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INTRODUCTION

Regardless of the constant flux in business trends affecting blue-chip stalwarts and the nouveau riche start-ups of Silicon Valley alike, one business resource has remained unchanged: human capital. At the executive level, even as companies continue to downsize or further explore automation and streamlining, ample compensation packages for executives continue to be the norm without substantial signs of any change in the trend.[1] This increasing dependency on human capital is especially poignant in Chapter 11 restructurings where companies rely on corporate leadership to navigate the process.[2] In the wake of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA),[3] much attention was given to the drastic changes in the approach to executive compensation.[4] Initially, there was a flurry of activity regarding Key Employee *Retention* Plans (KERPs), reflecting the uncertainty within the practice and lack of applicable case law following the radical changes to the

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1. *See* Emily Chasan, *Companies Say 'No Way' to 'Say on Pay'*, WALL ST. J. (Aug. 26, 2014, 1:36 PM), http://blogs.wsj.com/cfo/2014/08/26/companies-say-no-way-to-say-on-pa/.

2. DOUGLAS G. BAIRD, ELEMENTS OF BANKRUPTCY 234 (6th ed. 2014). *See also* Scott A. Wolfson & Valerie R. Jackson, *Key Employee Incentive Programs Make "Cents" for Creditors*, 31 AM. BANKR. INST. J. 22 (2012).

3. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

4. Morris J. Massel, *Executive Compensation in the Post-BAPCPA Era*, 2007 AM. BANKR. INST. J. 16 (2007).

Bankruptcy Code (the Code).[5] More recently, the Key Employee *Incentive* Plan (KEIP) developed to replace the KERP and its stringent requirements. Recently, the Southern District of New York (S.D.N.Y.) rejected two KEIPs in *In re Hawker Beechcraft, Inc.* (*Hawker*)[6] and *In re Residential Capital, LLC* (*Residential Capital*).[7] These rejections surprised many throughout the industry and raised questions about the appropriate course of action for a debtor to take, both pre- and post-petition, in order to ensure the necessary level of executive compensation.[8] In particular, part of what makes these decisions so unique in comparison to their predecessors is that both were relatively inventive in their use of substantially negotiated asset sales.[9]

Both KERPs and KEIPs are rooted in § 503(c) of the Code.[10] There is however, a fundamental difference in the amount of scrutiny between KERPs and KEIPs.[11] A KERP, as its name implies, is sought primarily for retentive effect, while a KEIP is designed to be incentivizing.[12] The Code treats retention and incentivization very differently, imposing stringent requirements on plans that are designed primarily to be retentive under § 503(c)(1), while inadvertently creating a loophole for those that are characterized as primarily incentivizing—a difference sometimes considered more form than substance.[13] The policy behind such disparate treatment is the difference between the principles underpinning the respective plans. That is, a KERP exists to motivate an employee merely "to

5. *See, e.g.*, Rebecca Revich, Note, *The KERP Revolution*, 81 AM. BANKR. L.J. 87 (2007).

6. *In re* Hawker Beechcraft, Inc., 479 B.R. 308 (Bankr. S.D.N.Y. 2012).

7. *In re* Residential Capital, LLC, 478 B.R. 154 (Bankr. S.D.N.Y. 2012).

8. *See, e.g.*, Mitchell A. Seider, Michael J. Riela & Catherine M. Martin, *Two Recent Decisions Highlight Pitfalls in Creating and Implementing Key Employee Incentive Plans for Executives in Bankruptcy Cases*, CLIENT ALERT NO. 1404 (Latham & Watkins LLP, New York, N.Y.) (Sept. 24, 2012), https://www.lw.com/thoughtLeadership/employee-incentive-plans-executives-bankruptcy.

9. *See infra* Part I.A.

10. *See* 11 U.S.C. § 503(c) (2012).

11. *Hawker*, 479 B.R. at 313.

12. *See* Seider, Riela & Martin, *supra* note 8.

13. Dorothy Hubbard Cornwell, Comment, *To Catch a KERP: Devising a More Effective Regulation Than § 503(c)*, 25 EMORY BANKR. DEV. J. 485 (2009). *See also infra* Part I.B.

remain with the debtor's business . . . ."[14] On the other hand, the lofty-sounding incentive plan implies substantial additional work on the part of the debtor's executive management.[15] In practice, however, the distinction has generally existed primarily in name only.[16]

This Note seeks to examine the recent shift towards rejecting proposed KEIPs within the Southern District of New York as highlighted by the *Hawker* and *Residential Capital* decisions, and why the current standard is inadequate to address the special concerns that arose in those two cases. In order to do so, this Note will first examine the historical basis for executive compensation in bankruptcy, the formulation of the 2005 BAPCPA amendments, and the cases that followed. This Note will then present the *Hawker* and *Residential Capital* cases, followed by an analysis of why the application of § 503(c) as it currently stands was inadequate for the proposed asset sales presented in those cases. Ultimately, this Note will propose adjustments to § 503(c) that better reflect the unique circumstances of those two cases.

I. HISTORY

A. Section 363(b) Retention Programs Pre-BAPCPA and Asset Sales

Prior to the introduction of § 503(c), debtors used several different mechanisms embodied in the Code to propose payments to retain management in bankruptcy proceedings. Two of the most popular were § 363(b) for authorizing transactions outside of the ordinary course and § 105(a)[17] as an exercise of the bankruptcy court's equitable power.[18] Section 363(b) is of particular importance

14. 11 U.S.C. § 503(c)(1).

15. *Hawker*, 479 B.R. at 315. "[T]he KEIP required the executives 'to *do more* . . . .'" *Id.*

16. *See* Cornwell, *supra* note 13, at 506.

17. 11 U.S.C. § 105(a) (2012). This section of the Code provides that a bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." *Id.*

18. Emily Watson Harring, Note, *Walking and Talking Like a KERP: Implications of BAPCPA Section 503(c) for Effective Leadership at Troubled Companies*, 2008 U. ILL. L. REV. 1285, 1292–95 (2008).

because it was applied to both retention plans and is still in use today for the approval of asset sales.

Section 363(b)(1) states that "[t]he trustee,[19] after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . . ."[20] In approving such transactions outside of the ordinary course, a court looks for an articulable business purpose.[21] This business judgment rule, originally developed by the Delaware courts outside of the realm of bankruptcy, is a particularly deferential standard.[22] Despite its non-bankruptcy origins, it was readily adopted by the bankruptcy courts of the S.D.N.Y. and elsewhere, and reflects a hesitancy to intervene in corporate decision making.[23]

In the context of retention plans, courts viewed such programs as using property of the estate outside of the ordinary course of business and hence subject to the requirements of § 363(b)(1). In approving retentive programs, the bankruptcy courts developed a two-part test requiring that the plan was (1) a product of the debtor's business judgment, and (2) "reasonable and fair" under the circumstances.[24]

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19. In a Chapter 11 proceeding, the debtor in possession (usually referred to as the DIP) is, in most circumstances, the trustee. 11 U.S.C. §§ 1107, 1108 (2012); FED. R. BANKR. P. 9001 (2014). Under these rules, the DIP retains control of the day-to-day operations of the business. *Id.*

20. 11 U.S.C. § 363(b)(1) (2012).

21. Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1070 (2d Cir. 1983).

> The history surrounding the enactment in 1978 of current Chapter 11 and the logic underlying it buttress our conclusion that there must be some articulated business justification, other than appeasement of major creditors, for using, selling or leasing property out of the ordinary course of business before the bankruptcy judge may order such disposition under section 363(b).

Id.

22. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000). The court defined the business judgment rule as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Id.*

23. Allison K. Verderber Herriott, Comment, *Toward an Understanding of the Dialectical Tensions Inherent in CEO and Key Employee Retention Plans During Bankruptcy*, 98 NW. U. L. REV. 579, 589 (2004) (citing Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (*In re* Integrated Res. Inc.), 147 B.R. 650 (Bankr. S.D.N.Y. 1992)).

24. *In re* InterCo, 128 B.R. 229, 234 (Bankr. E.D. Mo. 1991). *See generally* Herriott, *supra* note 23, at 591–92.

This standard was relatively permissive and generally encouraged retention programs.[25]

Section 363(b) is still used today as the standard through which courts allow debtors to engage in asset sales during the bankruptcy process. As per the terms of § 363(b)(1), after the required "notice and hearing" and with subsequent approval of the court, a debtor can sell its assets.[26] Asset sales under § 363(b) are popular due to their speed, lower cost relative to Chapter 11 proceedings, and potential to produce cash or other value for the estate.[27] The relatively low-threshold requirements imposed by § 363(b)(1) and the benefits that come with it combine to further the central goal of bankruptcy—preserving the value of the estate.[28] The Second Circuit set the standard for applying § 363(b)(1) in *Committee of Equity Security Holders v. Lionel Corp.* (*In re Lionel Corp.*), requiring an "articulated business justification[]" to balance the potential need to act quickly in order to protect the estate against a rubber-stamp approval.[29]

In spite of this permissive standard, several cases pushed the boundaries of § 363(b) to the breaking point. Perhaps the most infamous is *Enron*,[30] which after its filing (at the time the largest corporate filing in Chapter 11 history),[31] sought and received approval of a $140 million retention program, all the while being investigated by the SEC and Congress.[32] Those who were shocked by

25. *See* Harring, *supra* note 18, at 1293–94.

26. 11 U.S.C. § 363(b)(1) (2012).

27. *See* Jacob A. Kling, *Rethinking 363 Sales*, 17 STAN. J.L. BUS. & FIN. 258, 262 (2012).

28. *Id.* at 263. *See also infra* Part II.A.

29. *In re* Lionel Corp., 722 F.2d at 1069–70.

30. Debtors' Mot. for Approval of Key Emp. Retention Program Pursuant to Bankr. Code Section 363(b) and to Authorize Admin. Expense Priority for Indem. Claims Arising from Postpetition Servs. of Dirs. and Officers Pursuant to Sections 503(b) and 507 of the Bankr. Code at 16, *In re* Enron Corp., No. 01-16034, 2002 WL 32150521, at *1 (Bankr. S.D.N.Y. Mar. 29, 2002).

31. *See* Richard A. Oppel, Jr. & Andrew Ross Sorkin, *Enron Corp. Files Largest U.S. Claim for Bankruptcy*, N.Y. TIMES (Dec. 3, 2001), http://www.nytimes.com/2001/12/03/business/enron-s-collapse-the-overview-enron-corp-files-largest-us-claim-for-bankruptcy.html.

32. *See* Herriott, *supra* note 23, at 584. The pain was especially 'sharp for those not receiving a payout. A group of ex-Enron employees expressed criticism that was even more severe:

> "The [KERP] motion demonstrates a tin ear for the realities surrounding this case; the collapse of Enron has created the deepest crisis of confidence in corporate governance in at least a generation," said the ex-employee coalition. "[T]he debtors seek to pay

the massive *Enron* filing were dumbfounded within the year by the even-larger *WorldCom* case,[33] which exceed the size of *Enron* and shared its scandal.[34] In spite of this, the court approved the proposal, which included a $25 million bonus plan that was extremely retentive in nature.[35] Perhaps one of the most sordid scandals came to light in the wake of *Adelphia*, which led to arrests and criminal charges within a month of filing.[36] Taking cues from its predecessors, *Adelphia* also proposed a multimillion-dollar KERP, albeit with some slight downward adjustments (foreshadowing the drastic changes in incentive payment law to come).[37] Although they were received well

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> huge sums to top executives who may have been enmeshed in a web of pre-petition wrong doing which is now under intense investigation."

Enron Executive Retention Plan Stirs Up Firestorm of Objections, 1 No. 6 ANDREWS ENRON LITIG. REP. 1 (2002).

33. Mot. of the Debtors Pursuant to Sections 363(b) and 105(a) of the Bankr. Code for Authorization to Establish a Key Emp. Retention Plan, *In re* WorldCom, Inc., No. 02-13533 (Bankr. S.D.N.Y. Oct. 18, 2002) [hereinafter WorldCom KERP].

34. *See* Cornwell, *supra* note 13, at 496–97 (citing *The WorldCom Case: Looking at Bankruptcy and Competition Issues: Hearing Before S. Comm. on the Judiciary*, 108th Cong. 2 (2003) (statement of Richard Thornburgh, Bankruptcy Examiner, Kirkpatrick & Lockhart, LLP). The WorldCom scandal revealed almost $4 billion worth of fraudulent activity. *Id.* at 497.

35. *See* Cornwell, *supra* note 13, at 497 (citing *Judge Approves Bonus Plan for WorldCom Employees*, N.Y. TIMES (Oct. 30, 2002), http://www.nytimes.com/2002/10/30/business/company-news-judge-approves-bonus-plan-for-worldcom-employees.html). The WorldCom KERP sought to pay executive's based on a "Stay Bonus," calculated as a percentage of the employee's base salary, if the employee remained employed by WorldCom on certain dates (one of which was 60 days after confirmation of the plan, triggering a payout of 50 percent of the Stay Bonus). WorldCom KERP ¶ 13. The motion also provided "that each Key Employee who remains employed by the Debtors on the date that a plan of reorganization is confirmed (the 'Plan Confirmation Date') will receive an additional bonus amount equal to 10% of the Key Employee's Stay Bonus (the 'Plan Progress Bonus')." *Id.* The Plan Progress Bonus would be earned if the Plan Confirmation Date occurred by December 2003. *See id.* Should the Plan Confirmation Date occur earlier, the Plan Progress would increase as set forth on the schedule, which allowed payment of up to 200 percent of the Plan Progress Bonus if the plan was confirmed by October of 2003. *See id.* ¶ 14.

36. Jerry Markon & Robert Frank, *Adelphia Officials Are Arrested, Charged With 'Massive' Fraud*, WALL ST. J. (July 25, 2002, 12:01 AM), http://www.wsj.com/articles/SB1027516262583067680.

37. Responding to considerable flack after filing their initial motion outlining key employee payments, the Debtors adjusted the proposed plan to remove several executive vice presidents from the program. These changes preserved approximately $5.65 million, reducing and reallocating payments from the "stay pool" (to be paid upon certain dates as long as employees remained with the Debtor), from approximately $20 million to $10 million, to the "sale pool" (to be paid if the Debtor's business was sold, and which was viewed as more incentivizing), thus increasing it to $18 million from $11 million, and decreasing the CEO's

by the S.D.N.Y., these high-profile instances did not go unnoticed by Congress.

B. BAPCPA

This dark triad of *Enron*, *Worldcom*, and *Adelphia* drastically altered the way the Code approached executive compensation. Despite Congress's previous failed attempts,[38] in the wake of these bankruptcies—in which the large payouts to executives were thrust into the public eye, alongside fraud and misdealing—Congress took drastic action.[39] Senator Kennedy decried "the truly incredible abuses of the bankruptcy system" and the "corporate executives who have exploited the system to line their own pockets."[40] The result was the drastic change embodied with the arrival of BAPCPA's § 503(c), along with the accompanying body of criticism.[41]

The resulting changes created starkly different sets of standards for programs that were retentive compared to those that were incentivizing.[42] Under § 503(c)(3), incentivizing programs must be

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discretionary pool used to grant supplemental bonuses from $6 million to $3 million. Debtors' Reply to Objections to Debtors' Mot. Pursuant to Sections 105(a) and 363(b) of the Bankr. Code for an Order Approving (I) Amended Performance Retention Plan, (II) Amended Severance Plan and Employment Agreements, and (III) Key Emp. Continuity Program, at ¶¶ 12–15, *In re* Adelphia Commc'ns Corp., No. 02-41729 (Bankr. S.D.N.Y. Aug. 20, 2004). Despite these substantial changes, this was still not enough to avoid the ire of Senator Kennedy and others in Congress. *See infra* Part I.B.

38. Congress first attempted to curb executive compensation with the Employee Abuse Prevention Act of 2002. H.R. 5221, 107th Cong. (2002). The bill sought "[t]o protect employees and retirees from corporate practices that deprive them of their earnings and retirement savings when a business files for bankruptcy under title 11, United States Code." *Id.* However, the bill was never enacted. *S. 2798 (107th): Employee Abuse Prevention Act of 2002*, GOVTRACK, https://www.govtrack.us/congress/bills/107/s2798 (last accessed Sept. 25, 2016).

39. *See* BAPCPA, *supra* note 3.

40. 151 CONG. REC. S1834 (2005) (statement of Sen. Edward "Ted" Kennedy).

41. *See* Revich, *supra* note 5, at 94. In an article written shortly after the 2005 enactments, the author characterizes the additions embodied in § 503(c) as "not well drafted," the breadth as "difficult to discern[,]" and the exceptions "so narrowly drawn that very few (if any) [proposed plans] will be able to meet the necessary qualifications." *Id.*

42. 11 U.S.C. § 503(c) (2012) provides:

> (c) Notwithstanding subsection (b), there shall neither be allowed, nor paid—
>
> (1) a transfer made to, or an obligation incurred for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtor's business, absent a finding by the court based on evidence in the record that—

"justified by the facts and circumstances of the case . . . ."[43] Programs that are adjudged to be primarily retentive, however, are subject to much more stringent standards with numerical guidelines under § 503(c)(1).[44] As the cases discussed below demonstrate, this distinction between incentive and retentive programs is crucial to obtaining approval of a KEIP.[45]

> (A) 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;
>
> (B) the services provided by the person are essential to the survival of the business; and
>
> (C) either—
>
> (i) 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
>
> (ii) 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;
>
> (2) a severance payment to an insider of the debtor, unless—
>
> (A) the payment is 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 nonmanagement employees during the calendar year in which the payment is made; or
>
> (3) 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.

43. 11 U.S.C. § 503(c)(3).

44. 11 U.S.C. § 503(c). In particular, § 503(c)(1) requires that the person(s) sought to be retained have a "bona fide job offer" elsewhere and that it be tied to benefits received by non-management. 11 U.S.C. §§ 503(c)(1)(A), (C).

45. While the distinction of whether or not a person to whom proposed payments are made is an "insider" is defined by 11 U.S.C. § 101(31) (2012), this classification was not at issue in the *Hawker* or *Residential Capital* decisions. Both cases largely involve payments to management, which in general is sufficient to establish insider status under the Code. *See* Smith v. Ruby (*In re* Public Access Technology.com, Inc.), 307 B.R. 500, 505 (Bankr. E.D. Va. 2004). "A defendant's status as a director or an officer is alone sufficient to establish that he is an insider." *Id.*

C. Post-BAPCPA Cases

The cases that followed BAPCPA proved influential in determining the contours of standard KEIP practice. The *Dana I* and *Dana II* decisions laid the basic foundation for both successful and unsuccessful KEIPs and provided the backdrop that most other cases were measured against. Building on this framework, the trio of *Mesa Air*, *Borders*, and *Velo Holdings* advanced the jurisprudence of the increasing breadth of KEIPs that ultimately provided the basis for inclusion of asset sale targets presented in both *Hawker* and *Residential Capital*.

1. *Dana I* and *Dana II*

One of the first major cases within the S.D.N.Y. that dealt with the changes to § 503(c) was *In re Dana Corp.* (*Dana I*).[46] The Debtor, a manufacturer of vehicle parts, filed a motion seeking to enter into employment agreements under §§ 363(b) and 105(a) contending that the newly enacted provisions of § 503(c) did not apply.[47] The Debtors proposed a plan consisting of base salaries,[48] an annual incentive plan (AIP), a completion bonus, a severance package, and a senior executive retirement program (SERP).[49] The AIP sought to continue the prepetition incentive program, which based cash awards on short-term financial targets.[50] A completion bonus was proposed in place of the CEO's prepetition long-term incentive bonus[51] and consisted of two components, one of which was tied solely to the date of plan confirmation and the other to

46. *In re* Dana Corp. (*Dana I*), 351 B.R. 96 (Bankr. S.D.N.Y. 2006).

47. *Id.* at 98, 100–01.

48. The proposed base salaries for five of Dana's executives were $500,000–$600,000, and a base salary of $1,552,500 for the CEO, Michael Burns. *Id.* at 99–100.

49. *Id.*

50. *Id.* at 99. "[T]he size of that award depends on whether Dana meets threshold, target, or superior performance goals established by Dana's Compensation Committee[,]" with postpetition amounts to be determined in consultation with the Creditors' Committee. *Id.*

51. Michael Burns' prepetition incentives contemplated equity awards of $4 million annually. *Id.*

various levels of the total enterprise value (TEV) after a period of time.[52]

Paying close attention to the terms of the completion bonuses and the severance payments, the S.D.N.Y. found that the proposed incentive plan failed under § 503(c).[53] The court found that the payments were more retentive than incentivizing and thus subject to § 503(c) because it considered the levels to be "artificially low" for both of the TEV bonuses.[54] Furthermore, because the executives would be paid—at least in part—simply due to confirmation of the Chapter 11 plan (pursuant to the terms of the Completion Bonus), the court also found this to be retentive.[55] The court felt that a compensation system that relied so heavily on payments to be made simply on the basis of remaining with Dana until certain dates was retentive rather than incentivizing, famously noting, "[i]f it walks like a duck (KERP), and quacks like a duck (KERP), it's a duck (KERP)."[56] However, looking forward, the court cautioned that there may be "incentivizing plans which may have *some* components that arguably have a retentive effect," and that such retentive components did not automatically violate § 503(c).[57] The court also noted that § 503(c)(3) does not preclude a court from analyzing such motions under the business judgment rule.[58]

The Debtors returned with a revised incentive plan in *Dana II* that was approved under § 503(c).[59] Dana kept the AIP, which was

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52. *Id.* The fixed component was to be paid "without regard to performance or creditor recovery, payable in cash on the effective date of a plan of reorganization[,]" and was in the amount of $3,100,000 for Burns. *Id.* The second component based on the total enterprise value (TEV) of the Debtors' business six months after the Effective Date, ranging from a minimum TEV of $2 billion paying out a bonus of $4,133,000 to Burns (Threshold Completion Bonus), up to a TEV of $2.6 billion paying Burns $6,200,000 (Target Completion Bonus). *Id.*

53. *Id.* at 103.

54. *Id.* at 102.

55. *Id.* Additionally, the court found that the severance packages failed under § 503(c)(2). *Id.* Section 503(c)(2) requires that severances payments be "part of a program that is generally applicable to all full-time employees[]" and "not greater than 10 times the amount of the mean severance pay given to nonmanagment employees during the calendar year in which the payment is made . . . ." 11 U.S.C. § 503(c)(2)(A)–(B) (2012). The provisions of the executive and CEO "Non-Compete" packages failed to do either. *Dana I*, 351 B.R. at 98, 102.

56. *Id.* at 102 n.3.

57. *Id.* at 103.

58. *Id.*

59. *In re* Dana Corp. (*Dana II*), 358 B.R. 567, 584 (Bankr. S.D.N.Y. 2006).

approved as a transaction within the ordinary course of business under § 363(c), on the grounds that it was a continuation of a prepetition program (and therefore ordinary course).[60] Replacing the Completion Bonus, however, was the Long Term Incentive Plan (LTIP).[61] The LTIP was tied entirely to EBITDAR,[62] unlike the Completion Bonus of *Dana I*.[63] The court scrutinized the LTIP under § 503(c)(3), using its previous decision in *Dana I* as support alongside a Delaware Bankruptcy Court decision, which concluded that § 503(c)(3) was "a reiteration of the standard under 363 [sic] under which courts had previously authorized transfers outside the ordinary course of business based on the business judgment of the debtor" that was to be analyzed using the "sound business judgment" test.[64]

Although the court articulated the various factors of this business judgment test, it did not analyze each with particularity as they applied to the LTIP.[65] Instead, the court focused primarily on the

60. *Id.* at 579–81. Freedom of the debtor to operate in the ordinary course under § 363(c) reflects the idea that in Chapter 11, debtors should be allowed flexibility when engaging in daily operations. *Id.* at 580. In order to determine whether a transaction is in the ordinary course, courts have developed a two-step test consisting of horizontal and vertical components. *Id.* The horizontal component examines the transaction in industry-wide context and practice, while the vertical component tests whether the transaction presents risks similar to those normally present when a creditor extends credit to the debtor. *Id.* (citing *In re* Crystal Apparel Inc., 207 B.R. 406, 409 (Bankr. S.D.N.Y. 1998)). *See also infra* note 69.

61. *Dana II*, 358 B.R. at 573–74. Furthermore, the new compensation plan proposed to pay severance "in an amount that complies with section 503(c)(2) of the Bankruptcy Code[,]" heavily modified so as to limit amounts paid in the event of either pre or postpetition departure. *Id.*

62. *Id.* at 574. Earnings Before Interest, Taxes, Depreciation, Amortization and Restructuring Costs. EBITDAR is EBITDA with the cost of restructuring (R) added in, and represents a multiple that can be used to easily compare a variety of businesses across a wide range of industries. It is also useful, particularly in the bankruptcy process, for creditors to measure income available for interest payments. *See EBITDA*, REUTERS FIN. GLOSSARY, http://glossary.reuters.com/index.php?title=EBITDA (last visited Jan. 22, 2015).

63. *Dana II*, 358 B.R. at 573. This is substantially different than the Completion Bonus proposed in *Dana I*, which sought to mimic, with the possibility of eclipsing, executive management's long-term incentives. *See Dana I*.

64. *Dana II*, 358 B.R. at 576.

65. *Id.* at 576–77. The factors are as follows:

> -Is there a reasonable relationship between the plan proposed and the results to be obtained, i.e. will the key employees stay for as long as it take 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?* . . .

uncertainty of the EBITDAR targets, especially in the context of the faltering automotive parts industry, concluding that such LTIP targets were "clearly not 'lay-ups[]'" and thus incentivizing and constituted "fair and reasonable exercise of business judgment."[66] Despite this finding, the court was concerned about the possible total compensation available to executives under the various programs in conjunction with the AIP.[67] In order to combat what it considered potentially unreasonable compensation if executives earned large awards under both the LTIP and the AIP, the court approved the LTIP, "provided that an appropriate yearly ceiling" was placed on senior management's total compensation.[68] This cap allowed the *Dana II* court a degree of flexibility in applying the factors to decide on the executive compensation plan.

2. *Mesa Air*, *Borders*, and *Velo Holdings*

As illustrated by *In re Mesa Air Group, Inc.*, the S.D.N.Y. seemed to relax the standards through which it analyzed KEIPs.[69] The court

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> -Is the cost of the plan reasonable in the context of the debtor's assets, liabilities and earning potential?
>
> -Is the scope of the plan fair and reasonable; does it apply to all employees; does it discriminate unfairly?
>
> -Is the plan or proposal consistent with industry standards
>
> -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?
>
> -Did the debtor receive independent counsel in performing due diligence and in creating and authorizing the incentive compensation?

Id.

66. *Id.* at 582–83. The court also approved Dana's employment agreements on the same grounds, although with more particularity to the various factors. The court gave particular credence to the Debtors' use of outside experts (and their collaboration with the creditors and equity committees) as well as the Dana board's belief that the current management's "continuing presence" was necessary for the reorganization process. *Id.* at 578–79.

67. *Id.* at 583.

68. *Id.* at 583–84. In particular, the court was concerned that "the inclusion of both incentive programs in 2007 and 2008, in their current form, may not accomplish the 'sharing the pain' objective." *Id.*

69. *In re* Mesa Air Grp., Inc., 2010 Bankr. LEXIS 3334 (Bankr. S.D.N.Y. 2010). In part, the court relied on two Delaware cases, *In re Global Home Products* and *In re Nellson Nutraceuticals*, noting that, "[t]he effect of section 503(c) was to put in place 'a set of

quickly disposed of objections and found that the Debtors had met *both* the § 363 standards and the stricter § 503(c) standards.[70] Taking cues from the Delaware Bankruptcy Court,[71] the Southern District of New York found the proposed incentives were approvable as within the ordinary course since the payments, which "were consistent with past practices[,]" were within the horizontal and vertical ordinary course tests and were "a reasonable exercise of their business judgment made in good faith."[72] The court also held that the payments could be approved under § 503(c)(3).[73] In finding so, the court recognized that under this theory the payments would thus necessarily be those "outside the ordinary course of business" as per the language of § 503(c) and subject to the "sound business judgment" requirement articulated in *Dana II*.[74] However, unlike *Dana II*, rather than requiring EBITDA or EBITDAR goals, the court was content with one that incorporated both substantive aspects of the Debtors' business operations[75] and simplified financial targets.[76]

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challenging standards' and 'high hurdles' for debtors to overcome before retention bonuses could be paid." *Mesa Air*, 2010 Bankr. LEXIS 3334, at *7 (quoting *In re* Global Home Prods., LLC, 369 B.R. 778, 784–85 (Bankr. D. Del. 2007)). Furthermore, it also adopted the *Nellson Nutraceuticals* business judgment standard:

> If a particular transaction passes the horizontal and vertical tests, it is then considered an "ordinary course" transaction subject to approval under section 363. As an ordinary course transaction, the inquiry is then whether the debtor has a valid business purpose for engaging in the particular transaction, and whether "the conduct involves a business judgment made in good faith upon a reasonable basis and within the scope of authority under the Bankruptcy Code."

Mesa Air, 2010 Bankr. LEXIS 3334, at *8–9 (quoting *In re* Nellson Nutraceutical, Inc., 369 B.R. 787, 799 (Bankr. D. Del. 2007)).

70. *Mesa Air*, 2010 Bankr. LEXIS, 3334 at *3. "The Debtors have established their *prima facie* case that the Incentive Payments are a valid exercise of their business judgment under both sections 363 and 503(c)." *Id.* at *9.

71. *See supra*, note 69.

72. *Mesa Air*, 2010 Bankr. LEXIS 3334, at *10–11.

73. *Id.* at *3.

74. *Id.* The court did not, however, individually apply the factors outlined in *Dana II*. *Id.*

75. These operational goals included, "maintenance of flight schedules, efficient return of aircraft, securing aircraft equipment at reduced rates and negotiation of reduced rates for aircraft of the Debtors that were no longer in service." *Id.* at *11–12.

76. The financial targets were, generally speaking, bonuses triggered by reaching profit targets between $1 million and $10 million, over which an additional amount would be paid, and the court found that "[s]uch payments are consistent with past practices and clearly tied to the performance of the Debtors." *Id.* at *13.

Absent from the court's analysis was the need for a "stretch" goal to meet the § 503(c) standards.

By the next year, the utilization of operational factors was indeed incorporated by the S.D.N.Y. in *In re Borders Group*.[77] The Debtors bifurcated their plans into a KEIP and a KERP.[78] The KEIP proposed payment upon either a Chapter 11 plan confirmation or a § 363 sale, as well as incentives in the form of real estate lease amendments resulting in rent reductions or non-headcount annualized cost reductions.[79] While described by the court as "financial" benchmarks, these incentives were in many ways closer to the operational goals of *Mesa Air* than the EBITDAR targets of its predecessors.[80] However,

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77. *In re* Borders Grp., 453 B.R. 459 (Bankr. S.D.N.Y. 2011). As one of the more high-profile debtors of the past several years, the national bookstore chain grabbed headlines when it filed for Chapter 11 in February of 2011. *See* Joesph Checkler & Jeffery A. Trachtenberg, *Bookseller Borders Begins a New Chapter . . . 11*, WALL ST. J. (Feb. 17, 2011, 12:01 AM), http://www.wsj.com/articles/SB10001424052748703373404576147922340434998. Beyond its specific application in regards to KEIPs, *Borders* serves as a useful reminder of the speed at which fortunes can change during the pendency of a bankruptcy case, having converted to liquidation only several months after the initial filing. *See* Mike Spector & Jeffrey A. Trachtenberg, *Borders Forced to Liquidate, Close All Stores*, WALL ST. J. (July 19, 2011), http://www.wsj.com/articles/SB10001424052702303661904576454353768550280.

78. *Borders*, 453 B.R. at 466–67. The KERP was for a designated class of "Critical Employees" who were director levels "believed to be critical to the Debtors' business and reorganization" as well as a smaller number of "Discretionary Employees . . . ." The Critical Employees were paid out of a pool of approximate $933,000 and received a "lump sum payment approximating 30% of base salary that is commensurate with the prepetition Annual Performance Bonus Plan[,]" which ranged "from $28,000 to $53,000" and varied "based on the Critical Employee's position, responsibilities, and other factors[,]" while the Discretionary Employees participated in a pool of $300,000 and did not earn more than $20,000 individually. *Id.*

79. *Id.* at 465–66. The court in *Hawker* noted with particularity this requirement of a § 363 going concern sale versus "a liquidation or going-out-of-business sales at the majority of the debtors' stores, the confirmation of a non-consensual plan, or the approval of a sale over the Committee's objection." *In re* Hawker Beechcraft, Inc., 479 B.R. 308, 314 (Bankr. S.D.N.Y. 2012) (citing *Borders*, 453 B.R. at 465–66). Such a requirement limited the eligibility for the bonuses available under the KEIP and led to its approval "because the financial milestones and accomplishment of a qualifying transaction were both required, the debtors had to achieve rent reductions or other cost reductions, and the type of qualifying transaction was limited to one that continued the businesses in one form or another." *Hawker*, 479 B.R. at 314 (citing *Borders*, 453 B.R. at 471–72).

80. *Borders*, 453 B.R. at 472. The court outlined some of the ways that management would need to work in order to meet the requirements of the KEIP, many of which were integral to the specific nature of the Debtors' business, noting:

> Specifically, the Management Participants will need to work expeditiously to meet the targets outlined in the KEIP. To achieve these goals, the Management Participants will

even though the *Borders* court alluded to the *Mesa Air* court's use of performance goals, it made a deeper inquiry into the plan.[81] Noting that the Debtors had moved under § 363(b)(1) rather than § 503(c), the court articulated that "the legal standard under section 363(b) is no different than section 503(c)(3)," and thus the analysis "is equally applicable to both statutory provisions."[82] The court concluded that under this standard and based on its analysis, the Debtors had "exercised sound business judgment."[83]

Just prior to the *Hawker* and *Residential Capital* decisions, *In re Velo Holdings*[84] found the KEIP proposed by the Debtors, a marketing services firm,[85] valid when conditioned largely on various sale targets.[86] The Debtors maintained three major business units.[87] Under the terms of the proposed KEIP, developed in conjunction with lenders, payments would be made for (1) meeting financial milestones for one of the continuing business units, and (2) meeting price targets for the sale of the other two business units (in conjunction with financial targets if those units sold below a certain price threshold).[88]

> need to be involved in the negotiation and documentation of substantial rent concessions on approximately 400 leases, the cancellation of some 700 high cost contracts and achievement of greater operational efficiencies and working capital.

Id.

81. Unlike the gloss in *Mesa Air*, the court focused on whether the goals would be difficult to achieve and conducted a full *Dana II* analysis, individually addressing each of the six factors. *Id.* at 472, 474–77.

82. *Id.* at 473–74.

83. *Id.* at 474.

84. *In re* Velo Holdings, Inc., 427 B.R. 201 (Bankr. S.D.N.Y. 2012).

85. *UPDATE 1-Velo Holdings Files for Ch.11 Bankruptcy*, REUTERS (Apr. 2, 2012, 10:01 PM), http://www.reuters.com/article/2012/04/03/veloholdingsinc-idUSL3E8F30SV20120403.

86. *Velo Holdings*, 472 B.R. at 213.

87. *Id.* at 204–05.

88. *Id.* at 205–07. Specifically, the thresholds of the sales targets were those at which a lender could acquire the assets with a credit bid. *Id.* If the sale price for each unit was at or below the credit bid threshold, payment was conditioned upon revenue and EBITDA targets; if the price was above the credit bid threshold, the payments would be determined on the cash above the credit bid threshold. *Id.* Simply speaking, a credit bid is a practice that allows an undersecured lender to bid the amount of its claim in a sale, even if the actual value of the collateral is less (and thus avoid the sale of the property at a price below the secured amount). *See generally* John T. Gregg, *A Review of Credit Bidding Under 11 U.S.C.A. § 363(k)*, 2008 ANN. SURV. BANKR. L. 17 (2008). In this instance, the system proposed was conditioned on whether the asset sales realized an amount above the secured lenders' claims. *Id.*

The court noted that the Debtors used these financial targets for incentive programs in previous years.[89] More innovatively, the court specifically addressed the sale targets.[90] It considered the target prices adequate and announced that such sales were "consistent with the policies [maximizing value and creditor recovery] underlying chapter 11."[91]

The court found the KEIP to be primarily incentivizing rather than retentive on the basis that it required the Debtors to "stretch" to meet projected revenue and EBITDA targets.[92] Based on a brief analysis using the *Dana II* factors, the court concluded that the Debtors also met the analogous § 363(b)[93] and § 503(c)(3) standards.[94]

3. *Hawker*

Within two months of *Velo Holdings*, the Southern District of New York seemed to reverse course and adopt a tougher stance, rejecting the proposed KEIP in *In re Hawker Beechraft, Inc*.[95] Prior to filing a Chapter 11 petition in May of 2012, the Debtors entered into a Restructuring Support Agreement (RSA) with the majority of their creditors that would convert all of the prepetition debt into

89. *Velo Holdings*, 472 B.R. at 211.

90. *Id.*

91. *Id.*

92. *Id.* at 207–08. Specifically, the court found that the KEIP required management "to *do more* to meet the wide-scale goals outlined in the KEIP as they must address concerns and issues that are unique to the bankruptcy proceeding." *Id.* at 210. The court further explained that the KEIP encouraged management "to increase their pre-bankruptcy job responsibilities to achieve the bonus requirements and financial targets." *Id.*

93. While the court did outline the requirements for approval of an incentive program under § 363 for a transaction in the ordinary course, and at several points reiterated that the incentive program was in certain ways a continuation of the programs used in previous years, the court did not explicitly state that the incentive program passed as a transaction within the ordinary course. *Id.* at 211–12. Specifically, although it explained the horizontal and vertical tests, the court did not definitively articulate whether the Debtors' incentive programs qualified. *Id.* However, based on the court's statement that the KEIP was an exercise of sound business judgment under "section 363[,]" as opposed to specifying § 363(b), while referring to "section 503(c)(3)" in the same sentence with particularity, it seems likely that the court, at least impliedly, found the KEIP to also qualify as a transaction within the ordinary course. *Id.* at 212–13. This structure is consistent with Judge Glenn's form in *Mesa Air*. *In re* Mesa Air Grp., Inc., 2010 Bankr. LEXIS 3334, at *13 (Bankr. S.D.N.Y. 2010).

94. *Velo Holdings*, 472 B.R. at 212–13.

95. *In re* Hawker Beechcraft, Inc., 479 B.R. 308 (Bankr. S.D.N.Y. 2012).

equity (the Standalone Transaction) and would confirm their plan by December 15 of that same year (the final component of the Standalone Plan).[96] The Debtors were not precluded by the RSA from seeking an outside transaction, such as an asset sale, in order to provide greater value to the estate (Third Party Transaction).[97] In July, the Debtors received a proposal from Superior Aviation Beijing, Co., Ltd. (Superior) offering to purchase nearly all of the Debtors' assets for $1.79 billion in an all-cash transaction (the Superior Proposal).[98] The Debtors had historically maintained incentive plans based on cash and profit targets,[99] and in 2012, the Debtors retained executive compensation consultants to develop a senior management incentive program.[100] Following this, the Debtors developed the KEIP and sought its approval.[101]

The proposed KEIP created two mutually exclusive avenues for awards to members of the senior leadership team (SLT).[102] Members of the SLT were eligible for an award upon the consummation of the Standalone Plan (Standalone Transaction Award).[103] Such an award was bifurcated, with 50 percent tied to the timing of confirmation (Consummation Award), and the other 50 percent conditioned on financial targets (Financial Performance Award).[104] The other method by which members of the SLT were eligible for an award was tied to

96. *Id.* at 309.

97. *Id.* at 309–10.

98. *Id.* at 310. The terms of the Superior Proposal contemplated "a 45 day exclusive access period during which the Debtors would cease soliciting or negotiating with other third parties, the parties would execute a definitive agreement, the Debtors would hold a bankruptcy auction and the parties would obtain the necessary regulatory approvals." *Id.*

99. *Id.* None of these were paid in the year prior to filing the Chapter 11 petition. *Id.*

100. *Id.* "According to the testimony of Nick Bubnovich, a former director of Towers Watson [the Debtor's executive compensation consultants] who testified as an expert, the Debtor's senior management's base salary stood at 58% below the market median, substantially below market." *Id.* (internal citations omitted).

101. *Id.* at 310–11.

102. *Id.* at 311.

103. *Id.*

104. *Id.* The Consummation Award paid between 50 to 100 percent of the recipient's base salary if the Standalone Plan was confirmed before December 15, 2012 (the sooner the confirmation, the higher the percentage). *Id.* No award was to be paid after December 15, 2012. *Id.* The Financial Performance Award was calculated on a sliding scale of target cash flows up until the consummation of the plan. *Id.* The lowest target awarded 50 percent of the recipient's base salary for achieving the projections of the business plan. *Id.* at 311–12. No award would be earned for performance below such target. *Id.* at 311.

the completion of an asset sale of at least $1.79 billion that closed by January 15, 2013 (Third-Party Transaction Award), with lower prices resulting in lower awards down to a floor.[105] If a Third Party Transaction was pursued but failed to close through no fault of senior management, the members of the SLT would receive the Standalone Transaction Award, with the Financial Performance Award adjusted to reflect costs incurred.[106]

The court rejected the Debtors' proposed KEIP.[107] As a threshold matter, the court felt that the Debtors failed to identify with particularity why each SLT member was necessary to meet specified targets.[108] More substantively, while the proposed KEIP contained incentivizing targets for each of the proposed transactions, "one of which was bound to occur[,]" the lowest levels were within reach.[109] The court noted that under the Standalone Transaction partial payment was triggered by confirmation alone, and given the Superior Proposal price, the Third-Party Transaction did "not seem to be much of a challenge[,]" because an award was still available for a sale price down to $1 billion.[110]

The court also perceived a technicality relating to the portion of the award tied to confirmation or consummation. If such date was delayed due to an appeal and the SLT member changed jobs before the resolution of the issue, the bonus would be forfeited. Thus, it was retentive in that it required remaining employed with the Debtors.[111] Finally, the court construed the statements of the CEO—that loss of

105. *Id.* at 312. For a price below $1.79 billion, the Third-Party Transaction Award (a maximum of 200 percent of the SLT member's base salary) would decrease by 25 percent for each decrease of $100 million in purchase price, with no award paid below a sale price of approximately $1 billion. *Id.* at 312, 314 n.9.

106. *Id.* at 312.

107. *Id.* at 315–16.

108. *Id.* at 313.

109. *Id.* at 313–14.

110. *Id.* at 314. The court likened the KEIP in this sense to that rejected in *Dana I*. *Id.* The court also rejected the Debtors' contentions that there existed "numerous uncertainties on the income and expense sides[]" on the basis that "uncertainty is inherent in every prediction," which Judge Bernstein assumed "were taken into account when the predictions were made by the Debtors' sophisticated financial employees and professionals." *Id.* at 314 n.8.

111. *Id.* at 314.

SLT members would undermine the reorganization efforts against the Debtors—as evidence of a retentive purpose.[112]

In the court's discussion, it distinguished its decision from previous KEIP approvals. In rejecting the comparison to *Borders*, the court noted that the *Borders*' awards were based on the combination of targets rather than a bifurcation into smaller awards, and furthermore, that the proposed Third-Party Transaction targets were not challenging enough.[113] Likewise, in the comparison to *Dana II*, the court considered the LTIP thresholds more difficult to achieve than the minimum Financial Performance Awards proposed.[114] Finally, in the comparison to *Velo Holdings*, the court acknowledged the similarity of the financial targets proposed by the Debtors but said it was "still distinguishable[]" on the basis that it believed the managements' continuing responsibilities in *Velo Holdings* were greater than those proposed by the current Debtors.[115]

4. *Residential Capital*

Within the same week, the Southern District of New York also rejected the Debtors' motion in *In re Residential Capital, LLC*.[116] The Debtors, major mortgage servicers and originators, encountered serious financial difficulties as a result of the 2008 financial crisis.[117] Working with major mortgage servicer Ally Financial Inc. (AFI), the Debtors developed plans to shed certain businesses in the lead-up to the filing for Chapter 11 relief.[118] These plans included two proposed

112. *Id.*

113. *Id.* at 314–15.

114. *Id.* at 315.

115. *Id.* The court did note that the Debtors presented testimony that required management to provide services necessary to pursue both alternatives and "[t]o that extent, *Velo Holdings* is analogous." *Id.* The court further noted that possibility of the Consummation Award or Third-Party Transaction Award at the already offered Superior Proposal price, both of which were possible under flexible deadlines, but did not further distinguish these transactions from the incentive plan in *Velo Holdings*. *Id.*

116. *In re* Residential Capital, LLC, 478 B.R. 154 (Bankr. S.D.N.Y. 2012). Simply put, the court found "when [the KEIP] allows for nearly two thirds of the KEIP Awards to vest upon the closing of two section 363 asset sales that were negotiated before the commencement of these cases, and where that KEIP does not impose any additional financial metrics or hurdles in order for those KEIP awards to vest[,]" it does "not pass muster under section 503(c)(1)." *Id.* at 157.

117. *Id.* at 158.

118. *Id.* at 158–61, 158 n.7.

sales (Asset Sales).[119] One proposed sale was of the loan origination and servicing businesses (Platform Sale) to proposed stalking horse bidder[120] Nationstar Mortgage LLC (Nationstar), and the other was of a portfolio of various loans and residual assets (Legacy Sale) with AFI as the proposed stalking horse.[121] This required major efforts by the Debtors, which as the court noted with particularity, needed to be done prior to the Chapter 11 filing.[122]

The awards of the proposed KEIP were dependent upon the realization of various milestones, classified as Sales Milestones and Financial and Operational Performance Milestones.[123] The two Sales Milestones[124] vested awards of 90, 100, or 200 percent of the Sales Milestone totals upon the closing of an Asset Sale, a closing as a result of an auction, or a closing through which the sale proceeds were in excess of the stalking horse bid by at least 3 percent, respectively.[125] The Financial and Operational Milestones awarded 10 percent of the total KEIP award each (for a total of 30 percent of the overall KEIP) for meeting cash flow targets, a "Top 3" servicer ranking, and a positive performance review by the Compensation

119. *Id.* at 159.

120. A "stalking horse" is a device commonly employed in an asset sale whereby the debtor and potential purchaser enter into discussions that result in an initial bid, with the hope that an initial bid will spur further interest and help the debtor to realize the maximum potential value. In return for this assistance to the debtor, many such bidders require additional fees and other protections. *See generally* 8B C.J.S. *Bankruptcy* § 900 (2016).

121. *Residential Capital*, 478 B.R. at 159.

122. *Id.* at 161. The court noted:

> "[t]he point here is that this work was largely done *before* the Debtors . . . engaged in the pre-petition marketing process[,]" and that such distinction was "important because an employee 'incentive' plan should incentivize employees for their post-petition efforts, not compensate them for the work they did before the bankruptcy filing."

Id.

123. *Id.* at 163.

124. The Sales Milestones combined accounted for 70 percent of each participant's total award under the KEIP. *Id.* The Platform Sale comprised 42 percent and the Legacy Sale comprised the other 28 percent. *Id.*

125. *Id.* Under this structure, 63 percent of the total KEIP awards would vest solely on the completion of these transactions as proposed in conjunction with the stalking horse bidders. *Id.* at 157 n.2.

Committee.[126] The top three executives were not eligible for awards under the KEIP.[127]

The court rejected the proposed KEIP.[128] While the court recognized that the total amount of the proposed awards as a percentage of potential value to be realized was substantially smaller than average—and thus reasonable in the typical market—it rejected this fact as sufficient upon which to approve the KEIP. It took further issue that those receiving payments from the KEIP possibly stood to earn more than they would under the Debtors' prepetition incentive plans.[129] Additionally, the court was concerned with the fact that only 30 percent of the total KEIP awards would vest as a result of the Financial and Operational Performance Milestones, and that up to 63 percent of the awards could be realized on the basis of the stalking horse bids alone.[130] While, the court did accept the idea that there was still substantial work to do in preparation for a successful auction,[131] the court felt that "the current Plan design rewards the KEIP Participants for work that was mostly done prepetition. Accordingly,

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126. *Id.* at 164.

127. *Id.* at 163 n.15.

128. *Id.* at 164.

129. *Id.* at 164–67.

130. *Id.* at 164, 171–72. Specifically, the court noted:

> [T]o the extent the KEIP Awards are based on these Financial and Operational Performance Milestones, the issue is whether each of these hurdles is sufficiently challenging and incentivizing; if so, each milestone would be judged under section 503(c)(3). But where, as here, the Plan design provides that only 30% of the proposed awards are based on financial and operational performance metrics, the Court will not parse the Plan and consider whether these components of the Plan should be approved separate from the Plan as a whole.

Id. at 164.

131. The court gave particular weight to the number of parties, noting that "[t]wenty-seven additional parties (other than Nationstar and Berkshire Hathaway) have signed nondisclosure agreements, and hopefully many will bid in the auction." *Id.* at 164. This fact informed its perception that:

> [T]he Debtor's employees will indeed be required to perform additional work leading up to the auction. Potential bidders particularly for the Platform Sale need cooperation and assistance in due diligence; in meeting and working with Fannie Mae, Freddie Mac, and Ginnie Mae, among others, to assure that the purchaser can continue servicing loans on their behalf; to develop information necessary to obtain licenses required to operate in the many jurisdictions in which the Debtors currently service loans; and generally in obtaining more information about the Debtors' businesses.

Id.

the KEIP is not supportable . . . unless combined with challenging financial metrics relating to the performance of the business."[132] Thus, while it failed to find fault with a particular component of the plan per se, it took primary issue with the weight allocated to the various avenues of awards.

In its discussion, the court analogized the proposed KEIP to that of *Dana I*, finding that because 63 percent of the KEIP awards were accessible on the closing of the Asset Sales, the proposed KEIP was primarily retentive rather than incentivizing, and therefore failed under the higher § 503(c)(1) scrutiny.[133] The court rejected the Debtors' argument that the novelty and magnitude of such an asset sale within the industry under such conditions were sufficiently incentivizing due to uncertainty of whether the Debtors' businesses could survive to actually reach the Closings.[134] In response, the court pointed out that there was sufficiently "lively bidding" at the stalking horse phase of the bidding to give it "substantial doubts" that the targets were "sufficiently aspirational" so as to be incentivizing.[135] Although the Asset Sales did not foreclose the possibility of receiving bids above those of the stalking horse bidders, which the court noted would have required substantial additional work even if the process went smoothly, the likelihood of the two stalking horse bids was not enough to overcome the burden of retentiveness.[136] Ultimately, the court concluded that the proposed KEIP "appear[ed] to attempt an end-run around section 503(c)(1)[,]" and that in order to pass muster "the Debtors must more closely link the vesting of the KEIP Awards to metrics that are directly tied to challenging financial and operational goals for the businesses . . . ."[137]

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132. *Id.*

133. *Id.* at 170–71. Most succinctly, the court opined that the proposed KEIP "bears a striking similarity to the plan proposed and rejected in *Dana I*, when the vesting of an award only required the eligible recipients to remain with the debtors' business until the effective date of a plan of reorganization. Such an award cannot be fairly characterized as primarily incentivizing." *Id.* at 173.

134. *Id.* at 171.

135. *Id.* In a footnote, Judge Glenn notes the Debtors' reliance on *In re* Diamond Glass, Inc., No. 08-10601 (CSS) (May 8, 2008). The court there found the KEIP was not primarily retentive in the stalking horse context due to the uncertainties surrounding such processes. Judge Glenn expressly disagreed with the court's reasoning. *Id.* at 172 n.25.

136. *Id.* at 171–72.

137. *Id.* at 173.

The S.D.N.Y. did approve Residential Capital's modified KEIP two months later.[138] The modified KEIP altered the payout that vested as a result of the Asset Sales, shifting the awards from 63 percent for closing the Asset Sales and 7 percent for the occurrence of an auction, to 20 percent for consummation of the Asset Sales and 50 percent for increasing the sales prices via auction.[139] Interestingly, the Performance and Operational Milestones remained the same.[140] In its order approving the amended KEIP, the court deferred 40 percent of all payments until the effective date of the Debtors' Chapter 11 plan.[141]

In summary, the rejection of the proposed KEIPs in *Hawker* and *Residential Capital* stands at the end of several years of developments within the Southern District of New York. While *Dana I* made it clear that a KEIP would not be approved based solely on the confirmation of a plan of reorganization, its progeny continued under the assumption that the ultimate goal of their reorganizations would be plan confirmation in some sense. While KEIPs in *Borders* and *Velo Holdings* contemplated asset sales, they were not serious considerations until *Hawker* and *Residential Capital*. As a result, these cases demonstrated the degree to which § 503(c) was not adequately equipped to deal with such concerns.

II. ANALYSIS AND PROPOSAL

At their core, *Hawker* and *Residential Capital* seem to reflect the rigidity and uncertainty of BAPCPA and its tension with the greater goals of Chapter 11. As these decisions illustrate, the changing landscape in Chapter 11 has led to some troubling results under

138. Order (I) Approving the Debtor's Key Emp. Incentive Plan for Certain Insiders and (II) Payment of Any Obligation Arising Thereunder as Admin. Expenses, *In re* Residential Capital, LLC, No. 12-12020 (Bankr. S.D.N.Y. Oct. 18, 2012) [hereinafter Modified KEIP Order].

139. Debtors' Amended Mot. for an Order Pursuant to Sections 503(c)(3) of the Bankr. Code Authorizing (I) Implementation of a Key Emp. Incentive Plan for Certain Insiders and (II) Payment of Any Obligation Arising Thereunder as Admin. Expenses at 8, *In re* Residential Capital, LLC, No. 12-12020 (Bankr. S.D.N.Y. Oct. 9, 2012) [hereinafter Amended KEIP Motion].

140. *Id.*

141. Modified KEIP Order, *supra* note 138, at 2.

BAPCPA. As it currently stands, the impact of § 503(c) is confusing, time consuming, and a source of uncertainty for debtors and their attorneys. This analysis shows how: (A) the impact of § 503(c) is at odds with the central goals of Chapter 11 restructuring, particularly within the context of an asset sale; (B) in its current state, § 503(c) is (1) at best confusing for debtors, and (2) at worst encouraging debtors to give less than their best efforts prepetition; and finally (C) how a better standard might be formulated.

A. The Impact of 503(c) is at Odds with the Fundamental Purposes of Chapter 11 Restructuring

As established by the United States Supreme Court, the "fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources."[142] To that end, the idea behind BAPCPA and its intended effect of reducing unwarranted and excessive executive compensation in order to better preserve the Chapter 11 estate is apparent. The *Dana* cases, however, represent that from the beginning, the § 503(c) requirements have been ineffective. While the court in *Dana I* rejected the initial plan as retentive, in accepting the modified plan in *Dana II* as primarily incentivizing, the court admitted, "the plan . . . is substantially watered down" from the original.[143] Rather than seeking to fundamentally alter the basis for—and more importantly the amount of, compensation—§ 503(c) in practice encourages debtors to simply tack on financial targets until the court is satisfied that the plan has become incentivizing.[144] The irony of a rule that essentially forces a

142. NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984).

143. *In re* Dana Corp. (*Dana II*), 358 B.R. 567, 571–72 (Bankr. S.D.N.Y. 2006).

144. One practitioner notes the tension inherent in EBITDA targets, specifically that they can be manipulated by terminating or rejecting executory contracts, hence increasing projected earnings and EBITDA but in reality drastically increasing unsecured damage claims which negatively impacts creditors by diluting claims. *See* Matthew J. Williams, *Location, Location, Location: Venue and Other Issues in Chapter 11 Bankruptcy Cases*, 2013 WL 936386, at *8 (Feb. 2013).

business to adopt financial targets in order to achieve the protections of the business judgment standard should not be lost.[145]

This “tack-on” effect is even more pronounced in the context of asset sales. The United States Supreme Court has acknowledged “the two recognized policies underlying Chapter 11, of preserving going concerns and maximizing property available to satisfy creditor . . . .”[146] Both the *Hawker* and *Residential Capital* decisions involved at least the strong possibility of a § 363 asset sale, which would have helped to drastically shorten the costly Chapter 11 process.[147] In many ways, the work to be done to keep the debtors on track was similar to the operational goals of *Mesa Air* in that both required day-to-day maintenance of daily operations as the deadlines approached.[148] However, in both instances the debtors were needlessly bound by § 503(c).

The sale process, particularly in the event of a severely distressed debtor, is a time and personnel sensitive proceeding.[149] In *Residential Capital*, the court justified its rejection of the KEIP by analogy to *Borders* and *Velo Holdings*, noting how the KEIP needed to be amended to include financial targets alongside the asset sale trigger.[150] Likewise, the court in *Hawker* noted the similarities to *Velo Holdings*, but distinguished it on the basis that more work remained in that case.[151] However, the asset sale triggers of the *Borders*[152] and

145. Thus, at what has essentially become insistence by the courts, companies are now forced to include financial targets whether or not they truly believe they are necessary to incentivize management. *See supra* note 22.

146. Bank of Am. Nat’l Trust & Savs. Ass’n v. 203 N. LaSalle St. P’ship, 526 U.S. 434, 453 (1999).

147. For further reading on some advantages of a § 363 sale over a traditional Chapter 11 plan confirmation, *see* Robert G. Sable, Michael J. Roeschenthaler & Daniel F. Blanks, *When the 363 Sale Is the Best Route*, 15 J. BANKR. L. & PRAC. 121 (2006).

148. *See In re* Mesa Air Grp., Inc., 2010 Bankr. LEXIS 334, at *11–12.

149. *See* Sable, Roeschenthaler & Blanks, *supra* note 147, at 122. Bankruptcy professionals recognize that the sale of distressed assets in a bankruptcy proceeding is a tense and time sensitive process. In particular, because of diligence and familiarity concerns, professional practice generally prefers that the legal professionals “designated as the main conduit should maintain that role throughout the sale process to maintain consistency in communications and to avoid confusion and misinformation.” *Id.* at 130–31. This need for speed and consistency is upended by a standard like the § 503(c) that is apt to disrupt the sale timeline.

150. *In re* Residential Capital, LLC, 478 B.R. 154, 172 (Bankr. S.D.N.Y. 2012).

151. *In re* Hawker Beechcraft, Inc., 479 B.R. 308, 315 (Bankr. S.D.N.Y. 2012).

Velo Holdings[153] KEIPs merely recognized the *possibility* of an asset sale.[154] In both instances the ill-fitting § 503(c) requirements needlessly delayed value-preserving transactions that had required substantial work.

Such results also conflict with the principal goals of Chapter 11 reorganization when the asset sale method of value preservation is supported by a majority of creditors.[155] In the Chapter 11 context, a debtor corporation's directors owe duties of loyalty and due care to creditors in addition to those normally owed to shareholders.[156] In both cases, the creditors' satisfaction of the value received from the possible sales is demonstrative of their satisfaction with the protection they are afforded. To allow § 503(c) to override the wishes of those with the greatest stake in the transactions at the expense of possibly reducing the value received by all creditors and shareholders (as a result of an aborted or delayed sale) runs contrary to this central Chapter 11 objective.

B. The Results Reached Under § 503(c) in the S.D.N.Y. are Confusing for Debtors and Practitioners Alike and May Lead to Undesirable Changes in Reorganization Strategies

As numerous practitioner articles reveal, there was widespread surprise within the industry in the wake of the *Hawker* and *Residential Capital* decisions.[157] The fact that two similar cases with

152. *In re* Borders Grp., 453 B.R. 459, 465 (Bankr. S.D.N.Y. 2011). The description of the plan mentions only the possibility of a "Qualifying Transaction," but makes no reference of an identified buyer or other sale process preparations. *Id.*

153. *In re* Velo Holdings, Inc., 472 B.R. 201, 206–07 (Bankr. S.D.N.Y. 2012). While the Debtors in *Velo Holdings* had roughly identified target price, there was still no evidence of substantial sale process preparations. *Id.*

154. This is a stark contrast to both *Hawker* and *Residential Capital* where the Debtors had identified buyers, received bids, and engaged in substantial due diligence procedures. *See In re* Hawker Beechcraft, Inc., 479 B.R. 308; *In re* Residential Capital, LLC, 478 B.R. at 160.

155. *See* Seider, Riela & Martin, *supra* note 8, at 1.

156. *See* CFTC v. Weintraub, 471 U.S. 343, 355 (1985); *see also* Wolf v. Weinstein, 372 U.S. 633, 649–57 (1963).

157. *See* Paul R. Hage & Patrick R. Mohan, *Recent Developments in Section 503—Administrative Expenses & Key Employee Retention, Incentive and Severance Plans*, 2013 ANN. SURV. BANKR. L. 25 (2013). The authors note "[c]ollectively, *In re Hawker Beechcraft* and *In re Residential Capital* represent a fairly dramatic departure from what has become the norm in large Chapter 11 cases, specifically, courts approving so-called incentive-based bonus

similar proposed KEIPs were ruled on within the span of a week serves as a good indicator that the course of action taken by the debtors in each was, at the time, in accordance with general practice.[158] These proposed KEIPs were not, unlike that in *Dana I*, among the first to test the new 2005 BAPCPA amendments. Instead they were fashioned after years of experience by law firms, financial and restructuring consultants, accountants and the like working with the S.D.N.Y. courts. That both should fail, for the same reasons, reflects a fair amount of confusion and surprise in these rulings and § 503(c) when applied to asset sales in negotiation.

The result of this surprising application should be obvious, as should the negative impact it will have on the goal of preserving value in Chapter 11 proceedings. In the wake of the decisions, one major law firm recommended, "the KEIP should be designed and approved before the company begins the sale or transaction process . . . ."[159] Section 503(c), when applied to asset sales in light of these rulings, will encourage debtors to delay pursuing much needed relief for their distressed organization. This result is contradictory to the central goal of bankruptcy: preserving value. By encouraging debtors to sit on their hands until the petition and motions are filed, rather than actively pursue any and all viable options (which may very well result in a shortened Chapter 11 process, further reducing the expenses of the estate and the burden on the courts), § 503(c) as currently applied risks further damaging estates and foreclosing the best possible recovery for creditors and shareholders alike.

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plans to insiders." *Id.* Likewise, several law firms with major bankruptcy and reorganization practices active in the S.D.N.Y. released analyses of the decisions. *See, e.g.*, Seider, Riela & Martin supra note 8, at 1; *see also* Paul Kizel, Sharon L. Levine & Elie J. Worenklein, *Debtors May Not Be Able to Keep the KEIP*, CLIENT ALERT at 3 (Lowenstein Sandler PC, New York, N.Y.) (Aug. 30, 2012) (noting "[t]he *Hawker* and *ResCap* decisions are particularly noteworthy because bonus programs for insiders have become a common occurrence in large [C]hapter 11 cases even after Congress enacted section 503(c). . . .").

158. This fact is even more startling in light of Judge Glenn's admonishment in footnote 19 of his opinion that "Mercer [the Debtors' benefits consultant] should know better" on the basis that they were also consultants to the Debtors in *Borders*. *In re* Residential Capital, LLC, 478 B.R. 154, 166 n.19 (Bankr. S.D.N.Y. 2012). The fact that Mercer proposed a KEIP that was different from *Borders* seems to speak loudly to the idea that Mercer recognized substantial differences between the two scenarios that justified the differences in the respective proposed KEIPs. *Id.*

159. Seider, Riela & Martin, *supra* note 8, at 6.

C. Ideas for a Better § 503(c) Standard

In light of these adverse effects on asset sales, there are several possibilities for improving the § 503(c) standards. Rather than focusing solely on the categorization of retentive versus incentivizing, a new standard might better serve the intended goals of the amended § 503(c) provisions and those of Chapter 11 restructuring in general. These include: (1) concrete numerical standards, thresholds, or benchmarks; (2) features and reformulations that allow greater judicial deference in retentive scenarios; and (3) different or additional standards for asset sale or expedited transactions.

1. Concrete Numerical Standards, Thresholds, or Benchmarks

One possible solution is to provide guidance in the form of more concrete numerical standards, thresholds, or benchmarks. Taking cues from § 503(c)(1)(C), which provides numerical standards for the size of KERP payments in relation to non-management employees or previous executive compensation,[160] a set of numerical safe harbors for proposed KEIPs outside of the § 503(c)(1)(C) requirements could also be developed. By providing thresholds for modest KEIPs, such as those tied to the size of the proposed payout as a portion of the overall transaction, the statute can provide greater guidance for at least a subset of proposed KEIPs, particularly those for transactions begun before the filing of bankruptcy. Such safe harbors would align with the goals of the 2005 BAPCPA amendments in reducing executive bonuses to levels that do not seem outrageous to the average eye. Such benchmarks, however, may pose major problems in light of the fact that each case is different, as reflected in the "facts and circumstances by the case[]" language of § 503(c)(3), and are therefore extremely difficult to formulate.[161]

160. 11 U.S.C. § 503(c)(1)(C)(i)–(ii) (2012).
161. 11 U.S.C. § 503(c)(3) (2012).

2. Features and Reformulations That Allow Greater Judicial Deference in Retentive Scenarios

A more likely and fruitful change to § 503(c) may be introducing greater judicial deference along with reformulating the sharp distinctions between retentive and incentivizing plans. As previous scholarship has suggested, a standard more reliant on judicial deference rather than formulaic divide better captures the subtleties of individual cases and may better serve the intended ends of § 503(c).[162] As it currently stands, neither § 503(c) nor the case law that has developed from it looks much to evidence of incompetent or reckless management, the very factors that would likely raise opposition to executive bonuses in bankruptcy. Instead, it imposes disparate standards on either side of the wall between retentive and incentivizing, even though the courts have repeatedly recognized that KEIPs "may contain some retentive effect[s] . . . ."[163]

In light of this recognition of the dubiousness of the retentive versus incentivizing categorization, a reformulation of a standard more in line with the impetus the amendments were designed to combat—excessive compensation—combined with greater judicial discretion may be a more fruitful course of action than continuing with § 503(c) as it currently stands. In particular, greater judicial discretion to realize instances of good-faith and diligent action by management to save the company and further the value preserving goals of Chapter 11, such as acting quickly to entertain various sale and reorganization options, rather than rewarding the debtor who sits on his hands to collect a bonus after waiting to file a motion as the

162. *See* Cornwell, *supra* note 13, at 516.

> No strict ceiling, constraint, or formula—like those § 503(c) employs—can capture all the subtleties and case-specific facts relevant in assessing the value of an employee to the debtor, creditors, and other employees. Thus, a system of deference promotes the flexibility that corporations need to manage themselves out of bankruptcy.

Cornwell, *supra* note 13, at 516. The author also goes on to note that as amended § 503(c) failed to specifically address the underlying elements of fraud that precipitated its enactment in the wake of the *Enron* and *WorldCom* cases, and that such scenarios may be better combated outside of bankruptcy law. Cornwell, *supra* note 13, at 515–17.

163. *In re* Velo Holdings, Inc., 427 B.R. 201, 210 (Bankr. S.D.N.Y. 2012).

company's situation worsens, would be far more in line with the goals of BAPCPA and bankruptcy at large.

3. Specialized Standards for Asset Sales and Other Transactions Initiated Prepetiton

An additional way to address the special issues presented in *Hawker* and *Residential Capital* scenarios, where debtors did substantial work prepetition, would be to provide a different set of standards for such transactions. Similar to what is described above, a standard that recognizes the process unique to an asset sale would be better-suited to achieving preservation of value and a timely exit from the Chapter 11 process. A key difference between the *Hawker* and (even more so) *Residential Capital* cases when compared to *Borders* is that in the former, the labor-intensive sale process was already underway. In spite of this, these two cases were held to the same standard as *Borders*, where the payout of a bonus upon an asset sale was a much more tentative possibility.[164]

A new standard for asset sales recognizing and scrutinizing the process as a whole rather than simply the remaining work to be done, would better incentivize management to explore all possible options and act quickly when necessary to preserve value. It is not hard to imagine that incentive payments for "bringing home" an asset sale in the mire of Chapter 11 could still meet the § 363 business judgment factors. Furthermore, recognizing that creditor satisfaction in soon-to-be-consummated transactions, rather than needlessly fulfilling financial targets, may itself be incentivizing and better serves the needs of asset sales.

CONCLUSION

The *Hawker* and *Residential Capital* cases highlight the ways in which § 503(c) remains ineffective across a broad range of various scenarios that arise in Chapter 11. While the predecessor cases established a generally clear path to the KEIP versus KERP designations, these two cases expose how § 503(c) fails to adequately

164. *In re* Borders Grp., 453 B.R. 459, 465 (Bankr. S.D.N.Y. 2011).

meet all of the necessary possibilities that can present themselves. Furthermore, given the disparity between the standards of §§ 503(c)(1) and (3), debtors and their counsel are forced to advocate for the lenient business judgment standard even if it does not exactly fit their objective, such as in the case of asset sales. By providing a standard better-suited to the unique needs of asset sales, such as less reliance on a hard distinction between retentive and incentivizing or a more holistic approach to the sale process, the Code can better serve the needs of a wide range of debtors. The *Hawker* and *Residential Capital* cases, while surprising, serve as a useful reminder for the continually evolving needs of the Bankruptcy Code.