defer taking their salary in return for receipt of their salary with a deferral bonus upon the sale of the debtor's assets. The total bonus to be paid to the three participating employees was $50,250.

The debtor and the committee argued that the relief should be granted in accordance with Sections 105 and 363(b) of the Bankruptcy Code and to the extent that Section 503(c) was applicable, as a result of the status of the employees as insiders, the facts and circumstances justified the requested relief thereunder.

***The Order*:**

On June 15, 2006, the court entered an *Order Authorizing Payment of Salary Deferral and Sale-Related Incentive Pay to Debtor's Employees Pursuant to 11 U.S.C. §§ 105, 363(b) and 503(c)(3)*, pursuant to which the debtor was authorized to pay a gross amount of no more than $102,416 to the deferring employees, payable upon the closing of the sale for their efforts in achieving such sale. However, the order provided that in order to receive the salary deferral and sale-related incentive pay, the deferring employees were required to remain employees of the debtor from the date of the entry of the order through and including the date of the closing of the sale.

***Author's Comment*:** This case provides another option to consider when seeking approval of an employee compensation program in the face of opposition: deferral of compensation, payable with a bonus, upon consummation of the respective transaction. This case is noteworthy in that the court approved the compensation program, which was clearly a retention based program, pursuant to Section 503(c)(3), which this court had begun to utilize when approving incentive based compensation programs.[1]

In re Werner Holding Co. (DE) Inc., No. 06-10578 (Bankr. D. Del. 2006)(J. Carey).

***The Programs*:**

Business Optimization Bonus Plan & Chicago Plan Transition Bonus Plan

***The Motion*:**

On June 30, 2006, the debtor filed a *Motion for Entry of Order Authorizing Debtor to Honor Prepetition Incentive-Based Bonus Plans Pursuant to Sections 363 and 105 of the Bankruptcy Code*, pursuant to which the debtor sought approval of its Business Optimization Bonus Plan (BOB Plan) and its Chicago Transition Bonus Plan (the Chicago Plan), both crafted by the debtor's management with the assistance of an outside consultant prior to the petition date.

The BOB Plan sought to reward employees by providing bonuses equal to a percentage ranging from 10 to 75 percent of the respective employee's annual salary upon meeting certain individual and collective goals. By the motion, the debtor proposed to make BOB Plan payments in 4 installments. Approximately 116 employees were eligible to participate in the BOB Plan and the debtor estimated that the total maximum cost would be $4,000,000, with the average amount payable to each employee being approximately $35,000.

[1] See *In re Musicland Holding Corp., et al.*, No. 06-10064 (Bankr. S.D.N.Y. 2006), in which Judge Bernstein notes that an incentive based program which calls for the participants' continued retention, may be subject to the purview of Section 503(c)(1).

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The Chicago Plan was crafted to motivate employees deemed critical to the transition of the debtor's operations to Juarez, Mexico. The Chicago Plan bonuses ranged from 8 to 100 percent of an employee's annual base salary and the bonuses were payable in one lump sum within 15 days of the participating employee's meeting performance objectives. Approximately 81 employees were eligible for the Chicago Plan and the debtor estimated that the total maximum cost would be $2,600,000, with the average amount payable to each employee being approximately $32,000.

The Orders:

By July 28, 2006, and Aug. 23, 2006, orders, the court approved the BOB Plan and the Chicago Plan. With respect to the 10 executive participants of the BOB Plan, the court limited the relief granted to the debtor. One of the executives could not receive payment if he was terminated for cause. Another executive's payment was subject to disgorgement if he voluntarily terminated his employment before a certain date.

Furthermore, the order required the debtor to complete written evaluations of each executive's entitlement to payment, providing copies to the committee. The committee thereafter had an opportunity to object to any payments made. Whereas most orders approving incentive programs grant administrative expenses to the participants, this order purposefully did not create an obligation on the debtor, but rather gave the debtor discretion as to whether and when to pay.

***The Hearing*:**

At the July 25, 2006, hearing, although the court shared some of the objectors' reservations concerning payment to the nine executives, the court sensed a consensus that the rank and file supervisors who were key to the continued operation of the business should receive payments under the BOB Plan and the court was willing to give interim approval for the July payment to those individuals.

***Author's Comment*:** This case provides further options to consider when seeking approval of an employee compensation program in the face of opposition. Whereas most orders approving employee compensation programs grant such payments administrative priority, this order purposefully did not. Furthermore, the creditors' committee had an opportunity to object to the payments prior to the debtor's making such payments. These bargaining options may assist a debtor in garnering committee support of a proposed employee compensation program.

In re Radnor Holdings Corporation, et al., No. 06-10894 (Bankr. D. Del. 2006)(J. Walsh).

***The Program*:**

Management Incentive Plan (MIP)

***The Motion*:**

On Aug. 31, 2006, the debtors filed a *Motion for Order Under Bankruptcy Code Sections 105 and 363(b) Authorizing Payment of Sale-Related Incentive Pay to Senior Management*. The program was intended to provide participants with greater compensation in the event that they obtained greater value for the debtors' estates. The debtors proposed that upon the closing of a sale or alternative transaction, a pool of funds would be made available to the program participants. The incentive compensation pool would increase only as the value of the transaction increased.

The debtors proposed that the initial amount of the incentive compensation pool be $700,000, which was the amount of incentive compensation that the purchaser of substantially all of the debtors' assets agreed to assume upon consummation of the sale. Under the program, the minimum incentive pool would not increase unless and until the debtors received aggregate consideration sufficient to pay the lenders under the debtor-in-possession facility.

Pursuant to the program, four members of the debtors' senior management were designated as participants. The debtors also requested that a portion of the pool be made available to pay junior members of management that provided significant benefits to the restructuring process and requested that upon consummation of the sale, the pool of $700,000 be divided as follows: $625,000 to senior management and $75,000 to the junior executives. The debtors argued that the program did not conflict with Section 503(c), which only applies to payments meant to induce insiders to remain with the debtors' business. The debtors argued that the program was not intended to induce anyone to remain with the debtors' business. Although participants were required to be employed on the date of sale or alternative transaction, the debtors argued that such requirement was not intended to induce any participant to remain in the debtors' employ. Rather the payments were intended to ensure that the participants continue their efforts to solicit/facilitate the consideration of alternative transactions.

***The Order*:**

On Oct. 4, 2006, the court entered an *Order Under Bankruptcy Code Sections 105 and 363(b) Authorizing Payment of Sale-Related Incentive Pay to Senior Management*, pursuant to which the court approved the MIP.

***The Hearing*:**

At the Oct. 4, 2006, hearing, the U.S. Trustee argued that because Sections 503(c)(1) and (c)(2) apply to insiders, the court should find that Section 503(c)(3) does as well. In response, the court made clear that "well, I would agree with you if 503(c)(3) said other transfers or obligations with respect to insiders. But Congress didn't say that."

***Author's Comment*:** Similar to the *Aphton Corporation* case, this court approved the respective program as an incentive based program under § 503(c)(3), notwithstanding the requirement that the participants remain in the debtors' employ through a specified period of time. These rulings, coupled with the court's statements in *Musicland Holding Corp.*, have the potential to muddy the waters in distinguishing between a retention program subject to (c)(1) and an incentive program subject to (c)(3). This could be an issue that may ultimately require clarification by Congress or the U.S. Supreme Court.

With respect to the court's interpretation of Section 503(c)(3), although it may seem obvious that (c)(3) does not only apply to insiders, this case certainly provides clarity to the extent necessary.

In re Advanced Marketing Services Inc., et al., No. 06-11480 (Bankr. D. Del. 2006)(J. Sontchi).

***The Programs*:**
Management Incentive Plan (MIP) and Employee Retention Plan (ERP)

***The Motion*:**
On Feb. 23, 2007, the debtors filed a *Motion for Order Authorizing Payments of (i) Sale-Related Incentive Pay to AMS Senior Management and (ii) Retention Pay to Certain AMS Employees Pursuant to Sections 105(a) and 363 of the Bankruptcy Code*, pursuant to which the debtors requested that the court approve (i) a management incentive plan and (ii) an employee retention plan. The motion was filed in conjunction with one of the debtor's efforts to sell substantially all of its assets.

Under the MIP, the debtors proposed to provide six senior executives with the ability to share in an incentive compensation pool of at least $765,000. Payment under the MIP, however, would be contingent upon the occurrence of: (1) the closing of the sale of the debtors' assets; and (2) completion of the debtors' inventory return program in the event that such inventory was not sold in conjunction with the sale. The MIP would further provide participants with an opportunity to earn additional compensation in the event that a higher and better offer was realized by the debtors. Specifically, the MIP provided that the participants would receive 1 percent of any additional consideration received in excess of the stalking horse's purchase price through an alternate transaction. For additional compensation exceeding $2 million above the purchase price, the MIP proposed to provide the plan participants with 2 percent of such excess consideration.

Under the ERP, 67 non-executive employees would be eligible to receive bonuses ranging from $7,500 to $50,000 based on (1) a consideration of their compensation in effect; (2) employment position classification; and (3) continued employment with the debtors on April 30, 2007. The debtor estimated that the total cost of the ERP would be $915,000. The purpose of the ERP was to retain the participants to continue to operate the debtors' business and enable a going concern sale and to complete the inventory return program.

The debtors sought approval of the MIP and the ERP pursuant to Sections 363(b)(1) and 105(a) of the Bankruptcy Code and argued that neither Section 503(c)(1) nor (c)(2) were applicable to the MIP. In respect of § 503(c)(1), the debtors argued that the MIP was not intended to induce the participants to remain with the debtors' business and the MIP did not contain a date certain through which participants were required to remain employed with the debtors. Rather, the benchmark for payments were developed to ensure that the participants maximized value for the estate. The debtors characterized the MIP as a performance based, sale-related incentive plan and not a retention plan or severance program. With respect to the ERP, the debtors urged that the program was supported by a valid business reason.

***The Orders*:**
On March 5, 2007, the court entered an *Order Authorizing Implementation of Employee Retention Plan and Payment of Retention Pay to Certain AMS Employees Pursuant to Sections 105(a) and 363 of the Bankruptcy Code*. The order authorized the debtors to pay retention bonuses in the aggregate amount of $820,000 under the ERP. To the extent that a participant received a commensurate employment offer from the purchaser of the debtors' assets, regardless of whether the employee accepted or rejected such offer, such employee was ineligible to receive any retention bonus under the ERP.

On March 13, 2007, the court entered an *Order Authorizing Implementation of Management Incentive Plan and Payment of Incentive Pay to AMS Senior Management Pursuant to Sections 105(a) and 363 of the Bankruptcy Code*. The order authorized the debtors to pay incentive bonuses to the MIP participants in the aggregate amount of $635,000. The order further provided that with the exception of one of the participants (the CEO), to the extent that a participant was offered commensurate employment from the purchaser of the debtors' assets within 30 days of the closing of the sale, regardless of whether such participant accepted or rejected the offer, such participant would only be eligible to receive 50 percent of the participant's share of the bonus pool. The CEO, on the other hand, was entitled to receive 70 percent of this share of the bonus pool upon the closing of the sale and would be paid the remaining 30 percent on or about the 90th day following the closing of the sale, provided, however, that if he received an offer of commensurate employment from the purchaser of the debtors' assets within 90 days after the closing of the sale, he would not be entitled to receive such 30 percent balance. The order further provided that the payments made under the MIP were administrative expenses pursuant to Section 503(b) of the Bankruptcy Code.

***The Hearing*:**
As the March 5, 2007, order approved the ERP, the March 13, 2007, hearing pertained solely to approval of the MIP. At the hearing, debtors' counsel advised that payment under the MIP was contingent upon the occurrence of four events: (1) the closing of the sale of the debtors' assets; (2) completion of the debtors' inventory return program in the event that such inventory was not sold in conjunction with the sale; (3) collection of accounts receivable of one of the debtors' subsidiaries; and (4) the sale or liquidation of a certain foreign business identified by the debtors.

At the hearing, the U.S. Trustee argued that at least two of the participants of the MIP were insiders and therefore asserted that Section 503(1) was applicable. First, the court noted that ''in order for (c)(1) to apply, it's not only an insider, but it's for the purpose of inducing such person to remain.'' (Transcript at p. 39). Second, in response to the trustee's assertion that only two of the participants were insiders, the court noted:

> my feeling is words matter. And if you're going to call somebody a vice president, I think he's an officer, unless you can give me some sort of evidence to the contrary that would indicate that it's a title, and doesn't really have any actual effect on reality. So I really consider them all insiders.

(Transcript at p. 40).

The trustee also asserted that the MIP was a retention program subject to Section 503(c)(1), as opposed to an incentive program. In respect thereof, the court recog-

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nized the fine line between retention based programs and incentive based programs. In presenting a standard in distinguishing the two, the court stated:

> I think anyone's paycheck, in part, regardless of bonus and whatnot, has at least partly the purpose of inducing such person to stay with their employment. So it can't be, in my mind, the statute can't mean that if it is a purpose, retention, that that somehow swallows the rest of the program. So my - - when I dealt with this previously, I tried to focus on, you know, whether it was a primary or material purpose was retention. And I think the way this is structured . . . this is really structured not for the *primary or material purpose of retention*, but for the purpose of finishing the deal.

(Transcript at p. 41). (emphasis added).

With respect to the CEO, The trustee argued that because his compensation was contingent only upon the closing of the sale of the debtors' assets, the MIP, as it applied to him, was more in the nature of a severance program subject to § 503(c)(2). Counsel for the debtor and the creditors' committee argued that it was not a severance payment because it was not based on prior service to the debtors and that it was contingent upon the closing of the sale. In pondering the issue, the court stated, ''[w]ell, it can also be to incentivize someone to leave. I mean, it's a buyout. I mean, you could consider buyout part of a severance package.'' (Transcript at p. 44). Nevertheless, the court ultimately found that the CEO's payment was not a severance payment and stated,

> its in effect an accelerated payment of the incentive to Mr. Rautenstrauch for getting the closing of the B&T sale done and also in contemplation that in all likelihood his employment with the company will cease in the fairly near future, which makes sense to accelerate it to the, as a result of that. I'll find that its not a severance payment that implicates 503(c)(2), but is in fact an incentive program

(Transcript at p. 46).

Finally the court noted, ''it's obviously of significance to me that the Committee is on board in this case, and did significant work in ensuring that the incentive program was indeed an incentive program, and that the amount is reasonable.''

***Author's Comment*:** This case is replete with comments made by the court that did not make it into the court's order that a practitioner might find helpful or even instructive. First, the court provided some clarity with respect to Section 503(c)(1). First, the court made clear that status as an insider is not enough to invoke Section 503(c)(1). Rather, in addition to being an insider, the respective program must also be a retention program. Second, while acknowledging the lack of clarity between retention based programs and incentive based programs, the court established a test in determining the applicability of Section 503(c)(1). As set forth by the court, the distinguishing factor is whether the ''primary or material purpose'' of the program is to retain the participant. If so, and the participant is an insider, the program is subject to the requirements of Section 503(c)(1). Third, the court appeared to create a presumption that a party may be deemed an insider, merely by his title.

Please look for Part Two of this article in next week's issue of BNA's Bankruptcy Law Reporter as we study cases decided in the Southern District of New York.

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