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

BY STEPHEN B. GERALD

This is the second part of a two part series studying the judicial interpretation, thus far, of Congress's 2005 amendments to the U.S. Bankruptcy Code, affecting key employee retention programs (or KERPs). In last week's issue of *BNA's Bankruptcy Law Reporter,* we studied cases decided in the District of Delaware. This second part studies cases from the Southern District of New York.

THE NEW YORK CASES

In re: Refco Inc., et al., No. 05-60006 (Bankr. S.D.N.Y. 2005)(J. Drain).

The Program:

Key Employee Compensation Program

The Motion:

On Dec. 21, 2005, the debtors filed a *Motion for Order Under 11 U.S.C. §§ 105 and 363 Authorizing Implementation of Key Employee Compensation Program.* The debtors stated that the program was designed to retain certain employees key to the successful wind-down of the debtors' business operations by providing a financial incentive for them to remain. None of the key employees held officer or director positions with the debtors. The program was part of a larger effort to retain certain employees of non-debtor affiliates that were also conducting wind-down operations and covered 17 employees of the debtors and 15 employees whose work benefited both debtor and non-debtor entities.

Under the program, key employees would be eligible to receive (i) a year-end bonus consistent with the debtors' historical policy; and (ii) a performance bonus based on a successful and timely sale and wind-down of the debtors' businesses. Additionally, key employees would remain eligible to receive severance benefits consistent with the debtors' severance policy, which provided for two weeks' salary per year of service, capped at six months' salary.

The program divided key employees into two tiers. The first tier included employees with knowledge and expertise necessary to lead the wind-down and maximize the value of the debtors' estates. The debtors proposed to provide these employees with a year-end bonus equal to four months' salary and a performance bonus equal to one month base salary for each month they worked during a four month period. The second tier included employees who would support the efforts to wind-down the debtors' businesses and maximize value for their estates and who had the institutional knowledge and expertise to assist in these efforts. The debtors proposed to provide these employees with a year end bonus equal to two months' salary and a performance bonus equal to one-half month of their base salary for each month they worked in the same four month period. The proposed maximum payable amount to all key employees was approximately $1.4 million.

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.

The debtors proposed to pay 50 percent of the year-end bonus in the first paycheck of 2006 if the employee did not resign prior to Jan. 1, 2006. The debtors proposed to place the remaining 50 percent in escrow, to be paid after the earlier of March 31, 2006, or the covered employee's separation date. Furthermore, in order to receive the full year-end bonus, employees would have to be employed by the debtors on Dec. 31, 2005, and the earlier of March 31, 2006, or the date on which the employee's services were no longer needed.

A covered employee's performance bonus would accrue monthly and would be placed in escrow, to be paid after the earlier of March 31, 2006 or the covered employee's separation date. The performance bonus would be pro-rated for those employees whose last date of employment fell before the end of the month. In order to receive a performance bonus, a covered employee needed to remain actively employed by the debtors through and including the earlier of March 31, 2006, or such employee's separation date. Any key employee who voluntarily left the debtors' employment before the target dates would forfeit their rights to future payment under the program. Any amounts that would have otherwise been payable, but were not paid due to voluntary resignation, would be returned to the estate.

The Order:

On Jan. 18, 2006, the court entered an *Order Under 11 U.S.C. §§ 105 and 363 Approving Implementation of Key Employee Compensation Program*. The order granted administrative priority to the payments to be made under the program pursuant to Sections 503(b)(1)(A) and 504(a)(2) of the Bankruptcy Code. The order was without prejudice of a subsequent determination within 60 days after entry of the order that the costs of the program should be allocated to debtor or non-debtor entities other than as identified in the motion. The order provided protection to the creditor's committee by enabling it to inform the debtors of any particular employee that it believed failed to cooperate adequately and should therefore be removed from the debtors' consideration for payment.

The Hearing:

At the Jan. 10, 2006, hearing on the motion, the court found that the respective employees did not fall within the purview of Section 503(c), as none of them were ''insiders'' as defined in Section 101(31). Although the employees may have had certain decision making authority pre-petition, they did not have any such authority during the bankruptcy. The court stated:

> [b]ased upon the current status of this debtor which is – or these debtors – which is that they are not operating but are in liquidation mode, I do not believe that they have the type of decision making authority that was addressed by section 503(c), or that there is a basis to assume that they are being offered this KERP because they are insiders. Rather, it's clear to me they're offered the KERP because they are productive employees, and more importantly, critical to the efficient administration of the estate and the economical administration of the estate going forward.

(Transcript at p. 30). The court further noted that,

> I generally have been reluctant to approve KERP's even before BAPCPA, but one circumstance in my mind clearly justifies the KERP, and that is where the employees are working themselves out of a job in facilitating an orderly liquidation and that is clearly what's happening here.

(Transcript at p. 30).

Author's Comment: This case is insightful because it addresses some of the issues raised in *Flyi Inc.*, No. 05-20011 (Bankr. D. Del. 2005), that were not ultimately addressed by the court in light of the debtors' and the U.S. Trustee's settlement. In *Flyi Inc.*, the debtors argued in their motion that their compensation program did not conflict with Section 503(c) because that section only applies to entities continuing as viable commercial enterprises. As the *Flyi Inc.* debtors were in the process of liquidating their estates, they argued that there would be no business remaining, and thus Section 503(c) was inapplicable. Although the *Flyi Inc.* court never addressed this argument, in finding that Section 503(c) was inapplicable, the *Refco Inc.* court appeared to rely on that very argument. This ruling is important as it provides a basis for liquidating debtors to avoid application of Section 503(c) and an ability to utilize the more lenient business judgment standard set forth in Section 363 and described by the court in *In re Nobex*, *supra*.

Additionally, in *Flyi Inc.*, the debtors noted that if the court found that the program contravened Section 503(c) with respect to the participating insiders, they intended to, *inter alia*, demote such employees so that they were no longer insiders. Although those efforts never occurred in *Flyi Inc.*, in finding that the respective employees were not insiders within the definition set forth in Section 101(31), the *Refco Inc.* court noted that although the employees may have had certain decision making authority pre-petition, they did not have any such authority during the bankruptcy. This is an important finding as it legitimizes efforts to strip insider status away from a plan participant in order to avoid applicability of Section 503(c).

In re Musicland Holding Corp., et al., No. 06-10064 (Bankr. S.D.N.Y. 2006)(J. Bernstein).

The Programs:

Shrink Plan, Severance Plan, Corporate Management Incentive Plan

The Motion:

On Jan. 12, 2006, the debtors filed a *Motion for Order Authorizing, But Not Directing, Debtors to Pay Certain Prepetition 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*. By the motion, the debtors requested authority to implement or continue the following programs:

Shrink Plan – Pre-petition, the debtors initiated a retention and severance program in connection with going out of business (GOB) sales to retain store managers and incentivize them through store closing dates. Under the Shrink Plan, each store manager was eligible to receive a $500 bonus depending on the results of the GOB sales. The debtors estimated the cost of continuing this program to range between $150,000 and $186,000.

   ISSN 1044-7474

Severance – Pre-petition, the debtors offered severance benefits to certain employees in the event of involuntary termination. Benefits were determined by years of service and position. The debtors requested authority to continue the program and pay severance obligations to employees terminated post-petition. The debtors estimated that between the petition date and the first week of February (approximately three weeks), severance payments would total approximately $2.2 million to more than 125 employees who had been employed with the debtors between one to 24 years.

Corporate MIP - Shortly before the petition date, the debtors increased base salaries to market competitive levels for approximately 35 employees (less than $480,000 on an aggregate annual basis). The debtors also compensated corporate employees under a Management Incentive Program (MIP) for performance meeting various profitability or operational goals. Under the MIP, if certain target metrics were met, individualized bonuses would be paid based on a percentage of employees' salaries. The debtors sought to continue and honor any pre-petition obligations owed under the Corporate MIP and also sought to enhance the Corporate MIP for 2006 to reward certain officers, directors, and managers that would continue to play a critical role in the debtors' restructuring.

Modified Corporate MIP – the debtors proposed to pay 25 percent of the current Corporate MIP 2006 target bonuses. The debtors proposed to create a discretionary pool of $665,000 to be paid in one installment following the close of fiscal year Feb. 28, 2006. The debtors argued that the modified Corporate MIP was critical to properly incentivize eligible employees.

The debtors sought approval of the motion pursuant to Sections 105 and 363 and asserted that the payments were in the ordinary course of business pursuant to Section 363(c). The debtors asserted that none of the programs resembled a retention program; rather, the debtors merely sought to continue their prepetition practice of rewarding employees' performance. The debtors asserted that § 503(c) was inapplicable.

The Orders:

By orders dated Jan. 17, 2006, Feb. 1, 2006, Feb. 22, 2006, and March 27, 2006, the court approved the various programs. With respect to the Modified Corporate MIP, the court authorized the debtor to pay $368,144 to 94 employees. The debtors withdrew their request for the remaining $171,138 from the Modified Corporate MIP payable to 5 additional employees.

The Hearing:

At the March 1, 2006 hearing, the court expressed concern as to whether the programs were actually disguised retention plans. In questioning debtors' counsel as to whether a participant would receive a bonus if they resigned immediately after entry of an order, with a sale occurring a month after, the court noted, ''I would think they'd have to stay around. It sure looks like a retention plan to me.'' (Transcript p. 29).

When debtors' counsel argued that the effect of every performance program is to prevent employees from leaving, the court responded, ''not necessarily. Somebody could have done enough on the sale that they've earned their money now and they can leave. And if the sale goes forward they get paid. You know, when I read it, it certainly sounded like a retention program to me. Unless you're telling me that they don't have to stay around to get the money. And then I question you, why, you know, why would the debtor do that.'' (Transcript p. 30). In response thereto, the debtors' counsel argued that the plans were performance based. The court, however, made clear that, ''I understand that it's performance-based, but they still have to stay around to get it, don't they?'' Debtors' counsel replied in the affirmative but argued that the Bankruptcy Code does not provide that if one of the impacts of a program is to keep people, or one of the terms is that they are staying, that it is an impermissible retention program. The Court concluded, ''well it's — it just sounds like a KERP to me. It's not permissible or impermissible. You just have to satisfy the requirements of the code.'' (Transcript at p. 31).

Author's Comment: This case presents an important issue that must be considered when seeking approval of an employee compensation program. In *In re Nobex*, No. 05-20050 (Bankr. D. Del. 2005), Judge Walrath appeared to provide debtors with a way to avoid the applicability of Section 503(c) by structuring programs as incentive programs, as opposed to retention programs. Incentive programs are by definition performance based. In *Musicland Holding Corp.*, the court raises the issue that performance based programs may nevertheless be retention programs subject to Section 503(c). Accordingly, in structuring employee compensation programs, this case makes clear that it is important to understand the interplay between retention based and incentive based programs. As noted above, the inconsistency between the comments made by this court and the holdings in *Aphton Corporation*, No. 06-10510 (Bankr. D. Del. 2006), and *Radnor Holdings Corp.*, No. 06-10894 (Bankr. D. Del. 2006), may require further explanation or reconciliation.

The Program:

Supplemental Incentive Plan

The Motion:

The debtors also filed, on Jan. 20, 2006, a *Motion for Order Approving Debtors' Supplemental Incentive Plan*. By this motion, the debtors sought to implement an incentive plan to further incentivize those employees who the debtors characterized would be working at a ''feverish pace.'' Under this program, five senior management employees would be eligible to receive success payments from a pool of $1 million. A separate pool of $200,000 would be established for additional management employees.

Payments under this supplemental program were to be conditioned upon the earlier to occur of (a) a closing of a sale of substantially all of the debtors' assets through one or more Section 363 sales or GOB sales; and (b) the consummation of a Chapter 11 plan of reorganization. Based on the results of the sale or restructuring of the debtors, the portion of the $1 million pool that was allocated to the CEO and CFO would be subject to upward adjustment to the extent agreed to by the Informal Committee of Secured Trade Creditors. The debtors sought approval of this program pursuant to Sections 105 and 363 and argued that Section 503(c) was inapplicable as the program did not resemble a retention program.

The Order:

On Aug. 11, 2006, the court entered an *Order Approving, and Authorizing Payments Under Debtor's Incen-*

tive Plan, approving the Supplemental Incentive Plan and allowing $816,200 of the $26,000,000 proceeds of the secured trade creditor's collateral to be paid to the respective employees. The secured trade creditor was not entitled to a replacement lien, a Section 507(b) claim, or an administrative priority claim.

Author's Comment: This case provides yet another option when seeking approval of an employee compensation program: tying the program into the cost of a sale. It is not clear whether the fact that the program was funded by the purchaser of the debtors' assets, as opposed to the estate, affected the applicability of Section 503(c).

In re Plusfunds Group Inc., No. 06-10402 (Bankr. S.D.N.Y. 2006)(J. Peck).

The Program:
Sale-Related Incentive Plan (SRIP)

The Motion:
On March 27, 2006, the debtor filed a *Motion for Order Under 11 U.S.C. §§ 105 and 363 Authorizing Continuation of the Sale-Related Incentive Plan.* The debtor sought approval of an incentive plan for six senior officers and managers that the debtor believed were key to the transaction and who were not part of a certain severance plan previously approved by the court for full-time employees.

The debtor was in the process of selling substantially all of its assets and entered into a sale agreement with a stalking horse bidder. Pursuant to the proposed program, the senior managers would share in a bonus pool starting at $300,000, which could increase by 3 percent of the amount by which the ultimate total gross purchase price reserved from the sale of substantially all of the debtor's assets exceeded $5,000,000.

The Order:
On April 19, 2006, the court entered an *Order Authorizing Sale-Related Incentive Plan*, approving the SRIP, pursuant to Sections 105, 363, and 503(c). The order provided that in the event of a successful sale of substantially all of the debtor's assets as a going concern, the debtor would be authorized to pay the incentive bonuses; provided, however, that no individual payment could exceed $72,220. The court accorded the payments under the SRIP administrative expense priority under Sections 503(b)(1)(A) and 507(a)(2).

The Hearing:
At the April 18, 2006 hearing, the court had a concern that the program was actually a disguised retention plan. In referring to *In re Nobex*, *supra*, the court noted that, ''Judge Walrath approved a plan that . . . that claim was purely contingent on a successful sale in which the proceeds exceeded the stalking horse's baseline number and this plan is predicated on timing benchmarks such that as I understand it . . . As I understand it, there's a vesting of entitlements purely as a result of the passage of time through the sale process without a demonstration that an individual who is participating in the program has added value and the nature of the value added.'' (Transcript at p. 53). The court further stated, ''I would be interested in knowing with particularity the role played by each beneficiary of this plan in the sale proces.. . . I would like to know in particular how the individual was critical to the sale which we're about to approve and to understand.. . . In approving the plan that has been fashioned here I need to be satisfied notwithstanding the fact that you've reached an agreement with the UST's office.''

In presenting the program to the court, the debtor advised the court that it had reached a settlement with the U.S. Trustee to treat the payments as severance payments under Section 503(c)(2). Nevertheless, while recognizing that the program could be interpreted as a severance plan, the court ultimately approved the plan pursuant to Section 503(c)(3) because it was

> designed to retain key employees whose services are critically needed by the debtor in its efforts to stabilize itself pending a sale and to provide reassurances to the investor community . . . I think a more accurate cubbyhole in which to place this is the broad catchall of 503(c)(3) which allows the Court to approve this kind of a program where the showings made . . . where the showings made demonstrate that the facts and circumstances of this case justify the approval of such transfers

(Transcript at p. 71-72). The court further explained:

> I also believe that this broad catchall is consistent with the general provisions of Section 502 which allow the Court to authorize transfers and payments that are actual and necessary expenses and the showings made here . . . demonstrate that these expense which are in relationship to the severance plan reasonable are also even without regard to the severance plan reasonable in order to achieve the debtor's business purpose [sic].

(Transcript at p. 72).

Author's Comment: Notwithstanding the debtor's and the U.S. Trustee's agreement to treat the program as a severance program under Section 503(c)(2), and the court's acknowledgement that the program could be interpreted as a severance program, the court approved the program pursuant to Section 503(c)(3), the catchall. The curious and unexplainable part of the court's ruling is that it found that the plan was a retention plan but did not require satisfaction of Section 503(c)(1). This ruling is particularly curious in light of the court's concern and comments at the hearing.

In re Calpine Corporation, et al., No. 05-60200 (Bankr. S.D.N.Y. 2005)(J. Lifland).

The Program:
Calpine Incentive Plan

The Motion:
On April 6, 2006, the debtors filed a *Motion for an Order Authorizing the Implementation of the Calpine Incentive Program.* The debtors claimed that the purpose of the Calpine Incentive Program was to return the overall compensation opportunity for certain of the debtors' key employees to market competitive levels in order to ensure the continued effective job performance necessary for the debtors' ongoing business operations and successful reorganization. The motion requested approval of the following programs:

Emergence Incentive Plan (EIP) – this program would provide cash awards, payable only at emergence to selected senior employees in the positions most capable of influencing the success of the debtors' ongoing business and reorganization efforts. The award level would be tied to value creation. Compensation for eligible employees would increase proportionately to the value created for the debtors and their creditors. There were 20 senior employees eligible for this program, which would begin with an incentive pool of $5.4 million earned for the successful consummation of a plan and a threshold adjusted enterprise value (AEV) of at least $5 billion. There would be an increase of $285,000 for each incremental increase of $100 million to AEV;

Management Incentive Plan – this program was similar to traditional bonus programs utilized by the debtors prepetition. There were 600 eligible employees for this program. Payments would only be made to the extent that performance objectives were achieved. The debtors estimated that if targets were met, the program would cost $23.5 million for 2006;

Supplemental Bonus Plan – this program was designed to address the immediate potential for the loss of key human capital in functions that were critical to the debtors' ongoing businesses. Persons identified by the debtors as performing critical functions and being at risk of being hired away would be provided with a supplemental cash award. None would be insiders. Payment would be made in two equal installments, the first upon court approval, and the second at year end. The aggregate cost would be $6 million;

Discretionary Bonus Plan – this program would provide a pool in the amount of $500,000 to be created annually, from which individual bonus payments of no more than $25,000 per employee, per year, could be awarded.

The debtors argued that the motion was authorized pursuant to Sections 363(b) and 503(c)(3). The debtors further argued that neither Section 503(c)(1) nor (c)(2) were applicable because the programs did not include retention payments to insiders or severance payments of any kind. Even to the extent that payments made pursuant to the EIP would be to insiders, the debtors argued that any such awards would not be retention payments.

The Order:

On May 15, 2006, the Court entered an *Order Authorizing the Implementation of the Calpine Incentive Program*, pursuant to which the Calpine Incentive Program, including the Emergence Incentive Plan, the Management Incentive Plan, the Supplemental Bonus Plan, and the Discretionary Bonus Plan, were all approved in all respects.

The Hearing:

At the April 26, 2006 hearing, the court addressed the ability of two of the program's participants to resign and still receive compensation. Specifically, the court stated:

> I have one problem, Mr. Cantor before I rule. There is one provision for the CEO and Mr. David, I believe, to receive some compensation if they leave for a good reason. I don't know what good reason is. It's a very subjective term that I can anticipate good reason being something very favorable to Mr. May and Mr. David but not favorable to others. It's very subjective and I don't know, unless you can define it better, I would have a problem with that because the trigger for the payment for good reason could be a good reason being bad health, that's one thing. A good reason could be an opportunity to take over General Motors, and that's another thing.

(Transcript at p. 81).

Author's Comment: This case is a good example of the need to keep employee compensation plans clear and objective. Subjective criteria may create problems, especially with respect to a participant's discretion to resign and continue to receive payments. The court's concern regarding a participant's ability to resign while still receiving program payments should be considered in respect of the line of cases distinguishing between retention based plans and incentive based plans. Although the program was approved as an incentive plan, pursuant to Section 503(c)(3), the court nevertheless had concern regarding the lack of required retention of certain participants.

In re Portrait Corporation of America Inc., et al., No. 06-22541 (Bankr. S.D.N.Y. 2006)(J. Hardin).

The Program:

Employment Agreement

The Motion:

On Aug. 31, 2006, the debtors filed their *Motion for an Order Pursuant to Section 365 of the Bankruptcy Code Authorizing the Debtors to Assume Certain Prepetition Employment Agreements*. By the motion, the debtors sought entry of an order pursuant to Section 365 authorizing the debtors to assume employment agreements entered into pre-petition with certain key employees, who were officers of the company. Under the agreements, all of the respective employees were entitled to termination payments of amounts equal to up to 100 percent of their salaries. While some of the agreements were entered into years before the petition date, others were entered into on the eve of the bankruptcy filing.

The Order:

On Sept. 27, 2006, the court entered an *Order Pursuant to Section 365 of the Bankruptcy Code Authorizing the Debtors to Assume Certain Prepetition Employment Agreements*, authorizing the debtors to assume the agreements as of the date of the order.

Author's Comment: This case is noteworthy in that it provides yet another alternative in avoiding the application of Section 503(c). By executing an employment agreement prior to the bankruptcy filing (even on the eve of bankruptcy), this case exemplifies a debtor's ability to provide the same relief that would otherwise be in a retention/incentive program, so long as the debtor satisfies Section 365 and the assumption of the agreement is within the debtor's business judgment. In this case, the assumed employment agreements provided termination payments to officers that would otherwise have been deemed severance payments subject to Section 503(c)(2).

In re Dana Corporation, et al. No. 06-10354 (Bankr. S.D.N.Y. 2006)(J. Lifland).

The Program:

Employment Agreements

The Motion:

On June 29, 2006, the debtors filed a *Motion of Debtor Dana Corporation, Pursuant to Sections 363, 365 and 105 of the Bankruptcy Code, for an Order Authorizing Dana Corporation to (A) Enter Into Employment Agreements with Michael J. Burns, Its President and Chief Executive Officer, and Five Key Executives of His Core Management Team, and (B) Assume Certain Change of Control Agreements, As Amended* (as subsequently supplemented). By the motion, the debtors sought an order pursuant to Sections 363(b), 365 and 105(a) to enter into employment agreements with their president and CEO and five other executives, and assume certain change of control agreements with three of the executives.

Pursuant to the proposed employment agreements, the base salaries ranged from $500,000 to $1,552,500. The CEO and the executives would also be eligible to participate in an annual incentive plan (AIP), which was conditioned upon debtors' short-term financial performance, the size of which would depend on whether the debtors met threshold target or superior performance goals. The 2006 AIP bonuses ranged from $336,000 to $2,070,000, and the 2007 amounts would be determined by the debtors' board of directors, in consultation with creditors' committee.

The CEO and the executives would also be eligible to participate in a completion bonus, which was comprised of two components. The first component was fixed, and awarded without regard to performance or creditor recovery, payable in cash on the effective date of a plan of reorganization, if such participants remained in the debtors' employ. The first component ranged from $400,000 to $3,100,000. The second component was uncapped, and variable, based on the debtors' total enterprise value six months after the effective date. Originally, the form of payment for this component was cash; however, under the debtors' supplement to the motion, any amount in excess of the minimum completion bonus would be payable in common stock of the reorganized debtors, as long as the stock was listed and readily tradable or subject to repurchase by the reorganized debtors, if the participants were not employed by the reorganized debtors after the effective date. Otherwise, the amounts would be payable in cash.

The CEO was also eligible to receive severance payments. If he was terminated without cause or resigned for a good reason, or if he failed to complete a replacement employment agreement, he would execute an eighteen month non-compete agreement in exchange for payments of $166,666.67 per month. Furthermore, he would be eligible to receive a pro rata payout of his completion bonus if the business plan was completed, but the effective date had not yet occurred. If the effective date had occurred, he would receive his full completion bonus.

Finally, the debtors proposed to assume the CEO's senior retirement programs under Section 365. If assumed, the CEO would receive a administrative claim against the estate in the amount of $6 million.

The Order:

On Sept. 5, 2006, the court issued its *Extract of Bench Ruling Denying Motion of Dana Corporation for an Order Authorizing Dana to Enter into Employment Agreements with its President and Chief Executive Officer and Five Key Executives of His Core Management Team*. In its ruling, the court stated that the basic issue of the case was ''is this a 'pay to stay' compensation plan (also known as a Key Employee Retention Program or KERP) subject to the limitations of Section 503(c), or can it be construed to be an incentivizing 'Produce Value for Pay' plan to be scrutinized through the business judgment lens of Section 363.''

In examining the proposed programs at issue, the court noted that the completion bonus included an amount payable to the participants upon the debtors' emergence from Chapter 11, regardless of the outcome of the cases. The court held that ''without tying this portion of the bonus to anything other than staying with the company until the effective date, this court cannot categorize a bonus of this size and form as an incentive bonus. Using a familiar fowl analogy, this compensation scheme walks, talks and is a retention bonus.''

With respect to the severance bonuses, the court found that the ''debtors try to circumvent the requirements of § 503(c)(2) by characterizing the amounts being paid to the executives upon involuntary dismissal or resigning for good cause as payments in exchange for non-compete agreements.. . . The Debtors have failed here to meet their burden of demonstrating that the payments in exchange for signing a non-compete agreement and other payments do not constitute 'severance' for purposes of § 503(c)(2), or that the evidentiary requirements have been satisfied.''

The court did note, however, that contrary to the contentions of several of the objectors, that the language of Section 503(c)(3) does not prevent the court from considering a program using the business judgment rule. ''While it may be possible to formulate a compensation package that passes muster under the § 363 business judgment rule or § 503(c) limitations, or both, this set of packages does neither. In so holding, I do not find that incentivizing plans which may have some components that arguably have a retentive effect, necessarily violate § 503(c)'s requirements.''

The Hearing:

At the Sept. 5, 2006, hearing, debtors' counsel argued that the program was tied to incentive benchmarks and that Section 502(c)(1) did not apply. In response, the court stated:

> I take it then that you agree that the incentives per se is [sic] not condemned or limited under 503, but your main argument, among other things, is that the metrics that have come out of two opposing camps are improper to be utilized for purposes of incentives . . . And to the extent you make that observation, I also observe that those metrics come our of [sic] parochial interests on both sides of the equation, and perhaps in some future program should be discarded completely as not giving any kind of real barometer of an incentive program for compensation . . . It's clear to me that the metrics that have been put on the table on both sides are born of parochial interests, and I don't know that that should be the driving mechanism.

   ISSN 1044-7474

(Transcript at p. 36).

Author's Comment: In respect of the ongoing distinction between retention based programs and incentive based programs, the court's holding that "incentivizing plans which may have some components that arguably have a retentive effect, necessarily violate § 503(c)'s requirements," is noteworthy. It is not clear, however, whether the court was referring to Section 503(c)(1) or Section 503(c) in general. The court did, however, clearly identify the distinction between the two types of programs when it stated that the basic issue of the case was whether it was a "pay to stay' compensation plan (also known as a Key Employee Retention Program or KERP) subject to the limitations of Section 503(c), or an incentivizing "Produce Value for Pay" plan to be scrutinized through the business judgment lens of Section 363.

The Motion:

Following the court's entry of the Sept. 5, 2006, order denying the motion, the debtor re-commenced negotiations with parties-in-interest in an attempt to garner approval of a modified employee compensation program. In respect thereof, on Nov. 6, 2006, the debtors filed a *Motion of Debtor Dana Corporation, Pursuant to Sections 105, 363, 365, 502 and 503 of the Bankruptcy Code, for an Order, (A) Authorizing Assumption of Employment Agreements, as Modified, (B) Approving Long-Term Incentive Plan and (C) Granting Related Relief.*[1] In addition to base salary and an annual incentive plan, the motion sought approval of the following terms:

Pension Benefits – the debtors sought to assume 100 percent of the executives' pension plans (ranging between $999,000 and $2.7 million) and 60 percent of the CEO's pension plan (60 percent of 5.9 million) with the remaining 40 percent being allowed as a general unsecured claim.

Severance – the debtors sought authority to pay severance to the executives, should the need arise, in an amount that complies with Section 502(c)(2). To quell the fears of objecting parties, the debtors agreed to submit a statement detailing the calculation, allowing sufficient notice of such proposed payments.

Non-Disclosure Agreement and Pre-Emergence or Post-Emergence Claim – in consideration for the assumption of the employment agreements and receipt of payments under the long term performance based incentive plan (LTIP), the CEO and the executives would execute new non-compete, non-solicitation, non-disclosure and non-disparagement agreements. In the event that the CEO was terminated prior to the debtors' emergence from Chapter 11, he would receive a pre-emergence claim, in the form of a general unsecured claim, in the amount of $4 million (with recovery limited to $3 million, less any severance actually paid). In the event of a post-emergence termination, a claim of $3 million would be paid ratably.

LTIP – under the LTIP, the executives would be eligible for a long-term incentive bonus if the company reached a certain Earnings Before Interest, Taxes, Depreciation, Amortization and Rent (EBITDAR). The amount of the incentive payment would increase if additional, higher EBITDAR benchmarks were reached. In order for the CEO to qualify for the minimum amount of the LTIP ($3 million), the company needed to achieve a 2007 EBITDAR of $250 million. The CEO would earn an additional $750,000 for each $100 million increase in EBITDAR, with a maximum payout of $4.5 million for 2007.

The debtors contended that the compensation provided was necessary and appropriate, and represented a reasonable exercise of the debtors' business judgment pursuant to Sections 363, 365, and 502, and was permissible under Section 503(c).

The Orders:

On Nov. 30, 2006, the court issued its *Memorandum Opinion Approving, in Part, Debtors' Motion for Authorization to Assume Employment Agreements, for Approval of a Long Term Incentive Plan and Related Relief*. In respect of its prior denial of the debtor's proposed program and its distinction between retention based programs and incentive based programs, the court noted that "[r]ecognizing the potential limitations of section 503(c) of the Bankruptcy Code as it applies to those employee retention provisions that are essentially 'pay to stay' key employee retention programs ('KERPS'), yet viewing compensation packages holistically, a *true* incentive plan may not be constrained by 503(c) limitations." *Id.*

In respect of the objecting parties' argument that the proposed pension benefits were retentive in nature, the court noted that "to the extent these conditions have any retentive impact, it is merely incidental to the terms of the pension plans and are ordinary and customary in such plans." The court found that the pension benefits were not retentive in nature and were not severance payments and their assumption was subject to the debtors' business judgment.

The objecting parties also contended that the pre-emergence claim and post-emergence claim violated Section 503(c). In respect of the pre-emergence claim, the court noted that it was a general unsecured claim and Section 503(c) only limits the allowance and payment of administrative claims. With respect to the post-emergence claim, the court noted that it could not guarantee that payment of the such claim would ultimately be approved.

Ultimately, the court held that the LTIP was not a KERP, but was "a program designed to incentivize the CEO and Senior Executives, and may be assumed by the Debtors if it is fair and reasonable exercise of business judgment." However, the court found that the program could result in a windfall and conditioned approval of the plan upon the debtor placing a yearly ceiling on each participant.

After the debtor negotiated proper ceilings on the program, on Dec. 18, 2006, the court entered an *Order, Pursuant to Sections 105, 363, 365, 502 and 503 of the Bankruptcy Code (A) Authorizing Assumption of Employment Agreements, as Modified, (B) Approving Long-Term Incentive Plan and (C) Granting Related Relief*, which implemented the memorandum opinion and the ceilings agreed to by the parties. On Dec. 28, 2006, the objecting parties noted their appeal of this order. The appeal is presently pending before the U.S. District Court for the Southern District of New York.

[1] Following the entry of this order, the debtors also filed their *Motion of Debtor Dana Corporation for Clarification and Reconsideration, Pursuant to Rules 9023 and 9024 of the Federal Rules of Bankruptcy Procedure, of Order Denying Executive Compensation Motion*, which was subsequently deemed moot by the court.

Author's Comment: In furtherance to the distinction between incentive based programs and retention based programs, it is noteworthy that the court approved the program at issue as an incentive based program, notwithstanding the retentive effect that the program had.

CONCLUSION

The cases studied herein exemplify the departure from retention based compensation programs in favor of incentive based programs. However, as the cases indicate, the distinction between the two types of programs is not very clear and may require further review. The extent to which an incentive based program may have a retentive effect, without requiring application of Section 503(c)(1), is the key issue. Until that issue is confronted, debtors seeking approval of compensation programs for insiders have their options.

Note to Readers

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   ISSN 1044-7474