2022

The Effect of Insider Status on the Court's Approval of a Key Employee Retention Plan

Perry Chresomales

St. John's University School of Law

The Effect of Insider Status on the Court's Approval of a Key Employee Retention Plan

2022 Volume XIV No. 2

The Effect of Insider Status on the Court's Approval of a Key Employee Retention Plan

Perry Chresomales, J.D. Candidate 2023

Cite as: *The Effect of Insider Status on the Court's Approval of a Key Employee Retention Plan*, 14 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 2 (2022).

Introduction

When a company that has filed for relief under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code") seeks to retain essential employees through the course of its bankruptcy, the payments made with the goal of retaining key employees are subject to the requirements of section 503(c) of the Bankruptcy Code. These payment plans, also known as Key Employee Retention Plans or "KERPs", are designed to "provide certain Key Employees with a financial incentive to forgo seeking alternative employment during the Debtors' bankruptcy proceeding as well as after confirmation of a chapter 11 plan."[1] In the face of public scrutiny surrounding these payments made to high level employees, Congress enacted certain of the BAPCPA amendments to "eradicate the notion that executives were entitled to bonuses simply for staying with the Company through the bankruptcy process."[2] The amendments "limited the scope" of KERPs and other programs designed to induce management to remain

---

[1] *In re* Residential Capital, LLC, 491 B.R. 73, 78 (Bankr. S.D.N.Y. 2013).

[2] *In re* Hawker Beechcraft, 479 B.R. 308, 312–13 (quoting *In re* Global Home Prods., LLC, 369 B.R. 778, 784 (Bankr. D.Del. 2007)).

with the debtor.[3] The amendments were implemented to "put in place 'a set of challenging standards' and 'high hurdles' for debtors to overcome before retention bonuses could be paid."[4] The amendments narrowed the circumstances in which KERP payments could be made and limited the amount of the KERP payments.[5]

Following the BAPCPA amendments, many debtors have been faced with the question of when the Bankruptcy Court will approve the proposed KERP. The answer is highly dependent on whether the employee is an insider of the debtor and if the KERP is a transaction outside the ordinary course of business. Precedent makes it clear that employees that exert sufficient control over the debtor are insiders and any KERP payments made to those employees must overcome the high hurdles imposed by section 503(c)(1). A debtor seeking to make payments to employees who lack such power will only have to meet the more lenient section 503(c)(3) requirements, provided that the KERP is a transaction outside the ordinary course of business.

DISCUSSION

I. Which employees are insiders according to 11 U.S.C. §101(31)(B)

Prior to determining whether a KERP will be approved, the court must first determine whether the employees receiving the payments are insiders. If the recipient of the KERP payment is an insider, the analysis proceeds under section 503(c)(1). Section 503(c)(1) says that there shall be no transfers "made to, or an obligation incurred for the benefit of, an insider of the

---

[3] *Id.*

[4] *In re* Borders Grp., 453 B.R. 459, 471 (Bankr. S.D.N.Y. 2011) (quoting *In re* Global Home Prods., LLC, 369 B.R. 778, 784-85 (Bankr. D.Del. 2007)).

[5] *In re* Global Home Prods., LLC., 369 B.R. 778, 785 (Bankr. D. Del. 2007).

debtor for the purpose of inducing such person to remain with the debtor's business" unless the three requirements of section 503(c)(1) are met. The three requirements are:

> (1) the transfer or obligation is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation; (2) the services provided by the person are essential to the survival of the business; and (3) either– the amount of the transfer made to, or obligation incurred for the benefit of, the person is not greater than an amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made or the obligation is incurred; or if no such similar transfers were made to, or obligations were incurred for the benefit of, such nonmanagement employees during such calendar year, the amount of the transfer or obligation 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 for any purpose during the calendar year before the year in which such transfer is made or obligation is incurred.[6]

Section 101(31)(B) of the Bankruptcy Code defines a corporate insider as a: (i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor.[7] This list is not exhaustive.[8] The Bankruptcy Code does not define the terms "director" or "officer."[9] When analyzing the employee's status as an insider, "title is insufficient to establish that an individual is a director or an officer."[10]

---

[6] 11 U.S.C. § 503(c)(1).
[7] 11 U.S.C. § 101(31)(B).
[8] *See* U.S. Bank N.A. v. Vill. at Lakeridge, LLC., 138 S.Ct 960, 963 (2018).
[9] *In re* LSC Commc'ns., Inc., 631 B.R. 818, 823 (S.D.N.Y. 2021).
[10] *Id.* (quoting *In r*e Borders Grp., Inc., 453 B.R. 459 (Bankr. S.D.N.Y. 2011)).

Courts have applied varying standards to determine an employee's status as an insider. Courts have regularly relied on dictionary definitions to control the analysis. For example, in *Borders*, the court noted that the Tenth Circuit in *Kunz* had defined "director" using Webster's Third International Dictionary and Black's Law Dictionary.[11] The Tenth Circuit noted that "[w]hen the term "director" is used in reference to a corporation, as it is used in the statutory definition of 'insider,' the term plainly means a person who is a member of the governing board of the corporation and participates in corporate governance."[12] When approached with the task of defining the term "officer," courts have also used Black's Law Dictionary to define officer as a "person elected or appointed by the board of directors to manage the daily operations of a corporation, such as the CEO, president, secretary, or treasurer."[13]

Additionally, courts have defined "officer" by analyzing both state and federal law.[14]. In *Fieldstone*, the Maryland District Court analyzed the Clayton Antitrust Act, the Model Business Corporation Act, and the Maryland Code to determine that "board appointment or election is frequently identified as distinguishing 'officer' positions from other titled positions within a corporation."[15] The *Fieldstone* Court went on to note that board appointment or election ordinarily signals that the employee is an officer as a matter of law.[16]

While the court in *Fieldstone* analyzed state and federal law to support its definition of "officer," state law has often been rejected as the sole source of the definition for "officer" under

---

[11] *In re* Borders Grp., Inc., 453 B.R. at 459.
[12] *In re* Kunz, 489 F.3d 1072, 1077 (10th Cir. 2007).
[13] Office of the U.S. Trustee v. Fieldstone Mortg. Co., No. 08–755, 2008 WL 4826291, at *3 n. 12 (D. Md. Nov.5, 2008) (quoting BLACK'S LAW DICTIONARY 1193 (9th ed. 2009)).
[14] *Id.* at *3.
[15] *Id.* at *4.
[16] *Id.* at *13–14.

section 101(31)(B).[17] In *NMI Sys.*, the bankruptcy court for the District of Columbia rejected the notion that state law was the sole source for the definition of "officer," but considered the state law definition as one factor in its analysis.[18]

Courts have also conducted a case-by-case, fact specific inquiry to determine the status of the employee at issue. For example, courts have looked at corporate documents to determine that an employee was not an insider.[19] In *Public Access Tech.,* the bankruptcy court for the Eastern District of Virigina was faced with deciding whether an employee holding the title "Executive Vice President" was an insider.[20] The court concluded that the Executive Vice President was not an insider because there were no corporate minutes, articles of incorporation, affidavits, or other documents to support that the employee was an insider.[21]

One feature that courts have predominantly focused on when determining whether an employee is an insider is the level of control over the debtor.[22] In *Borders*, the Bankruptcy Court for the Southern District of New York applied a control test to the employees at issue who all held director-level titles.[23] These employees, however, did not have any authority to implement company policies.[24] In addition, these employees did not report to the board of directors and instead had to either report to an officer or another employee that reported directly to an

---

[17] *See In re* NMI Sys., Inc., 179 B.R. 357, 371 (Bankr. D.D.C. 1995).
[18] *Id.*
[19] *See In re* Public Access Tech.Com, Inc., 307 B.R. 500, 506 (Bankr. E.D.V.A. 2004).
[20] *Id.*
[21] *Id.*
[22] *See In re* Babcock Dairy Co., 70 B.R. 657, 661, (Bankr. N.D. Ohio 1986) (finding that insiders will have the ability to exert sufficient control over the debtor or will be able to "dictate corporate policy and the disposition of corporate assets").
[23] *See In re* Borders Grp., 453 B.R. 459, 469 (Bankr. S.D.N.Y. 2011).
[24] *Id.*

officer.[25] It is important to note that while the control test has been widely adopted, some courts have rejected its application.[26] In *LSC*, the District Court for the Southern District of New York rejected the Bankruptcy Court's application of the control test for six employees that had been appointed by LSC's board.[27] The *LSC* Court relied on the employees' appointment by the board to determine that they were insiders who were ineligible to receive the KERP payments.[28]

II. Meeting the Stringent Requirements of Section 503(c)(1).

When a court finds that the employee receiving a KERP payment is an insider according to section 101(31)(b) of the Bankruptcy Code, the "stringent" requirements of section 503(c)(1) are used to analyze whether the KERP can be approved.[29] The debtor must prove all three requirements of section 503(c)(1) before any KERP payments can be made to the debtor's insiders.

Under the first requirement, the debtor must show that absent the KERP payments, the insider employee will leave their employment with the debtor because the employee has received a "firm, good faith offer to work for a different employer for at least the same or greater compensation."[30] To evaluate whether the first requirement has been met, the court must determine:

> (1) the employee's intention to leave unless the KERP is approved;
> (2) whether the employee's reason for leaving is because the employee received a valid offer of employment from someone other

[25] *Id.*
[26] *See In re* LSC Commun's, 631 B.R. 818, 826 (S.D.N.Y. 2021).
[27] *Id.* at 825.
[28] *Id.*
[29] *In re* Fieldstone Mortgage Co., 427 B.R. at 362.
[30] *Id.* at 363.

> than the debtor; and (3) whether the offer was at least as valuable or more valuable than that proposed by the KERP.[31]

The *Fieldstone* Court determined that a competing job offer was lacking because the company that offered the position was the company conducting the takeover of the debtor.[32] Because the debtor failed to meet its obligation under section 503(c)(1)(A), the KERP payment was denied.[33] The Court was satisfied that the requirement of section 503(c)(1)(B) had been met based on the testimony of the debtor's CEO.[34] While the third requirement of section 503(c)(1) is objective, section 503(c)(1)(B) is a subjective standard and imposes a heavy burden on the debtor. Under section 503(c)(1)(B), the debtor must show that the retention of the employee is critical to the success of the business.

III. When is a KERP "a transaction in the ordinary course of business"

If an employee is not an insider according to section 101(31)(B) of the Bankruptcy Code, the next step is to determine whether the KERP is a transaction in the ordinary course of business. This is an important step because if the employee is not an insider under section 101(31)(B) and the KERP is a transaction "outside the ordinary course of business," the debtor must meet the requirements of section 503(c)(3).[35]

Courts use a two-step horizontal and vertical test to determine whether a transaction is in the ordinary course of business.[36] The horizontal and vertical test "considers the reasonableness

[31] *Id.*
[32] *Id.*
[33] *Id.* at 364.
[34] *Id.*
[35] 11 U.S.C. § 503(c)(3).
[36] *In re* Dana Corp., 358 B.R. 567, 580 (Bankr. S.D.N.Y. 2006).

of the transaction from an industry-wide perspective and from the viewpoint of a creditor."[37] Under the horizontal inquiry, the question is "whether, from an industry-wide perspective, the transaction is of the sort commonly undertaken by companies in that industry."[38] The vertical inquiry analyzes the transaction from a hypothetical creditor's point of view.[39] The question of the vertical inquiry is "whether the transaction subjects a creditor to economic risk of a nature different from those he accepted when he decided to extend credit."[40]

Under the horizontal prong of the test, courts have looked to industry-practice, comparing the plan to plans that other companies have implemented.[41] Under the vertical prong, courts have considered whether the plan was a part of the debtor's prepetition practice.[42] If the court concludes that the KERP is a transaction outside the ordinary course of business, the KERP must be analyzed under section 503(c)(3).

IV. Applying Section 503(c)(3) to KERP Payments Outside the Ordinary Course of Business Made to Non-Insiders.

After finding that the employee is not a corporate insider and that the transaction is outside the ordinary course of business, the court turns to the language to section 503(c)(3) to approve the KERP payment. Section 503(c)(3) provides:

> notwithstanding section (b), there shall neither be allowed, nor paid: other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to, or obligations incurred for the benefit

---

[37] *Id.*
[38] *Id.* (quoting *In re* Crystal Apparel, Inc., 207 B.R. 406, 409 (Bankr. S.D.N.Y. 1997)).
[39] *Id.*
[40] *Id.* (quoting *In re* Crystal Apparel, Inc., 207 B.R. at 409).
[41] *See In re* Nellson Neutraceuticals, Inc., 369 B.R. 787, 798 (Bankr. D. Del. 2007).
[42] *In re* Dana Corp., 358 B.R. at 582.

> of, officers, managers, or consultants hired after the date of the filing of the petition.[43]

The facts and circumstances standard is the same standard as the sound business judgment test used in section 363 of the Bankruptcy Code for approving transactions in the ordinary course of business.[44] To assess whether a corporation exercised sound business judgment, courts have considered at least six factors, including:

1. Is there a reasonable relationship between the plan proposed and the results to be obtained, i.e., will the key employee stay for as long as it takes for the debtor to reorganize or market its assets, or, in the case of a performance incentive, is the plan calculated to achieve the desired performance?
2. Is the cost of the plan reasonable in the context of the debtor's assets, liabilities and earning potential?
3. Is the scope of the plan fair and reasonable; does it apply to all employees; does it discriminate unfairly?
4. Is the plan or proposal consistent with industry standards?
5. What were the due diligence efforts of the debtor in investigating the need for a plan; analyzing which key employees need to be incentivized; what is available; what is generally applicable in a particular industry?
6. Did the debtor receive independent counsel in performing due diligence and in creating and authorizing the incentive compensation?[45]

In re Residential Capital, LLC., is illustrative in its application of the *Dana II* factors to a KERP.[46] The court found that there was a reasonable relationship between the KERP and the results since the payments would ensure that key employees remained with the debtor and the debtor would incur significant losses if those employees left.[47] Next, the cost of the KERP was reasonable because the total cost of the KERP fell below the median cost of KERP implemented

---

[43] 11 U.S.C. § 503(c)(3).
[44] *In re* Dana Corp (Dana II), 358 B.R. 567, 576–77 (Bankr. S.D.N.Y. 2006).
[45] *Id.*
[46] 491 B.R. 73, 85 (Bankr. S.D.N.Y. 2013).
[47] *Id.*

by other chapter 11 debtors.[48] The scope of the KERP was fair and reasonable since the KERP applied to all remaining employees who would be staying with the debtor for longer than five months.[49] The debtor satisfied the final two factors by receiving independent counsel in the creation of the KERP "to ensure that the payments are fair and consistent with industry standards for a company operating under bankruptcy protection."[50] The court approved the KERP.[51]

CONCLUSION

When devising a Key Employee Retention Plan, debtors must assure that they are careful in crafting their plan. A company should be aware that title alone is not sufficient to deem an employee a statutory insider, but it becomes increasingly likely that an employee who exerts sufficient control over corporate policy will be deemed an insider. Should an employee set to receive a KERP be found an insider, the KERP will need to survive all of the strict requirements set forth in section 503(c)(1). If the KERP is a transaction made outside the ordinary course of business to a non-insider, the company must comply with the more lenient business judgment test.

---

[48] *Id.*
[49] *Id.* at 86.
[50] *Id.*
[51] *Id.*