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EXECUTIVE COMPENSATION AND BANKRUPTCY: RETENTION PAYMENT RULES

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Federal trial courts have begun interpreting changes made to the Bankruptcy Code in 2005 that were designed to restrict retention pay and severance benefits. Several recent cases have addressed what constitutes a retention payment, so as to be subject to the special and strict rules on the addition of that type of compensation during bankruptcy. Two of these recent decisions have involved Dana Corporation. *In re Dana Corporation,* 351 BR 96 (Bankr. S.D.N.Y. 2006) and *In re Dana Corporation*, 2006 WL 3479406 (Bankr. S.D.N.Y. 2006). A third case is *In re Global Home Products, LLC,* 2007 WL 689747 (Bankr. D.Del. 2007).

A primary issue in each case was whether a compensation program constituted a Key Employee Retention Plan ("KERP"), also known as a "pay to stay" compensation plan, or was instead a program intended to create incentives for management and key employees, that is, a "pay for value" compensation plan. If a plan is a KERP, it is subject to special restrictions set forth in Section 503(c)(1) of the Bankruptcy Code. If, instead, a plan is intended to provide incentive compensation to management employees, a court is to apply a more liberal business judgment review under Bankruptcy Code Section 363 in determining whether the debtor may adopt the program.

Historically, compensation issues for debtor companies have generally been governed by business judgment standards. In 2005, however, Congress modified the Bankruptcy Code through the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCA"). That Act addressed, in part, Congressional concern over perceived abuses concerning retention programs. In particular, Congress hoped to end the practice of paying substantial bonuses to executives simply by reason of their remaining with the debtor company through the bankruptcy process. Under the revised Bankruptcy Code provision, a bankruptcy court is not to authorize payments to an "insider" for the purpose of inducing the insider to remain in the debtor's employ, unless the court determines that (a) the payment is essential to the retention of the person because he or she has a bona fide job offer from another business at the same or a greater rate of compensation, (b) the services provided by the individual are essential to the survival of the business, and (c) certain limitations are applied to the amount of the compensation. As to those limitations, the amount of the retention payment to an insider must not be greater than 10 times the amount of the average compensation of a similar kind given to nonmanagement employees during the calendar year, or if there are no similar transfers during the year, no greater than 25 percent of the amount of any similar transfer to the insider during the calendar year before the year in which the compensation was paid.

As a result of these strict rules on the payment of retention bonuses, debtor companies generally seek to avoid the treatment of compensation presented to a bankruptcy court for approval as being subject to the retention payment rules. In the first Dana Corporation case (351 BR 96), the court concluded that a "completion bonus," to be paid upon an executive remaining employed through the effective date of the company's plan of reorganization, was in substance a retention payment subject to the BAPCA retention payment rules. It made this determination even though a portion of the payment turned on meeting certain performance targets. The court's conclusion rested in large part on its view that the payments looked very likely to be made, either because they were not subject to performance standards at all or because the stated performance standards appeared to be relatively easily attainable.

The court also concluded that the BAPCA's special restrictions on severance pay applied to compensation that was ostensibly in exchange for noncompetes, where that compensation was to be paid upon an executive's involuntary dismissal or resignation for good cause. The BAPCA severance pay rules are, like its retention pay provisions, very restrictive. They prohibit a bankruptcy court from approving a severance payment to an insider unless that payment is part of a program generally applicable to all full-time employees, and the amount of the payment is not greater than 10 times the amount of the average severance pay given to nonmanagement employees during the calendar year in which the payment is made.

There is also a "catch-all" prohibition under BAPCA that prohibits a court's approval of payments that are "outside the ordinary course of business and not justified by the facts and circumstances of the case," including payments for the benefit of officers, managers, or consultants hired after the filing of the bankruptcy petition.

In the second Dana Corporation decision, the company returned to the court with a modified compensation package, which the court approved. As one might expect, the compensation package had been restructured to largely avoid the application of Section 503(c). The bulk of the compensation did not, in substance, constitute retention or severance pay, and was determined by the court to be reasonable.

Lessons. The early cases interpreting the BAPCA amendments to the Bankruptcy Code suggest that courts will look to the substance of an arrangement to determine whether it is a retention payment. In particular, where compensation is framed in terms of performance standards that are, in reality, easily obtainable, a court may well treat those payments as retention compensation subject to the strict BAPCA constraints.

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