"Law Limits Executive Compensation"

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On April 20, 2005, President George W. Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. BAPCPA, which generally applies to bankruptcy cases filed on or after Oct. 17, 2005, represents the largest and most comprehensive overhaul of U.S. bankruptcy laws since the current Bankruptcy Code, found in Title 11 of the U.S. Code, was enacted in 1978.

Although many of the BAPCPA's changes to the Bankruptcy Code apply to consumers, the act made significant changes to the bankruptcy laws as they pertain to business bankruptcies. One change of particular interest to executives is that BAPCPA severely restricts the bankruptcy court's ability to approve, and a debtor's ability to pay, certain types of executive compensation in bankruptcy. These include restrictions on retention and severance payments.

Retention payments. Section 503(c)(1) of the Bankruptcy Code provides that the court shall not approve, and a debtor shall not make or incur, any transfer or obligation to or for the benefit of an insider of the debtor — typically the debtor's officers and directors — "for the purpose of inducting such person to remain with the debtor's business" without an express finding by the court that 1. The payment or obligation is essential to keep the person from accepting a bona fide job offer for the same or greater pay; 2. The person's continued retention is essential to the survival of the business; and 3. The amount of payment to made or obligation to be incurred does not exceed either 10 times the amounts paid to non-management employees in the same calendar year or 25 percent of the amounts paid to insiders in the calendar year preceding that in which the payment is to be made.

Richard Levin and Alesia Ranney-Marinelli, writing in the summer 2005 issue of *The American Bankruptcy Law Journal*, call this standard "extraordinarily difficult, if not impossible" to meet. They provide an example: If a director or officer must have a bona fide job offer from another company (presumably a company that is not financially distressed) at the same or greater pay for a retention payment to be permitted, why would the executive not accept such offer? And, if the exec has no intent to accept such offer, is the offer really bona fide?

Another problem arises if the company didn't make any retention payments to nonmanagement employees during the same calendar year, or to insiders during the preceding calendar year. Levin notes that, in this situation, arguably the maximum amount of any permissible payment will be zero, because any percentage times zero equals zero.

Severance payments. It's not just retention payments that the act targets. The bankruptcy court may not approve a severance payment to an insider under BAPCPA unless it is "(A) . . . part of a program that is generally applicable to all full time employees; and (B) the amount of the payment is not greater than 10 times the amount of the mean severance pay given to the nonmanagement employees during the calendar year in which the payment is made." Aside from the issue of calculating the amount of severance that may be approved — because, as stated earlier, zero times any percentage is zero — this provision may also directly impact a debtor's ability to assume or reject certain executory contracts.

It is not uncommon that all or a portion of a debtor's key officers and/or directors will have employment agreements that may contain provisions entitling the executive to certain severance payments or benefits upon a termination of employment not for cause. Section 365(a) of the Bankruptcy Code provides debtors with the right to assume or reject executory contracts, which include employment agreements.

Typically, courts will permit assumption or rejection upon a showing that assumption or rejection is in the debtor's best interests, based upon the debtor's business judgment, as the 5th U.S. Circuit Court of Appeals noted in 1985's *Richmond Leasing Co. v. Capital Bank N.A.* Once a company assumes a contract in bankruptcy, any amounts thereafter payable under the contract typically becomes administrative expenses, payable in 100-cent dollars. Thus, if a company assumes an employment agreement, with a severance provision, and the company later terminates the executive not for cause while the company is still in bankruptcy, the severance payment would be an administrative expense of the estate, payable in full.

However, the introductory languages to §503(c) forbids severance payments to insiders that don't meet the stated requirements. Thus, because a contract must generally be assumed or rejected in its entirety rather than in parts, two outcomes appear possible, neither of which is good news for execs: Either the bankruptcy court can't approve assumption of an insider's employment agreement if the contract contains a provision for severance payments exceeding the limits of BAPCPA, or, if the court approves assumption, the insider's severance payment is limited to the amount calculated pursuant to §503(c)(2).

Other payments. Section 503(c)(3) of the Bankruptcy Code also prohibits "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 of officers, managers or consultants hired after the date of the filing of the petition."

However, in one bright spot for executives, it appears that §503(c) to the Bankruptcy Code does not prohibit incentive or bonus plans based on performance or other benchmarks. Two bankruptcy cases on the East Coast bear this out. In the U.S. Bankruptcy Court for the Southern District of New York in *In Re: Musicland Holding Corp, et al.* (2006), and in the U.S. Bankruptcy Court of the District of Delaware in *In re: Nobex Corp.* (2005, the debtors sought court approval to continue certain existing incentive plans and pay incentive bonuses to senior management, respectively.

In their motion in *Musicland*, the debtors asserted that the proposed payments did not implicate or violate §503(c), because they would provide incentives to management to maximize the value of the debtors' estates through either a plan of reorganization or sale of substantially all assets; the payments thus would be akin to the success/transaction fees typically payable to investment bankers. The official committee of unsecured creditors objected on the grounds that the proposal looked like a disguised key employee retention program prohibited by §503(c). The committee ultimately withdrew its objection and the proposal was approved.

According to the debtor's motion in *Nobex*, the debtor contended that the requested incentive program did not implicate §503(c), because the proposed payments were not intended to be, nor were they structured as, retention or severance payments. The creditors' committee negotiated with the debtor and eventually agreed to the relief requested with certain modifications, which the court approved. Although BAPCPA enacted strict limitations on the types of payments to insiders that may be authorized during the course of a bankruptcy case, incentives and other types of payments are not per se prohibited. As time goes on, the landscape of authorized (and unauthorized) payments will become clearer.

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