

## **The United States Trustee Program Enforces BAPCPA's Limitations on Executive Compensation**

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Congress, through the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), amended the Bankruptcy Code to add 11 U.S.C. §503(c), in order to restrict the allowance and payment of administrative expenses to a debtor's officers, managers, and consultants. More than two years have passed since Congress adopted §503(c), and since that time, many have debated the merits of these new changes. Written material addressing their various implications is extensive. The purpose of this article is not to enter the fray. Instead, as the government agency charged with ensuring the integrity of the bankruptcy system, the United States Trustee Program (USTP) has sought to enforce the requirements of §503(c) to ensure that the changes are implemented and enforced in a way that best achieves Congress' intended purpose. This article is intended to provide an overview of the positions taken by the U.S. Trustees under §503(c) and to highlight efforts to ensure that debtors comply with these important new rules restricting retention payments and executive compensation in bankruptcy cases.

Regardless of one's opinion on the wisdom of the specific changes to the law in §503(c), many will agree that the effectiveness of the bankruptcy system does, to a significant degree, require both fairness and the public perception of fairness. Fairness is questioned when executives of big corporations receive large bonuses while their employees lose their jobs and retirees who invested in the companies' stock see their pensions drastically cut. With the addition of §503(c), Congress took aim at this problem in three distinct ways.

First, §503(c)(1) prohibits payments to an insider of the debtor "for the purpose of inducing such person to remain with the debtor's business" unless the debtor is able to prove that (i) the person receiving the payment has another bona fide job offer for the same or greater pay, (ii) the person's services are essential to the survival of the business, and (iii) the proposed payment is not greater than 10 times the average amount of similar payments made to nonmanagement employees during that same calendar year. The term "insider" is defined in 11 U.S.C. §101(31). If the debtor is a corporation, the term "insider" includes (among others) a "director," "officer," "person in control" and "managing agent" of the debtor.

Second, Congress sought to restrict severance payments by a debtor to its insiders. Under §503(c)(2), such payments are not permitted unless the debtor is able to prove that the payment is being made as part of a regular program available to all full-time employees and the proposed payment is not more than 10 times the amount paid to nonmanagement employees.

Finally, with §503(c)(3) Congress sought to curb extraordinary payments to “officers, managers, or consultants hired after the date of the filing of the petition.” Such payments may not be made if they are “outside the ordinary course of business” and if they are “not justified by the facts and circumstances of the case.”

Not surprisingly, corporate debtors and their counsel have devised a number of ways to evade the application of these new restrictions. Despite the enforcement challenges presented by such maneuvering, the U.S. Trustees have been diligent in seeking to ensure that debtors comply not only with the letter of the law, but also with its intended purpose. For example, the restrictions on retention and severance payments under §503(c) do not apply to non-insiders. While there may be legitimate reasons an employee accepts a demotion within a company, it would be inappropriate for an insider to do so on the eve of bankruptcy or immediately post-petition simply to game the system. U.S. Trustees routinely make inquiries to ensure that such practices do not occur and are active in filing objections when they perceive changes in employment status for this purpose. Such gamesmanship should not be countenanced by the courts, and the U.S. Trustees will continue to object to such practices.

A common yet difficult issue for the USTP and the courts to address is how to determine whether a compensation plan described as an employee incentive plan is, in fact, a disguised retention plan. This is the key issue with which the courts must wrestle. The ingenuity of debtors and their counsel have produced a variety of creative compensation plans, which are designed to avoid the implication that the proposed plans are retentive and thereby trigger the application of the restrictions on retention payments under §503(c)(1). For example, a proposed compensation plan often will establish benchmarks the employee must meet before payment will be awarded. Debtors argue that this construct clarifies that a plan has been developed to provide management incentives rather than to assure the retention of the employees. Merely postulating a justification besides retention is not sufficient, however. Section 503(c)(1) does not say that the payment must be made “solely” to retain the employee. Perhaps the best test was articulated by Bankruptcy Judge Burton Lifland who observed in *In re Dana* that if a bonus plan “walks like a duck (KERP) and quacks like a duck (KERP), it’s a duck (KERP).” *In re Dana Corp. (Dana I)*, 351 B.R. 96, 102 n. 3 (Bankr. S.D.N.Y. 2006).

Instead, U.S. Trustees and courts must look beyond the debtor’s characterization of its plan and make an independent determination whether the plan is a retention plan and, therefore, subject to §503(c). Among the factors the U.S. Trustees look for in making this determination is whether the benchmarks are too easily attained. For example, in a case in Massachusetts, a debtor proposed a compensation plan that would have awarded a \$1 million bonus for a small number of executives if they remained as employees of the debtor through the sale of the debtor’s business. The sale was expected to occur in less than 60 days, and the executives’ bonus would depend on the successful sale. Unsecured creditors, on the other hand, were to receive none of the sale proceeds. The U.S. Trustee and others objected, and the proposal was withdrawn.

Of course, in some cases, it is not apparent whether a plan’s proposed benchmarks represent real goals to be attained by the employee. U.S. Trustees often review a range of documents (i.e., spreadsheets detailing performance versus projections on a quarterly basis,

board of directors meeting minutes, board compensation committee minutes, and compensation expert reports) in their evaluation of the debtor's proposal. In certain of these cases, it may even be appropriate to seek the appointment of an examiner who can consider the standard compensation in the industry and the financial prospects of the company. An independent, unbiased expert can render a report on which the court and other parties may rely in deciding whether to object.

U.S. Trustees have also objected when debtors attempt to apply an unreasonably narrow definition of "severance" payment to avoid the evidentiary burdens of §503(c)(2). In the *Dana I* case mentioned above, the debtor sought approval of its compensation plan for certain executives. The debtor proposed that (i) if the CEO's employment was involuntarily terminated without "cause," (ii) if the CEO resigned for "good reason," or (iii) if the CEO failed to complete a replacement employment agreement with the reorganized company following good-faith negotiations, the CEO would execute a non-compete agreement in exchange for payments of approximately \$167,000 per month for the 18-month term of the agreement. Additionally, the CEO would be eligible to receive a pro rata payout of a "completion bonus" if the business plan had been completed but the effective date of a confirmed plan had not occurred. If the effective date of a confirmed plan occurred, the CEO would receive full payment of the completion bonus.

The U.S. Trustee objected to the proposed plan, arguing that the debtor was required to satisfy the requirements of §503(c). The debtor argued that the payments linked to the CEO's termination were not "severance" payments for §503(c)(2) purposes, but rather were "payments in exchange for non-compete agreements." *In re Dana Corp. (Dana I)*, 351 B.R. 96, 102 (Bankr. S.D.N.Y. 2006). The bankruptcy court rejected the debtor's construction of the "severance" term in §503(c)(2), and noted that "[s]everance pay is a form of compensation to alleviate the consequent need for economic readjustment but also to recompense him for certain losses attributable to the dismissal." *Id.* The court also rejected the characterization of the "completion bonus" as an incentive bonus, saying instead that if the "compensation scheme walks, talks and is a retention bonus" then it was subject to evidentiary standards of §503(c). *Id.*

Even if the proposed compensation plan does not trigger the requirements of §§503(c)(1) and (2), a debtor still must show that its compensation plan satisfies §503(c)(3). Some debtors have argued that §503(c)(3) – pertaining to payments outside the ordinary course of business – is merely a restatement of the "business judgment rule," and that their compensation plans should be allowed as long as the debtor is able to satisfy the standard similar to that applied in 11 U.S.C. §363 transactions. U.S. Trustees have objected to the application of the business judgment rule because §503(c)(3) applies a more rigorous standard. It requires that the payment be "justified by the facts and circumstances of the case." Conclusory statements about the business judgment of senior management are not enough. Instead, the debtor must show that a particular plan really benefits the debtor and that it makes sense within the larger context of the bankruptcy case.

Also worth mentioning are the changes in 11 U.S.C. §548(a)(1)(B)(ii)(IV), which allow for recovery, as a fraudulent transfer, of payments to an insider that are not in the ordinary course of business and for which the debtor received less than reasonably equivalent value. If the U.S. Trustee determines the debtor is unlikely to pursue those recoveries, he or she may move for the appointment of a trustee.

As with so many matters arising in bankruptcy, courts must make fact sensitive determinations in applying the new rules in §503(c). Therefore, one of the most important roles of a U.S. Trustee is to ensure that the proponent is compelled to present the requisite proof so the court can decide the facts. Motions filed by debtors seeking authority to make payments or incur obligations under §503(c) often raise more questions than they answer and omit critical information necessary to evaluate the plan's merits, such as: who is covered by the plan, whether the covered persons are "insiders," the performance criteria for receiving a bonus and the specific amounts proposed to be paid to each employee. Whether through discussions with the debtor or through the filing of a formal objection, U.S. Trustees routinely seek additional information about proposed compensation plans to ensure that they do not circumvent the restrictions of §503(c). Generally, the process of determining the nature and scope of compensation benefits payable to management, including insiders, and to rank-and-file employees should not wait until a motion seeking approval of an incentive program is filed. U.S. Trustees will frequently begin to explore compensation-related issues at the initial debtor interview and the meeting of creditors under 11 U.S.C. §341(a).

All parties are entitled to adequate notice and an opportunity to consider the merits of proposed compensation plans. U.S. Trustees often seek to ensure these procedural safeguards are preserved. In one case, a debtor asked the court for approval, as part of its "first day motions," of employee severance and retention plans that may have included insiders. The debtor included the plans among the more routine employee-related requests for relief typically granted as part of first-day orders and made no effort to establish that the requirements of §503(c) were met. The U.S. Trustee objected to expedited consideration of the compensation arrangement, and the court declined to approve the compensation plan without additional time for the parties to review the proposal.

Since the enactment of §503(c) through September 2007, U.S. Trustees have filed over 50 objections to executive compensation plans. This number does not include instances where the U.S. Trustee persuaded the debtor to modify its compensation scheme to avoid an objection by the U.S. Trustee. U.S. Trustees will continue to be vigilant in their application of §503(c), and debtors can continue to expect heavy scrutiny of their executive compensation plans. This does not, however, relieve debtors of their obligation to provide adequate information about their proposed compensation schemes in the first instance. Current and former employees of the debtor, as well as other interested parties, deserve complete and transparent disclosures regarding a debtor's compensation of its management and other insiders.