

## The future of key employee retention plans and their treatment in the Delaware bankruptcy court

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In the context of a commercial bankruptcy case, the retention of key employees is frequently crucial either to successfully reorganise the company or to maximise the value of the company's assets in a liquidation. Historically, debtors relied on section 503 of the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994) as the legal authority to seek approval of compensation packages to induce key employees to remain following a bankruptcy filing. Section 503 conferred administrative status on the actual costs and expenses necessary to preserve the debtors' estate, including wages, salaries, or commissions for services rendered after the commencement of the case. This provision enabled debtors to offer key employees retention bonuses, severance pay and other compensation packages, known as KERPS, as incentives to remain employed by the debtors and provide invaluable services in the bankruptcy case and insured that, in all but the most unusual cases, these expenses would be paid in full.

On 20 April 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), which became effective on 17 October 2005. In the BAPCPA, the United States Congress amended section 503 so that the provision now includes a new subsection (c) that sets limitations on retention bonuses and severance payments to insiders (which by definition includes directors, officers, and persons in control of the debtor) and other transfers or obligations made or incurred outside the ordinary course of business. The change was a response to opinions expressed by commentators and advocates of employees and retirees that executives, officers and other persons managing the debtor too often were receiving excessive retention payments and other bonuses for post petition services,

while lower level employees and creditors were forced to incur reductions in payments from the debtors.

As a result, since the effective date of the BAPCPA, corporate debtors seeking to retain key insider employees by offering retention bonuses, severance plans and other compensation packages have been faced with these statutory limitations. Section 503(c) has been highly criticised by the legal community on a number of grounds, including that it is ambiguous and that the limitations are virtually insurmountable in the context of most bankruptcy cases. Nevertheless, it is the current state of bankruptcy law with respect to retention bonuses and severance packages. Its provisions set the following standards.

Section 503(c)(1) provides that a retention bonus to an insider shall not be allowed or paid unless the court finds that:

- the payment is essential to the retention because the individual has a bona fide job offer from another business at the same or greater rate of compensation;
- the services provided by the insider are essential to the survival of the business; and
- either (i) the payment is not greater than an amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to non-management employees during the same calendar year, or (ii) if there are no similar transfers made during the calendar year, the amount of the transfer 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 during the previous calendar year.

Section 503(c)(2) provides that a severance payment to an insider shall not be allowed or paid unless:

- the payment is part of a program that is

generally applicable to all full-time employees; and

- the amount of the payment is not greater than 10 times the amount of the mean severance pay given to non-management employees during the same calendar year.

Finally, section 503(c)(3) provides that any other payments that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to officers, managers, or consultants hired after the date of the filing of the petition, shall not be allowed or paid.

### Executive compensation plans in the District of Delaware

As a result of the limitations in section 503(c) on one hand and the necessity for debtors in bankruptcy to retain key personnel on the other hand, debtors have sought to create alternative compensation arrangements to motivate key insider employees that courts will approve. Success has been varied. Generally, in Delaware, debtors have been successful in persuading the Bankruptcy Court of the soundness of their proposed compensation plans primarily by relying either on statutory provisions other than section 503 or on subsection (c)(3) of 503. During the approval process, the Court has granted authority to debtors to maintain the confidentiality of certain aspects of their compensation packages (i) by entering orders allowing them to file under seal certain documents in support of the proposed retention bonus and incentive plans and (ii) by conducting closed hearings on certain aspects of the proposed plans.

### Incentive based plans

The most successful approach to compensation plans, to date, has been to propose ►►

incentive plans, rather than retention plans, for key employees. The incentive plans provide for a bonus to the employee if certain goals are achieved. Often the goals are related to the sale of assets or the financial performance of the company in bankruptcy. The incentive plans are designed to motivate the employee and benefit the bankruptcy estate, rather than to induce the employee to remain employed by the debtor. As a result, in various cases, the Delaware Court has found that incentive plans are not governed by section 503 and has approved them under other sections of the Bankruptcy Code. Debtors have also obtained approval of certain post petition payments to key employees made in conjunction with incentive plans that were in place prior to the bankruptcy filing on similar grounds. Finally, the Delaware Court has also approved a compensation plan under the catch-all provision of section 503(c)(3), where a post petition consulting agreement between the debtor and the president was ultimately proposed as an alternative to a retention bonus and severance plan.

#### **Confidential information related to executive compensation plans**

The Delaware Bankruptcy Court has also continued to safeguard confidential information related to compensation plans for key employees consistent with the Bankruptcy Code and Rules which permit, and in certain cases require, the Court to protect against disclosure of a trade secret or confidential research, development or commercial information and documents containing scandalous or defamatory matters.

The Court has permitted the debtors in certain cases to file under seal certain documents in support of the proposed compensation plans that contain non-public information regarding key employees' salaries, proposed bonuses and other confidential information. In each of these cases, the sealed documents have been available to objecting parties and/or to parties with a reasonable basis for reviewing the information that agreed to maintain confidentiality.

In one case, the Court closed a hearing to non-objecting third parties and directed any non-debtor party attending the hearing to keep confidential all information presented

at the hearing relating to the incentive plan that was under seal. The Court has also sealed portions of the transcript of a hearing relating to a motion for approval of incentive plans. In these cases, the hearing was closed or portions of the transcript sealed because the debtors presented evidence that they contended was highly confidential relating to the proposed compensation to certain key employees and/or the debtors' overall performance objectives and business strategies.

In each of the cases where the Court has allowed documents to be submitted under seal and/or conducted closed hearings, the grounds have been articulated as preventing (i) disclosure of confidential information regarding the debtors' business operations, objectives and strategies; (ii) a competitive, unhealthy work environment and low morale; and/or (iii) the use of the information by competitors in any effort to recruit key employees. These grounds are legitimate bases under the Bankruptcy Code and Rules related to confidential information.

#### **The future of KERP's under Section 503**

Section 503 of the BAPCPA has received much criticism from many in the legal community. The limitations on retention bonuses and severance payments to insiders in sections 503(c)(1) and (2) are considered impractical and have made it difficult for a debtor to obtain approval of such payments. In fact, there do not appear to be any reported decisions allowing a retention bonus under section 503(c)(1) or severance payment under section 503(c)(2) since the effective date of the BAPCPA.

Despite the criticism of section 503(c), the recent change of control in the House and Senate has prompted speculation that further bankruptcy reform could include even more restrictive provisions on compensation to insiders. One proposed amendment to section (c)(1) would extend the provision to apply not only to retention payments, but also payments for "performance, incentive or other bonus or any other compensation enhancement". Another would revise section (c)(3) to prevent any transfer to or obligation for the benefit of officers, managers or consultants retained by the debtor, unless the court finds that the

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transfers are essential to the survival of the business or to the liquidation or maximising of value of the debtors' assets because of the essential nature of the services provided and to the extent that the transfer is reasonable.

#### **Conclusion**

Although the future of key employee retention plans is uncertain, the Delaware Bankruptcy Court will continue to parse its way through the new legislative provisions and likely will continue to distinguish true incentive compensation plans from retention plans designed to compensate insiders for staying, not necessarily for performing. ■

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