
**KEY EMPLOYEE RETENTION PLANS, EXECUTIVE
COMPENSATION, AND BAPCPA: NO REST FOR
CONGRESS, NO MORE FOR EXECES**

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I. INTRODUCTION

This article explores the issue of key employee compensation in Chapter 11 bankruptcy proceedings. Section II first looks at the history of key employee retention plans before analyzing recent legislative changes that have curtailed the effectiveness of such plans. Section III analyzes the new legislation and the changes it has made to key employee compensation motions in bankruptcy. Finally, Section IV offers recommendations for changes to the current statutes and other ways to halt unjustifiably large bonuses being paid to employees of bankrupt corporations.

II. BACKGROUND

A. *The Way We Were: Employee Bonuses Before 2005*

Executive compensation is a hot topic in American politics.¹ The subject has recently been in the news due to the current unstable economy.² Executive bonuses, especially, have been sharply examined in the media.³

It is not, however, merely a recent bone of contention in Washington, D.C., or around the country. Congress first tackled the issue in a failed piece of legislation: the Employee Abuse Prevention Act of 2002.⁴ That bill was intended to “protect employees and retirees from corporate practices that deprive them of their earnings and retirement savings when a business files for bankruptcy.”⁵ It was not until 2005, however, and the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”) that Congress finally passed legislation tackling the issue of executive compensation in the context of business bankruptcies.⁶

What was the problem Congress was attempting to fix? Pre-BAPCPA, Chapter 11 debtors-in-possession⁷ often filed motions seeking court approval of a “key employee retention program” (“KERP”).⁸

1. See, e.g., Steve Lohr, *In Bailout Furor, Wall Street Pay Becomes a Target*, N.Y. TIMES, Sept. 23, 2008, at A1. For example, the *New York Times* online has a “Times Topics” section dedicated solely to executive compensation issues. See Times Topics: Executive Pay, http://topics.nytimes.com/top/reference/timestopics/subjects/e/executive_pay/index.html?scp=1spot&sq=executive%20compensatio&st=cse (last visited Mar. 18, 2009) [hereinafter Times Topics].

2. See Times Topics, *supra* note 1.

3. See, e.g., Gretchen Morgenson, *Royal Pay at Delphi, Reined in by a Judge*, N.Y. TIMES, Jan. 27, 2008, at BU.

4. Employee Abuse Prevention Act of 2002, S. 2798, H.R. 5221, 107th Cong. (2002).

5. *Id.*

6. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005) [hereinafter BAPCPA].

7. A debtor-in-possession is a special creation of Chapter 11 of the Bankruptcy Code. 11 U.S.C. § 1101(a) (2006). A debtor-in-possession is the debtor, but is also vested with the rights and powers of a trustee in bankruptcy. 11 U.S.C. § 1107(a) (2006); see also *Georgia Pac. Corp. v. Sigma Serv. Corp.*, 712 F.2d 962, 965 (5th Cir. 1983). A full discussion of these rights and the related duties of a trustee or debtor-in-possession is outside the scope of this article.

8. See *infra* Part II.A.4.

1. *What Is a KERP?*

A key employee retention plan is just that—a means for a company undergoing Chapter 11 bankruptcy proceedings to retain important members of its management structure.⁹ A KERP usually included “lump-sum retention payments to employees who remain employed by the debtor through a particular date,”¹⁰ along with possible bonus payments and/or severance payments due upon involuntary termination.¹¹ These plans were usually offered to the debtor’s executive officers and senior management.¹²

2. *The Purpose of KERPs*

Many arguments were put forward to justify the use of KERPs in retaining key employees. The most common of these was the need to persuade employees to stick with a company undergoing the unsteady process of bankruptcy reorganization.¹³ In addition, debtors often argued that the cost of hiring and training new employees would cost more than using bonuses to persuade current employees to remain on the job.¹⁴ Notions of equity were also argued—employees should earn a bonus “for their hard work and dedication to the business.”¹⁵ Finally, debtors argued that certain employees were just too important to the management structure and needed to be retained in order to promote continuity and preserve the value of the business as a whole.¹⁶

9. Paul R. Hage, *Key Employee Retention Plans Under BAPCPA: Is There Anything Left?*, 17 J. BANKR. L. & PRAC. 1 Art. 4, Part I.B.2 (2008).

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.* at Part I.B.1. See also A. Mechele Dickerson, *Approving Employee Retention and Severance Programs: Judicial Discretion Run Amuck?*, 11 AM. BANKR. INST. L. REV. 93, 98 (2003). See also *In re Aerovox, Inc.*, 269 B.R. 74, 76 (Bankr. D. Mass. 2001) (summarizing the benefits to the company achieved by retaining important employees). For a list of common arguments in favor of KERPs and a critique of these arguments, see Robert J. Keach, *Seventh Annual Great Debates: Resolved: Incentive and Retention Programs Should Be Banned*, Am. Bankr. Inst., Part III, Apr. 10, 2003.

14. Dickerson, *supra* note 13, at 98; see also *Aerovox*, 269 B.R. at 79 (describing costs associated with headhunters and recruitment of new employees).

15. Dickerson, *supra* note 13, at 98.

16. *Id.* at 99; see also *Aerovox*, 269 B.R. at 81–82 (finding that employees eligible for the retention payments were necessary for the successful reorganization of the company).

All of these arguments rest on the underlying objective of a bankruptcy reorganization—to maximize the value of the estate or the business so that creditors can recoup the greatest amount possible from the debtor.¹⁷ By retaining key employees, the business can continue to operate and can implement the reorganization process more quickly and efficiently.¹⁸

3. *The Statutory Authority and Standards for KERPs*

KERPs are mentioned nowhere in the Bankruptcy Code. However, “[p]rior to BAPCPA, bankruptcy courts generally agreed that KERPs were an important tool in the Chapter 11 rehabilitative process.”¹⁹ The court’s power in approving KERPs arises through two bankruptcy code provisions: sections 105 and 363. Section 105 provides that “[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”²⁰ This section grants very broad power to the bankruptcy court.

Section 363 governs the use, sale, or lease of the debtor’s property after the debtor has entered bankruptcy.²¹ Section 363 authorizes the debtor-in-possession, with the court’s approval, to “use, sell, or lease, other than in the ordinary course of business, property of the estate.”²² Because KERP payments were not normal payments made to the debtor’s employees, court approval of the KERP was necessary.

In approving any use of the debtor’s property outside the ordinary course of business, the bankruptcy court will apply the “business judgment rule.”²³ “In evaluating whether a sound business purpose justifies the use, sale or lease of property under Section 363(b), courts consider a variety of factors, which

17. See, e.g., *In re Johnson*, 8 B.R. 371, 374 (Bankr. D. Minn. 1981) (“The purpose of bankruptcy is to provide an equal opportunity for all creditors to share in the assets of the debtor available for distribution.”).

18. *Dickerson*, *supra* note 13, at 99. *Dickerson* cites to both *Aerovox*, 269 B.R. at 82, and *In re Montgomery Ward Holding Corp.*, 242 B.R. 147, 150 (Bankr. D. Del. 1999), as examples of cases where certain employees were found to be essential to the successful reorganization of the debtor.

19. Hage, *supra* note 9, at Part I.B.3.

20. 11 U.S.C. § 105(a) (2006).

21. *Id.* § 363 (2006).

22. § 363(b)(1).

23. *Montgomery Ward*, 242 B.R. at 153; Hage, *supra* note 9, at Part I.B.3.

essentially represent a ‘business judgment test.’”²⁴ This business judgment test is not a rigid set of guidelines; rather it is a weighing of certain factors and the circumstances of the case.²⁵ The business judgment test usually focuses on whether “the debtor exercised proper business judgment in formulating the program, i.e., whether a sound business practice justifies the request,”²⁶ and “whether the proposed program is fair and reasonable.”²⁷ This test, however, is not a difficult one for the debtor to pass. As the court stated in *In re Aerovox, Inc.*, “a debtor’s business decision ‘should be approved by the court unless it is shown to be so manifestly unreasonable that it could not be based upon sound business judgment, but only on bad faith, or whim or caprice.’”²⁸ As one commentator has pointed out, this threshold is relatively low and weighted heavily in the debtor’s favor:

[D]ebtor-proposed KERPS will be approved if the debtor demonstrates (through evidence) that the KERP constitutes a proper exercise of sound business judgment and the KERP is “fair and reasonable under the circumstances.” Significant deference is paid to the debtor’s business judgment, despite the obvious interest of senior management in achieving approval of the KERP.²⁹

4. *Examples of KERPs in Action*

In order to study the changes BAPCPA made in the implementation of KERPs, it is important to understand previous KERP iterations prior to BAPCPA. The four cases described below demonstrate the court’s role in approving, modifying, and denying

24. *Montgomery Ward*, 242 B.R. at 153.

25. *In re Aerovox, Inc.*, 269 B.R. 74, 80–81 (Bankr. D. Mass. 2001); *Montgomery Ward*, 242 B.R. at 154. The Second Circuit emphasized the need to weigh the circumstances by declaring that:

In fashioning its findings, a bankruptcy judge must not blindly follow the hue and cry of the most vocal special interest groups; rather, he should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike.

In re Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983).

26. Dickerson, *supra* note 13, at 98.

27. *Id.*

28. *Aerovox*, 269 B.R. at 80 (citing *In re Logical Software, Inc.*, 66 B.R. 683, 686 (Bankr. D. Mass. 1986) (additional citations omitted)).

29. Keach, *supra* note 13, at Part II.

proposed KERPs prior to the enactment of BAPCPA.

a. In re Geneva Steel Co.³⁰

Geneva Steel Company sought approval of a retention program for six of its senior executives and thirty managers.³¹ The plan consisted of a severance plan for the six senior executives and a bonus payable to the executives and the managers upon emergence from bankruptcy.³² The severance plan paid the executives six months' salary if they were terminated prior to the "substantial consummation of a plan of reorganization,"³³ or nine months' salary if the executives were terminated within ninety days of plan consummation.³⁴ The bonus plan entitled the executives to a payment of 50% of their annual salary upon plan confirmation and gave the managers a discretionary bonus of up to 25% of their annual salary.³⁵

When the court addressed Geneva's motion for approval, it expressed disapproval that Geneva had neither sought nor obtained the approval of the Steelworkers Union.³⁶ "Management may appropriately reserve decisions on executive benefits to itself and its directors when all is well, but when the continued existence of the business is in question and the executive benefits are subject to court approval, the dynamics of the decision making process must change."³⁷ The court held that the severance package was too much of a potential windfall to the executives because it did not contain a mitigation provision if the executive found work within the six to nine-month period after termination.³⁸ The court also opined that the bonuses payable to the executives should be made in the form of stock rather than in cash.³⁹ With these potential flaws pointed out, the court denied Geneva's motion but expressly left open the possibility that an amended plan would be

30. 236 B.R. 770 (Bankr. D. Utah 1999).

31. *Id.* at 771.

32. *Id.*

33. *Id.* at 772.

34. *Id.*

35. *Id.*

36. *Id.* at 773 ("The court finds that to propose this retention program without first having discussed its provisions with the Steelworkers is not an example of sound business judgment.").

37. *Id.*

38. *Id.* at 773-74.

39. *Id.* at 774.

entertained by the court in the future if the debtor presented one.⁴⁰

*b. In re Aerovox, Inc.*⁴¹

Aerovox, Inc. entered Chapter 11 with a goal of finding a buyer for its assets.⁴² The debtor proposed a plan that would give key employees a retention plan bonus of three months' salary when the employee was either involuntarily terminated, all of the debtor's assets were sold, or on June 6, 2002, whichever came first.⁴³ The plan also proposed a severance package that included at least a payment equal to six months' salary for the employee.⁴⁴ The debtor argued that the plan was necessary to prevent critical employees from leaving the company.⁴⁵ However, the Unsecured Creditors Committee "maintained that the KERP was unnecessary and excessive and was not designed to achieve a particular result."⁴⁶ The Unsecured Creditors Committee argued that the debtor should prove that the key personnel whom the debtor was trying to retain were in fact threatening to leave.⁴⁷

The court examined the evidence and applied the business judgment rule to the debtor's proposal and its supporting evidence.

In determining whether to approve the business decision of a debtor-in-possession or a trustee, the "bankruptcy court sits as an overseer of the wisdom with which the bankruptcy estate's property is being managed by the trustee or debtor-in-possession, and not, as it does in other circumstances, as the arbiter of disputes between the creditors and the estate."⁴⁸

Based upon the facts and circumstances of the proposed plans, the court deferred to the debtor's judgment that the retention and severance plans were indeed necessary and appropriate.⁴⁹ As

40. *Id.*

41. 269 B.R. 74 (Bankr. D. Mass. 2001).

42. *Id.* at 78.

43. *Id.* at 77.

44. *Id.*

45. *Id.* at 75.

46. *Id.* at 76.

47. *Id.*

48. *Id.* at 80 (citing *In re Orion Pictures Corp.*, 4 F.3d 1095, 1099 (2d Cir. 1993)).

49. *Id.* at 81.

additional support for its decision, the court also noted that the objecting unsecured creditors had not produced any evidence that rebutted the debtor's evidence that the KERP was an exercise of sound business judgment.⁵⁰

c. *In re Interco Inc.*⁵¹

In *In re Interco, Inc.*, the court analyzed the proposed retention plan, focusing on factors like the necessity of the company to retain certain employees for a successful reorganization, the current below-industry standard compensation of the executives, the use of performance goals as a measure of the amount of the bonus to be given, the reasonableness of the costs as opposed to the risk to the entire reorganization without the critical executives, and the use of similar plans in other bankruptcies.⁵² After examining this evidence, the court found that the debtor's business judgment was acceptable and the proposed plan would be confirmed as an exercise of sound business judgment.⁵³

d. *In re Allied Holdings, Inc.*⁵⁴

In *In re Allied Holdings, Inc.*, the debtors, with the support of the Unsecured Creditors Committee and the secured lenders, proposed a KERP that would benefit four "tiers" of employees.⁵⁵ The plan provided a retention or emergence bonus equal to a certain percentage of the employee's annual salary as follows: Tier 1: 75% to 90%; Tier 2: 59.4% to 85%; Tier 3: 35% to 50%; and Tier 4: 20% to 25%.⁵⁶ The bonuses were to be paid in four installments, payable on certain milestones and dates.⁵⁷ There was also an additional fund of \$150,000 from which the debtor could give discretionary bonuses of not more than \$30,000 to an employee.⁵⁸ The KERP, however, was opposed by the union representing the debtors' employees and the United States Trustee.⁵⁹

50. *Id.* at 82.

51. 128 B.R. 229 (Bankr. M.D. Mo. 1991).

52. *Id.* at 230-32.

53. *Id.* at 234.

54. 337 B.R. 716 (Bankr. N.D. Ga. 2005).

55. *Id.* at 717-18.

56. *Id.* at 718.

57. *Id.* at 718-19.

58. *Id.* at 719.

59. *Id.* at 717.

The court assessed the plan and applied the business judgment rule, requiring that there be a sound business purpose for the plan and that the plan be fair and reasonable.⁶⁰ As the court stated, “[t]his approach avoids the possibility that the debtor will have unfettered discretion in devising a plan and also permits the Court to ‘analyze factors, based on the facts and circumstances of each case,’ and ‘to tailor the Retention Plan to accomplish necessary goals.’”⁶¹ Because the debtors had sought the advice of an outside consultant, had secured the unsecured committee’s participation in the creation of the KERP, and had created a compensation committee to oversee the formulation of the KERP, the debtors had clearly used sound business judgment to achieve a reasonable plan.⁶²

The court did, however, reduce the bonuses payable to the top two tiers of employees because “the payment of such large bonuses . . . at this time would be unfair to the Debtors’ unionized employees, considering the fact that the parties have indicated that the Debtors must seek further concessions from the unionized employees.”⁶³ The court ordered that the KERP be approved with the caveat that Tier 1 bonuses were not to exceed 75% of annual salary and Tier 2 bonuses were not to exceed 70% of annual salary.⁶⁴

These cases demonstrate the court’s involvement in the approval and modification of proposed KERPs. This involvement, however, was not without its detractors.

5. *Criticisms of KERPs*

While the court had the power to and did approve KERPs, there were several arguments against their availability to debtors. First amongst these was the simple fact that KERPs were not necessarily that useful. “There is no evidence that bonus payments actually result in the retention of employees who would otherwise leave, and considerable anecdotal evidence in cases with KERPs that they made no material difference.”⁶⁵ In addition to their

60. *Id.* at 722.

61. *Id.* (quoting *In re Georgetown Steel, LLC*, 306 B.R. 549, 556 (Bankr. D.S.C. 2004)).

62. *Id.* at 722–24.

63. *Id.* at 725.

64. *Id.* at 726–27.

65. Keach, *supra* note 13, at Part IV. Keach cites examples from both the

doubtful utility in retaining employees, KERPs also often have a negative impact on employee morale as a whole.⁶⁶ This effect was noted by the court in *Geneva Steel*, discussed above.⁶⁷ In *Geneva Steel*, the debtor was chastised by the court for failing to seek the employee union's acquiescence to the proposed retention and bonus plan for senior executives and noted "the depth of the [union's] opposition" to the KERP.⁶⁸ The court denied the proposed KERP because it had too many windfall qualities for the benefit of the executives.⁶⁹

Courts have sometimes factored in the disparity between the salaries earned by a debtor's executives with the salaries paid to executives in similar, yet financially sound, businesses.⁷⁰ But why should an executive who has seen his company fall into financial hardship necessarily expect or deserve a "market rate" salary?

The assumption that persons employed by companies in bankruptcy should receive as much as those not in that unfortunate state is one of the primary places where bankruptcy realities run directly counter to the instinctive views of the rest of the world. When confronted with economic difficulties outside of bankruptcy, we usually assume we must spend less on ourselves and cannot afford the same amount of professional assistance.⁷¹

Yet bankruptcy courts have allowed companies to bolster the pay packages offered to executives even after those executives have helmed the ship as it was going down.⁷²

Another worrisome aspect of KERP implementation is the court's deferential standard in examining the need and reasonableness of the proposed plan. As discussed above, a court would apply the business judgment rule to determine the

Kmart and Enron bankruptcies, demonstrating that the implementation of a KERP had very little effect on the number of employees who were leaving the company on a weekly basis. *Id.*

66. *Id.*

67. *See supra* Part II.A.4.a.

68. *In re Geneva Steel Co.*, 236 B.R. 770, 773 (Bankr. D. Utah 1999).

69. *Id.* at 773-74.

70. *See, e.g., In re Interco Inc.*, 128 B.R. 229, 231 (Bankr. M.D. Mo. 1991).

71. Karen Cordry & Zachary Mosner, *Challenging the "Lake Wobegon Syndrome": What Hath Congress Wrought with KERPS?*, 25 AM. BANKR. INST. J. 12, 12 (2006).

72. *See, e.g., In re Aerovox, Inc.*, 269 B.R. 74, 82 (Bankr. D. Mass. 2001) (stating that the debtor showed that the KERP was an exercise of sound business judgment); *Interco*, 128 B.R. at 234 (stating that the court accepted the debtor's business judgment regarding incentive retention programs).

appropriateness of the proposed KERP.⁷³ The application of the business judgment rule in essence meant that the court would approve the KERP so long as the plan was not “so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, or whim or caprice.”⁷⁴ While this standard may be a good measure for a debtor’s use of its property in arms-length transactions,⁷⁵ it is much harder to apply to a plan that has been negotiated by the same managers and executives who stand to benefit from its implementation.⁷⁶ Often the evidence provided by the debtor is through the testimony of experts who are paid by the debtor (and thus by the executives who manage the debtor’s business).⁷⁷ For example, in *Aerovox*, the court relied on the testimony of two of the debtor’s executives in holding that the proposed KERP was a sound business judgment on the part of the debtor.⁷⁸ Though not necessarily unreliable, such evidence should perhaps be scrutinized by the court under a less deferential standard than the business judgment rule.

Finally, KERPs tend to undermine the reputation of the bankruptcy system as a whole.

KERPS breed a lack of faith in, and a lack of respect for, the bankruptcy system among creditors and rank and file employees who cannot grasp how the guys who drove the bus off the road get bonuses while vendors go unpaid, retiree benefits are slashed, and other wage-related,

73. See *supra* Part II.A.3.

74. *In re Logical Software, Inc.*, 66 B.R. 683, 686 (Bankr. D. Mass. 1986) (citing *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1047 (4th Cir. 1985)).

75. Section 363 of the United States Code requires court approval of all transactions in which the debtor proposes to use, sell, or lease any of its property “other than in the ordinary course of business.” 11 U.S.C. § 363(b)(1) (2006). The bankruptcy courts have created the business judgment rule to determine when there is sufficient reason or benefit to use the estate property to offset the immediate loss of the property from the estate. See *In re Lionel Corp.*, 722 F.2d 1063, 1071–72 (2d Cir. 1983). Thus, in an arms-length transaction, the benefits and disadvantages to the bankruptcy estate are more clearly delineated.

76. *Cordry & Mosner*, *supra* note 71, at 61.

77. See Keach, *supra* note 13, at Part II (“The supporting ‘evidence’ cited in the decided cases is generally vague and self-serving [M]ost of the evidence is in the form of testimony of insiders (often executives who will benefit from the KERP) and of HR ‘experts’ who design KERPS. One has to question the reliability of such evidence.”). See also Gretchen Morgenson, *Gilded Paychecks: Troubling Conflicts; Outside Advice on Boss’s Pay May Not Be So Independent*, N.Y. TIMES, Apr. 10, 2006, at A1.

78. *In re Aerovox, Inc.*, 269 B.R. 74, 78–80 (Bankr. D. Mass. 2001).

pension and severance claims remain unsatisfied.⁷⁹

This criticism became more and more obvious as a wave of large bankruptcies produced newsworthy accounts of huge bonus packages paid to top executives.

B. After Several Huge, High-Profile Bankruptcies Were Filed, KERPs Came Into the Public Awareness

Starting in 2001, several high-profile bankruptcy cases entered the public's awareness.⁸⁰ Along with these high-profile bankruptcies came news stories detailing the huge retention plans that were proposed by the companies.⁸¹

The first of these companies to seek a huge retention bonus program was Polaroid Corporation.⁸² The debtors asked the court to allow bonus and incentive payments to about forty-five executives and up to \$19 million.⁸³ These payments would be in addition to the executives' receipt of 5% to 6% of the proceeds from a sale of Polaroid's assets.⁸⁴ This proposal, however, was strenuously opposed by a group of Polaroid's retirees and employees.⁸⁵ The employees and retirees were incensed at the prospect of such a huge payment to Polaroid's executives after the company had already laid off thousands and had cut medical and life insurance benefits for employees.⁸⁶ In the end, Polaroid withdrew its plan in response to the intense pressure from the

79. Keach, *supra* note 13, at Part IV.

80. See Stephen Labaton, *Crime and Consequences Still Weigh on Corporate World; Four Years Later, Enron's Shadow Lingers as Change Comes Slowly*, N.Y. TIMES, Jan. 5, 2006, at C1 (including a chart that provides a timeline of major bankruptcy filings and the criminal proceedings against many of the major executives of the bankrupt companies).

81. See *Polaroid Seeks to Reward Top Executives with Bonuses*, N.Y. TIMES, Dec. 7, 2001, at C3; Thomas S. Mulligan, *Judge OKs Enron Plan to Retain Senior Workers*, L.A. TIMES, Apr. 17, 2002, at Business Desk 3; Jennifer LeClaire, *Bonuses Amid Bankruptcy Draw Ire of Axed Workers*, CHRISTIAN SCI. MONITOR, June 17, 2002, at 14; James S. Granelli, *Global Crossing Offers Bonus Plan*, L.A. TIMES, Apr. 12, 2002, at Business Desk 2; Rebecca Blumenstein, *WorldCom Judge Approves Plan to Keep Employees*, WALL ST. J., Oct. 30, 2002, at B3.

82. See *Polaroid Seeks to Reward Top Executives*, *supra* note 81.

83. *Id.*

84. *Id.*

85. *Polaroid Retirees Oppose Bonus Plan*, N.Y. TIMES, Dec. 11, 2001, at C10; see also *Polaroid Withdraws \$5 Million Bonus Plan to Retain Executives*, WALL ST. J., Jan. 14, 2002, at B5 [hereinafter *Polaroid Withdraws*].

86. *Polaroid Withdraws*, *supra* note 85.

employees and retirees.⁸⁷

Enron was the next major bankruptcy to hit the public consciousness.⁸⁸ The debtors quickly moved for and received judicial approval of a retention bonus plan. “Under the proposal, about 1,700 employees would share \$40 million in retention bonuses, \$7 million in severance payments and from \$47.4 million to \$90 million in incentive bonuses based on the amount of cash raised from asset sales.”⁸⁹ While these huge amounts raised public ire, an even more controversial provision of the Enron plan allowed waivers to be given to certain employees, which allowed those employees to retain large bonuses just before Enron filed for bankruptcy.⁹⁰

Kmart also implemented a large executive retention bonus plan. As one reporter pointed out, the disparity between the treatment of executives and the treatment of rank-and-file employees was often astounding: “Kmart . . . is awarding retention bonuses worth \$150 million to managers while more than 22,000 workers are sent home without severance, for example, and . . . Enron is paying \$140 million to hold key personnel while cutting about 4,500 jobs.”⁹¹ Public pressure was mounting—“some view it as ironic that company captains are receiving major money to stay on board when they are presumably the ones who steered the business into the rocks.”⁹² The companies, however, kept the plans coming even as public scrutiny increased.

In 2002, Global Crossing Ltd. sought bankruptcy court approval of a retention plan that “would pay nine executive vice presidents bonuses of up to half of their annual salaries and 295 other high level executives up to 27.5% of their pay.”⁹³ The plan would pay out up to \$15 million total.⁹⁴ The company would, however, also be cutting 16% of its workforce in the reorganization process.⁹⁵

87. *Id.*

88. *See* Labaton, *supra* note 80.

89. Mulligan, *supra* note 81.

90. *Id.*

91. LeClaire, *supra* note 81.

92. *Id.*

93. Granelli, *supra* note 81.

94. *Id.*

95. *Id.*

C. *The Legislature Took Notice and Acted*

As these huge bankruptcies became more common and the public became aware of these valuable payouts to executives, Congress attempted to rein in the corporations. The first attempt, which proved unsuccessful, was the Employee Abuse Prevention Act of 2002.⁹⁶

The Employee Abuse Prevention Act was intended “[t]o protect employees and retirees from corporate practices that deprive them of their earnings and retirement savings when a business files for bankruptcy”⁹⁷ Section 104 of the bill proposed an amendment to section 503 of the Bankruptcy Code.⁹⁸ That amendment would place restrictions on payments made “to an insider of the debtor for the purpose of inducing such person to remain with the debtor’s business”⁹⁹ on “a severance payment to an insider of the debtor”¹⁰⁰ and on “other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case.”¹⁰¹ However, this bill was never enacted.

In 2005, Congress considered the Bankruptcy Abuse Prevention and Consumer Protection Act.¹⁰² While the bill was before the Senate Judiciary Committee, Senator Kennedy introduced an amendment to section 503(c) that was extremely similar to section 104 of the Employee Abuse Prevention Act.¹⁰³ The purpose of the amendment was “[t]o expand the authority of bankruptcy courts to limit retention bonuses and severance pay to corporate insiders.”¹⁰⁴

Further legislative history about this portion of the bill is scanty. During the extensive debate on the bill, Senator Kennedy rose and pointed to the Polaroid Company bankruptcy as an example of corporate insiders receiving handsome bonuses at the

96. S. 2798, 107th Cong. (2002); H.R. 5221, 107th Cong. (2002).

97. S. 2798; H.R. 5221 (citing the title of the bill).

98. S. 2798 § 104; H.R. 5221 § 104.

99. S. 2798 § 104(c)(1)(A); H.R. 5221 § 104(c)(1)(A).

100. S. 2798 § 104(c)(1)(B); H.R. 5221 § 104(c)(1)(B).

101. S. 2798 § 104(c)(1)(C); H.R. 5221 § 104(c)(1)(C).

102. S. 256, 109th Cong. (2005); H.R. 685, 109th Cong. (2005) (enacted).

103. Rebecca Revich, *The KERP Revolution*, 81 AM. BANKR. L.J. 87, 88 (2007).
See also Amend. No. 5202 to S. 256, 109th Cong. (2005), <http://www.abiworld.org/pdfs/amend5202.pdf> (last visited Feb. 6, 2009).

104. Amend. No. 5202 to S. 256, 109th Cong. (2005) (citing the purpose as listed on the amendment).

expense of the rank and file employees.¹⁰⁵ He went on to say that:

Current law on corporate bankruptcy is grossly inadequate in dealing with these problems. Often, the very insiders whose misconduct brought the company down do very well in bankruptcy. . . . Increasingly, the bankruptcy court has become a place where corporate executives go to get permission to line their own pockets and break their promise to their workers and retirees.¹⁰⁶

Several other times during the debate, large bankruptcies like Adelphia, Enron, United Airlines, TWA, Kmart, Polaroid, and Global Crossing were mentioned.¹⁰⁷

On March 10, 2005, BAPCPA passed in the Senate.¹⁰⁸ The House debated on the bill for only one hour.¹⁰⁹ The House passed it the same day.¹¹⁰ President Bush signed the bill into law on April 20, 2005.¹¹¹

With the passage of BAPCPA, section 503(c) was inserted into the Code.¹¹² That section is worth setting forth here in full:

§ 503. Allowance of administrative expenses

* * *

105. 151 CONG. REC. S1979, 1990-91 (daily ed. Mar. 3, 2005) (statement of Sen. Kennedy).

106. *Id.* at S1990. Senator Kennedy was not alone in his condemnation of the current state of affairs. Senator Durbin also rose to point out several examples of corporate insiders receiving huge bonuses:

If I went to Illinois and asked the people I represent what they think we should do when it comes to bankruptcy, I am virtually certain that the first thing they would say to me is, you have to do something about these horrible corporate bankruptcies, Enron, WorldCom, and the list goes on, and the abuses which these officers and CEOs have demonstrated as heads of these corporations, the fact that because they were feathering their own beds when their companies went bankrupt, hurting shareholders, hurting employees, hurting investors in pension plans, and hurting retirees. I think my constituents in Illinois are right. When it comes to bankruptcy, that is the scandal in America.

Id. at S1986.

107. *See, e.g.*, 151 CONG. REC. 21, S1818 (daily ed. Mar. 1, 2005) (statement of Sen. Durbin); 151 CONG. REC. 23 at S1987 (statement of Sen. Durbin); 151 CONG. REC. 23 at S1991 (statement of Sen. Kennedy).

108. 151 CONG. REC. 28, S2474 (daily ed. Mar. 10, 2005). The vote was 74 yeas, 25 nays, and 1 abstention (Sen. Clinton).

109. 151 CONG. REC. 44, H1974 (daily ed. Apr. 14, 2005).

110. *Id.* at H1991-92.

111. Pub. L. No. 109-8, 119 Stat. 23 (2005).

112. *Id.*

(c) Notwithstanding subsection (b), there shall neither be allowed, nor paid —

(1) a transfer made to, or an obligation incurred for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtor's business, absent a finding by the court based on evidence in the record that—

(A) the transfer or obligation is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation;

(B) the services provided by the person are essential to the survival of the business; and

(C) either—

(i) the amount of the transfer made to, or obligation incurred for the benefit of, the person is not greater than the amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made or the obligation is incurred; or

(ii) if no such similar transfers were made to, or obligations were incurred for the benefit of, such nonmanagement employees during such calendar year, the amount of the transfer or obligation is not greater than an amount equal to 25 percent of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider for any purpose during the calendar year before the year in which such transfer is made or obligation is incurred;

(2) a severance payment to an insider of the debtor, unless—

(A) the payment is part of a program that is generally applicable to all full-time employees; and

(B) the amount of the payment is not greater than 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made; or

(3) other transfers or obligations that are outside the ordinary course of business and not justified by the facts

and circumstances of the case, including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition.¹¹³

The language of this section purports to strictly limit payments to insiders of the debtor, be they bonuses or severance payments. In practice, however, this purpose has been left to judicial interpretation.¹¹⁴

III. ANALYSIS

A. *The Decisions Since BAPCPA*

The bankruptcy court has only had a handful of chances to apply the new section 503(c) to proposed bonus plans. The following cases are briefly examined to serve as an overview. The decisions and the rules that can be gleaned from them are more closely examined in Part III.B below.

1. *In re Nobex Corp.*¹¹⁵

In re Nobex was one of the first opportunities for the bankruptcy court to apply the new section 503(c). The debtors were not reorganizing but were seeking a sale of all of the company's assets.¹¹⁶ The debtors proposed a bonus plan for two of its managers.¹¹⁷ The plan proposed to pay the managers a bonus equal to a percentage of the gross purchase price received for the sale of the company's assets, with the applicable percentage increasing as the sale price increased.¹¹⁸

The court found that the two managers eligible for the bonus packages were critical to the winding-down of the business.¹¹⁹ The court also found that "[t]he unique skills and expertise of [the managers] are essential to the Debtor's successful implementation of the sale procedures presently proposed by the Debtor and ability to maximize the value of the Debtor's assets."¹²⁰ When the court

113. 11 U.S.C. § 503(c) (2006).

114. *See infra* Part III.

115. No. 05-20050(MFW), 2006 WL 4063024 (Bankr. D. Del. Jan. 19, 2006).

116. *Id.* at *1.

117. *Id.* at *2.

118. *Id.* at *3-4.

119. *Id.* at *2.

120. *Id.*

turned to considering the bonus plan under the new strictures of section 503(c), the court found that because the plan was incentive-based,¹²¹ it did not fall into the purview of sections 503(c)(1) or (c)(2).¹²² The court then held that section 503(c)(3) did not prohibit the proposed plan.¹²³ Therefore, the court ruled that the debtors merely had to meet the burden of proof required by section 363—the business judgment rule—in order to be acceptable.¹²⁴ The court held that the debtors had met this burden and thus approved the bonus plan under section 363.¹²⁵

2. *In re Airway Industries, Inc.*¹²⁶

In *In re Airway Industries, Inc.*, one of the debtor's secured lenders wanted to give a bonus to certain employees of the debtor if the debtor sold all of its assets, either inside or outside of bankruptcy, and the secured lender received a cash distribution from that sale.¹²⁷ The court held that the proposed bonus was outside the confines of section 503(c) because the money was not coming from the debtor; rather, it was coming from an outside source and was only going to specific employees, not to the debtor itself.¹²⁸ Thus, there was no risk of diminution of the estate.¹²⁹

3. *In re CEP Holdings, LLC*¹³⁰

The court in *In re CEP Holdings, LLC* had previously issued an oral opinion approving the debtors' "performance bonus plan" for "all but certain members of the Debtors' management team."¹³¹ The court had disallowed the bonus payments for the President and CEO and the President of the Board because they were

121. *Id.* at *3 (finding that the bonus is clearly incentive-based because the managers are only eligible to receive it if they can achieve a higher gross sale price than the stalking-horse bid). A "stalking-horse bid" is "[a]n initial bid on a bankrupt company's assets from an interested buyer chosen by the bankrupt company." Investopedia, Stalking-Horse Bid, <http://www.investopedia.com/terms/s/stalkinghorsebid.asp> (last visited Mar. 22, 2009).

122. *Nobex*, 2006 WL 4063024 at *3.

123. *Id.*

124. *Id.*

125. *Id.*

126. 354 B.R. 82 (Bankr. W.D. Pa. 2006).

127. *Id.* at 85.

128. *Id.* at 87–88.

129. *Id.* at 88.

130. No. 06-51847, 2006 WL 3422665 (Bankr. N.D. Ohio Nov. 28, 2006).

131. *Id.* at *1.

insiders of the company.¹³² “[T]he Court believed that it was not possible under Section 503(c)(3) . . . to find that the proposed payment amounts to these two insiders were, in the language of the Code, justified by the facts and circumstances of the case.”¹³³

4. *In re Calpine Corp.*¹³⁴

In an unpublished order in *In re Calpine Corp.*, the court granted Calpine’s motion for approval of its “Incentive Program,” which was made up of an “Emergence Incentive Plan,” a “Management Incentive Plan,” a “Supplemental Bonus Plan,” and a “Discretionary Bonus Plan.”¹³⁵ Each of these plans featured bonus payments contingent on the achievement of certain performance goals.¹³⁶ While the order did not set forth the court’s reasoning behind its ruling, it can be assumed that the court approved the plan under section 503(c)(3).

5. *In re Dana Corp. (“Dana I”)*¹³⁷

It was not until Dana Corporation proposed its incentive plan in *In re Dana Corp. (Dana I)*, that the court denied a plan under section 503(c). The plan proposed by the debtor included base salary, an annual incentive bonus plan, and “Target Completion Bonuses” for each of the executives.¹³⁸ The completion bonuses had both fixed and variable components.¹³⁹ The fixed component of the completion bonuses would be “payable in cash on the effective date of a plan of reorganization” if the executive was still employed by Dana.¹⁴⁰ The variable component was based on the “Total Enterprise Value” of the debtor measured six months after the effective date.¹⁴¹ This bonus varied based on the level of the value, but a bonus was still payable even if the debtor’s enterprise

132. *Id.*

133. *Id.* (internal quotes omitted).

134. Order Authorizing the Implementation of the Calpine Incentive Program, No. 05-60200(BRL) (Bankr. S.D.N.Y. May 15, 2005), *available at* <http://www.bankruptcylitigationblog.com/calpine%20order%20approving%20incentive%20plan.pdf> (last visited Feb. 20, 2009).

135. *Id.* ¶ 2.

136. *Id.* at Ex. 1.

137. 351 B.R. 96 (*Dana I*) (Bankr. S.D.N.Y. 2006).

138. *Id.* at 99.

139. *Id.*

140. *Id.*

141. *Id.*

value decreased a certain percentage.¹⁴²

When the court analyzed the proposed plans, it noted that the fixed component of the plans could clearly not be categorized as incentive-based.¹⁴³ Because a portion of the plan was not tied to performance goals, the court held that it fell within section 503(c)(1)'s prohibition of retention bonus plans.¹⁴⁴ Thus, the court could not approve the plan regardless of whether the debtor had exercised its sound business judgment in proposing it.¹⁴⁵

6. *In re Dana Corp.* (“Dana II”)¹⁴⁶

The Dana executives, however, were not deterred. After the previous motion for approval of its bonus plan failed, the debtor modified the plan and negotiated with its creditors to gain their approval of the modified plan.¹⁴⁷ Notably, the court pointed out: “The plan before the Court today, unlike the previous iteration, has *no guaranteed payments* to the CEO or Senior Executives other than base salary and is a substantial retreat from the original proposals.”¹⁴⁸ Because the plan in front of the court was now clearly based on performance goals and served to incentivize the executives, the plan could be approved under section 503(c).¹⁴⁹

7. *In re Global Home Products, LLC*¹⁵⁰

The debtors in *Global Home* sought approval of two plans, one applicable to eligible managers and the other to eligible sales staff.¹⁵¹ Both plans would only pay bonuses if the company achieved certain EBITDAR (Earnings Before Interest, Taxes, Depreciation and Rent) and cash flow goals.¹⁵² Importantly, the

142. *Id.*

143. *Id.* at 102 (“Without tying [the fixed] portion of the [completion] 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.”).

144. *See id.* (discussing 11 U.S.C. § 503(c) (2006)). The court added, in a now famous footnote: “If it walks like a duck (KERP) and quacks like a duck (KERP), it’s a duck (KERP).” *Id.* at 102 n.3.

145. *Id.* at 100–01.

146. 358 B.R. 567 (*Dana II*) (Bankr. S.D.N.Y. 2006).

147. *Id.* at 571.

148. *Id.* at 574.

149. *Id.* at 584 (discussing § 503(c)).

150. 369 B.R. 778 (Bankr. D. Del. 2007).

151. *Id.* at 780–81.

152. *Id.*

court noted that the debtor had offered similar incentive programs prior to filing for bankruptcy.¹⁵³

The court recognized that the new section 503(c) imposed severe limitations on bonus plans that were intended to retain employees.¹⁵⁴ However, the court also noted that “[t]he entire analysis changes if a bonus plan is not primarily motivated to retain personnel or is not in the nature of severance.”¹⁵⁵ Following the reasoning of *Dana II*, the court declared that if the plan was not retentive in nature, it should be analyzed under the business judgment rule.¹⁵⁶ The court also held that the plans were proposed in the ordinary course of the debtor’s business, making section 503(c) inapplicable.¹⁵⁷

8. *In re Nellson Nutraceutical, Inc.*¹⁵⁸

Nellson Nutraceutical also dealt with a longstanding employee incentive program.¹⁵⁹ The debtors had previously implemented a plan that awarded bonuses based on the company’s achievement of certain financial targets.¹⁶⁰ The court determined that the debtor’s bonus programs were implemented in the ordinary course of the debtor’s business.¹⁶¹ Because the plan was in the ordinary course of business, the court refused to analyze it under the business judgment rule.¹⁶² Instead, the court held that the constraints of section 503(c)(3) only apply to transactions made “outside the ordinary course of business” and thus if a transaction—including an incentive-based bonus program—is within the ordinary course of business, section 503 will not apply to bar that transaction.¹⁶³ The incentive plans were allowed as a reasonable action within the

153. *Id.* at 780 n.4.

154. *Id.* at 785 (discussing 11 U.S.C. § 503(c) (2006)).

155. *Id.*

156. *Id.* at 786.

157. *Id.*

158. 369 B.R. 787 (Bankr. D. Del. 2007).

159. *Id.* at 795.

160. *Id.* at 793.

161. *Id.* at 797.

162. *Id.* at 799 (“Because the entire incentive program before the Court in this case is within the ordinary course of the Debtors’ business judgment, however, the criteria developed in *Dana Corp.* for analyzing whether an incentive plan adopted outside the ordinary course of business is a reasonable exercise of a debtor’s business judgment are not applicable here.”).

163. *Id.* at 801 (quoting 11 U.S.C. § 503(c)(3) (2006)).

debtor's ordinary course of business.¹⁶⁴

B. What Standards Have Been Created by the Case Law Since BAPCPA Was Enacted?

While the existing case law interpreting section 503(c) is currently somewhat sparse, some important standards can be gleaned from the cases discussed above.

1. If a Plan Is To Be Considered Incentive-Based, What Constitutes an Incentive?

Most of the cases decided under BAPCPA's new section 503(c) have hinged on the idea of an incentive-based retention program rather than an outlawed KERP.¹⁶⁵ The courts have declared that this distinction can either make or break the approval of a bonus plan for employees of a bankrupt company.¹⁶⁶ The incentives accepted by courts thus far have included giving employees a bonus if they can secure a higher selling price for the company's assets than the current stalking-horse bid¹⁶⁷ or allowing bonuses for employees if the company can exceed specific EBITDAR targets.¹⁶⁸ As the *Dana II* court noted, these incentives encourage the eligible employees to "produce and increase the value of the estate"¹⁶⁹

The *Dana I* court was the first to examine section 503(c) carefully and create some boundaries between retention and incentive-based plans. In *Dana I*, the court noted that "section 503(c) establishes specific evidentiary standards that must be met before a bankruptcy court may authorize payments made to an insider for the purpose of inducing such person to remain with a debtor's business, or payments made on account of severance."¹⁷⁰ The court cited to sections 503(c)(1) and (2) before declaring that if a plan falls within the purview of either section, the "Bankruptcy Code makes it abundantly clear" that such a plan cannot be

164. *Id.* at 804.

165. *See supra* Part III.A.

166. *See, e.g., In re Global Home Prods.*, 369 B.R. 778, 785 (Bankr. D. Del. 2007) ("The entire analysis changes if a bonus plan is not primarily motivated to retain personnel or is not in the nature of severance.").

167. *In re Nobex Corp.*, No. 05-20050, 2006 WL 4063024, at *2-3 (Bankr. D. Del. 2006). *See also supra* note 121 (defining a "stalking-horse bid").

168. *In re Dana Corp. (Dana II)*, 358 B.R. 567, 574 (Bankr. S.D.N.Y. 2006); *Global Home*, 369 B.R. at 780-81; *Nellson Nutraceutical*, 369 B.R. at 791-92.

169. *Dana II*, 358 B.R. at 584.

170. *In re Dana Corp. (Dana I)*, 351 B.R. 96, 100 (Bankr. S.D.N.Y. 2006).

allowed even though there may be a “sound business purpose” for its implementation.¹⁷¹ Thus, when a court examines a proposed bonus program, it must first determine if it is impermissible under sections 503(c)(1) or (2). Although the debtor urged that the proposed plan did not fall into either of these sections and should instead be analyzed under section 503(c)(3), the court found that the proposed plans were not incentive-based and so were not allowable under section 503(c)(1).¹⁷² The court did go out of its way to emphasize, though, that bonus plans could be allowed under section 503(c): “I do not find that incentivizing plans which may have *some* components that arguably have a retentive effect, necessarily violate section 503(c)’s requirements.”¹⁷³

It was not until *Dana II* that the court had an opportunity to clarify the distinction between retentive and incentivizing bonus programs.¹⁷⁴ First, the court set out a “holistic” approach to examining a proposed plan.¹⁷⁵ In general, a plan must be considered as a whole and the specifics of the plan must be examined, including:

[W]hether the amount of cost or expense is reasonable and in the best interest of the estate; whether the services to be provided are likely to enhance a successful reorganization or liquidation of the debtor; [and] whether the debtor exercised proper business judgment in implementing any application for continuing, resuming, or retaining the executive.¹⁷⁶

By examining a plan with its entire purpose in mind, as well as taking into account section 503(c)’s limitations on KERPs and severance packages,¹⁷⁷ the *Dana II* court declared that “a *true* incentive plan may not be constrained by 503(c) limitations.”¹⁷⁸

Thus, the distinction between a plan that is geared toward merely retaining employees and a plan that encourages the employees to meet certain goals becomes paramount to a plan’s success.¹⁷⁹ The *Dana II* court emphasized that in order for a plan to

171. *Id.* at 100–01.

172. *Id.* at 102.

173. *Id.* at 103.

174. *Dana II*, 358 B.R. 567.

175. *Id.* at 571.

176. *Id.*

177. 11 U.S.C. § 503(c)(1), (2) (2006).

178. *Dana II*, 358 B.R. at 571.

179. *Id.* at 575. The *Dana II* court examined the statute and concluded that “section 503(c) was not intended to foreclose a chapter 11 debtor from *reasonably*

be one that relied on incentives, the plan must be “calculated to achieve the desired performance.”¹⁸⁰ The court also noted that factors like an analysis of which employees needed to be incentivized, what kind of incentives are generally applicable in an industry, and whether the debtor received independent counsel in creating the incentive plan should also be considered.¹⁸¹ If a plan is clearly an incentive plan, even if it may have some retentive impact, it will be analyzed under section 503(c)(3) and not automatically subjected to the high evidentiary standards of sections 503(c)(1) and (2).¹⁸²

From these cases, and from *Dana I* and *II* in particular, it is clear that structuring a bonus plan around incentives will make it much more likely to be approved by the court. Though Congress may have intended to curtail executive compensation with the implementation of section 503(c),¹⁸³ the courts have interpreted the statute as written to limit only clearly retentive programs.¹⁸⁴ A bankruptcy court will examine a proposed plan and consider what kind of performance goals are to be achieved in determining its incentivizing nature.¹⁸⁵ If those goals are indeed related to the performance of the employees, then the employees will earn their bonus and the plan will be approved.¹⁸⁶

2. What Is the Definition of an “Insider” for Purposes of Section 503(c)?

The Code provides a definition of an “insider” in section

compensating employees, including ‘insiders,’ for their contribution to the debtors’ reorganization.” *Id.* (citing *In re Nobex Corp.*, No. 05-20050, 2006 WL 4063024, at *3 (Bankr. D. Del. 2006)).

180. *Id.* at 576.

181. *Id.* at 577.

182. *See id.* at 576; *In re Global Home Prods.*, 369 B.R. 778, 787 (Bankr. D. Del. 2007).

183. *See infra* Part II.C.

184. *Dana II*, 358 B.R. at 576 (“[S]ection 503(c)(3) gives the court discretion as to bonus and incentive plans, which are not primarily motivated by retention or in the nature of severance.”).

185. *Id.* at 576–77.

186. *See* MaryJo Bellew & Edith K. Altice, *Tackle § 503(c) by Structuring a “MIP” – And Other Strategies to Have in Your Playbook*, 27 AM. BANKR. INST. J. 34, 76–77 (2008). Bellew and Altice point out that “debtors must structure their proposed insider compensation bonuses and awards around measurable targets or benchmarks, such as achieving certain EBITDAR, cash flow or sales targets.” *Id.* at 77. However, it is also important that the selected target is not “so low that payment will essentially be guaranteed.” *Id.* at 78.

101.¹⁸⁷ However, the definition is not all that conclusive.¹⁸⁸ Rather, it is merely a list that includes certain employment positions within a debtor corporation or people within certain family relationships with a debtor.¹⁸⁹ Thus, an important distinction for section 503(c) purposes—whether an employee is an “insider”—can be a hazy area of interpretation for the courts.¹⁹⁰

Past precedent and legislative history does provide some direction. “The legislative history of section 101(31) infers that an ‘insider’ is a person or entity with ‘a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm’s length with debtor.’”¹⁹¹ In addition, case law has also emphasized the position of the employee and whether or not his position is high enough that he would be involved in setting the policy or making important decisions for the company.¹⁹²

Since the enactment of BAPCPA, one case has looked squarely at the use of the term “insider” in section 503.¹⁹³ In *In re CEP Holdings*, the court emphasized the idea of control in defining who is an insider for 503(c) purposes.¹⁹⁴ One of the most important

187. 11 U.S.C. § 101(31) (2006).

188. Bellew & Altice, *supra* note 186, at 78.

189. *Id.* For example, if a debtor is a corporation, insiders of the debtor would include a director, officer, or person in control of the debtor. § 101(31)(B). In addition, an insider could be a “managing agent of the debtor.” § 101(31)(F).

190. Marcia L. Goldstein et al., *First Day Issues: Key Employees*, ALI-ABA Course of Study, Mar. 29, 2007 (“In light of the recent changes to section 503 of the Bankruptcy Code, the status of an employee and whether or not an individual is an ‘insider’ are key elements in developing an employee compensation bonus program.”).

191. *Id.* at 9 (citing S. Rep. No. 95-989, 95th Cong. 2d Admin. News 5787, 5810).

192. See, e.g., *In re NMI Sys., Inc.*, 179 B.R. 357, 369–70 (Bankr. D. Dist. Col. 1995). The court in *In re NMI Systems, Inc.* held that:

The appropriate test for whether [an employee] was an officer is whether [the employee] occupied a high position within the corporation making him active in setting overall corporate policy or performing other important executive duties The term “officer” . . . is broader and includes, for example, those in the collective group exercising overall authority regarding the debtor’s corporate decisions who, as members of that insider group, are in a position to exert undue influence over corporate decisions

Id. See also 9 AM. JUR. *Bankruptcy* § 210 (2008).

193. *In re CEP Holdings, LLC*, No. 06-51847, 2006 WL 3422665, at *1 (Bankr. N.D. Ohio Nov. 28, 2006).

194. *Id.* at *3 (“The Court believes that in the context of Section 503(c)(3), insider status under the ‘control’ provision of Section 101(31)(B)(iii) should be

things to know in determining who is an insider when considering bonus plans is “whether the potential plan recipient had significant input into the negotiation of the plan (including the amount of additional compensation that the employee would receive under the plan).”¹⁹⁵ It is important to note, however, that the title of an employee is not itself determinative of insider status;¹⁹⁶ a court must look at the entirety of the employee’s status and responsibilities in order to determine his insider or non-insider status.¹⁹⁷

3. *What Is the Standard for Approving Plans Under Section 503(c)(3)?*

Section 503(c)(3) forbids payments “that are outside the ordinary course of business and not justified by the facts and circumstances of the case”¹⁹⁸ The section is otherwise silent about when a payment would be “justified by the facts and circumstances” of a case. Courts, therefore, have interpreted this language to simply be a reiteration of the business judgment rule already used by bankruptcy courts in applying other sections of the Code.¹⁹⁹ In particular, the *Dana II* court declared that section 503(c)(3) called for no different determination than whether the debtor’s proposed bonus plan met the “sound business judgment” test.²⁰⁰

4. *How Have the Courts Applied the Business Judgment Rule to Proposed Bonus Plans Since BAPCPA?*

The “business judgment rule” is just what its name implies—it

determined, at least in part, by reference to the payment recipient’s control of the specific transaction under consideration and the impact of that transaction upon the debtor’s creditors.”).

195. *Id.*

196. *Id.* at *1.

197. See Craig A. Christensen, *Key Employee Retention Plans (“KERPS”) Under the 2005 Bankruptcy Abuse Prevention and Consumer Protection Amendments (“BAPCPA”)*, Am. Bankr. Inst., Feb. 14, 2008. Christensen points out that “many individuals bear the nomenclature of ‘officer,’ such as vice-president, but a careful examination of the official corporate records will show no action by the board of directors actually making these individuals an officer of the corporation. Without official board action it is unlikely that they qualify as ‘officers.’” *Id.*

198. 11 U.S.C. § 503(c)(3) (2006).

199. See Hage, *supra* note 9, at Part I.B.3. Courts have used sections 363(b) and 105(a) as the basis of the business judgment rule. *Id.* For further discussion of the business judgment rule, see *supra* Part II.A.4 and *infra* Part III.C.

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

requires a bankruptcy judge to weigh the evidence presented to determine whether the debtor has exercised sound judgment before the judge may approve the debtor's proposed course of action.²⁰¹ In the case of approving KERPs, courts also required that the debtor's proposed plan was "fair and reasonable."²⁰²

While BAPCPA may have effectively outlawed KERPs, courts have still approved incentive-based bonus plans under section 503(c)(3) by applying the business judgment rule.²⁰³ The factors to be considered in applying the business judgment rule were reiterated in *Dana II*:

Courts consider the following in determining if the structure of a compensation proposal and the process for developing the proposal meet the "sound business judgment" test:

- Is there a reasonable relationship between the plan proposed and the results to be obtained, i.e., . . . is the plan calculated to achieve the desired performance?
- Is the cost of the plan reasonable in the context of the debtor's assets, liabilities and earning potential?
- Is the scope of the plan fair and reasonable; does it apply to all employees; does it discriminate unfairly?
- Is the plan or proposal consistent with industry standards?

201. See *In re Lionel Corp.*, 722 F.2d 1063, 1071 (C.A.N.Y. 1983). The *Lionel* court interpreted section 363 of the Code, which allows a judge to authorize the use, sale, or lease of the debtor's property "other than in the ordinary course of business . . ." 11 U.S.C. § 363(b)(1) (2006). See also *In re Cont'l Air Lines, Inc.*, 780 F.2d 1223, 1226 (5th Cir. 1986) ("[F]or the debtor-in-possession or trustee to satisfy its fiduciary duty to the debtor, creditors and equity holders, there must be some articulated business justification for using, selling, or leasing the property outside the ordinary course of business.") (citing *Lionel*, 722 F.2d at 1071). Coupled with the business justification is also a rebuttable presumption that the debtor has acted in good faith in proposing the course of business. *In re Integrated Res., Inc.*, 147 B.R. 650, 656 (S.D.N.Y. 1992) ("The business judgment rule 'is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'" (quoting *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985))).

202. *In re Allied Holdings, Inc.*, 337 B.R. 716, 722 (Bankr. N.D. Ga. 2005). See also Hage, *supra* note 9, at Part I.B.3.

203. *In re Global Home Prods.*, 369 B.R. 778, 787 (Bankr. D. Del. 2007); *Dana II*, 358 B.R. 567, 584 (Bankr. S.D.N.Y. 2006); *In re Nobex Corp.*, No. 05-20050, 2006 WL 4063024, at *3 (Bankr. D. Del. 2006).

- What were the due diligence efforts of the debtor in investigating the need for a plan; analyzing which key employees need to be incentivized; what is available; what is generally applicable in a particular industry?
- Did the debtor receive independent counsel in performing due diligence and in creating and authorizing the incentive compensation?²⁰⁴

Thus, in general, courts will look at a proposed incentive-based bonus plan and consider these factors in determining whether the choice to implement the plan is a sound business judgment. In reality, however, the business judgment rule comes with a very deferential treatment of the debtor's decisions,²⁰⁵ so this test may not be so difficult to pass.

C. Applying the Business Judgment Rule Through Section 503(c)(3) Has Allowed Debtors to Continue to Offer Bonus Plans Only Slightly Different from Pre-BAPCPA KERPs

Section 503(c)(1) was intended—and has been interpreted—to preclude a debtor from offering key employee retention programs.²⁰⁶ Indeed, some commentators have criticized this ban²⁰⁷ and expressed fear that the requirements in section 503(c)(1) were impossible to meet²⁰⁸ and contrary to the Code's overall policy.²⁰⁹

204. *Dana II*, 358 B.R. at 576–77.

205. *In re Aerovox, Inc.*, 269 B.R. 74, 80 (Bankr. D. Mass. 2001) (stating that a debtor's business decision "should be approved by the court unless it is shown to be 'so manifestly unreasonable that it could not be based upon sound business judgment, but only on bad faith, or whim or caprice.'") (citing *In re Logical Software, Inc.*, 66 B.R. 683, 686 (Bankr. D. Mass. 1986)).

206. *Global Home*, 369 B.R. at 785 ("The statute makes it abundantly clear that in a post-BAPCPA bankruptcy case, KERPs and severance arrangements subject to review under § 503(c)—those whose purpose is to retain employees—are severely restricted."); *In re Dana Corp. (Dana I)*, 351 B.R. 96, 100–01 (Bankr. S.D.N.Y. 2006) ("The recent amendment to the Bankruptcy Code makes it abundantly clear that, to the extent a proposed transfer falls within sections 503(c)(1) or (c)(2), then the business judgment rule does not apply, irrespective of whether a sound business purpose may actually exist.").

207. David Crapo, *Changes to Key Retention Plans: Amendments Significantly Modified the Treatment of Severances and Bonuses*, 187 N.J.L.J. 173, 173 (2007) ("The new § 503(c) eliminates much of the discretion that debtors had previously enjoyed in implementing KERPs and severance plans and that bankruptcy courts enjoyed in evaluating and approving them.").

208. See Richard Levin & Alesia Ranne-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 603, 620–21 (2005); Revich, *supra* note

However, solace can now be found in the bankruptcy court's interpretation of section 503(c)(3) and its willingness to work around section 503(c)(1)'s feeble roadblock to allowing debtors to offer bonuses to their employees.

Nobex was the first case in which the court declared that an incentive-based plan was not the same as a retention plan.²¹⁰ Because it was incentive-based, the plan did not fall into the purview of section 503(c)(1) and section 503(c)(3) did not prohibit incentive-based pay to employees.²¹¹ Thus, the first inkling of how to avoid the anti-KERP provisions was blotted into precedent.

Following *Nobex*, the United States Bankruptcy Court for the Southern District of New York heard a motion to approve debtor Calpine Corporation's incentive program.²¹² With no memorandum explaining the decision, the court granted the debtor's motion in a bench order and approved an incentive program consisting of an "Emergence Incentive Plan," "Management Incentive Plan," "Supplemental Bonus Plan," and "Discretionary Bonus Plan."²¹³ Payments under the Emergence Incentive Plan and Management Incentive Plan were contingent upon an employee's achievement of certain performance targets.²¹⁴ The Supplemental Bonus Plan, interestingly, was a retention-type program but was written to exclude the debtor's "insiders."²¹⁵ However, no definition of an "insider" was provided.²¹⁶ Finally, the Discretionary Bonus Plan was simply a \$500,000 pool from which could be distributed, at the sole discretion of the CEO, bonus

103, at 95; Margaret Howard, *The Law of Unintended Consequences*, 31 S. ILL. U. L.J. 451, 457 (2007).

209. Ira L. Herman, *Statutory Schizophrenia and the New Chapter 11*, 2 AM. BANKR. INST. J. 30, 30 (2007) ("The uncertainty, delay and added expense that may be engendered by these BAPCPA provisions could be particularly nettlesome if the courts are to move reorganization cases more quickly through the bankruptcy system to give effect to the second policy imperative embedded in BAPCPA chapter 11 provisions: 'the need for speed.'" (citation omitted)).

210. *In re Nobex Corp.*, No. 05-20050, 2006 WL 4063024, at *3 (Bankr. D. Del. 2006).

211. *Id.*

212. See Order Authorizing the Implementation of the Calpine Incentive Program, *supra* note 134.

213. *Id.* ¶ 2, Ex. 1.

214. *Id.* at Ex. 1.

215. *Id.*

216. *Id.*

payments of up to \$25,000 per employee per year.²¹⁷ No reference was made to section 503(c) in the order.²¹⁸

Dana I succeeded *Calpine* in the bonus plan hunt, and the debtors urged the court to follow the *Calpine* lead.²¹⁹ The court, however, paused to examine the plans proposed by the debtor and found that the plans themselves were not truly incentive-based.²²⁰ The sticking point was that the plans proposed involved some “fixed” payments that would be made to an employee simply because he had remained at the company until the “effective date of a plan of reorganization.”²²¹ Thus, the court brought section 503(c)(1) into play and held that this non-incentivizing—or retention—plan could not be approved.²²² The court did, however, go out of its way to leave the door open for truly incentive-based bonus plans.²²³

The door being left wide open, *Dana Corp.* adjusted its plan and tried again to cross the threshold. With a slightly different plan laid before it, the court declared it to be properly incentive-based.²²⁴ Following the *Nobex* and *Calpine* lead, the court applied section 503(c)(3) to the plan in order to determine if it should be authorized.²²⁵ As section 503(c)(3) really requires “no more stringent a test than” the business judgment rule,²²⁶ “section 503(c)(3) gives the court discretion as to bonus and incentive plans, which are not primarily motivated by retention or in the nature of severance.”²²⁷ The plans were authorized as reasonable business judgments on the part of the debtors.²²⁸

These cases make it clear that bonus plans can be approved when they are incentive-based and are proper exercises of the

217. *Id.*

218. *Id.*

219. *In re Dana Corp. (Dana I)*, 351 B.R. 96, 101–02 (Bankr. S.D.N.Y. 2006). In fact, both the *Calpine* and *Dana* motions were heard and decided by the same judge, Judge Burton R. Lifland.

220. *Id.* at 102.

221. *Id.* at 99.

222. *Id.*

223. *Id.* at 103.

224. *In re Dana Corp. (Dana II)*, 358 B.R. 567, 574 (Bankr. S.D.N.Y. 2006).

225. *Id.* at 576; *see also id.* at 584 (“By presenting an executive compensation package that properly incentivizes the CEO and Senior Executives to produce and increase the value of the estate, the Debtors have established that section 503(c)(1) does not apply to the Executive Compensation Motion.”).

226. *Id.* at 576.

227. *Id.*

228. *Id.* at 584.

debtor's business judgment. There is, however, another avenue toward approval of bonus plans that seems to circumvent section 503(c) entirely.

This route began to take shape in *Global Home*. In that case the court did find that the bonus plan was properly incentive-based.²²⁹ However, the plan in question was not a "new" plan; a nearly identical plan had been previously implemented by the company before filing for bankruptcy.²³⁰ Thus, because the plan was not new, the court held that it was "clearly in the ordinary course of [the debtor's] business."²³¹ The court then went on to declare that "[t]he Court is fully satisfied on the basis of the facts presented that [the debtor is] asking it to approve incentive, not retention plans and, therefore, section 503(c) does not come into play."²³² In one fell swoop, the court simply removed section 503(c) from consideration, but it is unclear from the decision if this was because the plan was incentivizing or because the plan was in the debtor's ordinary course of business.

Nellson Nutraceutical more clearly defined the path for avoiding section 503(c) altogether. The debtors in that case had used incentive-based bonus programs for several years prior to filing for bankruptcy.²³³ The court found the debtor's plan to be in the ordinary course of the debtor's business.²³⁴

As a beginning rule, the court held that "if the Court determines that a transaction is in the ordinary course of a debtor's business, the Court will not entertain an objection to the transaction"²³⁵ However, the court did note that section 503(c)(1) does not apply only to transactions outside of the ordinary course of business.²³⁶ By its plain language section 503(c)(1) applies to any transfer that is "for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtor's business."²³⁷ Thus, creditors can still raise objections under this section and can argue that a proposed bonus

229. *In re Global Home Prods.*, 369 B.R. 778, 786 (Bankr. D. Del. 2007).

230. *Id.*

231. *Id.*

232. *Id.* at 787.

233. *In re Nellson Nutraceutical, Inc.*, 369 B.R. 787, 795 (Bankr. D. Del. 2007).

234. *Id.* at 797.

235. *Id.*

236. *Id.* at 800.

237. *Id.* at 800–01 (quoting § 503(c)(1)(2006)).

plan is retentive in nature and thus barred by section 503(c)(1).²³⁸

However, the constraints of section 503(c)(3) only apply to transactions made “outside the ordinary course of business”²³⁹ and thus, if a transaction—including an incentive-based bonus program—is within the ordinary course of business, section 503 will not apply to bar that payment.²⁴⁰ Simply put, if a debtor can show that a bonus program is within the ordinary course of its business, and that bonus program is not retentive in nature, section 503 will not come into play at all. It is merely up to the court to determine whether or not the plan is a sound exercise of the debtor’s business judgment under Code section 363.²⁴¹

If a company is capable of doing a little pre-bankruptcy planning, this avenue may be useful for implementing bonus programs.²⁴² As one commentator put it: “If the plan is part of the ordinary course of business of the debtor and the industry, there should be little concern that the motive is traditional incentive and not primarily post-bankruptcy retention.”²⁴³

D. Judicial Interpretation of Section 503(c) Has Begun, but Questions and Flaws Still Remain in the Statute

While courts have interpreted and applied section 503(c) in a handful of cases, there is some language in the section that has yet to be addressed. Boldly stated, “[t]he language of § 503(c) is not well drafted”²⁴⁴ For instance, section 503(c)(1) restricts payments to an insider “for the purpose of inducing such person to remain.”²⁴⁵ The meaning of this phrase is not given anywhere in the Code. If we take the everyday meanings of the words “purpose,” “induce,” and “remain” into consideration, section

238. See *id.* at 801 (stating that section 503(c)(1) is applicable “provided that the payments under the bonus program are to ‘an insider of the debtor for the purpose of inducing such person to remain with the debtor’s business.’”).

239. § 503(c)(3).

240. *Nellson Nutraceutical*, 369 B.R. at 801.

241. *Id.* at 804. See also Bellew, *supra* note 186, at 78 (recommending that debtors propose plans that will be considered within the “ordinary course” of their business).

242. See Crapo, *supra* note 207, at 173 (“Section 503(c) clearly creates a strong incentive for debtors to characterize or structure [bonus plan] payments obligations to the insider, as something other than either retention or severance payments.”).

243. Christensen, *supra* note 197, at 157.

244. Revich, *supra* note 103, at 94.

245. 11 U.S.C. § 503(c)(1) (2006).

503(c)(1) could be read to mean “payments to an insider are prohibited if they are set up in order to persuade or influence that person to stay with the same company.”²⁴⁶ But this reading still gives us no reference point as to the length of time an employee must “remain” with the company,²⁴⁷ nor does it tell us if the “purpose” involved must be the sole purpose behind the payments.²⁴⁸

IV. RECOMMENDATIONS

In order to truly achieve the goal Congress set in passing section 503(c), several changes should be implemented. First, the section itself should be modified to make its provisions more clear.²⁴⁹ Second, further limitations should be placed upon the bonuses available, even those that are not retention-based.²⁵⁰ Finally, bankruptcy judges should be encouraged to take a closer look at all proposed bonus plans and should use their inherent powers²⁵¹ to ensure that bonuses are necessary and reasonable without deferring too much to the business judgment of the debtor.²⁵²

A. *How Should Section 503(c) Be Changed to End Unnecessary Bonuses or to Reduce the Size of the Bonuses?*

The goal of the legislature is clear—section 503(c) was intended to curtail the massive bonuses being paid to executives when the companies they helmed were driven into bankruptcy.²⁵³ While this intent has been followed by the judges interpreting the Bankruptcy Code, section 503(c) could be clarified and its requirements tightened by implementing the following suggestions.

246. Hage, *supra* note 9, at Part IV.B.

247. *Id.*

248. *Id.*

249. *Infra* Part IV.A.

250. *Infra* Part IV.B.

251. *See* 11 U.S.C. § 105(a) (2006). This section, entitled “Power of court,” states that: “The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.” *Id.*

252. *See supra* Part III.C.

253. *See supra* Part II.C.

1. Implement Procedural Limitations on Motions for and Approval of Incentive Programs

Among bankruptcy petitioners, there are certain motions that are referred to as “first day” motions.²⁵⁴ Among these is the motion to approve employee bonus plans.²⁵⁵ By filing these motions contemporaneously with the filing of the bankruptcy petition itself,²⁵⁶ the debtors give the creditors and other interested parties very little time to scrutinize the proposed plans before the issue is decided.

In a hearing before the House Judiciary Committee, Richard Levin of the National Bankruptcy Conference proposed implementing procedural limitations on the timing of motions for approval of bonus plans.²⁵⁷ He suggested that:

A reasonable minimum notice period should be imposed to allow a creditors’ committee to be formed and to provide the committee and other parties a fair opportunity for review of the proposed program, and, if agreement is not reached, for there to be a fair opportunity for the parties to be heard before the court.²⁵⁸

Indeed, the cases interpreting section 503(c) have already found the agreement or disagreement of the creditors’ committees and other creditors to be an important factor for consideration. In *Dana I* the court noted that “[t]he plan generated extensive opposition.”²⁵⁹ However, in *Dana II* the court noted with approval that the debtor had modified its plan and had negotiated with many of its creditors to gain approval of the modified plan.²⁶⁰ Allowing the creditors to have input on the proposed bonus plans will decrease the possibility that the plan overreaches and allows

254. See Am. Bankr. Inst., *Early Case Motions: First-Day Orders: KERPS; Critical Vendors*, Oct. 5, 2007 [hereinafter *Early Case Motions*]. Examples of common first-day motions include motions on the effect of the bankruptcy filing on a debtor’s operations, motions that address the debtor’s relationships with its employees, creditors and customers, and motions relating to additional financing that the debtor intends to seek after the bankruptcy filing. *Id.*

255. *Id.*; see also Goldstein et al., *supra* note 190, at 4–10.

256. *Early Case Motions*, *supra* note 254.

257. *Executive Compensation in Chapter 11 Bankruptcy Cases: How Much Is Too Much?: Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 110th Cong. 22 (2007) [hereinafter “Levin Testimony”] (testimony of Richard Levin, Esq.).

258. *Id.* at 26.

259. *In re Dana Corp. (Dana I)*, 351 B.R. 96, 98 (Bankr. S.D.N.Y. 2006).

260. *In re Dana Corp. (Dana II)*, 358 B.R. 567, 571–72 (Bankr. S.D.N.Y. 2006).

bonuses that are out of line.²⁶¹

2. *Create a Strict Definition of Which Employees Constitute “Insiders” for the Purposes of Section 503(c)*

The term “insider” is a somewhat flexible concept in bankruptcy law. The only major case dealing with the definition is *NMI Systems, Inc. v. Pillard*, which held that:

[T]he appropriate test for whether [the employee] was an officer is whether [the employee] occupied a high position within the corporation making him active in setting overall corporate policy or performing other important executive duties of such a character that it is likely that he would be accorded less than arm’s-length treatment in the payment of his antecedent claim against the debtor. . . .²⁶²

While this decision does give some guidance, a definition this open-ended can lead to substantial disagreement and litigation.

Levin also proposed amending section 503(c) to tighten up the definition of insider so as to remove any doubt regarding whom the section should apply to.²⁶³ Instead of requiring a factual determination in each case, the insider designation should be modeled on the SEC Regulations.²⁶⁴ Specifically, Item 402(a) of SEC Regulation S-K requires a corporation to disclose the compensation received by the three most highly compensated executive officers.²⁶⁵ Limiting the insider definition to these individuals, Levin argues, allows a debtor to “offer the incentives necessary to keep key middle managers and star performers focused on their jobs, without generating expensive, time-consuming, and distracting litigation.”²⁶⁶ This limitation would also exclude an important or high-powered employee who may have

261. See Levin Testimony, *supra* note 257, at 26 (participation by all involved parties is more likely to lead to “the negotiation of reasonable and balanced solutions.”).

262. 179 B.R. 357, 369–70 (Bankr. D.C. 1995) (quoted in *In re CEP Holdings, LLC*, No. 06-51847, 2006 WL 3422665, at *1 (Bankr. N.D. Ohio Nov. 28, 2006)). For a detailed analysis of *NMI Systems*, see Brad B. Erens, *New Section 503(c) of the Bankruptcy Code – Who Is an “Officer” Under the KERP Amendment?*, 2 No. 11 ANDREWS BANKR. LITIG. REP. 2 (2005).

263. Levin Testimony, *supra* note 257, at 22, 26.

264. *Id.* at 26.

265. 17 C.F.R. § 229.402(a)(3) (2008). The “three most highly compensated” individuals does not include the PEO and PFO. *Id.*

266. Levin Testimony, *supra* note 257, at 26.

control over some aspect of the debtor's business, but who has no input into the level of compensation given to himself or to other employees.²⁶⁷

This definition, however, may be somewhat narrow for the purposes that section 503(c) intended to achieve.²⁶⁸ As discussed above, Congress enacted section 503(c) in response to the bankruptcies of several large corporations and the wealthy executive compensation packages that were proposed and approved.²⁶⁹ As the law currently stands, rather than focusing on the specific executives defined by SEC Regulation, "a court may determine that officers of a debtor for purposes of new Section 503(c) are only those senior employees of the debtor who have significant influence or input with respect to the design of the debtor's [bonus plan]"²⁷⁰ Creating a definition of the term "insider" that takes into account the individuals involved with the bonus plan creation process may help courts apply the standards of 503(c) uniformly and justly in many different circumstances.

B. What Additional Limitations Should Be Put on Incentive Plans in Chapter 11 Bankruptcies?

Merely implementing procedural limits or fiddling with the language of section 503(c) is not the only way to improve the process of approving bonus plans or to narrowly tailor the use of bonus plans to those circumstances where they are necessary and reasonable. For the reasons explained below, Congress should continue to examine the use of bonus plans and should consider other limitations on their amounts, recipients, and requirements.

First, there is no solid evidence that KERPs or incentive-based programs actually contribute to the successful reorganization of a company in Chapter 11.²⁷¹ Robert Keach highlighted this

267. *Id.*

268. *See* Erens, *supra* note 262.

269. *See id.* For example, the Polaroid bankruptcy was discussed in the debates on the Senate floor several times. *See, e.g.*, 151 CONG. REC. 23 S1990 (daily ed. Mar. 3, 2005) (statement of Sen. Kennedy). Erens suggests that "[t]he resulting KERP amendment introduced by Kennedy, then, might be seen as a reaction to what some perceived as abuse of power by senior management at Polaroid." Erens, *supra* note 262. *See also supra* Part II.C.

270. Erens, *supra* note 262.

271. Keach, *supra* note 13, at Part IV. Keach notes that the bankruptcy of Kmart as an example of a company that had obtained a KERP for key employees only to have many of those covered employees leave the company anyway. *Id.*

shortcoming even before BAPCPA was enacted: “There is no evidence that bonus payments actually result in the retention of employees who would otherwise leave, and considerable anecdotal evidence in cases with KERPs that they made no material difference.”²⁷² Keach goes on to cite to human resource experts who have pointed out that money is often not a critical factor in retaining employees.²⁷³ If money is not a critical factor, why should a debtor throw it at employees who may already want to leave?

One of the strongest arguments against KERPs and bonus programs may be that when bonuses are paid to already highly compensated executives, employee morale can be easily lost.²⁷⁴ All too often in business bankruptcies, the rank and file employees are asked to sacrifice wages, benefits, and working conditions while the executives—who were in charge when the finances started to get shaky—are offered bonuses and incentives to remain at the company.²⁷⁵ The results of such proposals can be disastrous for the company.

This effect was obvious in *Geneva Steel*.²⁷⁶ In that case, the debtor proposed a large bonus program for key executives, arguing that the plan was within its sound business judgment.²⁷⁷ However, the court noted that “[w]hile there is evidence that retention of the key employees is critical to Geneva’s survival, there is also evidence that granting the Motion as prayed may jeopardize the continuing support of the Steelworkers in Geneva’s reorganization process.”²⁷⁸ The loss of union support would mean the loss of the foundational workforce of the company. Thus, the court denied the motion and encouraged the debtor to rework the plan and to take the concerns

272. *Id.* at Part III.

273. *Id.* at Part IV.

274. *Id.*

275. See, e.g., *Executive Compensation in Chapter 11 Bankruptcy Cases: How Much Is Too Much?: Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 110th Cong. 14–17 (2007) (testimony of Antoinette Muoneke). Ms. Muoneke’s prepared statement detailed the pay cuts, longer hours, and loss of benefits she suffered after the bankruptcy of her employer, United Airlines. *Id.* at 15–17. She also expressed her anger at enduring these losses while at the same time United’s “CEO used the bankruptcy laws to take pay, bonuses and stock equaling over 1000 times” her compensation and received a bonus of “125% of his annual salary.” *Id.* at 17.

276. *In re Geneva Steel Co.*, 236 B.R. 770, 773 (Bankr. D. Utah 1999).

277. *Id.* at 772. This case was decided pre-BAPCPA and involved a true KERP; this does not limit the similar effect incentive-based bonus plans can have on employee morale in post-BAPCPA bankruptcies.

278. *Id.* at 773.

of the union into account.²⁷⁹ It is obvious from this case that overly generous bonus plans can cause havoc for the executives who propose them.

Finally, these large bonuses also have a detrimental effect on the perception of the bankruptcy system by the public at large. For example, one newspaper report began with the following:

A company files for bankruptcy, thousands of workers lose their jobs and the stock price becomes nearly worthless. So what do its executives and managers do? They ask for bonuses, sometimes worth millions of dollars. Never mind cost-cutting in every other part of the business. Never mind tough economic times that make it less likely key employees will flee to other jobs.²⁸⁰

Executive compensation itself has become a hot topic in the American media²⁸¹ and the approval of excessive bonuses continues to raise the ire of the public. Thus, further caps should be placed on the amounts available for bonuses and on the executives eligible to receive them.

C. Bankruptcy Judges Have the Power to Stem the Tide of These Large Bonuses and Should Do So More Often

Even without specific Congressional action, the bankruptcy court has the inherent power to rein in any overblown bonus plan. Section 105(a) of the Bankruptcy Code states:

The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.²⁸²

The equitable powers of the bankruptcy court should be brought to bear on motions for large bonuses. This power allows a judge to “look through form to the substance of a transaction and devise

279. *Id.* at 774.

280. Rachel Beck, *Greedy or Need? Big Bonuses During Bankruptcy*, TELEGRAPH-HERALD (Dubuque, Iowa), Jan. 26, 2003, at D3.

281. *See supra* Part II.B. and note 1.

282. 11 U.S.C. § 105(a) (2006).

new remedies where those at law are inadequate.”²⁸³ Judges should not feel required to adhere to a presumption of reasonableness under the business judgment rule when examining these programs.²⁸⁴ Instead, a court should feel free to analyze the bonus plans before them and raise any objections and concerns on their own prerogative.²⁸⁵

V. CONCLUSION

The issue of KERPs and bonuses is not a new one in bankruptcy. However, this issue is now part of the larger, more noticeable, public awareness of executive compensation.²⁸⁶ Congress has attempted to make changes, but these changes have not yet completely addressed the issue. More will have to be done before section 503 is clearly stated, uniformly interpreted, and successful in its purpose.

283. *In re Chinichian v. Campolongo*, 784 F.2d 1440, 1443 (9th Cir. 1986) (citations omitted).

284. Allison K. Verderber Herriott, Comment, *Toward an Understanding of the Dialectical Tensions Inherent in CEO and Key Employee Retention Plans During Bankruptcy*, 98 NW. U. L. REV. 579, 589 (2004) (“Case law has defined the business judgment rule as ‘a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.’”) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

285. *Id.* at 588.

286. *See supra* note 1.