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Introduction

Section 503(c) of the United States Bankruptcy Code (the "Bankruptcy Code") imposes strict limitations on companies in chapter 11 who want to make bonus payments to retain employees.[1] In particular, section 503(c) limits a chapter 11 debtor's ability to favor employees over the interests of the estate to ensure that any bonus payment is designed for the overall benefit of the bankrupt estate.[2] This memo details the differences between bonus payments under sections 503(c)(1) and 503(c)(3) and explains how a chapter 11 debtor should design bonus payments to employees to ensure those payments pass scrutiny under these provisions.[3]

I. Definitions under Section 503(c)

A. *Key Employee Retention Plan ("KERP")*

[1] 11 U.S.C. § 503(c) (2012).
[2] *In re Airway Indus., Inc.*, 354 B.R. 82, 87 n.12, 89 (Bankr. W.D. Pa. 2006); *In re Pilgrim's Pride Corp.*, 401 B.R. 229, 234, 237 n.14 (Bankr. N.D. Tex. 2009).
[3] Under section 503(c)(2), a severance payment to an insider is not allowed unless the payment is generally applicable to all full-time employees and the payment is not greater than 10 times the amount of the mean severance paid to non-management employees during the calendar year in which the severance is paid. 11 U.S.C. § 503(c)(2). This memo does not address severance payments under 503(c)(2).

Section 503(c)(1) prohibits the debtor from making payments to an insider employee[4] to induce the employee to remain with the company.[5] This section was added to the Bankruptcy Code to "eradicate the notion that executives were entitled to bonuses simply for staying with the Company through the bankruptcy process."[6] However, a chapter 11 debtor may overcome this prohibition if the court finds that the payment is to be made to an insider employee under a Key Employee Retention Plan ("KERP") that satisfies the following elements: (i) the insider employee has a bona fide job offer from another employer at the same or greater rate of compensation; (ii) the insider employee performs functions that are essential to the survival of the business; and (iii) the bonus amount requested for the insider employee is not greater than 10 times the average bonus given to non-management employees during the same calendar year or in the absence of such payments to non-management employees, the bonus payment to the insider is not greater than 25 percent of the bonus paid to the insider in the previous calendar year.[7] The term "KERP," while not specifically in section 503, has been identified by bankruptcy courts to refer to the plans under section 503(c)(1) of the Bankruptcy Code.[8]

B. Key Employee Incentive Plan ("KEIP")

Section 503(c)(3) prohibits any payment (retention or non-retention) to any employee (insider or non-insider) that is outside the ordinary course of business.[9] However, a chapter 11 debtor may overcome this prohibition if the court finds that the payment is made under a Key Employee Incentive Plan ("KEIP") that is outside the ordinary course of business and is justified

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[4] The term "insider" is defined in section 101 of the Bankruptcy Code. Where the debtor is a corporation, the term "insider" includes directors, officers, individuals in control of the debtor, partnerships in which the debtor is a general partner, general partners, and any relatives of the above. 11 U.S.C. § 101(31(B)(i)–(vi).
[5] 11 U.S.C. § 503(c)(1).
[6] *In re Global Home Prods.*, LLC, 369 B.R. 778, 784 (Bankr. D. Del. 2007).
[7] 11 U.S.C. § 503(c)(1)(A)-(C).
[8] *See In re Airway Indus., Inc.*, 354 B.R. 82 (Bankr. W.D. Pa. 2006); *In re Am. Eagle Energy Corp.*, No. 15-15073, 2016 WL 3573952 (Bankr. D. Colo. 2016).
[9] 11 U.S.C. § 503(c)(3).

by the facts and circumstances of the case.[10] The term "KEIP," while not specifically in section 503, has been identified by bankruptcy courts to refer to the plans under section 503(c)(3) of the Bankruptcy Code.[11] To pass scrutiny under section 503(c)(3), debtors often seek to incentivize the employee and pay bonuses for future performance, including reaching difficult to achieve and measurable milestones such as selling assets at above an existing bid or meeting certain financial goals.[12]

II. Key Differences between Sections 503(c)(1) and 503(c)(3)

The requirements under section 503(c)(1) are straight-forward and it is generally clear whether a bonus payment qualifies under this exception. The first and third requirements under section 503(c)(1) are objective, while the second requirement is subjective since it requires the debtor to prove that the insider employee's services are essential to the survival of the business. This requirement imposes a heavy burden on the debtor to show that retention of the insider employee would not just be beneficial to the bankrupt estate, but rather critical to its survival. Section 503(c)(3) imposes a lesser burden on the debtor than 503(c)(1), but is also less straight-forward and therefore, more open to judicial interpretation.

Many bankruptcy courts have held the 503(c)(3) standard to be synonymous with the "business judgment" standard applicable to transactions under section 363(b)(1) of the Bankruptcy Code.[13] Under section 363(b)(1), a debtor may engage in transactions in the ordinary

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[10] *In re Am. Eagle Energy Corp.*, No. 15-15073, 2016 WL 3573952 (Bankr. D. Colo. 2016); 11 U.S.C. § 503(c)(3).
[11] *See In re Airway Indus., Inc.*, 354 B.R. 82 (Bankr. W.D. Pa. 2006); *In re Am. Eagle Energy Corp.*, No. 15-15073, 2016 WL 3573952 (Bankr. D. Colo. 2016).
[12] *See* Letter from Ronald Weich, Assistant Att'y Gen., U.S. Dep't. of Just., Off. of Legis. Aff. to Senator Charles E. Grassley regarding restrictions on retention and incentive bonuses paid to executives of companies seeking chapter 11 relief at *1–2 (Mar. 5, 2012), as reprinted in Wall Street J. (Mar. 13, 2012), *available at* http://online.wsj.com/public/resources/documents/Letter031312.pdf.
[13] *In re Dana Corp.* (Dana I), 351 B.R. 96, 100 (Bankr. S.D.N.Y. 2006); *In re Residential Capital, LLC*, 478 B.R. 154, 167 (Bankr. S.D.N.Y. 2012). Section 363(b)(1) governed KERPS prior to the BAPCPA and is not as strict as the test under 503(c)(1).

course of business without court approval.[14] However, a debtor must obtain court approval for transactions outside the ordinary course of business.[15] In determining whether to approve a transaction outside of the debtor's ordinary course of business, a court will generally defer to the debtor's business judgment. The business judgment test requires a debtor to prove that the transaction at issue is "within the fair and reasonable business judgment of the debtors and thus within the zone of acceptability."[16]

When a bonus payment is at issue, the court must first determine whether the payment is a disguised retentive payment that should be scrutinized under 503(c)(1) or a true incentive plan that should be analyzed under 363(b)(1) and 503(c)(3).[17] This analysis depends on whether the performance goals and metrics are challenging and whether attaining those goals will have a positive impact on the overall outcome of the bankrupt estate.[18]

The KEIP/KERP distinction is important because each provides a different framework through which a chapter 11 debtor may seek approval of a bonus plan. KERPs have straightforward, well-articulated, and stricter requirements that are applicable to insider employees only. Bonus plans will pass scrutiny under this provision only when they meet the line-by-line requirements. However, when companies are unable to meet this high standard, they can use the KEIP framework, which is applicable to both insider and non-insider employees, is more deferential to the debtor and, highly dependent on the court's analysis of the evidence provided by the debtor. Courts have developed differing views over time; however, more recent decisions illustrate a willingness to defer to the evidence provided by a debtor to prove the plan

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[14] 11 U.S.C. § 363(b)(1) (2012).
[15] *In re Alpha Nat. Res., Inc.*, 546 B.R. 348, 356 (Bankr. E.D. Va. 2016).
[16] *In re Dana Corp. (Dana II)*, 358 B.R. 567, 571 (Bankr. S.D.N.Y. 2006).
[17] *In re* Alpha Nat. Res., Inc., 546 B.R. at 358.
[18] *Id.*

is a KEIP, rather than to compel a debtor to meet the higher standard of proving a KERP when the evidence provided by the debtor is highly specified, technical, and targeted.

III. Some Courts Look to the Business Judgment Test When Evaluating KERPS and KEIPS

In *In re Alpha Natural Resources,* for example, the Bankruptcy Court for the Eastern District of Virginia showed deference to a restructuring expert's characterization of certain financial targets as "aggressive".[19] In *In re Patriot Coal*, the Bankruptcy Court for the Eastern District of Missouri held that the bonus payment's consistency with industry standards is one measure of exercising proper business judgment.[20] The Missouri bankruptcy court in *Patriot* further stated that certain top heavy employees perform duties that are more integral to the performance of the company and therefore, it would be reasonable and fair for these employees to be eligible for higher incentive and retention payments.[21] In *In re Borders Group*, the Bankruptcy Court for the Southern District of New York upheld a KEIP because the insiders who would benefit from the KEIP had to meet specific financial targets relating to annual rent reductions or other cost reductions as well as distributions to unsecured creditors by a specific date.[22] In *In re Airway Industries*, the Bankruptcy Court for the Western District of Pennsylvania upheld a KERP for insiders who were being offered jobs elsewhere and determined the company's efforts to be bona fide and in good faith to maximize the value of the estate.[23]

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[19] *Id*.
[20] *In re Patriot Coal Corp*., 492 B.R. 518, 530 (Bankr. E.D. Mo. 2013).
[21] *Id*. at 535.
[22] *In re Borders Group., Inc*., 453 B.R. 459, 465 (Bankr. S.D.N.Y. 2011).
[23] *In re* Airway Industries, Inc., 354 B.R. at 85

IV. Other Courts Conduct Their Own Independent Analysis to Determine Business Justification

Other courts take the position that 503(c)(3) imposes a higher standard than the business judgment test because the 503(c)(3) test is not the same as the standard under 363(b)(1).[24] The Texas bankruptcy court elevated the standard finding that even if the court finds that the debtor has demonstrated a sound business reason for the incentive, the court *must* do an independent analysis to determine if the proposed bonus plan will best serve the creditors and the debtor's estate.[25] The Texas bankruptcy court explained that Congress would not have added a new provision to the Bankruptcy Code were it meant to be synonymous with an older provision of the Bankruptcy Code; it is presumed that Congress meant for independent sections of the Bankruptcy Code to have independent and differing impacts.[26] The Texas bankruptcy court determined that the use of the language "justified by the facts and circumstances of the case" suggests that Congress intended for the courts to have a more critical role in assessing transactions under 503(c)(3).[27]

Under this heightened standard, even if the debtor articulates a good business justification, the court must independently consider whether the KEIP would maximize the return to creditors and benefit the debtor's overall estate.[28] A debtor must prove by a "preponderance of the evidence that the KEIP is primarily incentivizing and not primarily retentive."[29] A court cannot simply rely on the labels proffered by the debtor when considering whether the intent of the plan is to primarily incent or retain ("a debtor's label of a plan as

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[24] *In re* Alpha Nat. Res., Inc., 546 B.R. at 357.
[25] *In re* Pilgrim's Pride Corp., 401 B.R. at 237.
[26] *Id*.
[27] *Id*.
[28] *In re* Alpha Nat. Res., Inc., 546 B.R. at 357.
[29] *In re* Residential Capital, LLC, 478 B.R. at 170.

incentivizing to avoid the strictures of section 503(c)(c) must be viewed with skepticism….").[30] The targeted performance goals must be meaningful and challenging to qualify the plan as passing under the 503(c)(3) standard.[31]

However, a bonus payment that has some retentive effects should not automatically raise the higher 503(c)(1) standard.[32] Courts have recognized that incentive bonuses can have a retentive purpose, but where the other strict standards are met, this retentive purpose does not preclude the plan to be deemed an acceptable KEIP.[33]

V. Courts Have Recognized and Rejected KEIPS Disguised as Prohibited KERPS

Companies in chapter 11 unable to meet the strict criteria of section 503(c)(1) (KERPS) often design bonus plans and claim they meet the criteria under section 503(c)(3) (KEIPS) when they actually do not, and are instead disguised retention plan payments that are prohibited under 503(c)(1). A bonus plan that proposes performance goals that are easily achieved should be re-characterized as a KERP subject to the higher 503(c)(1) standard.[34] In *In re Residential Capital*, the Bankruptcy Court for the Southern District of New York rejected a proposed KEIP as a disguised KERP because the bonus payout was contingent on a sale that was bound to happen regardless of further action by the KEIP participants (the KEIP participants would only need to remain with the debtor to qualify for the bonus payment).[35] The New York bankruptcy court explained that increased responsibilities alone are not sufficient to justify business necessity

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[30] *In re* Alpha Nat. Res., Inc., 546 B.R. at 357 (quoting *In re* Residential Capital, LLC, 478 B.R. at 170).
[31] *Dana II*, 358 B.R. at 571.
[32] *In re Global Home Prods., LLC*, 369 B.R. 778, 785 (Bankr. D. Del. 2007).
[33] *In re* Patriot Coal Corp., 492 B.R. at 533; *In re Nellson Nutraceutical, Inc.*, 369 B.R. 787, 803 (Bankr. D. Del. 2007).
[34] *In re* Alpha Nat. Res., Inc., 546 B.R. at 357 (describing the New York bankruptcy court's reasoning in *Dana I*, 351 B.R. at 102 n. 3).
[35] *In re* Residential Capital, LLC, 478 B.R. at 172.

under 503(c)(3) and that instead "the debtors must more closely link vesting of the KEIP Awards to metrics that are directly tied to challenging financial and operational goals."[36]

In *In re Hawker Beechcraft*, the Bankruptcy Court for the Southern District of New York found that the debtor's bonus plan did not satisfy 503(c)(3) because the participants would be able to earn the bonus without meeting any specified financial targets (will earn the bonus under one of two transactions, one of which is bound to occur).[37] Similarly, a KEIP was deemed as a disguised KERP in *Dana I* because the participants would receive a bonus payment regardless of the outcome of the bankruptcy.[38] Even where the debtor set forth three performance levels under a KEIP, the Bankruptcy Court for New Hampshire deemed it a disguised KERP pointing to a lack of information provided by the debtor to show how it would achieve each of the different levels and how a KEIP participant would move from one level to the next.[39] The New Hampshire bankruptcy court criticized the plan as seeking to make bonus payments to insiders for doing a job they were already obligated to do even if they performed at a level below that necessary to ensure the ultimate success of the debtor's bankruptcy proceedings.[40]

VI. Courts Have Articulated a Framework to Conduct a 503(c)(3) Analysis

In contrast, where the debtor proposes to make bonus payments to insiders to prevent them from going to the debtor's competitors, enabling the debtor to complete its bankruptcy proceedings free of threat from the competitor, a court may conclude that the bonus payments were justified under 503(c)(3).[41] The *Dana II* court laid out several questions a court should ask

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[36] *Id*. at 173.
[37] *In re Hawker Beechcraft, Inc*., 479 B.R. 308, 313 (Bankr. S.D.N.Y. 2012).
[38] *Dana I*, 351 B.R. at 100.
[39] *In re GT Advanced Tech., Inc*., No. 14-11916, 2015 WL 5737181 *3, *5 (Bankr. D. N.H. 2015). Debtor's three levels were "threshold," "target," and "stretch," with "threshold" being the level required to get any bonus, "stretch" being the maximum level of bonus, and "target" being somewhere in between.
[40] *Id*. at *6.
[41] *In re* Pilgrim's Pride Corp., 401 B.R. at 235.

to determine if a bonus payment to an insider is acceptable under 503(c)(3) including the following:

- Is the plan calculated to achieve the desired results?
- Is the cost reasonable in the context of the debtor's assets, liabilities, and earnings potential?
- Is the scope of the plan fair and reasonable?
- Is the proposal consistent with industry standards?
- What due diligence did the debtor undertake in determining the necessity of the plan?
- Did the debtor seek independent counseling in forming the plan?[42]

Additionally, where the bonus payout was contingent on the sale of an asset by a specified deadline and where the sale was not negotiated prior to the company petitioning for bankruptcy, the bonus payment was deemed a KEIP subject to 503(c)(3) analysis and not disguised as a KERP barred under 503(c)(1).[43] In *In re Alpha Natural Resources*, the KEIP participants were tasked with slowing down the debtor's cash bleed, reducing expenses, and maintaining liquidity without compromising safety and environmental standards.[44] Therefore, the KEIP satisfied both the business judgment test and the heightened scrutiny set forward by *In re Pilgrim's Pride*.[45] In reaching this conclusion, the *Alpha* Court laid out certain questions that create a framework to conduct this analysis by adopting the *Dana II* factors and adding a few additional pieces to the analysis:

- Is the scope of the KEIP reasonable?
- Did the debtor undertake suitable due diligence for adoption of the KEIP by an independent compensation committee?
- Are the participants of the KEIP appropriate – do they have additional responsibilities than the ones they had prior to the filing of the bankruptcy?
- Is the cost of the KEIP reasonable in the context of the debtor's assets, liabilities, and earnings potential?

[42] *Danna II*, 358 B.R. at 576–77.
[43] *In re* Alpha Nat. Res., Inc., 546 B.R. at 360.
[44] *Id*. at 362.
[45] *Id*. at 363.

- Is the plan designed to achieve the desired performance results?
- Is the plan consistent with industry standards?
- Can the debtor prove the employees would otherwise leave to the detriment of the bankrupt estate?
- Can the court determine that the plan is reasonable given all the facts and circumstances?
- Does the plan satisfy the heightened scrutiny standard set forth in *Pilgrim's Pride*?[46]

More recently in *In re American Eagle Energy*, the Bankruptcy Court for the District of Colorado adhered to an analysis of the nine factors articulated in *In re Alpha Natural Resources* to determine whether a bonus payment plan is a KEIP or a disguised KERP.[47] In analyzing each factor, the Colorado bankruptcy court found:

- the scope of the bonus plan was reasonable, covering only certain employees performing crucial duties to remain with the company (only two of the employees were covered under the proposed plan and the bonus plan was conceived *after* the Chief Financial Officer and other employees had either resigned or had been let go to reduce costs),
- suitable due diligence was undertaken for adoption of the plan by an independent compensation committee,
- the participants were appropriate: the two insiders receiving the payments were performing a myriad of new functions, not just continuing to perform old responsibilities they had prior to the filing (the in-house counsel took on HR and IT responsibilities),
- the cost of the plan was reasonable in the context of the debtor's assets, liabilities and earning potential (one of the employees requested a 50% raise which represented $300k in base salary as compensation for his new and added duties – instead of granting this request, the debtor provided a salary of $230k and offered a $60k bonus if certain specified financial targets were met),
- the plan was properly designed to achieve performance standards: the plan targeted to maintain operations and to provide timely accruable financial, operation and asset reports, and data to the extent necessary to maximize value in a sale,
- the plan was consistent with industry standards: bonuses were modest and fell within the fair and reasonable business judgment of the debtor – the amounts were modest compared to those requested and allowed in other cases cited by the parties,

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[46] *In re* Am. Eagle Energy Corp., 2016 WL 3573952 *2.
[47] *In re* Am. Eagle Energy Corp., 2016 WL 3573952 *2; *In re* Alpha Nat. Res., Inc., 546 B.R. at 356.

- the plan fell within the fair and reasonable business judgment of the debtor: the debtor did not want to risk the employees leaving or just "going thru the motions" in performing their new duties,
- the plan was not disguised as a KERP – the objectors have a narrow focus on the cash balance performance standard missing the point to be found from all the facts and circumstances, and
- the plan satisfied the heightened scrutiny standard set forth in *Pilgrim's Pride* - that the plan was justified by the facts and circumstances of the case.[48]

Conclusion

It is critical for companies in chapter 11 to understand the nuanced approach they must take in designing a bonus plan for insider or non-insider employees if the plan to pass statutory scrutiny under 503(c). A chapter 11 debtor must be mindful of the high burden imposed by 503(c)(1) to substantiate a KERP. If trying to substantiate a KEIP, the articulated performance standards must be tied to specific, targeted goals by a specific deadline for the court to approve the plan under 503(c)(3). Companies must be careful in designing the plan as a disguised KEIP that does not meet the requirements of a KEIP and instead triggers the higher standard of a KERP. Failing to meet the lower standard triggers the higher standard under the statute - if the plan fails the lower standard, it will certainly fail under the higher standard.

[48] *In re* Am. Eagle Energy Corp., 2016 WL 3573952 *3-7.