

## NOTES

### ARE KERPS ALIVE IN ESSENCE? THE VIABILITY OF EXECUTIVE INCENTIVE BONUS PLANS AFTER 11 U.S.C. § 503(C)(1)

MELISSA C. KING<sup>†</sup>

#### INTRODUCTION

Two hundred and eight CEOs and corporate directors from twenty-five of the largest corporations to file for bankruptcy in 2001 and 2002 walked away from their failing companies with gross earnings of \$3.3 billion.<sup>1</sup> Paid handsomely for utter failure, these “barons of bankruptcy”<sup>2</sup> jumped ship with titanic personal fortunes as their companies foundered or sank. Top offenders included Gary Winnick of Global Crossing, who “earned” \$512 million, Ken Lay, former CEO and Chairman of Enron, who “earned” \$247 million, and Jeff Skilling, former Enron President, who “earned” \$89 million.<sup>3</sup>

Contributing in large part to the excessive earnings of these corporate insiders were all-cash retention bonuses, or Key

---

<sup>†</sup> Notes and Comments Editor, *St. John's Law Review*; J.D. Candidate, 2009, St. John's University School of Law; B.A., History & International Political Economy, 2006, Fordham University.

<sup>1</sup> Ien Cheng, *Survivors Who Laughed All the Way to the Bank: Barons of Bankruptcy Part I*, FIN. TIMES (London), July 31, 2002, at 10 (surveying 181 executives and twenty-seven directors from the twenty-five largest U.S. public companies to go bankrupt in 2001 and 2002). The earnings figures for these executives included salary, bonuses, share sales, and other cash payments—including annual and long-term performance pay-outs, signing and retention bonuses, severance payments, and forgiven cash loans—paid out between January 1999 and December 2001. *Id.* The study reported that fifty-two executives and directors each made more than \$10 million, thirty-one more than \$25 million, sixteen more than \$50 million, and eight of them topped an astounding \$100 million. *Id.*

<sup>2</sup> *Id.* (calling these “barons of bankruptcy . . . a privileged group of top business people who made extraordinary personal fortunes even as their companies were heading for disaster”).

<sup>3</sup> *Id.*

Employee Retention Plans (“KERPs”).<sup>4</sup> Debtor corporations utilized KERPs to retain executives and directors whose wisdom and guidance had steered them into bankruptcy in the first place.<sup>5</sup> KERPs insulated these insiders from the financial risks facing nearly all employees, creditors, and shareholders in reorganization.<sup>6</sup>

The inequity of KERPs, approved by bankruptcy courts and paid out amidst massive layoffs and record-breaking creditor claims, garnered intense public scrutiny and congressional attention. This attention resulted in newly enacted 11 U.S.C. § 503(c)(1), part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”).<sup>7</sup> Section 503(c)(1) prohibits any “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.”<sup>8</sup>

---

<sup>4</sup> See Jennifer LeClaire, *Bonuses Amid Bankruptcy Draw Ire of Axed Workers*, CHRISTIAN SCI. MONITOR (Boston), June 17, 2002, at 14. Debtor corporations paid out generous retention bonuses to induce key executives to remain. For example, in December 2001, days before Enron Corporation filed for bankruptcy, the firm paid more than \$100 million in retention bonuses to executives, some of which exceeded \$1 million per person. Kathryn Kranhold & Mitchell Pacelle, *About Those Big Enron Bonuses . . .*, WALL ST. J., June 12, 2002, at C1. Moreover, in April 2002, Enron received court approval to pay \$140 million in retention bonuses to 1,700 executives and managers. Jeff St. Onge, *Bankruptcy Judge OKs WorldCom Bonuses*, RECORD (Bergen County, N.J.), Oct. 30, 2002, at B01. Also, in December 2001, Polaroid paid forty-five top executives court-approved KERPs totaling \$1.55 million. *Polaroid Withdraws \$5 Million Bonus Plan To Retain Executives*, WALL ST. J., Jan. 14, 2002, at B5. In March 2002, Kmart received court approval to pay up to \$150 million in retention bonuses to 9,950 mid-level executives. St. Onge, *supra*. In October 2002, a bankruptcy court approved, over the objections of creditors and stockholders, KERPs for 325 WorldCom executives totaling \$25 million. *Id.*

<sup>5</sup> There is something obviously unfair about rewarding executives of companies in bankruptcy with gross retention bonuses as dedicated employees lose their jobs, benefits, and nest eggs and shareholders lose their investments. See *In re U.S. Airways, Inc.*, 329 B.R. 793, 797 (Bankr. E.D. Va. 2005) (“All too often [KERPs] have been used to lavishly reward—at the expense of the creditor body—the very executives whose bad decisions or lack of foresight were responsible for the debtor’s financial plight.”).

<sup>6</sup> See *id.* (“[E]ven where external circumstances rather than the executives are to blame, there is something inherently unseemly in the effort to insulate the executives from the financial risks all other stakeholders face in the bankruptcy process.”).

<sup>7</sup> Pub. L. No. 109-8, 119 Stat. 23 (codified in scattered sections of 11 U.S.C.).

<sup>8</sup> 11 U.S.C. § 503(c)(1) (2000 & Supp. V 2005).

Seemingly, § 503(c)(1) has eliminated KERPs.<sup>9</sup> Debtor corporations, however, are currently attempting to circumvent § 503(c)(1)'s prohibition by restructuring and re-characterizing KERPs as *incentive* bonus plans.<sup>10</sup> In theory, incentive bonus plans, unlike KERPs, require executives to reach certain productivity levels and performance goals before receiving their bonuses.<sup>11</sup> The emergence of incentive bonus plans, therefore, has raised the issue of whether such plans are essentially “for the purpose of inducing [an insider] to remain with the debtor’s business,”<sup>12</sup> and thereby explicitly prohibited by § 503(c)(1), or whether incentive bonus plans are only incidentally retentive in effect and thus allowable.<sup>13</sup>

Debtor corporations assert that incentive bonus plans are not prohibited under § 503(c)(1) because “the purpose” of such “incentive” plans is not simply to induce executives to remain with the corporation through reorganization, but rather to achieve specified challenging productivity goals. United States trustees, creditors, employees, and shareholders disagree. They assert that incentive bonus plans, more often than not, have “terribly low performance thresholds” making them in effect “merely ‘artfully worded creations’ that bear no actual distinction from ordinary retention packages under the prior KERP standards.”<sup>14</sup> Moreover, they assert that—regardless of the

---

<sup>9</sup> *In re U.S. Airways*, 329 B.R. at 797–98 (“[Section 503(c)(1)] severely limit[ed] both the circumstances under which . . . retention payments [would] be made to insiders as well as the amount of such payments . . .”).

<sup>10</sup> Marie Leone, *Bankruptcy Pay: Will “Stay” Bonuses Go?*, CFO.COM, Sept. 13, 2006, [http://www.cfo.com/article.cfm/7905100/c\\_2984364/?f=archives](http://www.cfo.com/article.cfm/7905100/c_2984364/?f=archives) (“A provision in the new bankruptcy law amendments has companies scurrying to transform executive retention packages into performance-based incentive pay.”).

<sup>11</sup> *Id.* At least most of the time this is the case. See *In re Global Homes Prods., LLC*, 369 B.R. 778, 786–87 (Bankr. D. Del. 2007) (paying out incentive bonuses even though productivity levels were not reached).

<sup>12</sup> 11 U.S.C. § 503(c)(1).

<sup>13</sup> Incentive bonus plans are potentially allowable under the more flexible standard in § 503(c)(3) or § 363(b). In contrast to the strict prohibition on retention bonuses set forth in § 503(c)(1), § 503(c)(3) prohibits any “other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case.” 11 U.S.C. § 503(c)(3). Similarly, § 363(b) provides that a “trustee [or debtor in possession], after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.” 11 U.S.C. § 363(b)(1) (2000).

<sup>14</sup> Karen Lee Turner & Ronald S. Gellert, *Dana Hits a Roadblock: Why Post-BAPCPA Laws May Impose Stricter KERP Standards*, 3 *Andrews Bankr. Litig. Rep.* (West) 2 (Nov. 6, 2006).

performance level specified—an unavoidable purpose of incentive bonus plans is to induce the recipient to remain with the corporation through reorganization and, as such, are prohibited under § 503(c)(1).

This Note argues that incentive bonus plans, although violating § 503(c)(1)'s intent to curb excessive executive compensation in reorganization, are not prohibited by the statute's language. While incentive bonus plans may have some incidental retentive effect, "the purpose" of such plans is not to "induc[e the insider] to remain with the debtor's business."<sup>15</sup> Part I of this Note describes the pre-BAPCPA bankruptcy court approval process for KERPs, the corporate behavior motivating BAPCPA's passage, BAPCPA's legislative path, and § 503(c)(1)'s KERP restrictions. Part II considers the response of debtor corporations to § 503(c)(1)'s prohibition, namely the creation of incentive bonus plans, and the arguments for and against this response. Part III proposes—based on the statute's text, its legislative history, and bankruptcy court precedent—that while incentive bonus plans technically remain a viable option for corporations in reorganization, such plans circumvent the spirit of the legislation and therefore must be addressed by bankruptcy courts and, if necessary, Congress. Part III also includes an outline of how incentive bonus plans might be addressed.

## I. THE PRE-BAPCPA STATE OF AFFAIRS

### A. *Nearly Unfettered Approval: KERPs and the Courts*

Prior to the passage of BAPCPA, a debtor corporation in reorganization routinely used KERPs or "pay-to-stay" bonuses to retain and compensate executives deemed vital to the corporation's successful Chapter 11 reorganization.<sup>16</sup> While the

---

<sup>15</sup> 11 U.S.C. § 503(c)(1).

<sup>16</sup> See, e.g., *In re Aerovox, Inc.*, 269 B.R. 74, 76 (Bankr. D. Mass. 2001). Debtors utilized KERPs:

1) to keep the eligible employees, including the Key Employees, in the Debtors employ; 2) to compensate the eligible employees, including the Key Employees, for assuming additional administrative and operational burdens imposed on the Debtor by its Chapter 11 case; and 3) to allow the eligible employees, including the Key Employees, to use their best efforts to ensure the maximization of estate assets for the benefits of creditors.

Bankruptcy Code did not expressly mention KERPs or provide a method for their implementation,<sup>17</sup> a debtor corporation sought and attained bankruptcy court approval for KERPs under sections 363(b) and 105(a) of the Bankruptcy Code. Section 363(b) provides that a “trustee [or debtor in possession], after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.”<sup>18</sup> Section 105(a) allows a court to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code].”<sup>19</sup> Since KERPs involved a commitment of the estate assets, specifically cash, outside the ordinary course of business,<sup>20</sup> a debtor corporation sought approval for and the bankruptcy court approved KERPs after a hearing under the authority of the above two sections.<sup>21</sup>

At the required hearing, the bankruptcy court applied the business judgment rule to determine whether or not to approve a proposed KERP.<sup>22</sup> Under this deferential standard, the decision of a debtor corporation to enter into a KERP was presumed valid if the decision was attributable to any rational business purpose and was fair and reasonable under the facts and circumstances of the individual case.<sup>23</sup> Parties opposing a KERP had the heavy

---

*Id.* (internal quotation marks omitted). KERPs were considered necessary to counteract the loss of certain economic protections afforded to key employees in solvency. *Id.* at 75–76.

<sup>17</sup> *In re Brooklyn Hosp. Ctr.*, 341 B.R. 405, 410 (Bankr. E.D.N.Y. 2006); *In re U.S. Airways, Inc.*, 329 B.R. 793, 797 (Bankr. E.D. Va. 2005) (“The Bankruptcy Code does not specifically address so-called Key Employee Retention Plans, or KERPs, whether adopted before the filing of a bankruptcy petition or after.”).

<sup>18</sup> 11 U.S.C. § 363(b)(1) (2000).

<sup>19</sup> *Id.* § 105(a).

<sup>20</sup> *See In re Allied Holdings, Inc.*, 337 B.R. 716, 721 (Bankr. N.D. Ga. 2005) (“KERP programs . . . have become customary uses of estate funds in large business reorganizations.”).

<sup>21</sup> *In re Adelpia Commc’ns Corp.*, No. 02-41729 (REG), 2003 WL 22316543, at \*29 (Bankr. S.D.N.Y. Mar. 4, 2003) (“[W]here . . . the debtor proposes to enter into a transaction out of the ordinary course that will involve a commitment of the estate’s assets—*e.g.*, its cash—and there are objections, the approval of the Court, after a hearing, is required.”).

<sup>22</sup> *In re Brooklyn*, 341 B.R. at 410 (“The business judgment rule ‘is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.’” (quoting *In re Adelpia*, 2003 WL 22316543, at \*30)).

<sup>23</sup> *Id.* at 410–12; *In re Allied Holdings*, 337 B.R. at 721; *In re U.S. Airways, Inc.*, 329 B.R. 793, 797–98 (Bankr. E.D. Va. 2005); *In re Aerovox, Inc.*, 269 B.R. 74, 80–81 (Bankr. D. Mass. 2001).

burden of overcoming this presumption of validity.<sup>24</sup> The deferential standard of review relegated the bankruptcy court to overseer of the judgment of the debtor corporation rather than primary decision maker.<sup>25</sup>

### B. KERPs Abused

Given the deferential standard of review and the heavy burden placed upon the challenger to rebut the presumption of reasonableness and fairness, KERPs were readily abused. KERPs, in essence, were the court-sanctioned lifeboat, or more appropriately the yacht, for executives in reorganization. Here are five examples:

#### *Enron*

A few days before Enron filed for bankruptcy in early December 2001, it paid out more than \$100 million in retention bonuses to top executives, some of which exceeded \$1 million per executive.<sup>26</sup> Of the recipients, Ken Lay, former Enron CEO and Chairman, received \$10.6 million, Jeff Skilling, former Enron President, received \$7.5 million, and David Delainey, a former Enron Energy Services executive, received \$4.2 million.<sup>27</sup> In sharp contrast, a few days after Enron filed for bankruptcy, each of the 4,000 Houston employees terminated by the corporation received only \$4,500 before taxes and lost almost their entire retirement savings.<sup>28</sup>

In addition to KERPs paid out just prior to bankruptcy, Enron sought and received bankruptcy court permission in April 2002 to pay as much as \$140 million in retention bonuses to 1,700 executives and managers.<sup>29</sup> Moreover, in a separate

---

<sup>24</sup> *In re Brooklyn*, 341 B.R. at 411.

<sup>25</sup> *In re Aerovox*, 269 B.R. at 80 (“[T]he ‘bankruptcy court sits as an overseer of the wisdom with which the bankruptcy estate’s property is being managed by the trustee or debtor-in-possession, and not, as it does in other circumstances, as the arbiter of disputes between creditors and the estate.’” (quoting *Orion Pictures Corp. v. Showtime Networks, Inc.* (*In re Orion Pictures Corp.*), 4 F.3d 1095, 1099 (2d Cir. 1993))).

<sup>26</sup> *Kranhold & Pacelle*, *supra* note 4.

<sup>27</sup> David Barboza, *Officials Got a Windfall Before Enron’s Collapse*, N.Y. TIMES, June 18, 2002, at C1.

<sup>28</sup> Nancy Rivera Brooks, *Enron Execs Were Paid To Remain*, L.A. TIMES, Dec. 7, 2001, at 3; Barnaby J. Feder, *Turmoil at WorldCom: The Executives*, N.Y. TIMES, June 29, 2002, at C3 (“Enron[s] . . . laid-off workers were receiving two weeks’ pay.”).

<sup>29</sup> *St. Onge*, *supra* note 4.

transaction in October 2002, Enron paid five top executives at Portland General Electric \$975,000 in retention bonuses, and was scheduled to award them another \$975,000 in June 2003.<sup>30</sup>

Although paid to remain, a number of executives who received retention bonuses were no longer with Enron as early as June 2002. Many retention bonus recipients apparently failed even to stay with the company for the ninety days required by their KERP agreements.<sup>31</sup> For example, Mark Haedicke, general counsel to Enron's wholesale unit, who received \$750,000 in retention bonuses, left Enron in the midst of its reorganization to work as a lawyer with UBS Warburg.<sup>32</sup> Similarly, John Lavorato, a top Enron manager who received \$5 million in retention bonuses, left Enron to work for UBS as a top trader.<sup>33</sup>

#### *WorldCom*

In July 2002, WorldCom filed for bankruptcy, owing creditors more than \$41 billion.<sup>34</sup> In 2000, prior to filing for bankruptcy, WorldCom paid 558 top executives approximately \$237 million in retention bonuses, averaging out to nearly \$425,000 per executive with some bonuses topping out at well over \$1 million.<sup>35</sup> As part of this plan, Bernard J. Ebbers, former CEO of WorldCom, received a \$10 million bonus and a severance package, which included a \$1.5 million annual payment for life, use of a company plane for thirty hours a year and medical insurance.<sup>36</sup>

In addition to retention bonuses paid out prior to bankruptcy, in October 2002, WorldCom sought and won, over the objections of creditors, shareholders, and employees, bankruptcy court approval to pay \$25 million in bonuses to 325 executives.<sup>37</sup> Executives covered under the plan received bonus payments in three installments equal to 35%–65% of their annual salaries, or about \$20,000 to \$125,000 per person.<sup>38</sup>

---

<sup>30</sup> Gail Kinsey Hill, *Five Top PGE Executives Receive Retention Bonuses from Enron*, OREGONIAN, Apr. 29, 2003, at A01.

<sup>31</sup> Kranhold & Pacelle, *supra* note 4.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> St. Onge, *supra* note 4.

<sup>35</sup> Feder, *supra* note 28.

<sup>36</sup> *Id.*

<sup>37</sup> St. Onge, *supra* note 4.

<sup>38</sup> *Id.*

*Kmart*

Kmart filed for bankruptcy in February 2002. In March 2002, Kmart sought and won bankruptcy court approval to pay up to \$150 million in bonuses to persuade executives to remain with the retailer through bankruptcy,<sup>39</sup> including a \$6.5 million bonus to Chuck Conaway, Kmart's former CEO.<sup>40</sup> Even while deep in bankruptcy, "Kmart exec[utives were] still living large and getting paid handsomely."<sup>41</sup>

*Polaroid*

After filing for bankruptcy in October 2001, Polaroid made a court-approved deal with creditors in December 2001 to pay out \$1.55 million in retention bonuses to forty-five executives.<sup>42</sup> In "contrast, just days before Polaroid filed for bankruptcy, it canceled health and life insurance for more than 6,000 retirees, and canceled health insurance coverage for workers on long term disability. It also [terminated] severance benefits for thousands of workers who were recently laid off."<sup>43</sup>

In addition, in April 2002, a bankruptcy court approved the payment of \$4.5 million in retention bonuses to forty executives.<sup>44</sup> The retention bonuses for the CFO, William Flaherty, and Senior Vice President, Neal Goldman, totaled 62.5% of their annual base

---

<sup>39</sup> *Id.*

<sup>40</sup> *Companies Crash, but CEOs Cash In*, TULSA WORLD, Mar. 3, 2002, at E1. Conaway was also previously the recipient of a \$4.3 million retention bonus in 2000 and a \$2 million retention bonus in 2001. Cheng, *supra* note 1. He also received, upon resignation, a \$5 million retention loan from the company. Nelson D. Schwartz, *Greed-Mart*, FORTUNE, Oct. 14, 2002, at 139. Moreover, before he resigned Conaway handed out \$30 million in retention loans to twenty-five top executives. *Id.*

<sup>41</sup> Schwartz, *supra* note 40 ("[E]ven if Kmart [went] down, [CEO James] Adamson [would] still walk away with a shopping cart full of cash."). Adamson received a \$2.5 million inducement payment to become Kmart's CEO. *Id.* In addition, his annual salary was \$1.5 million, and his guaranteed contractual perks included a "weekly private plane service between his residences in Detroit, New York, and Florida; a car and driver in Michigan and New York; and temporary accommodations at the swanky Townsend Hotel near Kmart headquarters. A standard room there costs \$320 a night." *Id.*

<sup>42</sup> *Polaroid Withdraws \$5 Million Bonus Plan To Retain Executives*, *supra* note 4.

<sup>43</sup> Press Release, Sen. Edward M. Kennedy, Senator Edward M. Kennedy Fights To Protect Americans from a Flawed Bankruptcy Bill (Feb. 17, 2005) [hereinafter Kennedy Press Release I], available at [http://kenedy.senate.gov/newsroom/press\\_release.cfm?id=0882831e-e21e-414c-8f78-70b2ff685f06](http://kenedy.senate.gov/newsroom/press_release.cfm?id=0882831e-e21e-414c-8f78-70b2ff685f06).

<sup>44</sup> *Polaroid Bonuses OK'd*, BOSTON GLOBE, Apr. 6, 2002, at C1.

salaries, and the bonuses for the remaining thirty-eight executives were equal to about 25% of their base salaries.<sup>45</sup>

### *Global Crossing*

After losing almost 90% of its stock market value during 2001, Global Crossing filed for bankruptcy in January 2002.<sup>46</sup> In April 2002, Global Crossing sought court approval to spend \$15 million to retain 300 executives<sup>47</sup> while “[m]any workers’ 401(k) retirement savings plans, loaded with company shares, became nearly worthless as the stock price sank.”<sup>48</sup> Moreover, immediately after it declared bankruptcy, Global Crossing stopped severance payments to previously laid-off workers.<sup>49</sup>

### *C. Congress Reacts*

Despite highly publicized and egregious KERP payments, Congress did not immediately respond. BAPCPA, as first introduced in the Senate by Senator Grassley (R-IA) and as referred to the Senate Judiciary Committee for approval, did not include § 503(c) or any other similar provision addressing KERPs.<sup>50</sup> The bill’s failure to address KERPs was brought to the attention of Congress during the Senate Judiciary Committee hearings by Dave McCall, Director of the United Steel Workers of America, AFL-CIO.<sup>51</sup> Highlighting the bill’s failure to address the problem of corporate abuse in bankruptcy generally and

---

<sup>45</sup> *Id.*

<sup>46</sup> *Companies Crash, but CEOs Cash In*, *supra* note 40.

<sup>47</sup> Leon Lazaroff, *Global Seeks \$15M for Retention Bonuses*, DAILY DEAL (New York), Apr. 12, 2002. “The proposed retention plan would provide \$10 million to about 300 employees and set aside \$5 million for a discretionary fund for employees deemed essential to the company’s reorganization efforts. According to the filing, the company’s chief executive, John Legere, would oversee the discretionary fund.” *Id.*

<sup>48</sup> *Companies Crash, but CEOs Cash In*, *supra* note 40. In the summer of 2001, James Welch, a fifty-five-year-old switching technician, held 6,200 Global Crossing shares in his 401(k), valued at about \$190,000. By March 2002, the value had plummeted to \$336. *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> See S. 256, 109th Cong. (as introduced in the Senate, Feb. 1, 2005). In fact, only a small section of the original bill, beginning on page 495 of the 501-page document, in any way addressed the topic of corporate abuse in bankruptcy. See *Bankruptcy Revision: Hearing Before the Comm. on Sen. Judiciary*, 109th Cong. (2005) [hereinafter *Hearing*] (statement of Dave McCall, Director, United Steel Workers of America, AFL-CIO).

<sup>51</sup> *Hearing*, *supra* note 50 (statement of Dave McCall, Director, United Steel Workers of America, AFL-CIO).

KERPs specifically, McCall called upon Congress to address, what he labeled, “notorious ‘KERPs.’”<sup>52</sup>

Heeding this call, Senator Edward Kennedy (D-MA) introduced § 503(c)<sup>53</sup> as an amendment to BAPCPA. Senator Kennedy, in a statement before the Senate Judiciary Committee,

---

<sup>52</sup> *Id.* McCall identified KERPs as “‘golden parachutes’ payable to the executives of a reorganizing company . . . rewarding them handsomely often after they have cut workers’ pay, reduced or eliminated retiree benefits, shuttered plants, and sold them off.” *Id.* He expressly called upon Congress to regulate KERP excess, noting that “[w]hen workers learn of a KERP . . . it puts our bankruptcy system in a bad light and often makes the difficult bargaining choices required in bankruptcy even harder to achieve.” *Id.*

<sup>53</sup> 11 U.S.C. § 503(c) (2000 & Supp. V 2005). Section 503(c) states:

Notwithstanding subsection (b), there shall neither be allowed, nor paid—

(1) a transfer made to, or an obligation incurred for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtor’s business, absent a finding by the court based on evidence in the record that—

(A) the transfer or obligation is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation;

(B) the services provided by the person are essential to the survival of the business; and

(C) either—

(i) the amount of the transfer made to, or obligation incurred for the benefit of, the person is not greater than an amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made or the obligation is incurred; or

(ii) if no such similar transfers were made to, or obligations were incurred for the benefit of, such nonmanagement employees during such calendar year, the amount of the transfer or obligation is not greater than an amount equal to 25 percent of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider for any purpose during the calendar year before the year in which such transfer is made or obligation is incurred;

(2) a severance payment to an insider of the debtor, unless—

(A) the payment is part of a program that is generally applicable to all full-time employees; and

(B) the amount of the payment is not greater than 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made; or

(3) other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition.

*Id.*

declared, “[i]f we’re going to pass a bankruptcy bill, let’s pass a real one. . . . [Let’s pass a] bill that cracks down on corporate executives who loot their companies at the expense of workers, retirees, creditors, and stockholders.”<sup>54</sup>

The language of § 503(c) is recycled. The exact language<sup>55</sup> first appeared as section 104 of the proposed Employee Abuse Prevention Act of 2002, introduced in the Senate by Senator Richard Durbin (D-IL), co-sponsored by Senator Patrick Leahy (D-VT), Senator Edward Kennedy (D-MA), Senator John Kerry (D-MA), and Senator John D. Rockefeller (D-WV) and introduced in the House by Congressman William Delahunt (D-MA).<sup>56</sup> Although never passed, the Employee Abuse Prevention Act of 2002 sought, among other things, to amend the Bankruptcy Code to limit retention bonuses and severance pay made for the benefit of an insider of the debtor<sup>57</sup> and to “empower[] bankruptcy judges and trustees to scrutinize and set aside transactions that strip companies of their assets and plunge them into bankruptcy.”<sup>58</sup>

The Senate Judiciary Committee adopted § 503(c) without recorded opposition and included it in the revised version of the BAPCPA bill sent to the Senate and House for ratification. Opposition to § 503(c), however, surfaced in both the Senate and House debates on the bill. Opponents voiced concern that the broad-brush language of § 503(c)(1) would not effectively address the problem and would prevent the responsible along with the irresponsible use of KERPs in Chapter 11 reorganization proceedings. As Senator Hatch stated on the Senate floor,

[Senator] Kennedy[] seeks to prevent unfair and unnecessary retention bonuses to insiders in Chapter 11 companies. The goal here is certainly laudable and I agree with the desire to try to do that, but it has come to light since our markup that this

---

<sup>54</sup> Kennedy Press Release I, *supra* note 43.

<sup>55</sup> Only a slight structural dissimilarity exists between § 104(c) as proposed in 2002 and § 503(c) as adopted in 2005. As proposed in 2002, the language included within the current § 503(c)(3) was divided between two paragraphs. *See* S. 2798, 107th Cong. (as introduced in the Senate, July 25, 2002).

<sup>56</sup> *See id.*; H.R. 5221, 107th Cong. (as introduced in the House, July 25, 2002).

<sup>57</sup> *See* S. 2798.

<sup>58</sup> Rep. William Delahunt, Statement of the Honorable William D. Delahunt of Massachusetts Regarding the Introduction of the Employee Abuse Prevention Act of 2002 (Aug. 1, 2002), *available at* <http://www.house.gov/delahunt/EAPA.shtml> (stating that the bill “enables courts to recover excessive retention bonuses” and “to hold corporate officeholders to the same standard of responsibility and accountability they have been preaching to people of more modest means”).

amendment may act to effectively prohibit responsible companies undergoing reorganization . . . from keeping key employees who may best be able to steer the company back into solvency.<sup>59</sup>

Congressman Chris Cannon reiterated a similar concern in the House debate on the bill:

It is very important that a Chapter 11 debtor be able to retain management that is dedicated to maintaining the company's value for the benefit of its creditors, investors, employees, and other stakeholders. . . . [Section 503(c)] should not be applied to invalidate such programs where there is no evidence of insider negligence, mismanagement, or fraudulent conduct contributed to a company's insolvency—in whole or in part.<sup>60</sup>

Concern about § 503(c)(1)'s blanket restriction on KERPs was not limited to Congress. In a letter read into the Congressional Record on March 9, 2005, by Senator Hatch, the Association of Insolvency and Restructuring Advisors wrote: "It is apparent that the Kennedy amendment is designed to prevent abuses of the system . . . . Unfortunately, [§ 503(c)(1)] goes too far and should be amended so as not to unnecessarily limit the bankruptcy court's ability to determine what is in the best interest of each individual bankruptcy estate."<sup>61</sup>

In an attempt to remedy the perceived deficiency of § 503(c), Senator Hatch proposed limiting § 503(c)(1)'s restriction to "payments where 'misconduct, fraud, or mismanagement' [were] present."<sup>62</sup> Such modifications, however, were not adopted or included in the final version of the bill approved by Congress and signed into law by President George W. Bush on April 20, 2005.

---

<sup>59</sup> 151 CONG. REC. S2340 (daily ed. Mar. 9, 2005) (statement of Sen. Hatch), 151 Cong Rec S 2306, at \*S2340 (LEXIS).

<sup>60</sup> 151 CONG. REC. H2050-51 (daily ed. Apr. 14, 2005) (statement of Rep. Cannon), 151 Cong Rec H 1993, at \*2050-51 (LEXIS).

<sup>61</sup> 151 CONG. REC. S2341 (daily ed. Mar. 9, 2005) (statement of Sen. Hatch), 151 Cong Rec S 2306, at \*S2341 (LEXIS).

<sup>62</sup> *Id.*

## II. THE CURRENT STATE OF AFFAIRS

A. *Section 503(c)(1) Closed One Door but Opened Another*

For all practical purposes § 503(c)(1) has eliminated KERPs as a viable option for debtors in reorganization.<sup>63</sup> Section 503(c)(1) prohibits the payment of sums to an insider “for the purpose of inducing such person to remain with the debtor’s business”<sup>64</sup> through reorganization, unless the debtor can demonstrate (1) that such payment is “essential to retention” because that person “has a bona fide job offer from another business at the same or greater rate of compensation”;<sup>65</sup> (2) that the services provided by the individual “are essential to the survival of the business”;<sup>66</sup> and (3) that the payment is either “not greater than an amount equal to 10 times the amount” of a retention bonus paid to non-management employees, or, if no such transfer was made to non-management, “is not greater than an amount equal to 25 percent of the amount” of a similar retention bonus paid to the executive during the previous year.<sup>67</sup> While technically a KERP is permissible if the above three requirements are satisfied, fulfilling such requirements is an onerous, if not impossible, task.<sup>68</sup> Thus, in effect, § 503(c)(1) is a blanket prohibition on KERPs.

---

<sup>63</sup> See Turner & Gellert, *supra* note 14 (“[I]t seems safe to assume that, for all practical purposes, the ‘retention bonus’ notion has been effectively eradicated under the Bankruptcy Code.”).

<sup>64</sup> 11 U.S.C. § 503(c)(1) (2000 & Supp. V 2005).

<sup>65</sup> *Id.* § 503(c)(1)(A). To satisfy this requirement, top executives would be required to search for and secure a bona fide job offer, resulting in lost productivity for the bankrupt company and ultimately, more often than not, in the executive leaving to go to the viable company that has offered him or her the same or greater compensation. See *In re Dana Corp.*, 358 B.R. 567, 575 n.11 (Bankr. S.D.N.Y. 2006). Moreover, the debtor corporation would be required to prove in court that the executive will take the alternate job offer without a KERP to induce him or her to stay. See *id.* This “nears absurdity” because “[i]t raises the question, Who would ever agree to remain with a sinking ship when a solvent company has made a competing job offer?” Turner & Gellert, *supra* note 14.

<sup>66</sup> 11 U.S.C. § 503(c)(1)(B). However, for a debtor in reorganization, the goal is not survival, but value maximization. See *In re Dana*, 358 B.R. at 575 n.11. Therefore, even if the debtor can prove that the corporation will be unable to maximize its value without the executive, it must nonetheless satisfy the more rigorous, but far less meaningful, requirement of proving that the corporation cannot survive without the executive in order to get court approval for a KERP. See *id.*

<sup>67</sup> 11 U.S.C. § 503(c)(1)(C).

<sup>68</sup> See *In re Dana*, 358 B.R. at 575 n.11; Turner & Gellert, *supra* note 14 (“[I]t is highly unlikely any debtor would ever propose a plan under this section, let alone

In an attempt to circumvent § 503(c)(1)'s prohibition, debtor corporations are restructuring and re-characterizing KERPs as incentive bonus plans. Incentive bonus plans require executives to reach certain productivity levels and performance goals before receiving their bonuses. The emergence of such plans has raised the issue of whether incentive bonus plans are merely recast KERPs essentially "for the purpose of inducing [an insider] to remain with the debtor's business"<sup>69</sup> and therefore prohibited under § 503(c)(1), or whether incentive bonus plans are only incidentally retentive and therefore not restricted by § 503(c)(1).<sup>70</sup>

*B. Competing Claims—Arguments For and Against Allowing Incentive Bonus Plans Under § 503(c)(1)*

Debtor corporations assert that incentive bonus plans, which are primarily incentivizing and only incidentally retentive, are not prohibited under § 503(c)(1). Section 503(c)(1), they argue, must be read narrowly to foreclose only payments made to executives for the *sole* or *primary* purpose of inducing them to remain with the corporation<sup>71</sup> and cannot be read to "prohibit compensation programs that reward executives for superior performance or that incorporate specific short-term and long-term performance metrics."<sup>72</sup> A broad reading of § 503(c)(1)'s prohibition, they argue, would effectively take away their ability to compensate executives in reorganization altogether because a basic purpose of all compensation, including salaries, bonuses, and benefits, is to encourage executives to come back to work

---

meet its standards."). Moreover, even if the debtor has satisfactorily demonstrated all of the above, the amount of the proposed KERP is severely limited. See 11 U.S.C. § 503(c)(1)(C).

<sup>69</sup> 11 U.S.C. § 503(c)(1).

<sup>70</sup> See *In re Dana*, 358 B.R. at 576.

<sup>71</sup> See Omnibus Reply to Objections to Motion of Debtor Dana Corporation, Pursuant to Sections 363, 365, and 105 of the Bankruptcy Code, for an Order Authorizing Dana Corporation to Enter into Employment Agreements with Michael J. Burns, its President and Chief Executive Officer, and Five Key Executives of his Core Management Team at 21, *In re Dana*, 358 B.R. at 576 (No. 06-10354) [hereinafter Omnibus Reply to Objections to Motion of Debtor Dana Corporation].

<sup>72</sup> *Id.* at 19, 21 ("[D]ebtors maintain the right to establish, or continue, incentive compensation programs that tie executive pay to the accomplishment of corporate goals.").

each day. This, they assert, would be both an absurd and dangerous result.<sup>73</sup>

Moreover, debtor corporations argue that keeping knowledgeable executives on board during reorganization is critical to the success of reorganization. Executives have essential knowledge and business skills, including institutional familiarity and client contacts, which are invaluable in reorganization. Because such skills are extremely valuable to viable corporations in the open market, to remain competitive debtor corporations assert that they must retain the means to compensate executives at a comparable and attractive level to counteract the lack of financial and job security inherent in reorganization.<sup>74</sup>

Furthermore, debtor corporations argue that “[b]y grafting insider-targeted, goal-driven payments onto an incentive plan and excising the tenure-based ‘retention’ requirement that traditionally has been the cornerstone of a” KERP,<sup>75</sup> an incentive bonus plan is a completely transformed approach to executive compensation. Incentive bonus plans seek to “include measurable and identifiable milestones based on challenging but achievable financial, operational, or procedural benchmarks,”<sup>76</sup> and therefore are fundamentally different than KERPs and allowable under § 503(c)(1).

United States trustees, creditors, shareholders, and employees, on the other hand, strongly disagree. They assert that incentive bonus plans are nothing more than repackaged retention plans and, as such, are expressly prohibited under § 503(c)(1). They argue that incentive bonus plans, although labeled “incentivizing,” have terribly low performance thresholds

---

<sup>73</sup> *Id.* at 20 (finding that reading § 503(c)(1) as prohibiting all such compensation would lead to the absurd result of not paying executives at all).

<sup>74</sup> See Debtors’ Motion for an Order Authorizing the Implementation of the Calpine Incentive Program at 5, *In re Calpine Corp.*, No. 05-60200 (BRL), 2008 Bankr. LEXIS 2152 (Bankr. S.D.N.Y. filed Apr. 6, 2006) (“Preserving and enhancing the value of the [d]ebtors’ estates depends on maintaining the focus, morale and loyalty of [executives] through the provision of market-competitive compensation.”).

<sup>75</sup> Ronald F. Greenspan & Matthew Pakkala, *KERPs Are Out, but Incentives Are In: Insider Retention Under BAPCPA*, J. CORP. RENEWAL, Aug. 2006, at 1, available at [http://www.fticonsulting.com/media/1642/KERPs\\_Are\\_Out\\_But\\_Incentives\\_Are\\_In.pdf](http://www.fticonsulting.com/media/1642/KERPs_Are_Out_But_Incentives_Are_In.pdf).

<sup>76</sup> *Id.* (“Examples [of benchmarks] include targets based on earnings before interest, taxes, depreciation, and amortization (EBITDA); cash-flow reductions; process improvements; asset sales; and successful plan confirmation.”).

and fanciful productivity goals<sup>77</sup> and therefore “exhibit[] all of the evils that . . . [§ 503(c)] of the Bankruptcy Code w[as] intended to eradicate.”<sup>78</sup>

Moreover, United States trustees, creditors, shareholders, and employees assert that regardless of the performance level specified, incentive bonus plans are categorically prohibited under § 503(c)(1). Advocating an expansive reading of § 503(c)(1), these groups assert that incentive bonus plans are prohibited, because a purpose of such plans is to induce executives to remain.

Furthermore, as a matter of policy, United States trustees, creditors, shareholders, and employees argue that when Congress amended BAPCPA to include § 503(c)(1), Congress intended to prevent corporate abuse in bankruptcy, specifically to prevent excessive executive compensation in reorganization.<sup>79</sup> Incentive bonus plans circumvent this spirit of and intent behind § 503(c)(1) by providing debtor corporations with an unchecked avenue by which to induce executives to remain. Therefore, to stay true to Congress’ legislative intent, they argue, § 503(c)(1) must be read to prohibit incentive bonus plans, the latest corporate creation to effectuate executive excesses.

### III. ARE INCENTIVE BONUS PLANS ALLOWABLE UNDER § 503(C)(1)?

While conceived as a broad remedy to corporate abuse in bankruptcy, specifically excessive executive compensation, as written § 503(c)(1) is only a narrow fix to a specific problem—the payment of bonuses to reward executives exclusively for remaining with a corporation during reorganization. As a consequence, incentive bonus plans, which are not exclusively for the purpose of inducing an executive to remain with the

---

<sup>77</sup> See Objection of the Official Committee of Equity Security Holders with Respect to Debtors’ Motion for an Order Authorizing Dana Corporation to (A) Enter into Employment Agreements with Michael J. Burns, its President and CEO, and Five Key Executives of his Core Management Team, and (B) Assume Certain Change of Control Agreements, as Amended at 3, *In re Dana Corp.*, 351 B.R. 96 (Bankr. S.D.N.Y. 2006) (No. 06-10354) (“[T]he enterprise value milestones for payment of the ‘incentive’ portion of the Completion Bonus, if approved, would reward the [e]xecutives for preserving the [d]ebtors’ current mediocre financial performance.”).

<sup>78</sup> *Id.* at 2.

<sup>79</sup> See *supra* Part I.C.

corporation through reorganization, do not fall within § 503(c)(1)'s express statutory prohibition and therefore are not prohibited.

Executive compensation plans simply labeled “incentive bonus plans,” however, are not allowed under § 503(c)(1). Section 503(c)(1) expressly prohibits payments “for the purpose of inducing . . . [an insider] to remain”;<sup>80</sup> therefore, if an incentive bonus plan sets forth no performance goals or negligible productivity levels, it is—despite its label—nothing more than a retention payment and as such is prohibited under the statutory language of § 503(c)(1). Only transfers which are truly primarily incentivizing and only coincidentally retentive therefore remain viable under § 503(c)(1).

Although not prohibited by the current statutory language of § 503(c)(1), incentive bonus plans, developed to side-step § 503(c)(1)'s restrictions, violate the spirit of and intent behind BAPCPA—to curb corporate abuse in bankruptcy. Incentive bonus plans, like KERPs, can be readily abused if left unmonitored. The bankruptcy courts and Congress must be cognizant of abuses and address incentive bonus plans with an eye towards balancing the need to prevent abuses with the need to fairly compensate executives in reorganization.

#### A. *Statutory Language*

Whether incentive bonuses are subject to the limitations of § 503(c)(1) turns, in large part, on the statutory meaning of § 503(c)(1)'s language, specifically the phrase “transfers made . . . for the purpose of inducing [insiders] to remain with the debtor's business.”<sup>81</sup> Two alternative interpretations are advanced. The first broadly construes the phrase “for the purpose of” to mean “for a purpose” or “for one purpose.” Under this interpretation, since “a” or “one” purpose of an incentive plan is to retain key executives, the plan is subject to the § 503(c)(1) restriction. The second possible interpretation narrowly construes the phrase “for the purpose of” to mean “for the sole purpose” or “for the primary purpose.” Under this interpretation, since the “sole” or “primary” purpose of an incentive plan is not to retain key executives, but is rather to reward them for achieving

---

<sup>80</sup> 11 U.S.C. § 503(c)(1) (2000 & Supp. V 2005).

<sup>81</sup> *Id.*

certain productivity goals, the plan is not prohibited under § 503(c)(1).

When interpreting a statute, a court must “begin with the understanding that Congress ‘says in a statute what it means and means in a statute what it says there.’”<sup>82</sup> “When a statute’s language is clear, [a court’s] only role is to enforce that language according to its terms.”<sup>83</sup> The court is not free to apply the statute the way it thinks Congress wanted to write it; it must apply the statute the way it was written. When interpreting the written text, “[i]t is a cardinal principle of statutory construction that a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant.”<sup>84</sup> In other words, “[i]t is [a court’s] duty ‘to give effect, if possible, to every clause and word of a statute.’”<sup>85</sup> Moreover, as a general rule “[u]nless otherwise defined, statutory terms are generally interpreted in accordance with their ordinary meaning.”<sup>86</sup>

The word choice, punctuation placement, and phrase construction therefore all illuminate the statute’s meaning. In this case, the article “the” is particularly significant. “[I]t is a rule of law well established that the definite article ‘the’ particularizes the subject which it precedes. It is a word of limitation as opposed to the indefinite or generalizing force of ‘a’ or ‘an.’”<sup>87</sup> By preceding the word “purpose” in § 503(c)(1) with the definite article “the” as opposed to the general article “a,” the statute is narrowed to restrict only transfers made for the specific purpose of “inducing [an insider] to remain with the

---

<sup>82</sup> *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000) (quoting *Conn. Nat’l Bank v. Germain*, 503 U.S. 249, 254 (1992)).

<sup>83</sup> *Arciniaga v. Gen. Motors Corp.*, 460 F.3d 231, 236 (2d Cir. 2006) (internal quotation marks omitted); see *BedRoc Ltd. v. United States*, 541 U.S. 176, 183 (2004) (“[A court’s] inquiry begins with the statutory text, and ends there as well if the text is unambiguous.”).

<sup>84</sup> *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) (internal quotation marks omitted).

<sup>85</sup> *United States v. Menasche*, 348 U.S. 528, 538–39 (1955) (quoting *Inhabitants of Montclair Twp. v. Ramsdell*, 107 U.S. 147, 152 (1883)).

<sup>86</sup> *BP Am. Prod. Co. v. Burton*, 127 S. Ct. 638, 643 (2006).

<sup>87</sup> *Am. Bus Ass’n v. Slater*, 231 F.3d 1, 4–5 (D.C. Cir. 2000) (quoting *Brooks v. Zabka*, 450 P.2d 653, 655 (Colo. 1969) (en banc)); see also BLACK’S LAW DICTIONARY 1647 (4th ed. 1968) (“The [is a]n article which particularizes the subject spoken of.”); MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY 1221 (10th ed. 1997) (“The . . . [is] used as a function word to indicate that a following noun or noun equivalent is a unique or a particular member of its class . . .”).

debtor's business."<sup>88</sup> Congress' use of the definite article "the" particularizes and limits the § 503(c)(1) restriction to retention payments only.<sup>89</sup> Transfers which are primarily incentivizing and only coincidentally retentive, therefore, are not prohibited by the language of § 503(c)(1).

### B. *Statutory Intent and Purpose*

Though the statutory language is narrow, the intent of Congress in enacting the statute was broad. As its name suggests, the Bankruptcy Abuse Prevention and Consumer Protection Act was intended to deal with "people who abuse

---

<sup>88</sup> 11 U.S.C. § 503(c)(1) (2000 & Supp. V 2005).

<sup>89</sup> Undertaking a similar interpretative approach, the United States Court of Appeals for the District of Columbia Circuit, in *American Bus Ass'n v. Slater*, reversed the district court's determination that the language of 42 U.S.C. § 12188(a)(1), the enforcement provision of the Americans with Disabilities Act, was broad enough to authorize the Department of Transportation to impose money damages against non-compliant bus companies. *See Slater*, 231 F.3d at 2. Section 12188(a)(1) provides that

[t]he remedies and procedures set forth in section 2000a-3(a) of this title are *the remedies and procedures* this subchapter provides to any person who is being subjected to discrimination on the basis of disability in violation of this subchapter or who has reasonable grounds for believing that such person is about to be subjected to discrimination in violation of section 12183 of this title.

42 U.S.C. § 12188(a)(1) (2000) (emphasis added).

In overturning the district court's broad interpretation of the statutory language, the Circuit Court held that "[b]y preceding the words 'remedies and procedures' with the definite article 'the,' as opposed to the more general 'a' or 'an,' Congress made clear that it understood § 2000a-3(a)'s remedies to be exclusive." *Slater*, 231 F.3d at 4. "The ADA's carefully crafted remedies scheme reveals the legislature's intent that the statute's enumerated remedies were to be exclusive, and consequent intent to deny agencies the power to authorize supplementary monetary relief." *Id.*

Utilizing an analogous interpretive method, Justice Scalia, in his concurring opinion in *Freytag v. Commissioner of Internal Revenue*, 501 U.S. 868 (1991), reached a similar conclusion regarding the impact of the definite article "the" on the meaning of the Appointments Clause. The Appointments Clause provides that "Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in *the Courts of Law*, or in the Heads of Departments." U.S. CONST. art. II, § 2, cl. 2 (emphasis added). In reviewing the statutory language, Justice Scalia concluded that

[t]he Clause does not refer generally to "Bodies exercising judicial Functions," or even to "Courts" generally, or even to "Courts of Law" generally. It refers to *the Courts of Law*." Certainly this does not mean *any* "Cour[t] of Law" (the Supreme Court of Rhode Island would not do). The definite article "the" obviously narrows the class of eligible "Courts of Law" . . . .

*Freytag*, 501 U.S. at 902.

the . . . bankruptcy system . . . [specifically] with the truly incredible abuses . . . seen in the Enron case, in the Worldcom case, in the Adelphia case and the Polaroid case.”<sup>90</sup> It is clear from Senator Kennedy’s statements introducing § 503(c)(1) that he intended the section to address the issue of corporate abuse in bankruptcy, specifically, “[c]orporate fraud and mismanagement [that] have forced many companies into bankruptcy, . . . [e]xecutives [who have] lined their own pockets [while] the employees and pensioners were left twisting in the wind [and] the real abuse by formerly wealthy bankrupts who game the system.”<sup>91</sup>

While Congress set out to write BAPCPA mindful of the “corporate mismanagement and fraud [that] ha[d] become a way of life in the highest echelons of corporate America,”<sup>92</sup> the broad and laudable intention to curb corporate abuse in bankruptcy did not translate into an effective far-reaching statutory solution; rather, it translated into the narrow KERP restrictions of § 503(c)(1).<sup>93</sup> The narrow language of § 503(c)(1) cannot be expanded *sua sponte* to bring about Congress’ broad intentions. Stretching the clearly narrow text of the statute to cover all transfers with a merely incidental retentive effect, without clear congressional direction, would lead to unintended and undesirable results—prohibiting all transfers to all insiders in the course of reorganization, including wages, health insurance coverage, bonuses, and pension plans.

---

<sup>90</sup> Press Release, Sen. Edward M. Kennedy, Statement of Senator Edward M. Kennedy on the Bankruptcy Bill (Mar. 1 2005) [hereinafter Kennedy Press Release II], available at <http://kennedy.senate.gov/newsroom/statement.cfm?id=23fddd97-41c4-4265-92d7-fc3262a8f0c7>. As Senator Durbin stated on the Senate floor, “[w]ouldn’t one think in a bankruptcy bill we would go after some of these corporate bankrupt cheaters? Wouldn’t one think we would go after these CEOs and officers who got hundreds of millions of dollars from these corporations[?] . . . It is time we went after those Enron cheaters.” 151 CONG. REC. S1818-01 (2005) (statement of Sen. Durbin), 2005 WL 473772.

<sup>91</sup> Kennedy Press Release I, *supra* note 43.

<sup>92</sup> Kennedy Press Release II, *supra* note 90.

<sup>93</sup> “As usual, Congress used a meat cleaver for delicate surgery, resulting in foreseeable consequences—*i.e.* clever lawyers finding ways through the new legislation.” THOMAS J. SALERNO, AM. BANKR. INST., COMP AND BONUS ISSUES UNDER THE NEW CODE, INCLUDING PENSION BENEFITS AND UNION CONTRACTS (2006), available at 060907 ABI-CLE 31 (West).

*C. Bankruptcy Court Precedent*

In the limited instances where the bankruptcy courts have addressed the scope of § 503(c)(1), their holdings reflect a narrow reading of the statute. The bankruptcy courts generally agree that incentive bonus plans have merely incidental retentive effects and are therefore not prohibited under § 503(c)(1).

*In re Dana Corporation I*<sup>94</sup>

On March 3, 2006, the debtor, Dana Corporation,<sup>95</sup> filed a voluntary Chapter 11 bankruptcy petition.<sup>96</sup> As part of its reorganization plan, Dana sought approval for an incentivizing compensation plan for its CEO and five executives.<sup>97</sup> The proposed plan included both “Annual Incentive Bonuses” conditioned on the company’s short-term financial performance<sup>98</sup> and “Target Completion Bonuses,” which included both a fixed bonus,<sup>99</sup> payable in cash without regard to performance or creditor recovery as long as the executives remained with the company, and an uncapped variable bonus based on the Total Enterprise Value<sup>100</sup> of the company at the start of reorganization and six months after that date.<sup>101</sup>

The Creditors’ Committee and the United Steel, Paper and Forestry, Rubber, Manufacturing, Energy, Allied Industrial Service Workers International Union objected to Dana’s plan, asserting that the plan was a KERP prohibited under § 503(c)(1).<sup>102</sup> Upon review of the plan, the bankruptcy court agreed. Judge Lifland held that without tying the fixed

---

<sup>94</sup> 351 B.R. 96 (Bankr. S.D.N.Y. 2006).

<sup>95</sup> Dana Corporation is one of the “leading suppliers of modules, systems and components for original equipment manufacturers and service customers in the light, commercial and off-highway vehicle markets.” *Id.* at 98.

<sup>96</sup> *Id.*

<sup>97</sup> *Id.*

<sup>98</sup> *Id.* at 99. The annual incentive bonuses proposed for the five executives ranged from \$336,000 to \$528,000. *Id.* The annual incentive bonus proposed for the CEO was \$2.07 million. *Id.*

<sup>99</sup> The fixed bonuses proposed ranged from \$400,000 to \$560,000 for each of the five executives and \$3.1 million for the CEO. *Id.*

<sup>100</sup> Under this component, the CEO would earn \$6.2 million if the debtor’s total enterprise value remained at \$2.6 billion and would earn \$4.133 million if the debtor’s total enterprise value went down to \$2 billion. *Id.* This bonus was payable in common stock of the reorganized Dana as long as the stock was listed and readily tradeable, or else the amounts were payable in cash. *Id.* at 99–100.

<sup>101</sup> *Id.*

<sup>102</sup> *Id.* at 98.

completion bonus to something other than the executive remaining with the debtor until its emergence from reorganization, the plan could not be categorized as an incentive bonus and was nothing more than a KERP prohibited under § 503(c)(1).<sup>103</sup>

Judge Lifland, however, qualified his holding. He asserted that in so holding he did “not find that incentivizing plans which may have *some* components that arguably have a retentive effect, necessarily violate section 503(c)’s requirements.”<sup>104</sup> In other words, Judge Lifland narrowly interpreted § 503(c)(1)’s prohibition as extending to those payments, such as the fixed completion bonus, whose sole purpose, although not labeled as such, was retention, but not as extending to primarily incentivizing bonus plans contingent on the attainment of performance levels that nonetheless have “some” retentive effect.

*In re Dana Corporation II*<sup>105</sup>

On Dana’s second go-round before Judge Lifland, it proposed and sought approval for a reformulated executive compensation plan. The reformulated plan replaced the problematic retentive Target Completion Bonuses discussed above with a “Long-Term Performance Based Incentive Plan” (“LTIP”).<sup>106</sup> The LTIP conditioned the executives’ receipt of bonuses on the attainment of certain “Earnings Before Interest, Taxes, Depreciation, Amortization and Restructuring Costs” (“EBITDAR”).<sup>107</sup> Thus under the LTIP, there were no guaranteed payments.<sup>108</sup>

---

<sup>103</sup> *Id.* at 102 n.3 (“If it walks like a duck (KERP) and quacks like a duck (KERP), it’s a duck (KERP).”).

<sup>104</sup> *Id.* at 103 (“While it may be possible to formulate a compensation package that passes muster under the section 363 business judgment rule or section 503(c) limitations, or both, this set of packages does neither.”).

<sup>105</sup> 358 B.R. 567 (Bankr. S.D.N.Y. 2006).

<sup>106</sup> *Id.* at 570.

<sup>107</sup> *Id.* at 574. In order for the CEO to qualify for the minimum LTIP of \$3 million, the company had to achieve a 2007 EBITDAR of \$250 million. *Id.* For each \$100 million increase in EBITDAR, the CEO would receive an additional \$750,000, with a maximum payout of \$4.5 million in 2007. *Id.* The first \$3 million would be paid in cash after the company’s emergence from bankruptcy, and any additional amounts would be paid in stock of the reorganized company. *Id.* If all EBITDAR goals were reached over a three-year period, LTIP bonuses would total \$11 million (\$5 million in cash) to the six executives. *Id.*

<sup>108</sup> *Id.*

By requiring executives to reach EBITDAR benchmarks that were “difficult targets to reach and [we]re clearly not ‘lay-ups’”<sup>109</sup> before they became eligible for any bonus payment, Judge Lifland held that the reformulated compensation plan was an incentive plan. Reiterating that “a true incentive plan may not be constrained by 503(c) limitations [and that] merely because a plan has some retentive effect does not mean that the plan, overall, is retentive rather than incentivizing in nature,”<sup>110</sup> Judge Lifland concluded that the revised compensation plan was not subject to the § 503(c)(1) prohibition and would be approved if it was “a fair and reasonable exercise of business judgment.”<sup>111</sup>

*In re Global Homes Products, LLC*<sup>112</sup>

Global Home Products<sup>113</sup> filed a voluntary petition for relief under the Bankruptcy Code on April 10, 2006.<sup>114</sup> As part of its reorganization, the debtor sought court approval for a Management Incentive Plan,<sup>115</sup> which awarded each eligible employee up to four quarterly incentive payments if the debtor attained either certain minimum EBITDAR or cash flow benchmarks,<sup>116</sup> and a Sales Bonus Plan,<sup>117</sup> which entitled certain sales managers to receive up to thirty percent of their annual base salaries plus a fifteen percent target bonus percentage payment if the debtor attained either certain minimum EBITDAR or cash flow benchmarks.<sup>118</sup>

Calculated to achieve certain performance results for the benefit of the debtor and virtually identical to pre-petition

---

<sup>109</sup> *Id.* at 583.

<sup>110</sup> *Id.* at 571.

<sup>111</sup> *Id.* at 583.

<sup>112</sup> 369 B.R. 778 (Bankr. D. Del. 2007).

<sup>113</sup> Global Home Products LLC is a designer and manufacturer of consumer and specialty products which it markets to retail customers, hospitality customers, and original equipment manufacturers. *Id.* at 780.

<sup>114</sup> *Id.*

<sup>115</sup> *Id.*

<sup>116</sup> *Id.* at 780. To be eligible for such bonuses the employee had to be employed by the debtor on the last day of the particular quarter in which the bonus was being paid for. *Id.* at 781. Debtors estimate that this Plan’s total cost will range between \$890,000, if the minimum EBITDAR and cash flow objectives are achieved, and \$2.7 million, if the maximum are achieved. *Id.*

<sup>117</sup> *Id.* at 779.

<sup>118</sup> *Id.* at 781.

plans,<sup>119</sup> the proposed compensation plans, the bankruptcy court concluded, were incentive, not retention, plans.<sup>120</sup> Distinguishing plans whose primary purpose was retention from those whose primary purpose was motivation with incidental retentive effect, the court held that the proposed compensation plans were not prohibited by § 503(c)(1) because “the purpose” of such plans was not to induce the executive to remain with the debtor through reorganization.<sup>121</sup>

*In re Nellson Nutraceutical, Inc.*<sup>122</sup>

On January 28, 2006, Nellson Nutraceutical, Inc.<sup>123</sup> voluntarily filed under Chapter 11.<sup>124</sup> As part of its reorganization plan, the debtor proposed and sought approval for an “Ordinary Course Employee Bonus Compensation Program,” covering about 130 to 140 employees divided into six levels, for the purpose of “keep[ing] momentum going forward . . . in both sales and EBITDA.”<sup>125</sup> Under this plan \$2.1 million was made available as bonuses if certain levels were achieved.<sup>126</sup>

The debtor, however, failed to achieve the lowest target EBITDAR set out in the plan, thereby technically prohibiting the payment of bonuses proposed in the plan. However, with court approval, the debtor modified the plan to allow for the payment of the bonuses as if the levels had been achieved.<sup>127</sup> The United States trustee vigorously opposed the court’s approval of such

---

<sup>119</sup> *Id.* at 786. The court inferred from the fact that the proposed compensation plans were virtually identical to pre-petition compensation plans that retention was clearly not the primary motive of the proposed plans. *Id.*

<sup>120</sup> *Id.* “The Court [was] fully satisfied . . . that Debtors [we]re asking it to approve incentive, not retention plans . . .” *Id.* at 787. Moreover, “[t]he fact . . . that all compensation has a retention element d[id] not reduce the Court’s conviction that Debtor’s primary goal [was] to create value by motivating performance.” *Id.* at 786.

<sup>121</sup> *Id.* at 785–87 (“Section[] 503(c)(1) . . . [is] plainly [a] high hurdle[] to clear if payments are primarily designed for retention. [But t]he entire analysis changes if a bonus plan is not primarily motivated to retain personnel . . .”).

<sup>122</sup> 369 B.R. 787 (Bankr. D. Del. 2007).

<sup>123</sup> Nellson Nutraceutical, Inc. and its affiliates are contract manufacturers of nutritional bars and powders. *Id.* at 791.

<sup>124</sup> *Id.* Prior to filing for bankruptcy, the debtor implemented KERPs for nine management employees totaling \$710,000. *Id.* Immediately after filing, however, the debtor replaced the KERPs with a Management Incentive Plan, which linked \$1.4 million in bonuses to the achievement of certain EBITDAR performance milestones. *Id.* at 791–92. This plan was approved by the court in a prior proceeding. *Id.* at 792.

<sup>125</sup> *Id.* at 790–92.

<sup>126</sup> *Id.* at 792.

<sup>127</sup> *Id.* at 793–97.

bonuses, arguing that “if an incentive plan is based on achievement of EBITDA targets and those targets are not achieved, yet the bonus is still received, . . . the plan cannot be an incentive plan but must, in fact, be solely a retention plan.”<sup>128</sup> The court disagreed. It determined that the sole or primary purpose of the Ordinary Course Bonuses was motivation and not retention, regardless of whether the bonuses were in fact paid because the set levels were achieved.<sup>129</sup>

Finding that the bonus plan was not for the primary purpose of inducing the executives to remain, the court held that § 503(c)(1) did not apply.<sup>130</sup> Reasoning that “when the statute’s language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms,”<sup>131</sup> the court concluded that “[a]ny payment to an employee, including regular wages, has at least a partial purpose of retaining the employee. Therefore . . . all payments to insiders would be subject to 503(c)(1), which would be an absurd result.”<sup>132</sup> To avoid such an absurd result, the court read § 503(c)(1) narrowly as prohibiting only those transfers whose primary purpose was to induce an insider to remain.<sup>133</sup>

#### *D. Keeping a Watchful Eye: Suggestions for a Solution*

Section 503(c)(1), which narrowly prohibits the payment of retention bonuses to executives in reorganization, is an important first step toward achieving Congress’ stated goal of curbing corporate abuse in bankruptcy, specifically excessive executive compensation in reorganization. Executives should not be isolated and protected to such an extent that they need only agree to stay on with the company through reorganization to be paid exceedingly generous bonuses. There are important reasons to keep executives onboard during reorganization—executives have the institutional knowledge necessary to maximize creditor

---

<sup>128</sup> *Id.* at 803.

<sup>129</sup> *Id.* (“[The Debtor] determined that the 2006 [Ordinary Course Payment] served its purpose by motivating the employees to do a ‘great job’ . . . . As such, the Debtors seek to award bonuses at a reduced level to compensate the employees for their success (albeit somewhat limited) in 2006 and to motivate the employees in 2007.”).

<sup>130</sup> *Id.* at 801-02.

<sup>131</sup> *Id.* at 801.

<sup>132</sup> *Id.* at 802.

<sup>133</sup> *Id.*

return and the vital client contact necessary to sustain and improve productive components of the company. Nevertheless, executives are only truly valuable to a debtor corporation in reorganization when they put their unique knowledge and skills to work moving the company toward solvency. An executive, therefore, should be required to do more than simply remain with the debtor corporation to receive a bonus. By altogether prohibiting the payment of purely retentive bonuses under § 503(c)(1), Congress has forced debtor corporations to require just that. The result—incentive bonus plans.

Incentive bonus plans are a vast improvement over KERPs; however, if treated in the same exceedingly deferential manner as pre-BAPCPA KERPs, incentive bonus plans are susceptible to the same abuse. For this reason, the bankruptcy courts, primarily, and Congress, secondarily and only if necessary, should proactively monitor and regulate incentive bonus plans. Putting bankruptcy courts at the forefront of regulating the new breed of executive compensation will allow incentive bonus plans to be dealt with on a case-by-case basis, avoiding the problems that result from wholesale congressional action.

In regulating incentive bonus plans, the bankruptcy courts must balance the need to compensate executives in reorganization with the need to curb abuse. To achieve this balance, bankruptcy courts should first distinguish among incentive bonus plans with non-existent performance levels, plans with terribly low performance levels, and plans with challenging yet attainable performance levels.

Incentive bonus plans with no specified performance levels should be re-characterized and treated as KERPs. Similar to the approach taken by Judge Lifland to Dana's initial executive compensation plan,<sup>134</sup> incentive bonus plans with no specified performance levels should be categorized as KERPs and prohibited under § 503(c)(1). Labels cannot and should not be determinative of character.

Where, however, incentive bonus plans set forth performance levels, the bankruptcy courts should distinguish between superficial and meaningful performance levels. To determine whether performance goals are meaningful or included simply to avoid § 503(c)(1)'s prohibition, bankruptcy courts should

---

<sup>134</sup> See *supra* notes 95–104 and accompanying text.

undertake an independent review of the proposed plans rather than immediately defer to the business judgment of the debtor. If a court, after reviewing the debtor's individual circumstances in reorganization, determines that the goals set forth are in no way challenging or meaningful, the incentive bonus plan should be re-categorized as a KERP and prohibited under § 503(c)(1). If, on the other hand, a court determines that the performance levels are meaningful, as an added layer of protection, the court should then further inquire into whether the plan is functioning as a reward for executive fraud, misconduct, or mismanagement. As Senator Hatch suggested, "payments where 'misconduct, fraud, or mismanagement' [are] present"<sup>135</sup> should be prohibited. Such an inquiry will help courts separate the Enrons, WorldComs, Kmarts, Global Crossings, and Polaroids from the rest of the corporate world.

The proposal outlined above requires the bankruptcy courts to act as arbiters rather than overseers when reviewing a debtor corporation's incentive bonus plan. By taking a more active role in the review process, bankruptcy courts may be able to curb abuse of incentive bonus plans where they were previously unable to with KERPs.

If it becomes necessary for Congress to address incentive bonus plans, it must take a more nuanced approach than that taken with KERPs. An outright prohibition would not be an effective solution. Rather, the legislation must reflect the fine distinctions set forth above.

#### *E. "Draining" the Excess: One Judge's Approach*

In January 2008, Judge Robert D. Drain, a federal bankruptcy judge in the Southern District of New York overseeing the Delphi Corporation reorganization, sharply reduced the corporation's proposed \$87 million executive incentive bonus plan to a mere \$16.5 million.<sup>136</sup> Judge Drain determined that the amount of the cash award was unreasonably excessive in light of the facts and circumstances of the case.<sup>137</sup> The judge's order came after his careful examination of the terms

---

<sup>135</sup> 151 CONG. REC. S2341 (daily ed. Mar. 9, 2005) (statement of Sen. Hatch), 151 Cong Rec S 2306, at \*S2341 (LEXIS).

<sup>136</sup> Gretchen Morgenson, *Royal Pay at Delphi, Reined in by a Judge*, N.Y. TIMES, Jan. 27, 2008, at BU1. Delphi agreed to the reduction. *Id.*

<sup>137</sup> *Id.*

of the payouts for approximately one hour and his questioning the Delphi compensation consultant who devised the plan.<sup>138</sup> Judge Drain's pragmatic and thoughtful approach to Delphi's executive incentive bonus plan illustrates the approach bankruptcy courts must take to keep incentive bonus plans in check, in line with the spirit and intent behind § 503(c)(1).

#### CONCLUSION

Given the narrow statutory language and already existing precedent in the bankruptcy courts, together with the fact that "*the purpose*" of a "true" incentive bonus plan is not to "induc[e] such person to remain with the debtor's business,"<sup>139</sup> § 503(c)(1) cannot be interpreted to prohibit incentive bonus plans. While the legislative history indicates a clear intent to fashion a far-reaching solution to excessive executive compensation in reorganization, the language of § 503(c)(1) is not elastic enough to accomplish this goal. If the plights of Enron, WorldCom, Kmart, Polaroid, and Global Crossing, however, have taught us anything, it is the necessity of regulation. Therefore, the bankruptcy courts and, if necessary, Congress, must step in to rein in incentive bonus plans, the newest breed of executive compensation in reorganization.

---

<sup>138</sup> *Id.*

<sup>139</sup> 11 U.S.C. § 503(c)(1) (2000 & Supp. V 2005).