WALKING AND TALKING LIKE A KERP: IMPLICATIONS OF BAPCPA SECTION 503(C) FOR EFFECTIVE LEADERSHIP AT TROUBLED COMPANIES

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Congress passed section 503(c) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 in the wake of negative media attention and public outcry following debacles like that of Enron, in which a bankruptcy court approved Enron's motion to pay $140 million to top executives, some of whom had been accused of wrongdoing, while ordinary employees lost their jobs and retirement savings. Section 503(c) severely limits a debtor's ability to distribute key employee retention payments by prohibiting a debtor from making a retention payment to "an insider" unless that person holds a bona fide job offer from another business at the same or greater rate of compensation and that person's services are "essential to the survival of the business." Many commentators and debtor firms have argued that section 503(c) impedes a debtor firm's ability to retain key personnel whose presence is essential to the firm's continuing operation or sale.

Section 503(c) treats retention packages differently from incentive and other types of packages, requiring courts to ask whether a proposed insider compensation package has a primarily retentive effect. The author asserts that section 503(c)(1)'s effective prohibition of compensation packages lacking any semblance to an incentive-based plan is an improvement upon earlier practices, but nevertheless fails to police excessive insider compensation. The author recommends raising to clear and convincing the burden of proof debtors must satisfy before a court will label a proposed scheme as incentive based under section 503(c)(3). Once this standard is met, the court would apply section 503(c)(3) to determine whether the proposed package is justified considering the facts of the particular case. The author further advocates refining the standard by which courts apply section 503(c)(3), suggesting that the debtor should have to demon-

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strate that considering the unique facts of the case, the proposed package will contribute to a successful reorganization.

I. INTRODUCTION

According to Senator Edward Kennedy, the purpose of section 503(c) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[1] (BAPCPA), which severely restricts debtor firms' ability to distribute key employee retention payments (KERPs), was "to stop the travesty of high-level corporate insiders walking away with millions of dollars in bankruptcy while workers and retirees are left empty handed."[2] Although laudable, this sentiment arguably undermines debtors' ability "to retain key personnel whose involvement and support is critical to the stability of continuing operations (and thus the value of the enterprise)."[3] As a result of the tension between creditors' and other stakeholders' concerns regarding excessive insider compensation and debtors' need to attract and retain skilled management, commentators have suggested that section 503(c) poses a substantial hurdle to Chapter 11's objective of preserving the going concern value[4] of troubled businesses.[5]

1. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005). Section 331 of the Act was enacted as section 503(c) of the Bankruptcy Code. All further references to the BAPCPA amendment involving insider compensation will be to the codified provision. BAPCPA provisions apply only in cases filed on or after October 17, 2005, which is 180 days after BAPCPA's enactment date (Apr. 20, 2005). *Id.*

2. 151 CONG. REC. S1991 (daily ed. Mar. 3, 2005) (statement of Sen. Kennedy); *see also* Karen Gross, et al., *Legislative Messaging and Bankruptcy Law*, 67 U. PITT. L. REV. 497, 503 (2006) (characterizing BAPCPA as "an attempt 'to improve bankruptcy law and practice by restoring personal responsibility and integrity in the bankruptcy system and ensure that the system is fair to both debtors and creditors'") (citation omitted).

3. Peter S. Fishman, *Not So Fast: Asset Sales Under the New Section 363*, AM. BANKR. INST. J., Sept. 2005, at 12, 81. Although Fishman made this statement in the context of describing the effect of retention payments on a section 363 sale of the business, the rationale for such payments applies with equal force where a reorganization is the objective.

4. Going concern value represents the value of the debtor firm as an ongoing commercial enterprise. BLACK'S LAW DICTIONARY 1587 (8th ed. 2004). This sum tends to exceed the liquidation value of the firm's assets because it includes the company's expectation of future profits.

5. George W. Kuney, *Hijacking Chapter 11*, 21 BANKR. DEV. J. 19, 29 (2004); *see also* Fishman, *supra* note 3, at 82 (suggesting that the new provision has added "much time, expense and uncertainty . . . to the process—none of which is likely to enhance the ability to maximize the value of the debtor's assets in a [section] 363 sale"); Steve H. Nickles, *Behavioral Effect of New Bankruptcy Law on Management and Lawyers: Collage of Recent Statutes and Cases Discouraging Chapter 11 Bankruptcy*, 59 ARK. L. REV. 329, 344–48 (2006) (arguing that section 503(c) "creates disincentives to take the firm into Chapter 11"); Amy Borrus, *Creditors Will Crack the Whip; Tough New Rules Will Make Corporate Bankruptcies "Quicker and More Brutal,"* BUS. WK., July 4, 2005, at 82 ("The new law strongly tilts the balance toward creditors and will force more companies to liquidate rather than work out their financial problems."). *But see* Sylvia Mayer & Katharine Caplan, *Does BAPCPA Signify the Fall of "Traditional" Executive Retention Plans and the Rise of "Everyman" Plans?*, 9 J. PRIVATE EQUITY, Mar. 22, 2006, at 73 (arguing that "[c]reative restructuring professionals will no doubt devise pragmatic means to retain mission-critical employees and companies will continue to file Chapter 11 and emerge from Chapter 11 with their key employees intact"); Kate Laughlin, *Concerns Exist over New Ch. 11 KERP Laws*, BANK LOAN REP., Nov. 28, 2005, at 1, 9 (predicting that section 503(c) "will result in creative lawyers delivering new means to achieve the same end").

Although the tension underlying section 503(c) may present a significant challenge to the Bankruptcy Code's[6] (Code) goals of preserving a debtor's going concern value and maximizing stakeholder recovery, the new provision also reflects a broader separation of powers problem that pervades the reorganization process. Before section 503(c)'s effective date in 2005,[7] bankruptcy courts entrusted KERPs' propriety to debtors' business judgment by treating them as a use of the debtor's property outside the ordinary course of business under section 363(b).[8] Together with section 105(a),[9] that provision afforded broad discretion to bankruptcy judges, who were able to inform their analysis by examining the unique circumstances surrounding each case. Nevertheless, the timing of debtors' requests for KERP approval, which typically occurred at the outset of a reorganization case, the lack of information available to a judge in evaluating the request, and an absence of workable alternatives to KERP approval posed unique obstacles to effective exercise of this power.[10]

As a result of these challenges, some scholars called attention to courts' basic inability to provide a meaningful check on debtors' management by analogizing court oversight of KERPs to judicial involvement in other aspects of the reorganization process, including first-day orders and priority schemes such as cross-collateralization and critical vendor orders.[11] Other commentators have noted that competition among bankruptcy courts, which led some judges to rubber-stamp cases in an effort to attract new ones, and consequent forum shopping by debtors further contributed to courts' failure to serve as an effective check upon KERP extravagance.[12] As a result, debtors received approval for well-planned and imprudent KERPs alike, contributing to public outrage over perceived corporate abuse in the form of excessive executive compensation.

6. Throughout the remainder of this note, references to the "Code" refer to the Bankruptcy Code as it existed before BAPCPA's effective date. References to the "Bankruptcy Code" refer to the bankruptcy statutes currently in force.

7. *See supra* note 1.

8. 11 U.S.C. § 363(b) (2000). Section 363(b) provides that the bankruptcy trustee "after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." *Id*.

9. 11 U.S.C. § 105(a) (2000); *see also infra* Part II.B.1.

10. *See* Charles J. Tabb, *A Critical Reappraisal of Cross-Collateralization in Bankruptcy*, 60 S. CAL. L. REV. 109, 171 (1986) [hereinafter Tabb, *A Critical Reappraisal*] (discussing this problem in the context of cross-collateralization); Charles Jordan Tabb, *Emergency Preferential Orders in Bankruptcy Reorganizations*, 65 AM. BANKR. L.J. 75, 78–79 (1991) [hereinafter Tabb, *Emergency Preferential Orders*] (observing these problems in the context of emergency preferential orders generally). For a brief explanation of emergency preferential orders, including cross-collateralization, see *infra* note 11.

11. *See generally* Tabb, *A Critical Reappraisal*, *supra* note 10, at 145 (explaining why cross-collateralization, another type of court-authorized preferential treatment which grants preference to unsecured creditors of the debtor, violates the Bankruptcy Code's basic premise of equality of distribution and thus should not be allowed); Tabb, *Emergency Preferential Orders*, *supra* note 10, at 115 (arguing that the pervasive problems presented by emergency orders that grant preferential treatment to nondebtor parties such as key employees justify a legislative ban of preferential orders in all cases).

12. *See* LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS 156 (2005).

In response to these events, Congress enacted section 503(c), which imposes a prohibitory rule that effectively bans retention payments to corporate "insiders."[13] The new provision has fueled a strident debate regarding which branch—Congress or the judiciary—is better positioned to provide effective oversight of reorganization cases. At bottom, the debate turns upon the proper extent of judicial flexibility. Under section 503(c), Congress has dramatically reallocated judicial discretion regarding executive compensation. The new provision virtually eliminates debtors' ability to issue retention and severance payments to key management, although judges retain some discretion to approve other types of payments through section 503(c)(3).[14]

Since BAPCPA's effective date, courts have rarely applied section 503(c)(1) to reject proposed executive compensation packages. In *In re Dana Corp.*, however, the Bankruptcy Court for the Southern District of New York disagreed with the debtor's assertion that this provision did not apply to its proposed compensation scheme.[15] The court further observed that the business judgment standard does not apply where a proposed package falls within the ambit of section 503(c)(1) or (2) regarding retention and severance payments.[16] In explaining the basis for its finding that the proposed compensation scheme had a primarily retentive effect, and thus was subject to the prohibitive restrictions of section 503(c)(1), the court distinguished the case from other recent decisions approving similar packages by pointing to strong objections filed by various parties in interest as well as the scheme's failure to provide for a meaningful incentive bonus.[17] As the judge memorably noted, "If it walks like a duck (KERP) and quacks like a duck (KERP), it's a duck (KERP)."[18] Together with the court's subsequent approval of a modified executive compensation package, an analysis of this decision illuminates bankruptcy courts' continuing ability to exercise discretion in evaluating executive compensation motions.

In light of *In re Dana* and other case law, this note examines the effect of section 503(c)'s virtual bar on retention payments to corporate insiders as a specific manifestation of a more fundamental separation of powers concern: the proper method of allocating oversight of bankruptcy

13. *See* 11 U.S.C.A. § 503(c)(1) (West Supp. 2007). Section 101(31) of the Code defines the term "insider" to include: (1) a director or officer of the debtor, (2) a "person in control of the debtor," (3) a "partnership in which the debtor is a general partner," (4) a "general partner of the debtor," (5) a relative of any of the foregoing individuals, (6) an affiliate, or (7) an insider of an affiliate. 11 U.S.C. § 101(31) (2000). Judges and scholars note that an evaluation of which employees qualify as "insiders" is not confined by labels such as "director" and "officer," but instead requires "a factual determination regarding the extent to which an individual was in control of a debtor." *In re* Dana Corp., 351 B.R. 96, 103 (Bankr. S.D.N.Y. 2006); Mayer & Caplan, *supra* note 5, at 71.

14. *See* 11 U.S.C.A. § 503(c).

15. 351 B.R. at 101.

16. *Id.* at 100–01.

17. *Id.* at 102.

18. *Id.* at 102 n.3.

reorganizations. Part II describes KERPs and their intended use as a tool to maximize creditor recovery. In addition, Part II examines courts' treatment of KERPs before section 503(c) as well as the driving forces behind Congress's enactment of the provision. Next, Part III analyzes section 503(c)'s effect on debtors' ability to navigate bankruptcy successfully in the context of two opinions handed down since the provision's effective date: *In re Nobex Corp.*, one of several cases in which courts have approved insider compensation packages, and *In re Dana*, one of the few decisions thus far in which courts have rejected a proposed package under section 503(c)(1). Part III then explores how these decisions effect an improvement upon courts' previously impotent policing of KERP requests. It suggests, however, that the case law nevertheless demonstrates section 503(c)'s fundamental inadequacy as an alternative policing tool. Part IV posits that, in view of the courts' interpretation of the new provision, the standard for court approval of insider incentive compensation packages under section 503(c)(3) should be heightened so that courts might better realize Congress's objective of maximizing enterprise value for the benefit of all stakeholders.

II. BACKGROUND

Section 503(c) provides, inter alia, that a debtor may not make a retention payment to an "insider" unless: (1) that individual holds "a bona fide job offer from another business at the same or greater rate of compensation," and (2) that individual's services are "essential to the survival of the business."[19] Assuming that an individual meets these requirements, any retention payment made is limited in amount as specified in the provision.[20] To understand how courts attempt to reconcile the interests driving section 503(c) with the critical function of top management in pulling the entity out of bankruptcy, one must first grasp the historical framework against which Congress enacted section 503(c). This framework includes three components: (1) a description of KERPs and their use as a mechanism for retaining effective (or ineffective) top management, (2) a brief overview of courts' use of the business judgment standard in evaluating KERPs under the Code, and (3) an examination of the controversy surrounding KERP usage that led to section 503(c)'s enactment.

19. 11 U.S.C.A. § 503(c)(1).

20. *Id.* Assuming that a proposed retention package meets these two requirements, any transfer made or obligation incurred is limited to ten times "the amount of a mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer" or obligation is made or incurred. If no such transfer or obligation was incurred for nonmanagement employees during the calendar year, the amount is limited to 25% of any "similar" transfer or obligation made to the insider "for any purpose" during the preceding calendar year. *Id.*

A. KERPs

To comprehend the historical background that culminated in section 503(c), one must first have some basic knowledge of KERPs and their purported functions. The following section describes KERPs and their variation across and within companies, details their evolution into a tool that debtors used to retain needed employees, and concludes by demonstrating why creditors and other stakeholders often endorsed KERPs as a means to maximize value.

1. What Are KERPs?

A KERP includes three basic components: (1) a payment trigger, (2) participants, and (3) payment amounts.[21] The first component, a payment trigger, describes the event or goal upon which payments are conditioned. For example, a debtor might provide that participants will receive payment upon the effective date of a reorganization plan.[22] The second component, participants, specifies which employees are eligible to receive payments. Thus, a debtor might include only top executives as participants.[23] The final component, payment amounts, stipulates the total amount to be paid under the KERP. Taking the prior example of a debtor whose KERP includes only select executives, the debtor might propose individual payments of varying amounts that total several million dollars.[24]

Although KERPs uniformly include these three components, debtors tailor each component to their unique business needs. As one commentator observed, KERP formulation is "inherently case-specific and dependent on the nature of the business, the issues faced by the company, and the competitive environment in which the debtor-employer exists."[25] For example, in view of its unique objectives, a debtor might structure a KERP's payment trigger in a way that conditions payments on achieving Chapter 11 plan confirmation, realizing a sale of substantially all of the debtor's assets, or simply remaining with the business

21. Mayer & Caplan, *supra* note 5, at 69.

22. *Id.*; *see, e.g.*, *In re* Interco Inc., 128 B.R. 229, 230–32 (Bankr. E.D. Mo. 1991) (approving bonuses of $1.5 million and $500,000 to be paid to the chairman of the board and executive vice president, respectively, upon confirmation of a Chapter 11 plan of reorganization). Upon filing for bankruptcy under Chapter 11, a debtor firm receives the first opportunity to propose a plan of reorganization. The bankruptcy court then determines whether it will confirm the plan as proposed. For details regarding plan proposal, see 11 U.S.C. §§ 1121–1123, 1125, and 1126 (2000). For details regarding plan confirmation, see 11 U.S.C. §§ 1128 and 1129 (2000).

23. Mayer & Caplan, *supra* note 5, at 69; *see, e.g.*, *In re* Am. W. Airlines, 171 B.R. 674, 675–76, 678 (Bankr. D. Ariz. 1994) (approving substantial "success bonuses" for the chairman of the board and chief operating officer, less substantial bonuses for twenty-eight other officers and managers, and $1,000 token bonuses for all employees hired prepetition).

24. Mayer & Caplan, *supra* note 5, at 69; *see, e.g.*, *In re Interco*, 128 B.R. at 230–32 (approving a KERP that covered 130 "Critical Executives" and would cost a maximum of approximately $5.7 million).

25. Mayer & Caplan, *supra* note 5, at 68.

through a certain date.[26] In addition, a particular compensation package might condition payment for different participant groups on the occurrence of different triggering events.[27]

A KERP's participants and payment amount components also vary across and within companies. A plan's participant pool can range from inclusion of only the highest levels of management to the entire employee population,[28] and payment amounts can vary from several million dollars to hundreds of millions of dollars.[29] In addition, the form of payment varies across companies and within particular packages.[30] In one study, of the 51% of responding Chapter 11 employers that offered retention bonuses in 2005, 21% offered the bonuses as a percentage of salary, 35% offered them as additional severance, and 44% offered such bonuses based upon other factors.[31] Moreover, although there seems to be a lack of consensus regarding how to calculate payment amounts, the most common approach is to negotiate them on an individual basis as opposed to using preset formulas.[32] Although companies thus structure KERPs in different ways, the next section explains that the purposes for which companies use KERPs are fairly common.

2. *Where Did KERPs Come from?*

Although frequently employed outside the bankruptcy context, financially troubled businesses' use of KERPs as a method to retain employees is a fairly new phenomenon.[33] Retention payments originated in the 1980s as a means for businesses to retain employees whose services were in short supply or whose jobs would terminate upon a fixed future event.[34] Thus, companies first adopted this payment option to compensate employees for the risks and opportunity costs associated with remaining with the business through a downsizing or merger as well as through reorganization.[35] Organizations also utilized retention payments to retain employees temporarily through facility relocations, plant closings, outsourcing, and offshoring.[36]

26. *Id.* at 69.
27. *Id.*
28. *Id.*
29. *Id.*
30. Lee Hecht Harrison, *More Employers Use Retention Bonuses*, http://msg1svc.net/static/LHH/html/Retention%20Bonus.html (last visited Apr. 17, 2008) (reporting statistics gathered by Lee Hecht Harrison, a global career services company).
31. *Id.*
32. *Id.*
33. For a discussion of the rise of KERPs at financially troubled business entities, see LoPUCKI, *supra* note 12, at 151–56.
34. *Id.* at 152.
35. A. Mechele Dickerson, *Approving Employee Retention and Severance Programs: Judicial Discretion Run Amuck?*, 11 AM. BANKR. INST. L. REV. 93, 95 (2003).
36. Harrison, *supra* note 30.

Beginning in the 1990s, companies in financial distress began frequently making such payments, which became "an increasingly popular trend" by 2001.[37] According to one study, the number of Chapter 11 employers that offered retention bonuses to assist in retaining employees throughout the reorganization or liquidation process increased from 36% in 1998 to nearly half (46%) in 2001.[38] And by 2005, the year of section 503(c)'s passage, the number of Chapter 11 employers that offered retention bonuses had increased to 51%.[39] Given KERPs' widespread use, companies recognized the importance of obtaining creditor and judicial endorsement of such payments. The following section demonstrates why creditors and courts alike frequently supported debtors' KERP requests.

3. *Why Did Creditors and Other Stakeholders Endorse KERPs?*

In the bankruptcy context, KERPs arose as a means to maximize creditor recoveries by inducing employees with critical knowledge and skill to remain with the employer until some future time.[40] With this ultimate goal in mind, creditors often endorsed proposed KERPs for three reasons. First, a creditor's decision whether to endorse a particular KERP required a cost-benefit analysis of whether the KERP would sufficiently enhance enterprise value to make the payments worthwhile from the creditor's perspective.[41] Given the possible alternatives to endorsement—for example, objecting to the plan and risking the departure of managers whose key input was essential to eventual recovery—creditors frequently resolved this analysis in favor of KERP endorsement.[42] Second, creditor constituencies enjoyed the opportunity to review the financial and human capital data that a debtor asserted in support of its KERP.[43] Finally, the debtor was required to demonstrate sound business judgment by stating the firm-specific rationales behind the proposed KERP.[44] Although this final requirement admittedly presented a low bar to court approval, creditors nevertheless often endorsed the proposal as likely to ensure management's key input in the case, thus maximizing their likely recovery. As the next section explains, courts frequently agreed, even absent such justifications.

B. *Courts' Treatment of KERPs Under the Code*

Before BAPCPA, the Code provided no guidance to assist the bankruptcy courts in evaluating debtors' requests regarding key em-

37. LOPUCKI, *supra* note 12, at 156 (citation omitted); *see also id.* at 152.
38. Harrison, *supra* note 30.
39. *Id*.
40. Mayer & Caplan, *supra* note 5, at 68.
41. *See id.* at 69.
42. *See id.*
43. *Id.*
44. *Id.*

ployee compensation. Absent other statutory direction, courts relied upon several loosely worded Code provisions for authority to evaluate KERP motions. Gradually, the courts developed a good faith business judgment standard that afforded broad deference to the debtor's choice of compensation package. Nevertheless, courts informed their analysis by considering several factors. This section describes the business judgment standard and outlines an illustrative case, *In re Interco Inc.*,[45] that demonstrates how some courts successfully applied relevant factors to consider the likely utility of proposed KERPs.

1. Section 363(b) and the Business Judgment Standard

Before BAPCPA's effective date, courts relied upon section 105(a)[46] of the Code to assess KERPs as an appropriate exercise of their equitable powers.[47] Citing section 363(b)(1),[48] courts treated such plans as a use of the estate's property "other than in the ordinary course of business."[49] To give creditors an opportunity to object if they deemed the terms of the proposed plan unlikely to maximize asset value,[50] section 363(b) requires that non-ordinary-course uses of the estate's property be approved by court order after notice and a hearing.[51]

Under section 363(b), courts developed a two-part test for determining whether to approve a proposed KERP.[52] First, a court had to determine that the debtor used "proper business judgment" in developing the plan.[53] Second, a court had to deem the plan "fair and reasonable."[54] As one court explained, this test heavily favored plan approval by requiring the court to approve a proposed plan "unless it is shown to be 'so manifestly unreasonable that it could not be based upon sound business judgment, but only on bad faith, or whim or caprice.'"[55] Applying this good faith business judgment standard, judges often implicitly agreed

45. 128 B.R. 229 (Bankr. E.D. Mo. 1991).

46. 11 U.S.C. § 105(a) (2000). This provision in part grants to bankruptcy courts the authority to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." *Id*.

47. Mayer & Caplan, *supra* note 5, at 68–69; *see also* Stuart A. Laven, Jr., *First-Day Motions Under the New Code: Careful Planning Required*, AM. INST. BANKR. J., July–Aug. 2005, at 12, 12.

48. 11 U.S.C. § 363(b)(1) (2000) (authorizing trustee, after notice and a hearing, to "use, sell, or lease, other than in the ordinary course of business, property of the estate").

49. Laven, Jr., *supra* note 47, at 12; *see also* Kuney, *supra* note 5, at 78 n.282 ("[P]ayment of a bonus of any type of estate property as part of a retention plan would generally be outside the ordinary course of the debtor's business and, thus, would be prohibited under 363(b)(1) unless there were notice or a hearing." (citing *In re* Buyer's Club Markets, Inc., 5 F.3d 455 (10th Cir. 1993); *In re* Media Cent., Inc., 115 B.R. 119 (Bankr. E.D. Tenn. 1990))).

50. *See* Kuney, *supra* note 5, at 78 n.279.

51. *See* 11 U.S.C. § 363(b)(1).

52. *See, e.g.*, *In re* Aerovox, Inc., 269 B.R. 74, 80–81 (Bankr. D. Mass. 2001); *In re* Montgomery Ward Holding Corp., 242 B.R. 147, 154 (Bankr. D. Del. 1999); *In re* Am. W. Airlines, Inc., 171 B.R. 674, 678 (Bankr. D. Ariz. 1994); *In re* Interco, Inc., 128 B.R. 229, 234 (Bankr. E.D. Mo. 1991).

53. Kuney, *supra* note 5, at 78–79.

54. *Id.*

55. *In re Aerovox*, 269 B.R. at 80 (citation omitted).

with debtors and creditors alike that a proposed KERP was likely to maximize creditor recoveries.[56]

2. *Application of the Business Judgment Standard:* In re Interco

Notwithstanding courts' routine approval of KERPs absent a showing of bad faith or caprice, courts gradually developed several factors to consider in determining whether debtors' proposed plans satisfied the business judgment standard.[57] For example, courts considered (1) the debtor's need to retain "mission-critical" individuals[58] as well as the anticipated departure of specific, highly marketable employees;[59] (2) the importance of persuading a group of employees to remain in light of either a substantial increase in those employees' duties as a result of the bankruptcy filing[60] or the likely elimination of those employees' positions following their role in the reorganization;[61] (3) the imperative of reducing turnover costs associated with employee departures;[62] and (4) the likelihood that a debtor would successfully reorganize[63]—a judgment informed in part by whether the proposed plan tied payments to meaningful bankruptcy and business-performance milestones.

One of the first KERPs to be approved, presented in *In re Interco*,[64] neatly illustrates the way in which some courts gave proper consideration to these factors. In that case, the court evaluated a proposed compensation scheme for 130 members of senior management.[65] The proposal tied payments to achievement of projected operational performance goals, with the possibility for higher payments in case of higher performance.[66] Payments were to be distributed on a staggered basis so that most would occur at and after the end of the fiscal year.[67]

56. Mayer & Caplan, *supra* note 5, at 69. *But see* Karen Cordry & Zachary Mosner, *Challenging the "Lake Woebegon Syndrome": What Hath Congress Wrought with KERPs?*, AM. BANKR. INST. J., June 2006, at 12, 61 (noting that such a standard, although useful "where the insider is not on both sides of the transaction," may not be appropriate as applied to KERPs, which allow the proponents of the motion to benefit personally from its approval).

57. The factors discussed in this paragraph are drawn from Mayer & Caplan, *supra* note 5, at 69, and from Cordry & Mosner, *supra* note 56, at 61–62.

58. *See, e.g.*, *In re* Georgetown Steel Co., 306 B.R. 549, 557 (Bankr. D.S.C. 2004).

59. *See, e.g.*, *In re* Geneva Steel Co., 236 B.R. 770, 772 (Bankr. D. Utah 1999).

60. *See, e.g.*, *In re Aerovox*, 269 B.R. at 79.

61. *See, e.g.*, *In re* U.S. Airways, Inc., 329 B.R. 793, 801 (Bankr. E.D. Va. 2005).

62. *See, e.g.*, *In re* Montgomery Ward Holding Corp., 242 B.R. 147, 155 (Bankr. D. Del. 1999).

63. *See id.* at 154–55 (holding that although the debtor need not demonstrate a "reasonable prospect of successfully reorganizing," that issue should inform the court's decision as to whether to approve a KERP). Approving a KERP with no assurance of success, however, may display inadequate attention to this factor. Interestingly, after receiving approval of its proposed KERP, Montgomery Ward's subsequent reorganization plan failed in less than two years, returning the company into bankruptcy to liquidate. Cordry & Mosner, *supra* note 56, at 61 n.5.

64. 128 B.R. 229 (Bankr. E.D. Mo. 1991).

65. *Id.* at 230.

66. *Id.* at 231.

67. *Id.*

In describing the debtor's asserted justifications for the scheme, the court noted targeted employees' concerns regarding their significantly increased workloads, employment security, and the worthlessness of the stock-based long-term incentive component of their executive compensation packages.[68] In addition, the court expected the plan to encourage retention among the recipients because the performance measures upon which the incentives would be based posed realistic targets,[69] and the awards contemplated were meaningful.[70] In sum, the court suggested that rejecting the plan before it as unreasonable would place the continued retention of indispensable executives throughout the debtor's reorganization process at an unacceptable risk.

C. *The Impetus Behind Section 503(c)*

Unfortunately, the dynamics of the Chapter 11 process do not always allow courts a meaningful opportunity to apply the aforementioned factors. Like other critical decisions in a reorganization case, such as cross-collateralization and critical vendor orders, KERP motions present a dilemma to effective court oversight because they are typically put forward at the outset of a case, when the court and creditors have "little time to develop the facts and little experience in the case by which to judge the prospects of reorganizing successfully."[71] At this stage in the proceedings, key employees and other parties have the opportunity to exert significant leverage to obtain benefits from the court.[72] After all, if the court rejects management's request, it risks insider departures and creditors' reduced prospect of increased recovery through successful reorganization.[73] On the other hand, approving such requests does not guarantee successful reorganization.[74] As a result, granting preferential treatment to key employees or other parties exerting leverage may also harm creditors' interests.

In addition to the challenges posed by the basic dynamics of reorganization, other factors contributed to the perceived need to change the process by which courts evaluated executive compensation motions. For example, although some judges followed the model of *In re Interco*,[75] others routinely approved KERPs that proved to be poorly conceived, if

68. *Id.* at 230–31.
69. *Id*. at 232.
70. *Id.*
71. Tabb, *A Critical Reappraisal*, *supra* note 10, at 171 (discussing this problem in the context of cross-collateralization).
72. Tabb, *Emergency Preferential Orders*, *supra* note 10, at 78–79 (observing these problems in the context of emergency preferential orders generally).
73. *Id.* at 78.
74. *Id.*
75. 128 B.R. 229 (Bankr. E.D. Mo. 1991).

not downright self-serving, by corporate insiders.[76] In addition, an increasing number of megafilings beginning in 2001, instances of high-profile corporate fraud, and a subsequent wave of negative media attention contributed to a widespread public perception that bankruptcy courts closed their eyes to abuse in the form of excessive executive compensation.[77] While acknowledging the legitimacy of KERPs' goal to maximize creditor recoveries, some observers began to view KERPs not as a mechanism that produced value for creditors, but as a tool regularly used by entrenched top managers to remain with the business that they had guided into bankruptcy.[78] A summary review of the pressures attending KERP usage during this period assists in understanding the perceived need for section 503(c) as a meaningful limit on retention payments at bankrupt companies.

1. Explosion of Megafilings

One precursor to section 503(c)'s enactment was the dramatic increase in Chapter 11 filings by large, high-profile companies—commonly referred to as megafilings—beginning in 2001. Of the fifteen largest bankruptcies since 1980, seven occurred in 2001 or 2002 and four more followed in 2003 and 2005.[79] Although many of the debtors involved in these cases sought KERP approval to encourage employee loyalty and retention,[80] some filings involved *Fortune 500* companies that received court approval for lavish KERPs while lower-echelon employees lost their jobs and retirement savings.[81] As a result of this well-publicized dichotomy, Chapter 11 debtors that offered retention bonuses only to upper-level insiders received heightened criticism from the media, the public, and legislators.[82] As one commentator noted, the wave of megafilings created "[a] perception of inequitable treatment"[83] that eventually led Congress to dictate legislatively "when (if ever) bankruptcy courts should be allowed to approve employee retention . . . programs . . . . [KERPs] are increasingly controversial because approving them creates

76. *See, e.g.*, *In re* Montgomery Ward Holding Corp., 242 B.R. 147 (Bankr. D. Del. 1999) (holding that a "reasonable prospect of successfully reorganizing" was unnecessary to approve a KERP). As noted previously, Montgomery Ward's subsequent reorganization plan failed within two years, causing the debtor to revert into bankruptcy and liquidate. *See supra* note 63.

77. Mayer & Caplan, *supra* note 5, at 69; *see also* LOPUCKI, *supra* note 12, at 152 (proposing that bankruptcy courts competed for lucrative cases and thus "were not up to the task" of rejecting KERP proposals by debtors' top management).

78. LOPUCKI, *supra* note 12, at 152, 156.

79. NEW GENERATION RES., INC., THE 15 LARGEST BANKRUPTCIES 1980–PRESENT (Dec. 27, 2002), *available at* http://www.bankruptcydata.com/research/15_largest.htm. The research calculated bankruptcy size based on the amount of prebankruptcy assets.

80. Dickerson, *supra* note 35, at 96–97.

81. *See* Kim Clark, *Bankrupt Lives*, U.S. NEWS & WORLD REPT., Sept. 16, 2002, at 52; Nelson D. Schwartz, *Greed-Mart; Attention, Kmart Investors. The Company May Be Bankrupt, but Its Top Brass Have Been Raking It in*, FORTUNE, Oct. 14, 2002, at 139.

82. Dickerson, *supra* note 35, at 93, 96–97.

83. *Id.* at 93.

the perception that bankruptcy courts condone a debtor's desire to give highly paid executives bonuses, while simultaneously laying off lower-level workers."[84] Although the increase in megafilings thus highlighted the perceived disparity between debtors' treatment of insiders and the rest of a debtor's employee base, it was not the only call to action heeded by legislators. As the next section demonstrates, some megafilings attracted further negative attention due to allegations of executive misconduct and accounting fraud.

2. Instances of High-Profile Corporate Fraud

Commentators seem to agree that Congress enacted section 503(c) in reaction to the specific "highly publicized problem" of "corporate management overreaching."[85] Key employees' receipt of massive retention payments, particularly at companies subject to allegations of fraud, attracted significant public, and consequently congressional, notice.[86] Enron is perhaps the most visible example. In 2002, a bankruptcy court approved the company's motion to grant $140 million in retention payments to its top executives, despite objections that the recipients of the proposed payments "may have been enmeshed in a web of pre-petition wrongdoing which is now under intense investigation."[87] Revelations that in the days immediately before filing Enron had awarded retention bonuses that ranged from $200,000 to $5 million to certain employees, some of whom had to stay only ninety days to receive the payments, further contributed to heightened scrutiny of executive compensation practices at Enron and its peers.[88]

84. *Id.* The author refers to the Employee Abuse Protection Act of 2002, S. 2798, H.R. 5221, 107th Cong. (2002). *See* Dickerson, *supra* note 35, at 103 n.52.

85. Gross et al., *supra* note 2, at 509–10.

86. *See* 151 CONG. REC. S1819 (daily ed. Mar. 1, 2005) (statement of Sen. Durbin) (noting that "[m]any of the companies that have gone into bankruptcy are associated with scandal" and urging the Senate to use the bankruptcy bill to hold accountable "the corporate crooks who are milking these corporations at the expense of employees and retirees"); *see also* Rebecca Revich, *The KERP Revolution*, 81 AM. BANKR. L.J. 87, 121 (2007) (citation omitted) (quoting Senator Kennedy's statement in the Congressional Record before the Judiciary Committee mark-up that the amendment was intended to prevent corporate insiders from "loot[ing] their companies at the expense of workers, retirees, creditors, and stockholders"). Other members of Congress seized upon the opportunity to protect debtors' legitimate need to retain key employees by suggesting that the amendment apply only in the case of "insider negligence, mismanagement, or fraudulent conduct [that] contributed to a company's insolvency." 151 CONG. REC. H2051 (daily ed. Apr. 14, 2005) (statement of Rep. Cannon). Although some commentators have embraced this solution to some of the objections raised by section 503(c), *see* Revich, *supra*, I do not endorse it here because it would not encompass much of the compensation abuse that, although legal, contributed to the negative media attention and subsequent public outrage discussed *infra* in Part II.C.3.

87. 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, 584 (2004).

88. Rachel Beck, *New Bankruptcy Law Cracks Down on Executive Bonuses*: *Retention Pay Will Still Be Available but with Excesses Cut Out*, ST. LOUIS POST-DISPATCH, Aug. 14, 2005, at C9.

One of Enron's peers, WorldCom, Inc., provides another example of a debtor whose fraud and executive misconduct caused observers to object to its proposed KERP. In support of its motion requesting approval of a retention plan that would cover 329 "key employees" and cost $25 million, the company claimed that, in its business judgment, a retention plan "is the most cost-effective manner in which to protect against attrition and to improve employee morale."[89] In a letter filed in response to the motion, however, an employee shareholder of the company challenged these grounds, noting that WorldCom presented no evidence that approval of the plan would advance either of these goals.[90] The letter further argued that the plan's provision for sizable payments to a small number of top executives rather than for small payments to rank-and-file employees, who had not received raises or bonuses in more than a year and had lost some or all of their retirement savings as a result of the bankruptcy, would actually negatively affect the morale of a majority of WorldCom employees.[91] Nevertheless, the court approved the KERP as proposed.[92]

The explosion in megafilings beginning in 2001 and the executive compensation debacles at Enron, WorldCom, and other companies charged with fraudulent practices focused the public eye upon executive compensation practices at bankrupt companies. The next section discusses how media coverage of these issues assists in understanding the magnitude of public outrage that drove the passage of section 503(c), and Part III analyzes how the new provision attempts to address these issues.

3. *Negative Media Attention*

By any account, the media played a pervasive role in section 503(c)'s enactment. Its coverage of the wave of megafilings beginning in 2001 and of instances of high-profile executive misconduct and accounting fraud led to increased public awareness of KERPs and executive compensation at financially troubled companies.[93] Highly publicized megafilings by companies responding to allegations of wrongdoing affected the public's opinion regarding debtors' executive compensation requests.[94] Media coverage further highlighted rank-and-file employees' loss of jobs and retirement savings while publicizing debtors' efforts to

89. Herriott, *supra* note 87, at 607 (citing Motion of the Debtors Pursuant to Sections 363(b) and 105(a) of the Bankruptcy Code for Authorization to Establish a Key Employee Retention Plan, *In re* WorldCom, Inc., No. 02-135333 (Bankr. S.D.N.Y. Oct. 18, 2002)).

90. *Id.* at 608.

91. *Id.* at 609.

92. *Id.*

93. *See id.* at 581–85 (describing media coverage of the Kmart, Global Crossing, Enron, and WorldCom bankruptcies and its negative influence on public perception of KERPs).

94. *See id.*

increase management compensation,[95] which was often bestowed upon the same individuals who led the business into bankruptcy.

The resulting change in public opinion subjected bankruptcy courts' frequently routine approval of retention packages to increased scrutiny. Thus, despite the multifactor analysis that courts sometimes performed[96] in deciding whether a debtor's unique circumstances merited a proposed KERP under the business judgment standard, highly publicized megafilings and instances of compensation abuse as well as the perception that highly paid insiders were profiting at other stakeholders' expense led Congress to view with increasing skepticism "the continued validity of allowing courts to exercise broad discretion when deciding whether to approve [KERPs]."[97] In response to public outcry fueled by negative media attention, Congress included section 503(c) as part of BAPCPA.[98] Part III of this note analyzes how the provision attempts to preserve judicial discretion while restraining courts' ability to approve insider compensation packages that are unlikely to assist the debtor in a successful reorganization or sale and then suggests that section 503(c) partially fails to realize this goal.

III. Analysis

In relevant part, section 503(c) provides that

> 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—
>
> (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

95. Mayer & Caplan, *supra* note 5, at 69.

96. *See* Dickerson, *supra* note 35, at 100–04 (discussing factors).

97. *Id.* at 103. The author refers to the Employee Abuse Prevention Act of 2002, from which BAPCPA section 503(c) was taken. *See* Mayer & Caplan, *supra* note 5, at 70.

98. For a revealing discussion of the relatively sparse deliberation that preceded the inclusion of section 503(c) in BAPCPA, see Cordry & Mosner, *supra* note 56, at 60.

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.[99]

Simply put, the provision virtually eliminates retention payments by debtors to insiders unless the insider holds a bona fide job offer and is deemed essential to the business's survival. Assuming these conditions are met—a big assumption—the amount of the transfer must not exceed the ceiling set forth in the provision. Moreover, other transfers not meant to induce the insider to remain with the business must nevertheless satisfy a business judgment standard. To understand the implications of these provisions for debtors' ability to navigate successfully through bankruptcy, one must first have some familiarity with recent decisions that have interpreted the provision as well as ways in which these decisions represent an improvement upon courts' application of the business judgment standard under the Code.

A. Illustrative Cases: In re Nobex *and* In re Dana

Decisions handed down since section 503(c)'s effective date reveal the thorny issues that courts confront in applying the provision to particular compensation plans. This section compares *In re Nobex*, one of the cases in which courts approved proposed insider pay plans under sec-

99. 11 U.S.C.A. § 503(c) (West Supp. 2007).

tion 503(c),[100] with *In re Dana*, one of the few cases thus far in which a court applied the provision to reject a proposed pay plan. In doing so, it examines the rationale for each decision to gain a better understanding of section 503(c)'s effect on courts' ability to exercise oversight of debtors' executive compensation.

1. In re Nobex

In re Nobex provides a starting point for examining the analysis by which courts evaluate executive compensation packages under section 503(c). Nobex Corporation, a private drug development company, filed for Chapter 11 on December 1, 2005.[101] After filing its petition, Nobex continued to operate as a debtor-in-possession and sought to orchestrate a sale of most of its assets[102] at a price higher than a proposed "stalking horse" bid of $3.5 million.[103] To sustain approximately three months of anticipated sale efforts, Nobex requested permission from the court to pay select members of existing senior management[104] sale-related incentive bonuses in addition to their regular compensation.[105]

The proposed compensation applied to two executives and varied depending on the ultimate valuation of the company's assets as reflected by the gross sale price. One of the executives eligible to receive a bonus was Charles Dimmler, Nobex's chairman and acting CEO.[106] The board appointed Dimmler as chairman on March 31, 2004.[107] The second eligible executive was Russell Savre, Nobex's vice president of finance and administration.[108] Savre was to be responsible for Nobex's due diligence responses in the process of marketing the company's assets to potential bidders.[109] Under the proposed incentive scheme, each executive could receive a bonus for his assistance in effecting the sale. The bonus would be payable upon the closing of a sale and was expressed as a percentage of the portion of the total gross price exceeding $3.5 million (the amount of the "stalking horse" bid).[110] Further, the amount of the bonus varied for each executive according to the sale's total gross price and could not exceed a maximum amount.[111]

100. Other debtors that have received approval for proposed compensation plans include Calpine and Plaint. Marie Leone, *Bankruptcy Pay: Will 'Stay' Bonuses Go?*, CFO.COM, Sept. 13, 2006, at 1, http://www.cfo.com/article.cfm/7905100/1/C_2984364?f=search.
101. *In re* Nobex Corp., No. 05-20050, 2006 Bankr. LEXIS 417, at *2 (Bankr. D. Del. 2006).
102. *Id.* at *2–3.
103. *Id.* at *6.
104. *Id.* at *3–4.
105. *Id.* at *6.
106. *Id.* at *3.
107. *Id.*
108. *Id.*
109. *Id.* at *4.
110. *Id.* at *9.
111. *Id.* The potential amount of Mr. Dimmler's bonus was structured as follows:

Nobex emphasized these facts in support of its contention that its proposed executive pay plan constituted a "pay for performance" plan subject to section 503(c)(3).[112] The court characterized this assertion as accurate, observing that the sale-related structure of the proposed payments established that the proposal was not a retention package.[113] According to the court, the payments had a primarily incentivizing, rather than retentive, effect because the participants would not receive the compensation unless the debtor achieved a minimum specified gross sale price.[114] As a result, the court held that section 503(c)(1) was inapplicable and reviewed the proposed compensation package under the business judgment standard of section 503(c)(3).

In support of its assertion that the motion to pay Dimmler and Savre sale-related incentive bonuses represented a sound exercise of business judgment, Nobex asserted that the executives possessed unique expertise and experience that made their involvement in the sale necessary to the due diligence process, asset marketing efforts, and interactions with potential purchasers.[115] The court agreed, authorizing Nobex's request under sections 105, 363(b), and 503(c).[116] In support of its conclusion,[117] the court found that Dimmler and Savre were the company's "only personnel with the necessary skill and experience to implement" the proposed sale procedures, interact with potential buyers, and ensure that the proposed sale maximized creditor recovery.[118] As the court noted, the "specific situation" of the proposed sale meant that the executives' "unique skills and expertise" were "essential to the Debtor's suc-

> (i) if the Sale is at a total gross price which exceeds $3,500,000.00 but does not exceed $10,000,000.00, an amount equal to six and one-half percent (6.5%) of the portion of the gross purchase price exceeding $3,500,000.00, not to exceed $422,500.00;
> (ii) if the Sale is at a total gross price which exceeds $10,000,000.00 but does not exceed $15,000,000.00, an amount equal to $422,500.00 plus four and one-half percent (4.5%) of the portion of the gross purchase price exceeding $10,000,000.00, not to exceed $225,00.00;
> (iii) if the Sale is at a total gross price which exceeds $15,000,000.00, an amount of $647,500.00 plus two and 75/100s percent (2.75%) of the amount of the gross purchase price exceeding $15,000,000.00; provided, however,
> (iv) if the Sale is at a gross price which produces sufficient funds so that allowed unsecured claims may be paid in full ("Full Payment Target) [sic], then the percentage applicable to the portion of the sale price exceeding the Full Payment Target shall be six and one-half percent (6.5%).

Id. at *9–10. The structure of Mr. Savre's bonus was similar, with the exception that the bonus amounts increased from (i) "two and one-half percent (2.5%) of the portion of the gross purchase price exceeding $3,500,000.00, not to exceed $162,500.000," to (ii) "$162,500.00 plus two percent (2.0%) of the portion of the gross purchase price exceeding $10,000,000.00, not to exceed $100,000.00," to (iii) "$262,500.00 plus one and 25/100s (1.25%) of the portion of the gross purchase price exceeding $15,000,000.00." *Id*. at *10–11. Further, if the sale allowed the Full Payment Target to be achieved, the percentage applicable to the portion of the gross purchase price exceeding the Full Payment Target would be 2.5 percent. *Id*. at *11.

112. *See id.* at *7.
113. *See id.*
114. *See id.*
115. *See id.* at *3.
116. *Id.* at *1, *8.
117. *See id.* at *8.
118. *Id.* at *4.

cessful implementation of the sale procedure . . . and ability to maximize the value of the Debtor's assets."[119] In addition, the court cited the support of the Official Committee of Unsecured Creditors as another factor that contributed to its finding that the specific facts and circumstances of the case justified the payments.[120]

In re Nobex thus demonstrates two points relevant to this note's analysis. First, the decision clarifies the analytical process by which a court decides whether a proposed pay plan has a primarily retentive or incentivizing effect. In holding that the proposed payments were not primarily intended to induce the executives to remain with Nobex, and consequently that the payments were not retention payments that would fall under section 503(c)(1), the court noted that the executives would receive the compensation only if the gross sale price of the company's assets exceeded $3.5 million, the amount of a proposed "stalking horse" bid.[121] Thus, the bonuses' connection to achievement of a meaningful performance goal—here, a minimum gross sales price for the debtor's assets—established that the payments at issue were not retention bonuses.

Second, *In re Nobex* elucidates the standard that a court will apply to decide whether a package that the court deems to have a primarily incentivizing effect demonstrates an exercise of sound business judgment under section 503(c)(3). The court noted that the sale-related payments at issue were "necessary, reasonable, appropriate," and in the best interest of creditors and the estate because they provided meaningful incentives to maximize the value of the debtor's assets.[122] Consequently, Nobex satisfied its burden of proof under section 503(c)(3) to demonstrate that the proposed incentive compensation package was a proper exercise of business judgment. The next section further clarifies the analytical process that courts apply under section 503(c)(3) by explaining why another company, Dana Corporation, failed to meet its burden under that provision.

2. In re Dana

Since section 503(c) became effective, the executive compensation package (Initial Compensation Motion) originally proposed in *In re Dana* remains one of the few packages that failed to gain approval under section 503(c)(3). Because the court eventually approved a revised compensation motion (Executive Compensation Motion), an examination of both proposals in *In re Dana* is critical in gaining a complete understanding of the case's significance. Specifically, *In re Dana* uniquely illuminates executive compensation package components and the circum-

119. *Id.* at *6.
120. *See id.* at *5, *7.
121. *Id.* at *6–7.
122. *Id.* at *7–8.

stances that affect a bankruptcy judge's determination of (1) whether the package has a primarily retentive or incentivizing effect under section 503(c)(1), and (2) whether a debtor has exercised sound business judgment in developing an incentivizing package under section 503(c)(3).

a. The Initial Compensation Motion

Dana Corporation, a major automobile parts supplier, filed for Chapter 11 on March 3, 2006.[123] Approximately four months later, Dana moved for court approval of an executive compensation package.[124] The Initial Compensation Motion applied to Michael Burns, Dana's president and CEO,[125] who had occupied the CEO position for two years before the petition date.[126] In addition to Burns, the proposed compensation package applied to five incumbent executives.[127]

In support of its motion, Dana argued that the proposed compensation package was necessary to incentivize the executives "to lead Dana and achieve an expedient and successful reorganization of the Debtors."[128] Specifically, Dana argued that approval of the motion would provide sufficient protection to the executives against "the imminent risk to their futures" during its "difficult and demanding restructuring effort."[129] The proposed package, Dana suggested, would eliminate the distraction of job insecurity "so that the members [of the management team] can dedicate themselves to the objectives of maximizing values for all of the Debtors' competing constituents."[130]

Under the Initial Compensation Motion, each of the executives would receive base salary, annual incentive plan bonuses (AIP bonuses), and "target completion bonuses."[131] Although Burns's base salary would remain unchanged from its prepetition amount of $1,552,500, proposed base salaries for each of the other five executives fell between $500,000 and $600,000.[132] The AIP component conditioned payment of the bonus upon Dana's attainment of threshold, target, or superior financial performance goals, with the bonus amount depending upon the level of per-

123. *In re* Dana Corp., 351 B.R. 96, 98 (Bankr. S.D.N.Y. 2006).

124. *Id.* After filing the initial compensation motion, Dana filed a modified motion, which to some extent altered the long-term incentive bonus in the form of the completion bonus as well as the senior executive retirement plan. The court noted, however, that the modified version of the plan did not alter the basic issues at hand. *Id.*

125. *Id.*

126. *Id.* at 99. Dana's board appointed Burns as CEO on March 1, 2004. *Id*.

127. *Id.* at 98.

128. *Id.* at 99.

129. *Id.*

130. *Id.*

131. *Id.* In addition to these components, the modified plan included a senior executive retirement program and a noncompete component. Because these elements are not relevant to this Note's analysis of retention programs, I do not discuss them here.

132. *Id.*

formance attained.[133] The proposed AIP bonuses ranged from $336,000 to $528,000 for all executives but the CEO.[134] Burns's AIP would remain unchanged from its prepetition amount of $2,070,000.[135] The final component of the proposed package, which is most relevant to this note's analysis, was the completion bonus. Under the version of the plan as submitted to the court, the completion bonus would consist of two components.[136] The first was a fixed component, which executives would receive regardless of Dana's performance or creditor recovery.[137] It would be payable in cash on the effective date of a reorganization plan (the "effective date), provided the executive was still employed by Dana,[138] and ranged from $400,000 to $560,000 for every executive except Burns, whose fixed component would amount to $3.1 million.[139] The second uncapped, variable component would be calculated based upon Dana's total enterprise value (TEV) six months after the effective date.[140] This component would be payable in common stock of reorganized Dana.[141]

Dana characterized the package as an incentivizing "[p]roduce [v]alue for [p]ay" compensation plan.[142] It relied on sections 105, 363(b), 365, and 101(31) of the Code as statutory authority for the proposed package, asserting that the business judgment of the Compensation Committee and Board was sufficient for the court's approval of the motion.[143] As a basis for its assertion that section 503(c) did not apply, Dana contended that the court had reached that conclusion after evaluating a similar motion[144] in *In re Calpine Corp*.[145] Dana further argued that, even if section 503(c) applied, the proposed package as submitted did not violate section (3) of that provision because it was "the result of a sound exercise of business judgment . . . ."[146] According to Dana, treating the proposal as subject to either section 503(c)(1) or (2) would reflect "a

133. *Id.* The plan provided that Dana's compensation committee would establish the threshold, target, and superior performance goals. *Id*.

134. *Id.*

135. *Id.*

136. *Id.* An earlier version of the plan called for a completion bonus that was not split into two components, was not linked to any performance goals, and was payable in cash. *Id.*

137. *Id.*

138. *Id.*

139. *Id.*

140. *Id.* As an example, the court noted that Mr. Burns would receive an additional $4,133,000 if Dana's TEV declined to the $2 billion threshold completion bonus, but would receive $6.2 million if TEV remained constant at $2.6 billion. *Id*.

141. *Id.* at 99–100. The plan further provided that amounts in excess of the minimum completion bonus would be payable in cash if either (1) Dana's common stock was not listed and readily tradable, or (2) if the common stock was subject to repurchase by reorganized Dana in the event that the executive was not employed by Dana after the effective date of a reorganization plan. *Id.*

142. *Id.* at 98.

143. *Id.* at 100.

144. *Id.* at 101.

145. No. 05-60200 (Bankr. S.D.N.Y. Jan. 27, 2006).

146. *In re Dana*, 351 B.R. at 100.

dangerously expansive and unworkable interpretation of section 503(c) . . . ."[147]

Judge Lifland disagreed, noting that bankruptcy courts "must look to the specific circumstances of these cases, and these Debtors" in assessing compensation motions pursuant to section 503(c).[148] Applying this principle, the court distinguished the case before it from *In re Calpine*, which had demonstrated a prima facie record that supported a largely unrebutted application for an "incentive."[149] Conversely, Dana's Initial Compensation Motion—particularly the portion addressing Burns's compensation package—had "generated extensive opposition"[150] in the form of "strong objections"[151] by the Creditors' Committee, the Ad Hoc Noteholders' Committee, two unions, and the United States Trustee (objecting parties).[152] The court concluded that the issues raised in these objections supported the conclusion that the motion "cannot fairly be compared to other compensation motions brought before this Court or other courts."[153]

The objecting parties argued against approval of the motion for three primary reasons, two of which are relevant here. First, it was contended that the threshold for payment of the variable component completion bonuses was artificially low, effectively rendering the bonuses retention payments.[154] The court agreed, noting that the executives would receive 66% of the target completion bonus if Dana's business performance declined from current TEV by 23%.[155] This threshold "more or less guarantee[d]" that the executives would receive the bonuses.[156]

Second, the plan provided that the executives would receive the fixed component of the completion bonus without regard to Dana's operating performance or creditor recovery.[157] Because payment of the bonus was conditioned only upon the executives' continued employment through the effective date of a reorganization plan, the court declined to classify the payment as an incentive bonus:[158] "Using a familiar fowl analogy, this compensation scheme walks, talks, and is a retention bonus."[159] In sum, Judge Lifland noted,

> While it may be possible to formulate a compensation package that passes muster under the section 363 business judgment rule or sec-

147. *Id.*
148. *Id.* at 101–02.
149. *Id.* at 102.
150. *Id.* at 98.
151. *Id.* at 102.
152. *Id.* at 98.
153. *Id.* at 102.
154. *Id.*
155. *Id.*
156. *Id.*
157. *Id.*
158. *Id.*
159. *Id.*

> tion 503(c) limitations, or both, this set of packages does neither. In so holding, I do not find that incentivizing plans which may have *some* components that arguably have a retentive effect, necessarily violate section 503(c)'s requirements.[160]

This formulation makes clear that although the particular plan presented to the court included too many retentive components to meet section 503(c)(3)'s requirements, an incentive plan that produces *some* retentive effects need not fail to pass muster under that provision.

The court's discussion in *In re Dana* clarifies two other points of interest to this note's analysis. The first relates to the circumstances in which the business judgment rule will apply. The decision makes clear that, even where a sound business purpose underlies a proposed compensation package, the business judgment rule will not apply if the package falls within the scope of sections 503(c)(1) or (2).[161] These sections outline evidentiary standards that a debtor must satisfy, regardless of the existence of a sound business purpose, if it seeks to use the transfer to induce the beneficiary to remain with the debtor's business.[162] The court emphasized, however, that the same is not true of section 503(c)(3). Where a compensation motion falls under that provision, courts are free to apply the business judgment rule in its analysis.[163]

The second point of interest resolved a debate among the parties concerning the effect of executives' hire dates on the court's analysis. The parties' opposing arguments required the court to determine whether the plain language of section 503(c)(3) prevented courts from relying on that provision in cases where the proposed compensation package would apply to executives hired prepetition.[164] Despite the absence of any guidance in the statute's legislative history, the court rejected the United States Trustee's position that Congress's inclusion of postpetition hires as one example of obligations subject to section 503(c)(3) required the court to consider Dana's plan (applicable to prepetition hires) under sections 503(c)(1) and (2).[165] Instead, the court concluded that "the plain language of the statute does not prohibit the court from analyzing transfers to prepetition hires expansively under this section."[166] Thus, transfers to prepetition and postpetition hires that are not subject to sections 503(c)(1) or (2) are to be analyzed alike under the business judgment standard of section 503(c)(3).

160. *Id.* at 103.
161. *Id.* at 100–01.
162. *Id.* at 100.
163. *Id.* at 102.
164. *Id.* at 101.
165. *Id.*
166. *Id.*

b. The Executive Compensation Motion

After the September 5, 2006 order (September 5 Order) denying Dana's request for approval of its Initial Compensation Motion, Dana negotiated with its Creditors' and Equity Committees to develop a modified executive compensation proposal (Executive Compensation Motion), which it submitted to the court for a hearing on November 21, 2006.[167] The Executive Compensation Motion included, *inter alia*, a long-term incentive plan (LTIP), which represented a substantially modified version of the target completion bonuses that Dana had included in its Initial Compensation Motion.[168] An examination of the court's justifications for approving this component as modified assists in gaining a better understanding of courts' practical exercise of discretion under section 503(c)(3).

Dana's proposed LTIP provided that Burns and other senior executives would receive incentive payments conditioned upon the company attaining certain EBITDAR[169] benchmarks.[170] Overall, the LTIP rewarded the six covered executives for attaining specified EBITDAR levels with payments totaling $11 million over three years, $5 million of which would be in the form of cash with the remainder in stock of the reorganized company.[171] For example, the LTIP stipulated that a minimum $250 million EBITDAR benchmark in 2007 would trigger a $3 million payment to Burns, which would be payable in cash in the post-emergence period.[172] For each additional $100 million in EBITDAR, Burns would receive a $750,000 increase, up to a maximum payout of $4.5 million for 2007.[173] Any payments beyond the initial $3 million would be payable in stock.[174] In 2008, a similar incentive structure would apply, except that all payments would be made in the form of stock.[175]

In explaining its basis for approving the LTIP, the court cited *In re Nobex*[176] for the proposition that Congress did not intend section 503(c) to preclude debtors from "*reasonably* compensating . . . 'insiders,' . . . for their contribution to the debtors' reorganization."[177] The court noted that the proposed payments were a significant reduction from the long-term incentives that the executives might have attained prepetition and represented a "substantial retreat" from the Initial Compensation Mo-

167. *In re* Dana Corp., 358 B.R. 567, 570–71 (Bankr. S.D.N.Y. 2006).
168. *Id.* at 574.
169. EBITDAR signifies Earnings Before Interest, Taxes, Depreciation, Amortization, and Restructuring Costs. *Id.* at 574 n.8.
170. *Id.* at 574.
171. *Id.*
172. *Id.*
173. *Id.*
174. *Id.*
175. *Id.*
176. No. 05-20050, 2006 Bankr. LEXIS 417 (Bankr. D. Del. Jan. 19, 2006); *see also In re* Werner Holding Co., No. 06-10578, 2006 Bankr. LEXIS 4049 (Bankr. D. Del. Oct. 18, 2006).
177. *In re Dana*, 358 B.R. at 575.

tion because the LTIP provided for no guaranteed payments other than base salary.[178] Conversely, the court rejected Dana's original proposal because it contemplated guaranteed distribution of a completion bonus upon the debtor's emergence from Chapter 11 as well as a separate bonus based upon the debtor's TEV that would be awarded upon emergence even if TEV declined from its current level.[179] The court also pointed to "uncontroverted evidence" establishing that achievement of the EBITDAR benchmarks proposed in the LTIP would be difficult and "uncertain, at best" due to the unique circumstances of the struggling automotive industry.[180] As a result, the court concluded that the LTIP represented a program whose primary purpose was to incentivize key employees to maximize enterprise value.[181]

The court proceeded to determine whether the entire Executive Compensation Motion, including the LTIP, represented a sound exercise of the debtor's business judgment under section 503(c)(3). In framing its analysis, the court observed that it was required to consider the compensation package as a whole, with due consideration for the total possible compensation available to each participant during the reorganization period.[182] To this end, the court engaged in a holistic analysis of three primary factors, including (1) whether the proposed cost or expense is reasonable and in the best interests of the estate, (2) whether the services that the targeted employees would provide are likely to enhance the prospect of successful reorganization for the debtor, and (3) whether the debtor exercised appropriate business judgment in bringing the motion.[183]

Applying these considerations, the court indicated that, although the executives' services were likely to enhance Dana's prospects for successful reorganization, the package's total possible expense might not serve the best interests of the estate. Despite its approval of the motion's omission of any guaranteed payments, the court observed that the total potential compensation available to the executives under the motion in 2007 and 2008 would include significant LTIP payments, base salary, and AIP payments worth up to 200% of base salary.[184] It concluded that this amount might be "outside the realm of reasonableness, disproportionate, and overly generous."[185] Nevertheless, the court approved the motion subject to inclusion of "an appropriate yearly ceiling" on the total compensation available to each executive during the reorganization period.[186]

178. *Id.* at 574.
179. *In re* Dana Corp., 351 B.R. 96, 102 (Bankr. S.D.N.Y. 2006).
180. *In re Dana*, 358 B.R. at 581.
181. *Id.* at 584.
182. *Id.* at 583.
183. *Id.* at 571.
184. *Id.* at 583.
185. *Id.* at 584.
186. *Id.*

The next section explains why two of the court's rationales for this decision—the inclusion of meaningful payment triggers and creditor endorsement or participation in package development—support the conclusion that courts' analysis of executive compensation motions under section 503(c) represents an improvement upon their review of KERP motions under the Code's previous business judgment standard.

B. Improvements upon the Code's Business Judgment Standard

Together with other recent case law, *In re Nobex* and *In re Dana* interpret section 503(c) in a way that takes into account the numerous pressures exerted by the provision's proponents and critics. This section argues that, although the new provision ultimately fails to provide an effective solution to the pressures at play in reorganization cases, *In re Dana* and its brethren[187] have improved upon courts' application of the business judgment standard to executive compensation motions by emphasizing the need for effective incentive structures and creditor participation in plan creation.

1. Effective Incentive Structures

Although *In re Nobex* and *In re Dana* initially resulted in different outcomes, both cases emphasized the centrality of effective incentives to approval of a compensation package under section 503(c). The court in *In re Nobex* approved the package at issue in part because participants would receive payment only if the gross sale price of the company's assets exceeded the amount of a proposed "stalking horse" bid.[188] The debtor's inclusion of sale-related payments led the court to conclude that the distributions contemplated by the package were not retention payments within the scope of section 503(c)(1).[189]

The court in *In re Dana* used the same basic analysis to arrive at the opposite conclusion. In that case, the court rejected the Initial Compensation Motion in part because two of the plan's components were not based on meaningful incentives. The first of these components provided that the beneficiaries would receive the fixed component of the comple-

187. For example, in January 2008 Judge Robert Drain of the United States Bankruptcy Court for the Southern District of New York approved automotive parts supplier Delphi Corporation's amended reorganization plan on the condition that the company reduce proposed executive cash bonuses from approximately $87 million to $16.5 million. *See* Gretchen Morgenson, *Reigning in Royal Pay*, INT'L HERALD TRIB., Jan. 28, 2008, at 13 (noting that, according to one union's counsel, the change represented "the largest reduction in proposed management compensation ever imposed by a bankruptcy court"). The court's decision to reduce the debtor's proposed pay plan for top managers by approximately $70 million arose from objections from two unions representing Delphi employees. *See id*. Interestingly, one rationale for the reduction was that the pay plan lacked an effective incentive structure because the company's emergence from bankruptcy represented the sole trigger for the massive payouts. *Id.*

188. No. 05-20050, 2006 Bankr. LEXIS 417, at *6–7 (Bankr. D. Del. Jan. 19, 2006).

189. *Id.* at *7.

tion bonus upon the effective date of a reorganization plan, regardless of Dana's performance or the amount of creditor recovery.[190] The court disagreed with the debtor's characterization of this payment as an incentive bonus, noting that the package conditioned the payments only on the beneficiaries' continued employment with the business.[191]

In regard to the second component, objecting parties argued that artificially low thresholds for payment of the variable component of the completion bonus rendered the payments akin to retention bonuses.[192] The court recognized their argument that, unlike the payouts approved in *In re Nobex*, distributions under Dana's Initial Compensation Motion were "more or less guaranteed" because participants would receive payments even if the debtor's TEV declined from its current level of performance.[193] In the same vein, the court approved Dana's Executive Compensation Motion on the ground that conditioning distributions on the debtor's attainment of challenging EBITDAR benchmarks provided an effective incentive because it would require participants to "stretch" to attain the desired operating results.[194]

Before section 503(c)'s effective date, the connection between proposed payments and participants' pursuit of meaningful objectives was one factor that a court could consider in determining whether to approve a KERP.[195] Subsequent cases make clear, however, that this connection is not simply relevant to court approval in some circumstances, but vital to approval of any package that a debtor asserts will incentivize participants under section 503(c)(3).[196] Together with an inquiry into whether creditors and other stakeholders have endorsed a particular plan, this requirement represents an improvement over courts' analysis under the Code because it increases the likelihood of a successful reorganization or sale, thereby ensuring that the payments will contribute to the Code's ultimate goals of maximizing creditor recoveries and preserving debtors' value as going concerns.

2. *Creditor Participation in Plan Creation*

In addition to emphasizing the need for a connection between distributions and effective performance goals, courts have consistently noted the importance of creditor endorsement when considering whether to approve incentive plans under section 503(c)(3). For example, the court in *In re Nobex* cited creditors' support as one basis for its finding

190. *In re* Dana Corp., 351 B.R. 96, 99 (Bankr. S.D.N.Y. 2006).
191. *Id.* at 102.
192. *Id.*
193. *Id.*
194. *In re* Dana Corp., 358 B.R. 567, 581 (Bankr. S.D.N.Y. 2006).
195. *See In re* Interco Inc., 128 B.R. 229, 232 (Bankr. E.D. Mo. 1991).
196. *See, e.g.*, *supra* note 187.

that the package would accomplish a sound business purpose.[197] The court noted that the endorsement of the Official Committee of Unsecured Creditors, which had successfully obtained modifications to the proposed sale-related compensation after negotiations, bolstered the debtor's claim that the program cost was necessary and justified.[198]

Similarly, the court in *In re Dana* observed that the presence or absence of opposition to a compensation motion is one of several unique circumstances that a court must consider in evaluating a compensation motion.[199] Nevertheless, the presence of opposition may prove significant only in cases with circumstances similar to those present in *In re Dana*, where "several parties in interest" filed "strong objections" that rebutted the case and record supporting the initial application.[200] In contrast to Dana's situation, *In re Calpine*, another case in which a debtor requested approval of "incentive" payments, involved a prima facie case and record that "was *largely* unrebutted, therefore not raising the issues currently before this Court."[201] Thus, it is possible that only substantial opposition will weigh against compensation package approval under section 503(c).

Although the Code's business judgment standard required courts to consider creditors' objections in evaluating KERP motions before section 503(c)'s enactment,[202] there is no evidence to suggest that such protests frequently, if ever, resulted in rejection by the court. In fact, commentators seem to agree that the public outrage surrounding KERP usage in the years preceding section 503(c)'s enactment arose in part from courts' routine approval in the face of virulent objection from various parties, including creditors.[203] Since section 503(c)'s effective date, however, courts afford stronger weight to creditor and stakeholder endorsement of a proposed compensation package,[204] as cases like *In re Nobex* and *In re Dana* demonstrate.

This change represents an improvement upon courts' analysis of KERP motions under the Code because it provides an incentive for debtors to engage interested parties in crafting an incentive-based compen-

197. *In re* Nobex Corp., 2006 Bankr. LEXIS 417, at *5 (Bankr. D. Del. Jan. 19, 2006).

198. *Id.*

199. 351 B.R. 96, 102 (Bankr. S.D.N.Y. 2006).

200. *Id.*

201. *Id.* (emphasis added).

202. *See* Kuney, *supra* note 5, at 77–78 n.279 (noting that, according to the Bankruptcy Court for the Southern District of New York, the Code requires notice and a hearing before approval of non-ordinary-course payments like KERPs "so that creditors, who have a vital interest in maximizing realization from assets of the estate, have an opportunity to review the terms of the proposed transaction and to object if they deem the terms and conditions are not in their best interest").

203. *See, e.g.*, *Enron Executive Retention Plan Stirs up Firestorm of Objections*, ANDREWS CORP. OFFICERS & DIR. LIABILITY LITIG. REP., Apr. 22, 2002, at 18 (reporting approval of Enron's KERP subject to court-imposed guidelines in the face of objections by creditors, shareholders, ex-employees, and the SEC); Herriott, *supra* note 87, at 608–09 (describing objections to WorldCom's KERP, which the court approved without amendment, by employee shareholder).

204. *See, e.g.*, *supra* note 187.

sation package. Because parties' endorsement of a package is unlikely in cases where a plan shows signs of management overreaching, and because experience under the Code demonstrates that interested parties are willing to approve legitimate plans as a way to maximize recovery, this consideration encourages submission of packages that provide incentives to effective leadership while discouraging submission of overreaching plans that are unlikely to win approval.

IV. RECOMMENDATION

As the above analysis demonstrates, section 503(c) requires courts to subject proposed insider compensation packages to individual scrutiny to determine whether they have a primarily retentive effect. The provision's differential treatment of retention packages and other types of compensation proposals, including incentive packages, significantly advances Congress's goal to constrain management overreaching. Further, the multifactor analysis applicable to incentive and other types of packages under section 503(c)(3)'s catch-all provision alleviates concerns that Congress imposed too great a constraint on judicial discretion.[205] In fact, cases like *In re Dana* demonstrate that the new provision may not go far enough in restraining judicial discretion, given debtors' tendency to continue tweaking a proposed package until courts deem it to exert a sufficiently incentivizing effect.

This note suggests that section 503(c)(1)'s virtual prohibition of compensation packages that lack any semblance of an incentive structure represents a material improvement upon courts' ability to approve pure retention payments under the Code's business judgment standard. Nevertheless, the following sections make clear that section 503(c) ultimately proves an inadequate mechanism for policing excessive insider compensation due to the incentive it provides for debtors to set incentive payment triggers only as high as is required to avoid court rejection. This note recommends (1) raising the burden of persuasion that debtors must satisfy before a court will characterize a proposed compensation package as an incentive scheme to be evaluated under section 503(c)(3), and (2)

205. For an explanation of the basis for these concerns, see Dickerson, *supra* note 35, at 105–07. Dickerson argues that "flexibly muddy rules" represent a favorable alternative to "clear, inflexible 'crystalline' rules" in the bankruptcy courtroom because (1) bankruptcy judges likely care more about reaching the correct result than competing for prestigious cases, (2) in the context of approving retention or severance programs, the courts generally take into account a common pool of factors, (3) the possibility of objections by parties in interest to a retention or severance program provides an ex ante incentive for debtors to negotiate reasonable program terms and critically examine those terms before submitting them to the court for approval, and (4) judicial discretion to review proposed packages and any subsequent objections deters creditors from unreasonably objecting to packages that are likely to contribute to a successful reorganization. *See also* Ted Janger, *Crystals and Mud in Bankruptcy Law: Judicial Competence and Statutory Design*, 43 ARIZ. L. REV. 559, 585 (2001) (arguing that muddy rules influence parties during negotiations to reach a bargained-for result that a neutral decision maker will find reasonable in the event of a later dispute, and that this benefit may outweigh the fact that muddy rules make ex post consensual resolution of a dispute more difficult).

refining the standard by which courts apply section 503(c)(3). Doing so would retain the possibility of incentive payments for debtors that legitimately need to encourage insiders' contributions to a successful reorganization while requiring debtors first to establish that the payments would promote the Bankruptcy Code's objective of maximizing enterprise value for the benefit of all stakeholders.

A. *The Current State of Judicial Discretion Under Section 503(c)(3)*

Because section 503(c)(1) stipulates that any compensation package offered to an insider "for the purpose of inducing such person to remain with the debtor's business" must be limited in amount and received only by individuals who meet certain requirements,[206] debtors will seek instead to compensate top management with incentive packages. Once a court has classified a proposed compensation package as having a primarily incentivizing effect, the court must decide whether it is "justified by the facts and circumstances of the case."[207] This determination requires the court to apply section 503(c)(3)'s business judgment standard by examining the unique circumstances surrounding the package. The analysis required by section 503(c)(3) improves upon the Code's previous good faith business judgment standard by affording more weight to some of its factors, such as whether a package is likely to enhance a debtor's prospect of successful reorganization and whether creditors and other stakeholders endorse the package as likely to maximize enterprise value. Thus, courts have interpreted section 503(c)(3) in a way that continues to allow them to consider a host of factors in cases where packages are deemed not to have a primarily retentive effect.

B. *An Argument for a More Onerous Burden of Persuasion and Application of Section 503(c)(3)*

The preceding section clarifies how section 503(c)(3)'s incorporation of the Code's business judgment standard and courts' subsequent emphasis of certain factors applicable under that standard, including effective incentive structures and creditor endorsement, have led to court approval of packages that fall more comfortably within the realm of reason than many KERPs approved under the Code's previous good faith business judgment standard. Although section 503(c)(3) preserves judicial discretion by allowing courts to consider various case-specific factors in evaluating insider incentive compensation packages, the provision ultimately fails to circumscribe the ability of debtors' management to obtain benefits that exceed the amount necessary to (1) encourage insider

206. 11 U.S.C.A. § 503(c)(1) (West Supp. 2007).
207. *See* discussion *supra* Part III.

contributions to a successful reorganization or sale, and (2) maximize the debtor's value as a going concern.

To remedy section 503(c)(3)'s failings, this note first recommends raising the burden of proof that a debtor must satisfy before a court will evaluate a proposed insider compensation package as an incentive-based scheme to a "clear and convincing" formula. The requirements that this standard would impose parallel those seen elsewhere in certain types of civil cases.[208] Under a "clear and convincing" standard, a civil plaintiff must establish "in the mind of the factfinder a 'firm belief or conviction' that the allegations in question are true."[209] In the present situation, this formulation would translate to a requirement that a debtor demonstrate a "highly probable"[210] likelihood that the proposed package will incentivize the covered insiders to contribute to a successful reorganization. Procedurally, a debtor might meet its "clear and convincing" burden in various ways. For example, a court might scrutinize the proposed package for meaningful payment triggers and indications that covered insiders would not receive sizeable payments regardless of the debtor's progress toward a successful reorganization or sale.

Once a debtor has met its burden of proving by "clear and convincing" evidence that the package is incentive-based, the court can apply section 503(c)(3) to determine whether the package is "justified by the facts and circumstances of the case."[211] To meet this standard, the debtor should supplement the demonstrations it has already made with a showing that the unique facts and circumstances surrounding its request, including creditor endorsement and the unique attributes of covered insiders, further increase the likelihood that the package will contribute to a successful reorganization. This note recommends that courts guard against overreaching plans by requiring the debtor to establish at least one of the following facts through an insider's[212] specific testimony regarding her role in the company: (1) the insider possesses specialized knowledge in regard to the debtor's unique business practices, strategic

208. Although in most civil cases a party who bears the burden of persuasion must prove it "by a preponderance of the evidence," she must do so instead "by clear, strong and convincing evidence" in certain types of cases. 2 JOHN W. STRONG ET AL., MCCORMICK ON EVIDENCE § 339 (5th ed. 1999). Most relevant for the purposes of this note are those cases involving (1) fraud or undue influence, (2) a special danger of deception, or (3) a particular type of claim that a court disfavors on policy grounds. *See id*. § 340. As discussed *supra* in Part II.C, insider compensation motions in bankruptcy cases arguably fall within each of these categories.

209. 1 CLIFFORD S. FISHMAN, JONES ON EVIDENCE: CIVIL AND CRIMINAL § 3:10 (7th ed. 1992 & Supp. 2007) (citation omitted).

210. *Id*.

211. 11 U.S.C.A. § 503(c)(3).

212. In cases of proposed incentive compensation packages that encompass too many insiders to make a requirement of individual testimony practicable, other arrangements may prove feasible. For example, a court might accept the testimony of particular insiders selected to serve as representatives for various levels of the debtor's employment hierarchy (e.g., one representative for members of executive management, another for mid-level management, etc.). Each representative would testify to the facts listed in the text as they apply in the aggregate to the representative's employment group.

vision, or industry niche; (2) the insider enjoys a network of contacts within the debtor's industry that would be difficult to obtain elsewhere; or (3) the insider has a history of extensive involvement in the debtor's business that makes her assistance in reorganization particularly valuable. A court should require the debtor to present the testimony in advance of the hearing on the motion for package approval.

Although courts have previously chosen to consider these facts under the Code's good faith business judgment standard and continue to do so under sections 503(c)(3)'s regime,[213] a requirement that the debtor establish them through specific testimony submitted in advance of its motion for package approval effects two improvements upon prior practice. First, as suggested above, this practice would constrain courts' ability to approve packages that provide for substantial incentive payments in cases where the debtor fails to demonstrate that participants' potential contributions merit the payment amounts. Second, the requirement that debtors submit the proposal to creditor constituencies and the court in advance of requests for package approval would eviscerate some of the problems currently posed by the dynamics of the reorganization process[214] by providing creditors and bankruptcy judges with time and information so that both groups can conduct an informed review of the proposed package terms.

Together with a heightened burden of persuasion that would require a debtor to demonstrate by "clear and convincing" evidence that a proposed compensation package is sufficiently incentivizing, a requirement of insider testimony in advance of requests for plan approval would allow courts to continue to consider case-specific facts and circumstances by engaging in a discretionary analysis of the factors previously included within section 503(c)(3)'s business judgment standard. Consequently, the endorsement or objections of creditor groups, unique insider attributes, and other aspects surrounding a particular package would continue to play a role in courts' evaluation of insider incentive compensation packages.

V. CONCLUSION

Congress enacted section 503(c) in response to public outrage over courts' routine approval of excessive executive compensation packages. Courts have interpreted the new provision, which represents a dramatic reallocation of judicial discretion, in a way that effects an improvement upon their previous application of the Code's good faith business judgment standard. Unfortunately, case law decided since section 503(c)'s effective date also demonstrates that the provision nevertheless fails to provide a complete solution to a broader separation of powers concern:

213. *See, e.g.*, *supra* notes 58, 96, 118–19 and accompanying text.
214. *See supra* notes 10, 11, 71, 72 and accompanying text.

how best to allocate oversight of Chapter 11 reorganization cases among the legislative and judicial branches of federal government. Unless Congress and the judiciary strike a more comfortable balance between prohibitory rules and case-by-case discretion, the public and creditors in particular may find themselves again witness to routine corporate abuse in the form of excessive executive compensation. To avoid this possibility, courts must raise the bar to evaluation of proposed packages under section 503(c)(3) and refine their application of that provision so that insider incentive compensation packages more effectively promote Chapter 11's ultimate goal of maximizing enterprise value for the benefit of all stakeholders.