

Client Alert

Latham & Watkins Finance Department

Two Recent Decisions Highlight Pitfalls in Creating and Implementing Key Employee Incentive Plans for Executives in Bankruptcy Cases

To successfully reorganize in Chapter 11, a bankrupt company may need to retain key employees who understand the company's business and who can design and implement the company's reorganization plan. Retaining and properly incentivizing these employees during a Chapter 11 case can be challenging for a number of reasons. For example, it may be difficult to replicate these employees' pre-petition compensation during the Chapter 11 case because a significant part of their compensation may have been in the form of stock options (which are likely worthless in light of the bankruptcy proceedings) and performance bonuses based on metrics that are no longer achievable. Furthermore, these employees may seriously consider other employment opportunities that do not involve the risks inherent in working for a company in Chapter 11.

To provide appropriate compensation to its key employees and to mitigate attrition risk during the bankruptcy case, a company in Chapter 11 may wish to implement key employee retention plans (KERPs) or key employee incentive plans (KEIPs). However, Title 11 of the United States Code (the Bankruptcy Code) significantly limits a bankrupt company's ability to implement these plans. The question of whether a proposed KERP or KEIP meets the Bankruptcy Code's requirements cannot be answered mechanically. Moreover, parties such as official creditors' committees, secured creditors and the Office of the United States Trustee (a federal government agency that has standing to be heard in all bankruptcy cases) are likely to object to any request for approval of a KERP or a KEIP.

In the *Residential Capital, LLC* and *Hawker Beechcraft, Inc.* Chapter 11 cases, bankruptcy courts in the Southern District of New York recently denied companies' motions to implement KEIPs, even though major creditor constituencies in both cases supported the proposed KEIPs. These decisions stand for the proposition that a proposed "incentive plan" that awards insiders simply for meeting case-specific milestone targets such as the consummation of a Chapter 11 plan or sale of assets that is already near completion (and does not require the satisfaction of challenging financial or operational targets), likely would be considered a disguised insider retention plan. These decisions also highlight the need for a thorough review and analysis of any proposed key employee retention or incentive program in bankruptcy.

"Two recent bankruptcy court decisions highlight that if a proposed insider 'incentive plan' does not require insiders to meet challenging financial or operational targets, it will likely be considered a disguised retention plan, and thus be subject to greater scrutiny."

The Relevant Bankruptcy Code Provisions

Section 503(c) of the Bankruptcy Code applies to payments under retention and incentive plans that are made to “insiders” of the company or that are made outside the ordinary course of business.¹ The determination of which particular section 503(c) requirements apply depends on (a) whether the plan provides for payments or for the incurrence of obligations to insiders, and (b) whether the plan is “retentive” or “incentivizing” in nature.

Section 503(c)(1) of the Bankruptcy Code provides that a company in bankruptcy may not make a payment or incur an obligation to (or for the benefit of) an insider for the purpose of inducing that insider to remain with the company’s business, unless the bankruptcy court determines that the following demanding requirements are satisfied:

- The proposed payment or obligation to the insider is essential to retention of the insider because he or she 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
- Either (i) the proposed payment or obligation to the insider is not greater than ten times the amount of the mean payments or obligations of a similar kind given to non-management employees during the same calendar year, or (ii) if no similar payment or obligation of a similar kind was provided to non-management employees during the same calendar year, the proposed payment or obligation to the insider is not more than 25 percent of the amount of any similar payment or obligation made to that insider during the previous calendar year

On the other hand, section 503(c)(3) of the Bankruptcy Code applies to proposed payments or obligations outside the ordinary course of business (a) to non-insiders and (b) to insiders that are *not* for the purpose of retaining those insiders. Under section 503(c)(3), a company only needs to demonstrate that the proposed payments or obligations are “justified by the facts and circumstances of the case.”

Because the requirements for approval of retention plans for insiders under section 503(c)(1) are so stringent, companies often argue that section 503(c)(3) applies because the recipients of payments under the proposed KEIPs are not “insiders,” and that if any recipients are insiders, then the purpose of the KEIP is not simply to retain those insiders.²

Who is an “Insider”?

To determine whether the requirements of section 503(c)(1) apply, one must first determine whether any of the beneficiaries of the KEIP are “insiders” of the company. Section 101(31) of the Bankruptcy Code provides that if the debtor is a corporation, “insider” includes directors, officers, persons in control of the debtor and general partners of the debtor, as well as their respective relatives. If the debtor is a partnership, section 101(31) of the Bankruptcy Code provides that “insider” includes general partners in the debtor, general partners of the debtor and persons in control of the debtor, as well as their respective relatives. The term “insider” also includes affiliates and insiders of affiliates of the debtor, as well as managing agents of the debtor.

The use of the word “includes” in section 101(31)’s definition of “insider” means that the list is illustrative rather than exclusive. Therefore, certain individuals can still be considered “insiders” even though they fall outside of the enumerated

categories in section 101(31). Courts determine whether a person is an “insider” on a case-by-case basis, generally holding that the term applies to “one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm’s length with the debtor.”³

Is Retention of Insiders the Purpose of the KEIP?

If any beneficiary of a proposed KEIP is an “insider,” then for the less stringent requirements of section 503(c)(3) to apply, the company must show by a preponderance of the evidence that the KEIP is *incentivizing* and not *retentive* with respect to the insider. In other words, the KEIP must offer incentives based on performance. It cannot be a “pay to stay” plan that awards insiders merely for staying with the company.⁴ Because at least one reason for making any payments to employees is to retain them, a number of bankruptcy courts have held that KEIP payments to insiders would be judged under section 503(c)(3) so long as the primary purpose of the KEIP is to incentivize (rather than to retain) the insider.⁵

To determine whether a KEIP is primarily incentivizing or primarily retentive, bankruptcy courts closely review the terms of the proposed incentive plan and the circumstances under which it is being proposed. A KEIP that provides performance targets for insiders that can be met too easily will likely be viewed as a veiled retention plan that would need to meet the stringent section 503(c)(1) requirements.

The Residential Capital, LLC Decision⁶

The Proposed KEIP

In the *In re Residential Capital, LLC* bankruptcy case in the Southern District of New York (Case No. 12-12020), the company proposed a KEIP that would have awarded between \$4.1 million and \$7 million in the aggregate to seventeen of its top twenty employees. The company acknowledged that each of these employees was an “insider.”

The proposed KEIP provided that a portion of the awards would vest upon the accomplishment of each of five milestones. Two of the milestones related to the sales of assets, while the other three related to financial and operational metrics. Specifically, approximately 63 percent of the awards under the proposed KEIP were to vest upon the closing of two sales of the company’s principal assets. Notably, the marketing processes with respect to the two asset sales were implemented *before* the company filed its bankruptcy case, and indeed the company had executed an asset purchase agreement with a “stalking horse” bidder with respect to each of these sales before the bankruptcy case was commenced.

In support of the proposed KEIP, the company stated that it was designed to compensate the seventeen insiders for the extra efforts that would be required of them during the pendency of the bankruptcy case. Specifically, the company noted that in addition to their normal daily duties, these insiders would be required to engage in daily diligence and marketing meetings with the stalking horse bidders and all other interested bidders, to ensure the complete segregation of the company’s operations from those of its parent, and to address a myriad of significant regulatory issues relating to the asset sales.

In its objection to the proposed KEIP, the United States Trustee argued that the company failed to show that (a) a reasonable relationship existed between the KEIP and the results to be obtained, (b) the cost and scope of the KEIP were reasonable,

(c) the KEIP was consistent with industry standards, and (d) they conducted reasonable due diligence in establishing the KEIP. The United States Trustee also argued that the KEIP was not primarily incentivizing because the primary target for the awards was the closing of sale transactions that had already been negotiated with stalking horse bidders.

The Bankruptcy Court's Denial of the KEIP Motion

In denying the company's KEIP motion, Judge Martin Glenn of the United States Bankruptcy Court for the Southern District of New York noted that 63 percent of the KEIP awards were linked solely to the closing of the two major asset sales, and that most of the employees' work with respect to those sales was performed before the bankruptcy filing. The Court rejected the company's argument that because of the magnitude of future tasks necessary to consummate those sales, the closure of those sales was not assured. In so doing, the Court noted that in light of the "lively bidding" during the Court hearings seeking approval of the stalking horse bidders (in which each bidder materially increased its proposed purchase price), "substantial doubts" existed as to whether the closing of the two asset sales was a target that was "significantly aspirational such that the KEIP is in fact primarily incentivizing." While the Court was sympathetic to the company's argument that the employees faced increased responsibilities in connection with the closing of the asset sales, it stated that the awards under the proposed KEIP were not primarily measured by the results of the auctions.

The Court held that because the largest component of the proposed KEIP in *Residential Capital* was tied only to the closing of the asset sales (and not tied to "additional challenging performance metrics"), the proposed KEIP was primarily retentive and thus had to satisfy the requirements of section 503(c)(1) of the Bankruptcy Code. Because the company did not try to satisfy those requirements, the Court denied the motion to approve the KEIP without prejudice.⁹ Notably, the Court provided some guidance to the company in reformulating their KEIP, stating that "[l]inking KEIP awards to increases in the auction sale prices of Debtors' assets, and to overall creditor recoveries may also provide permissible metrics for an incentivizing KEIP."¹⁰

The Hawker Beechcraft, Inc. Decision¹¹

The Proposed KEIP

In the *In re Hawker Beechcraft, Inc.* bankruptcy case in the Southern District of New York (Case No. 12-11873), the company proposed a KEIP that would award cash payments up to \$5.328 million in the aggregate to eight members of its senior management team upon the consummation of either a standalone restructuring plan or a transaction with a third party. To be eligible to receive any award, the employee must be employed on the effective date of the Chapter 11 plan unless he had been terminated without cause or resigned for good reason prior to the date of payment.

The terms of the company's "dual-track" restructuring process, which the KEIP was designed to incentivize, were negotiated by the company and the majority of its secured creditors before the bankruptcy filing. Under that process, the company would propose a "standalone" plan that would convert 100 percent of its debt to equity. At the same time, the company would engage in a marketing process to determine whether any transaction with a third party would generate more value than the standalone plan.

To incentivize consummation of the standalone plan, the proposed KEIP provided that each key employee could earn up to 200 percent of his annual base salary, with half of the total award based on the timing of the consummation of a plan and the remaining half based on achieving certain net cash flow targets. If the company pursued a third-party transaction instead, a separate set of incentives would apply, which would be based on the transaction price and on whether the transaction was consummated by a certain deadline (which could be extended by agreement with certain creditors). By the time the company sought approval of the KEIP, it had already received a “stalking horse” third party sale proposal for \$1.79 billion (the target price for a full award under the proposed KEIP) and it already had a plan and disclosure statement on file for the standalone debt-to-equity plan.

In support of the proposed KEIP, the company asserted that the awards were necessary to incentivize its “significantly undercompensated” senior management team in pursuing two separate alternative restructuring transactions on an accelerated timeline, in addition to running the company’s daily affairs. The company noted that it engaged an executive compensation consultant to help structure the KEIP and that it conducted due diligence to ensure that the KEIP was appropriate and competitive. The company also emphasized that the KEIP had the support of the unsecured creditors’ committee and the majority of its secured creditors.

The United States Trustee objected to the company’s motion to approve the KEIP, noting the apparent ease with which incentive awards could be earned. Specifically, the United States Trustee argued that (a) the company did not establish that the proposed targets represented “challenging results,” (b) the company did not provide sufficient information regarding how the key employees’ services were related to achieving a third-party transaction, particularly given the role of financial advisors and other professionals retained by the company to achieve a sale transaction, and (c) the requirement that the employees were required to be employed on the date of payment suggested that the awards were for retentive purposes.

The Bankruptcy Court’s Denial of the KEIP Motion

In denying the company’s motion to approve the KEIP, Judge Stuart M. Bernstein of the United States Bankruptcy Court for the Southern District of New York found that the company failed to establish that it was truly an incentive for several reasons. First, the company failed to identify the efforts each key employee would make, either individually or as part of a team, to achieve the proposed targets. The Court next found that the lowest levels of the incentive targets were “well within reach,” as the company was on target to meet the confirmation and consummation deadlines for a standalone plan and it already had an offer to purchase substantially all of its assets for the \$1.79 billion sale target price under the KEIP.

The Court also noted that the employees could earn half of their awards under the proposed KEIP for consummating a transaction under an indefinite deadline, without having to achieve any of the net cash flow targets. The Court found this feature to be unlike the incentive plan that had been approved in *In re Borders Group*, 453 B.R. 459 (Bankr. S.D.N.Y. 2011), where the proposed KEIP required insiders to confirm a non-liquidating plan or consummate a sale of the business and meet specific financial targets. Moreover, the Court noted that while the company’s proposed KEIP might be considered similar to the KEIP that was approved in *Velo Holdings Inc.*, 472 B.R. 201 (Bankr. S.D.N.Y. 2012), the KEIP in *Velo Holdings* included net cash flow targets, and the insider employees were required to increase their job responsibilities to achieve the bonus requirements. By comparison, the

insiders in *Hawker Beechcraft* could earn half of their awards without meeting any specific financial targets. Ultimately, the Court concluded that the KEIP must be denied given the likelihood that the key employees would “earn some bonus under the KEIP merely by remaining with the Debtors and regardless of the road the Debtors take.”¹²

Strategies to Increase the Likelihood of Obtaining Court Approval for a KEIP

Although a bankruptcy court's determination as to whether a proposed KEIP is permissible will depend on the particular facts and circumstances of each case, below are some strategies that may increase the likelihood of obtaining court approval of a KEIP:

- The company should be prepared to explain the process that it used to investigate and determine the need for a KEIP, the selection of the employees that would be covered by the KEIP and how the KEIP is designed to achieve the restructuring or performance results the company seeks to obtain
- The company should identify each KEIP participant's role and how his or her services relate to achieving the results the company seeks to obtain
- The proposed KEIP should require “insider” participants to meet sufficiently challenging financial or operational performance targets
- If the KEIP performance goals are based upon sales of assets or consummating other transactions, to the extent possible the KEIP should be designed and approved before the company begins the sale or transaction process, or the goals should be to achieve better prices or results than those of the sale or transaction that is already underway
- Consideration should be given to not requiring insider participants to be employed after the date that the performance targets are achieved, in order to eliminate one possible argument that that the plan is designed to be retentive to insiders
- The company should compare its pre-petition incentive plans to the terms of the proposed KEIP. If the KEIP will result in substantially greater compensation, the company should be prepared to demonstrate that substantially greater efforts or contributions by the participants are required to earn the additional compensation
- The company should compare the cost of the KEIP to its present and projected future assets and revenues, to ensure that the KEIP is not too costly
- The company should consider engaging a compensation consultant to assist in structuring the proposed KEIP. Among other things, that consultant should be able to compare the terms of the proposed KEIP to the compensation programs that are generally applicable in the company's industry, and be prepared to testify in court as necessary

Endnotes

- ¹ Congress enacted section 503(c) of the Bankruptcy Code as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 to “eradicate the notion that executives were entitled to bonuses simply for staying with the company during the bankruptcy process.” See *In re Global Home Prods., LLC*, 369 B.R. 778 (Bankr. D. Del. 2007).
- ² Alternatively, the company might argue that the proposed KEIP is within the ordinary course of its business, and thus subject to section 363(c) of the Bankruptcy Code. See, e.g., *In re Nellson Nutraceuticals*, 369 B.R. 787 (Bankr. D. Del. 2007).
- ³ See, e.g., *In re KDI Holdings, Inc.*, 277 B.R. 493, 511 (Bankr. S.D.N.Y. 1999). Generally, if an employee is determined to be an officer or director of a corporation, that employee would be considered an “insider.” *In re Borders Group, Inc.*, 453 B.R. 459, 468 (Bankr. S.D.N.Y. 2011) (citing *Smith v. Ruby (In re Public Access Technology.com, Inc.)*, 307 B.R. 500, 505 (Bankr. E.D. Va. 2004). Although articulating what, as a matter of law, suffices to make one a corporate insider may vary by case or jurisdiction, many courts agree that an employer’s decision to attach a particular title to a position is not dispositive for purposes of insider analysis. Instead, the analysis will often turn on the level of decision-making authority attached to the position and whether the individual has the ability to influence or implement corporate policies. See e.g., *In re NMI Systems, Inc.*, 179 B.R. 357, 370 (Bankr. D.D.C. 1995).
- ⁴ See, e.g., *In re Global Home Prods.*, 369 B.R. at 783; *In re Nellson Nutraceuticals*, 369 B.R. 787 (Bankr. D. Del. 2007).
- ⁵ See, e.g., *In re Residential Capital, LLC*, No. 12-12020 (Bankr. S.D.N.Y. Aug. 28, 2012); *In re Mesa Air Grp.*, No. 10-10018, 2010 WL 3810899 (Bankr. S.D.N.Y. Sept. 24, 2010).
- ⁶ *In re Residential Capital, LLC*, No. 12-12020 (Bankr. S.D.N.Y. Aug. 28, 2012).
- ⁹ The Court noted that the KEIP awards based on the three proposed financial/operational milestones may be appropriate so long as each of those milestones was “sufficiently challenging and incentivizing.” However, the Court declined to parse the proposed KEIP to consider whether the financial/operational component of the plan alone was permissible.
- ¹⁰ See *In re Residential Capital, LLC*, No. 12-12020 (Bankr. S.D.N.Y. Aug. 28, 2012) at n. 27. Though it did not impact its analysis of whether the proposed KEIP in *Residential Capital* was primarily retentive or primarily incentivizing, the Court also noted its concern that the total compensation the recipient employees might receive with the KEIP in 2012 (when the company was in bankruptcy) could be 30 percent more than the compensation they received during each of the two previous years (when the company was not in bankruptcy). The Court noted that the company did not provide a basis for it to conclude that paying these employees substantially more during the bankruptcy case was “justified under the facts and circumstances of the case” as required by section 503(c)(3). See *id.* at 17.
- ¹¹ *In re Hawker Beechcraft, Inc.*, No. 12-11873 (Bankr. S.D.N.Y. Aug. 24, 2012).
- ¹² See *id.* at 13.

If you have any questions about this *Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

Mitchell A. Seider
+1.212.906.1200
mitchell.seider@lw.com
New York

Michael J. Riela
+1.212.906.1373
michael.riela@lw.com
New York

Catherine M. Martin
+1.212.906.4507
catherine.martin@lw.com
New York

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the attorney with whom you normally consult. A complete list of our *Client Alerts* can be found on our website at www.lw.com.

If you wish to update your contact details or customize the information you receive from Latham & Watkins, visit <http://events.lw.com/reaction/subscriptionpage.html> to subscribe to our global client mailings program.

Abu Dhabi	Houston	Paris
Barcelona	London	Riyadh*
Beijing	Los Angeles	Rome
Boston	Madrid	San Diego
Brussels	Milan	San Francisco
Chicago	Moscow	Shanghai
Doha	Munich	Silicon Valley
Dubai	New Jersey	Singapore
Frankfurt	New York	Tokyo
Hamburg	Orange County	Washington, D.C.
Hong Kong		

* In association with the Law Office of Salman M. Al-Sudairi