

PAY TO STAY, PAY TO PERFORM, OR PAY TO GO?: CONSTRUING THE THRESHOLD TERMS OF § 503(C)(1) AND (2)

INTRODUCTION

On April 20, 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”).¹ This extensive legislation revising the United States Bankruptcy Code (“Bankruptcy Code” or “Code”)² was primarily aimed at preventing abuse of the consumer bankruptcy system under chapters 7 and 13 of the Code. In the years leading up to the enactment of the BAPCPA, however, a growing trend in business bankruptcies led some to perceive a need to prevent corporate abuse of the bankruptcy system as well. The odious trend that was the cause of such public disillusionment with the bankruptcy system was the institution, by business debtors in chapter 11 reorganization, of court-approved key employee retention programs, commonly known as KERPs.

Debtors in chapter 11 reorganization propose KERPs to adopt bonus and termination pay programs for certain “critical” or “key” employees, often insider executives, to induce them to continue their employment with the debtor’s business through the uncertainty of reorganization.³ The odiousness of the trend toward KERPs lies in the disparity that results when corporate debtors obtain court approval to pay rich bonuses or termination payments to their executives while pressuring, in the name of reorganization, their nonmanagement employees to accept lower wages and reduced benefits, and while laying off hundreds or thousands of nonmanagement employees with vast reductions in both severance, vacation, and sick-leave payments as well as pension and insurance plan contributions.

Polaroid is an example of a corporate debtor that has provided fuel for public fury in recent years. On October 12, 2001, Polaroid filed chapter 11 bankruptcy while executive vice president Neal D. Goldman wrote to former

¹ PUB. L. NO. 109-8, 119 STAT. 23 (2005) (codified in scattered sections of 11 U.S.C.).

² 11 U.S.C. §§ 101-1532 (2000).

³ See, e.g., *In re Georgetown Steel Co.*, 306 B.R. 549 (Bankr. D. S.C. 2004); *In re Interco Inc.*, 128 B.R. 229 (Bankr. E.D. Mo. 1991).

employees to inform them of the company's termination of all severance payments and funding for medical, dental and life insurance plans.⁴ Goldman wrote:

[Today] Polaroid Corp. took the painful but necessary step of voluntarily filing for reorganization under Chapter 11 of the U.S. Bankruptcy Code. . . . As a result of the filing, absent court approval, Polaroid is precluded from paying any obligations to creditors that existed prior to the filing. This includes former employees currently collecting severance.⁵

Six months later, a bankruptcy judge approved Polaroid's plan to pay \$4.5 million in retention bonuses to forty executives.⁶ Under the plan, Goldman and fellow executive vice president William Flaherty would be eligible to receive bonuses equal to 62.5% of their base pay as well as severance payments also equal to 62.5% of their base pay. Other executives would be eligible to receive bonuses and severance payments equaling 25 to 50% of their base salaries.⁷ This was Polaroid's *scaled-down* plan. Originally, Polaroid had proposed a plan to pay Chief Executive Officer ("CEO") Gary DiCamillo approximately \$1.5 million in retention incentives,⁸ which the company later withdrew in response to public outrage.⁹

Shortly after filing its chapter 11 petition in January 2002, Kmart became another major contributor to the public ire. On March 9, 2002, the company announced that it would close 284 stores and fire 22,000 employees without severance pay.¹⁰ Three days later, Kmart announced the resignation of CEO Chuck Conaway, who would walk away with a court-approved \$9.5 million—\$4.5 million in severance plus forgiveness for a \$5 million loan Kmart had made to the CEO a year earlier.¹¹

⁴ Bruce Rubenstein, *Polaroid's Bankruptcy Exposes GC to New Challenges*, CORP. LEGAL TIMES, Mar. 2002, at 26.

⁵ *Id.*

⁶ Greg Gatlin, *Court OKs Polaroid Pay; 'Key' Execs Getting \$4.5M in Bonuses*, BOSTON HERALD, Apr. 6, 2002, at 16.

⁷ *Id.*

⁸ *Exorbitant Bonuses Focus Public Attention on Bankruptcy*, CONSUMER BANKR. NEWS, Aug. 20, 2002, at 8.

⁹ Gatlin, *supra* note 6.

¹⁰ Frank Green, *Kmart Goes on a Crash Diet*, SAN DIEGO UNION-TRIBUNE, Mar. 9, 2002, at A-1.

¹¹ Jennifer Dixon, *Conaway's \$9-Million Exit Raises Questions*, DETROIT FREE PRESS, Mar. 12, 2002.

From toy merchants to steel companies, there have been many other similar corporate offenders in recent years.¹² Recently, just before the BAPCPA went into effect, major automotive parts company Delphi Corporation filed its chapter 11 petition and KERP.¹³ With a pension plan underfunded by \$11 million and proposals on the table to cut up to two-thirds of workers' pay and to make substantial reductions in retiree benefits, Delphi proposed an incentive bonus program to pay \$21.5 million to executives in the first six months and \$88 million more in cash to the company's top 500 employees upon emergence from bankruptcy.¹⁴ From the \$88 million, the company's top four executives would receive \$8.9 million.¹⁵

In the face of this growing disparity in corporate debtors' treatment of nonmanagement employees and their executive counterparts, Congress added an amendment to the BAPCPA that was aimed at curbing corporate bankruptcy abuse. The BAPCPA added a new provision to the Bankruptcy Code that now limits corporate debtors' ability to pay large retention bonuses and severance payments to their executives. The new § 503(c) limits debtors' ability to make or promise payments to insiders of the company to induce them to remain with the business, to pay severance to insiders, and to make any other payments or promises to pay outside the ordinary course of business and not justified by the facts and circumstances of the case.¹⁶ Debtors can no longer make retention payments to an insider without first making a showing that the insider has "a bona fide job offer from another business at the same or greater rate of compensation" and that the insider's services are "essential to the survival of the business."¹⁷ Moreover, the allowable amount of an insider payment is now capped.¹⁸ The payment must not be greater than ten times the mean amount of similar payments given to nonmanagement employees during the same calendar year.¹⁹ If no such payments were made or promised to nonmanagement employees during the calendar year, then the amount of the

¹² See, e.g., *Exorbitant Bonuses Focus Public Attention on Bankruptcy*, *supra* note 8 (noting, among others, that eToys reduced severance pay for laid off employees while paying \$1 million in bonuses to top three executives; LTV Steel paid \$1 million retention bonus to CEO on top of \$700,000 annual salary but cut healthcare for 80,000 retirees upon liquidation).

¹³ Gretchen Morgenson, *Oohs and Ahs at Delphi's Circus*, N.Y. TIMES, Nov. 13, 2005, § 3 (Sunday Business), at 1.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ 11 U.S.C.S. § 503(c) (LexisNexis 2006) (effective in cases commenced on or after Oct. 17, 2005).

¹⁷ *Id.* § 503(c)(1)(A), (B).

¹⁸ *Id.* § 503(c)(1)(C)(i).

¹⁹ *Id.*

retention payment is limited to twenty-five percent of any similar payment made or promised to the insider during the previous calendar year.²⁰ Similarly, debtors cannot make a severance payment to an insider unless it is part of a program applicable to all full-time employees.²¹ Insider severance payments are also capped.²² The payment must not be greater than ten times the mean severance pay given to nonmanagement employees during the same calendar year.²³

These new restrictions on debtors' ability to institute KERPs are quite strict. Section 503(c) creates detailed qualifications for judicial approval of programs that were hitherto a matter of the debtor in possession's ("DIP") business judgment and a bankruptcy judge's discretion. Moreover, § 503(c) places monetary caps on bonuses and severance payments where there had previously been none. Critics predict that § 503(c) will "effectively eliminate all companies' ability to ever receive court approval for a KERP."²⁴ Others believe that § 503(c) at least spells the end of KERPs as a common element of chapter 11 cases.²⁵ Furthermore, critics of § 503(c) complain that the amendment is poorly drafted, creating a great deal of ambiguity over how it will be interpreted in application.²⁶

This Comment will not attempt to resolve every ambiguity raised by § 503(c)²⁷ but will address, rather, the two most pressing questions of interpretation—those which will determine the scope of application for the strict limitations of § 503(c). First, application of § 503(c)(1) will demand an answer to the threshold question: what kinds of incentives should be considered "for the purpose of inducing [an insider] to remain with the debtor's business?" Only the approval of those transfers and obligations which are inducements to remain will be subject to the bona fide job offer requirement, the requirement that the recipient is essential to the survival of the business, and the monetary caps imposed by § 503(c)(1). Bonus programs, for

²⁰ *Id.* § 503(c)(1)(C)(ii).

²¹ *Id.* § 503(c)(2)(A).

²² *Id.* § 503(c)(2)(B).

²³ *Id.*

²⁴ 151 CONG. REC. H1993, 2051 (2005) (letter to Senator Arlen Specter from the Association of Insolvency and Restructuring Advisors).

²⁵ *See, e.g.*, 4 COLLIER ON BANKRUPTCY ¶ 503.17 (Lawrence P. King et al eds., 15th ed. rev. 2006).

²⁶ *See, e.g., id.*

²⁷ For a discussion of ambiguities raised by the language of § 503(c) that are beyond the scope of this Comment, *see* Karen Cordry and Zachary Mosner, *Challenging the "Lake Wobegon Syndrome": What Hath Congress Wrought with KERPs?*, 25-5 AM. BANKR. INST. J. 12, 61 (2006).

example, which are intended to create incentives that motivate employees toward superior performance may be beyond the reach of § 503(c)(1). Similarly, application of § 503(c)(2) will require an answer to the threshold question: what kinds of termination payments should be considered “severance”? Only those termination payments which are considered “severance” will trigger the requirement of a severance program for all full-time employees or the monetary caps imposed by § 503(c)(2). Some have argued for an interpretation implying a significant exception to § 503(c)(2) that excludes from its coverage claims for termination payments arising from individual employment contracts.²⁸

This Comment contends that these threshold questions of § 503(c) application must be answered in light of the public policies which underlie the bankruptcy system and which motivated Congress to enact § 503(c). Part I of this Comment provides background information on how KERPs fit into the chapter 11 business reorganization process before the enactment of § 503(c). By comparing the priority afforded KERP claims under the pre-BAPCPA Code with the priority afforded other employee wage and benefit claims, this Part explains why chapter 11 business debtors have been able to obtain court approval for supergenerous KERPs while cutting off employment, severance, and a multitude of other benefits to nonmanagement employees. Part II draws on the legislative history of the Bankruptcy Code, and, particularly, the legislative history of § 503(c) and other employment-related amendments enacted by the BAPCPA to show that Congress’s purposes in enacting § 503(c) were to restore protection for employees of bankrupt companies under the Code and to eliminate the ability of debtors to gain court approval for corporate practices that invoke a deep sense of unfairness. Part III argues that in applying § 503(c)(1), courts need to make a distinction between retention bonuses and performance-motivating incentives in order to avoid needlessly restricting incentives that have independent value to the estate beyond simply inducing an insider to remain. This Part shows that exempting legitimate performance incentives from the restrictions of § 503(c)(1) is consistent with Congress’s purposes in enacting § 503(c). In allowing such an exemption, however, courts must be careful to establish clear standards for determining what qualifies as a legitimate performance incentive because such an exemption has potential for abuse. Finally, Part IV of this Comment evaluates the contention that the term “severance” in § 503(c)(2) ought to be construed to exclude termination pay claims arising from individual employment contracts.

²⁸ See, e.g., 4 COLLIER ON BANKRUPTCY, *supra* note 25, at ¶ 503.17[2].

Part IV argues that to effect Congress's intent and to avoid rendering § 503(c)(2) virtually meaningless, courts should adopt a definition of severance that includes such termination payment provisions in individual employment contracts. This Part further demonstrates that a definition of severance that includes termination payment provisions in individual employment contracts is consistent with the severance rules adopted by courts in the majority of circuits.

I. THE PRE-BAPCPA DISPARITY: FULL PAYMENT FOR KERP CLAIMANTS; MUCH LESS FOR OTHER EMPLOYEES

To fully understand the import of § 503, one must understand how it occurred that the pre-BAPCPA bankruptcy system permitted the gross disparity between how executives and nonmanagement employees of the same companies have fared in many recent chapter 11 reorganizations. This Part explains, first, how KERPs fit into the bankruptcy system before the enactment of the BAPCPA and, second, how other employee claims for severance and other benefits were provided for in the pre-BAPCPA Code. Ultimately the great disparity of treatment for KERP claims and other employment-related claims was possible under the pre-BAPCPA Code because, while the Code effectively guaranteed full payment without any monetary caps or time limits for KERP claims,²⁹ it limited the amount of other employee claims for wages, severance, and benefit contributions that could be guaranteed full payment by imposing monetary caps and time limits on them.³⁰

A. *Administrative Priority: Full Payment for KERP Claimants*

The key to KERPs is administrative priority. Section 503 of the Code creates an allowed claim for administrative expenses.³¹ Administrative expenses are generally those incurred by the estate after the commencement of the chapter 11 case.³² Section 503(b) identifies a number of specific expenses that should be considered administrative,³³ with some of the most common including the reasonable compensation of professionals, such as attorneys or

²⁹ See *infra* notes 31–39, 104–05 and accompanying text.

³⁰ See *infra* notes 109–15 and accompanying text.

³¹ See 11 U.S.C. § 503(a)-(b) (2000).

³² 4 COLLIER, *supra* note 25, at ¶ 503.01.

³³ § 503(b).

accountants,³⁴ and wages, salaries, and commissions for services rendered to the estate.³⁵ Administrative expense allowance is not limited, however, to those expenses specifically identified, for the Code provides first for a broader category of administrative expenses designated simply as “the actual, necessary costs and expenses of preserving the estate.”³⁶

The significance of designating any claim as an administrative expense lies in the priority afforded administrative expense claims under § 507(a).³⁷ Before the enactment of the BAPCPA, administrative expenses were afforded first priority in the distribution of the assets of the estate.³⁸ In a chapter 11 case, the ultimate impact of administrative priority is revealed in plan confirmation. Unless an administrative expense claim holder agrees otherwise, a chapter 11 plan cannot be confirmed unless it provides for the full, cash payment of claims with administrative priority.³⁹ Thus, holders of administrative expense claims enjoy a significant level of security with regard to those claims.

Providing security is what KERPs are designed to do. The purpose of a chapter 11 reorganization case is to allow a debtor to restructure its finances so it can satisfy its debts while continuing to operate the business.⁴⁰ Thus, the Bankruptcy Code provides that a debtor in chapter 11 bankruptcy may continue to operate its business unless the bankruptcy court orders otherwise,⁴¹ and the debtor’s prepetition management usually remains in control of the business, as the DIP.⁴² The continued operation of a business necessarily requires the ability to retain and pay employees. For the most part, a DIP pays the postpetition salaries of its employees in the ordinary course of business, without need for court authorization.⁴³ For a number of reasons, however, retaining an executive employee in chapter 11 is not as simple as continuing to pay his or her salary. This is due in part to the reality that, outside of bankruptcy, the typical executive compensation package is composed of a

³⁴ *Id.* § 503(b)(4).

³⁵ *Id.* § 503(b)(1)(A)(i).

³⁶ *Id.* § 503(b)(1)(A).

³⁷ 4 COLLIER, *supra* note 25, at ¶ 503.01.

³⁸ § 507(a)(1) (2000), *amended by* 11 U.S.C.S § 507(a)(1)-(2) (LexisNexis 2006).

³⁹ *Id.* § 1129(a)(9)(A).

⁴⁰ 7 COLLIER, *supra* note 25, at ¶ 1108.01 (citing H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 220 (1977), S. REP. NO. 95-989, 95th Cong. 2d Sess. 116 (1978)).

⁴¹ 11 U.S.C. § 1108 (2005).

⁴² *Id.* §§ 1101(1), 1104. The DIP has substantially all of the rights and powers of a trustee and must perform, with limited exception, all of the functions and duties of a trustee. § 1107(a).

⁴³ See § 363(c)(1); see also Shari Siegel, *Perks and Parachutes: Severance, Bonuses and Other Employee Payments in Chap. 11*, BANKR. STRATEGIST, May 2000, at 1.

variety of incentive mechanisms, other than base salary, chosen to most efficiently attract, retain, and motivate the employee.⁴⁴

Executive salaries are often largely supplemented, for example, by equity-based incentives programs. An executive's compensation package might include annual awards of restricted stock that vest over the passage of time to provide a retention incentive, or upon achievement of specified performance objectives to provide a performance-motivating incentive.⁴⁵ Similarly, in most American companies, executive compensation is partially based upon an annual cash plan that provides for cash bonuses to be paid, often incrementally, upon the achievement of specified performance objectives.⁴⁶ Furthermore, most companies offer substantial termination pay arrangements to attract and retain executives.⁴⁷ Perhaps the most significant type of termination pay arrangement at the executive level is the change-of-control arrangement, designed to reduce executive uncertainty and anxiety when a company becomes the subject of a merger proposal.⁴⁸ Most often, change-of-control arrangements are provisions contained in employment agreements. Provisions of this type, commonly referred to as "golden parachutes," provide for the guaranteed payment of a fixed amount, usually two to three times the executive's annual compensation, in the event of the executive's involuntary termination or voluntary termination for good reason, following a change of control.⁴⁹ Change-of-control arrangements may also be contained in broader, often company-wide, severance plans instead of individual employment contracts.⁵⁰ Finally, widespread use of change-of-control employment agreements since the mid-1980s has led to "the emergence of comprehensive

⁴⁴ See Michael C. Jensen, Kevin J. Murphy, & Eric G. Wruck, *Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them* 19 (Harvard NOM Working Paper No. 04-28; ECGI-Fin. Working Paper No. 44/2004) (July 12, 2004), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=561305 (abstract only; follow links to download full document in pdf format) (last visited August 29, 2006).

⁴⁵ MICHAEL S. SIRKIN & LAWRENCE K. CAGNEY, EXECUTIVE COMPENSATION § 5.01[2] (2005).

⁴⁶ *Id.* at §6.01[1]-[2]. While a cash plan is primarily aimed at performance motivation, it can also hold retentive value if designed as a long-term plan providing for meaningful cash awards to be paid at the end of a multiyear performance period if performance objectives are met. *Id.*

⁴⁷ See SIRKIN & CAGNEY, *supra* note 45, at § 9.01[1]; Jensen, Murphy, & Wruck, *supra* note 44, at 28-29.

⁴⁸ SIRKIN & CAGNEY, *supra* note 45, at § 9.01[1].

⁴⁹ *Id.* at § 9.01[3][a].

⁵⁰ *Id.* at § 9.01[3][b].

employment agreements designed to protect executives from termination for reasons other than a change of control.”⁵¹

When a company enters chapter 11 reorganization, a number of the prepetition incentive mechanisms in its executives’ compensation packages may lose significant value due to circumstances external, or at most tangential, to the bankruptcy system and due to the operation of bankruptcy law itself. The most obvious externality that will cause a reduction in executive compensation value is a decrease in a company’s stock value. The value of a troubled company’s stock typically plummets upon or shortly before the company’s entry into chapter 11 reorganization,⁵² quickly draining value from equity-based incentives.⁵³ Cash plans can also lose value in reorganization. What were once meaningful performance incentives can become meaningless and valueless when executive focus must shift to running the business primarily for the benefit of creditors.⁵⁴

With a company’s entry into chapter 11, the security offered to executives by termination pay arrangements may also be significantly reduced. Under the scrutiny of the majority of courts, claims for severance pay under prepetition company-wide severance plans will be bifurcated so that only that portion of the claim that can be apportioned to services performed postpetition is afforded administrative priority, and the rest is treated as a general unsecured claim.⁵⁵

⁵¹ Jensen, Murphy, & Wruck, *supra* note 44, at 29. Such agreements typically provide for compensation even in the event of involuntary termination for incompetence, denying compensation only when termination is for “moral turpitude, gross negligence, or felony convictions.” *Id.*

⁵² See, e.g., *Exorbitant Bonuses Focus Public Attention on Bankruptcy*, *supra* note 8 (“[W]hen chief executive officer Gary DiCamillo joined Polaroid Corp., the company had 10,000 employees and its stock was trading at more than forty dollars a share. Five years later, Polaroid went bankrupt, thousands were laid off, and its shares traded for pennies.”).

⁵³ See, e.g., *Dai-Ichi Kangyo Bank v. Montgomery Ward Holding Corp.* (*In re Montgomery Ward Holding Corp.*), 242 B.R. 147 (D. Del. 1999); *In re Interco, Inc.* 128 B.R. 229 (Bankr. E.D. Mo. 1991); see also Debtor’s Motion for Approval of Key Employee Retention Program Pursuant to Bankruptcy Code Section 363(b) and to Authorize Administrative Expense Priority for Indemnification Claims Arising from Postpetition Services of Directors and Officers Pursuant to Sections 503(b) and 507 of the Bankruptcy Code, at para. 11, *In re Enron Corp.*, No. 01-16034 (Bankr. S.D.N.Y. Mar. 29, 2002) (“[T]he financial expectations of Key Employees have been frustrated as various equity-based incentive compensation plans previously granted to Key Employees and the Debtor’s 401(k) plan has [sic] lost value to the extent invested in Debtor’s common stock.”).

⁵⁴ In an extreme example, in reorganization, Enron liquidated a number of its noncore businesses, and key employees in those businesses, assisting with the process, found that the new focus of their work was literally “liquidating themselves out of a job.” Debtor’s Motion for Approval of Key Employee Retention Program, *In re Enron Corp.*, *supra* note 53, at para. 10.

⁵⁵ See, e.g., *In re Levinson Steel Co.*, 117 B.R. 194 (Bankr. W.D. Pa. 1990); *In re Allegheny Int’l, Inc.*, 118 B.R. 276 (Bankr. W.D. Pa. 1990); *Cramer v. Mammoth Mart, Inc.* (*In re Mammoth Mart, Inc.*), 536 F.2d

Under this rule, a terminated executive's severance plan will only guarantee him a portion, usually comparatively small, of the severance he would have been entitled to outside of bankruptcy. That portion of the severance that is treated as a general unsecured claim may only receive pennies on the dollar under a reorganization plan.⁵⁶ Thus, once a company files chapter 11 bankruptcy, the security offered by its severance policy is reduced in proportion to the amount of an executive's claim that will not receive administrative priority.⁵⁷ Employment contracts containing termination payment provisions are no more secure. Generally, termination pay claims arising from individual employment contracts that have been rejected or have not been assumed by the DIP do not receive administrative priority; rather they are treated as general unsecured claims, which will likely receive pennies on the dollar in a reorganization plan.⁵⁸ Thus, the security offered to executives in their employment agreements will also be significantly reduced when a company files a chapter 11 petition.

In the face of such significant reductions in the value and security of overall executive compensation packages for the past fifteen years, companies in chapter 11 reorganization have sought bankruptcy court authorization to undertake a variety of measures designed to create new incentives and reassurances for their executives.⁵⁹ The trend has been to seek approval for a number of different measures in a single motion for the approval of what has become commonly known as a "key employee retention program."⁶⁰ In their

950 (1st Cir. 1976). *But see* Strauss-Duparquet, Inc. v. Local Union No. 3, Int'l Bhd. of Electrical Workers (*In re* Strauss-Duparquet, Inc.), 386 F.2d 649 (2d Cir. 1967).

⁵⁶ *See, e.g.*, Yoder v. OH Bureau of Workers' Comp. (*In re* Suburban Motor Freight, Inc.), 998 F.2d 338, 342 (6th Cir. 1993) (noting, in chapter 11 cases, probability that nonpriority unsecured claims will receive pennies on the dollar); *In re* U.S. Airways Group, Inc., 303 B.R. 784, 792 (Bankr. E.D. Va. 2003) (noting, in chapter 11 cases, that general unsecured claims may receive only pennies on the dollar); *see also infra* notes 114–15 and accompanying text.

⁵⁷ *See id.*

⁵⁸ *See, e.g.*, Dullanty v. Selectors, Inc. (*In re* Selectors, Inc.), 85 B.R. 843 (B.A.P. 9th Cir. 1988); *In re* Nomus-Am., Inc., No. 01-50255 11, 2002 Bankr. LEXIS 1657 (Bankr. M.D.N.C. Feb. 8, 2002); *In re* M Group, Inc., 268 B.R. 896 (Bankr. D. Del. 2001); *In re* Commercial Fin. Serv., Inc., 233 B.R. 885 (Bankr. N.D. Okla. 1999); *In re* Crystal Apparel, Inc., 220 B.R. 816 (Bankr. S.D.N.Y. 1998); *In re* Jamesway Corp., 199 B.R. 836 (Bankr. S.D.N.Y. 1996); *In re* Uly-Pak, Inc., 128 B.R. 763 (Bankr. S.D. Ill. 1991); *In re* Hooker Inv., Inc. 145 B.R. 138 (Bankr. S.D.N.Y. 1992).

⁵⁹ *See, e.g.*, *In re* US Airways, Inc., 329 B.R. 793 (Bankr. E.D. Va. 2005); *In re* Montgomery Ward Holding Corp., 242 B.R. 147 (Bankr. D. Del. 1999); *In re* Geneva Steel Co., 236 B.R. 770 (Bankr. D. Utah 1999); *In re* Intercor Inc., 128 B.R. 229 (Bankr. E.D. Mo. 1991).

⁶⁰ Debtors employ variations on this title. *See, e.g.*, *In re* US Airways, Inc., 329 B.R. 793 ("Transaction Retention Program"); *In re* Georgetown Steel Co., 306 B.R. 549 (Bankr. D.S.C. 2004) ("Key Employee Retention Program"); *In re* Aerovox, Inc., 269 B.R. 74 (Bankr. D. Mass. 2001) ("Employee Retention and

motions, debtors argue that there is a danger that critical employees will be enticed away from the debtors' businesses for other employment opportunities because the total values of the employees' overall compensation packages have been reduced below market rates.⁶¹ Debtors insist that prepetition equity-based compensation plans have become worthless in bankruptcy.⁶² They plead that performance motivation incentives must be updated or replaced.⁶³ Debtors declare that in bankruptcy their key employees are exposed to increased insecurity about the future of their employment.⁶⁴ On top of these reductions in the value of executive compensation packages, debtors also argue that their key employees need new incentives because reorganization has imposed heavier workloads and new tasks upon those employees.⁶⁵ Finally, to support the remedial measures they propose, debtors typically assert that because the employees under their plans possess superior knowledge and familiarity with the business, they are critical to successful reorganization.⁶⁶ Moreover, replacement of employees of this sort would mean recruitment and training expenses that would likely be more costly than the proposed KERP.⁶⁷

Debtors propose a variety of incentive mechanisms in their KERPs, and each KERP usually contains more than one type of mechanism.⁶⁸ Nonetheless, the incentive mechanisms employed in KERPs generally fit into one of two major categories: bonuses or termination pay arrangements.⁶⁹

Debtors offer a variety of types of bonuses in their KERPs. In their simplest form, bonuses are scheduled to be paid to key employees if they remain actively employed with the debtor through a period extending from

Severance Program"); *In re Interco, Inc.*, 128 B.R. 229 ("Performance/Retention Program for Critical Executives").

⁶¹ See, e.g., *In re Geneva Steel Co.*, 236 B.R. 770; *In re Montgomery Ward Holding Corp.*, 242 B.R. 147; *In re Interco, Inc.* 128 B.R. 229.

⁶² See *In re Montgomery Ward Holding Corp.*, 242 B.R. 147; *In re Interco, Inc.*, 128 B.R. 22; Debtor's Motion for Approval of Key Employee Retention Program, *In re Enron Corp.*, *supra* note 53 at para. 11.

⁶³ See *In re Interco, Inc.*, 128 B.R. 22; Debtor's Motion for Approval of Key Employee Retention Program, *In re Enron Corp.*, *supra* note 53, at para. 10.

⁶⁴ See *In re Aerovox, Inc.*, 269 B.R. 74; *In re Interco, Inc.*, 128 B.R. 22; 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, at para. 19, *In re Worldcom, Inc.*, No. 02-13533 (Bankr. S.D.N.Y. Oct. 18, 2002).

⁶⁵ See *In re Aerovox, Inc.*, 269 B.R. 74; *In re Am. W. Airlines, Inc.*, 171 B.R. 674 (Bankr. D. Ariz. 1994); Motion of Debtors Pursuant to Sections 363(b) and 105(a), *In re Worldcom*, *supra* note 64, para. 19.

⁶⁶ See, e.g., *In re Montgomery Ward Holding Corp.*, 242 B.R. 147; *In re Geneva Steel Co.*, 236 B.R. 770; *In re Interco, Inc.*, 128 B.R. 229.

⁶⁷ See *supra* note 66.

⁶⁸ See *infra* notes 70–93 and accompanying text.

⁶⁹ See *infra* notes 70–93 and accompanying text.

approval of the KERP motion to a specified future date.⁷⁰ Other debtors employ more complex variations of this type of target-date bonus,⁷¹ presumably to increase their retentive effect.⁷² In Worldcom's KERP motion, for example, the debtors proposed "stay bonuses" equal to a percentage of an individual employee's annual base compensation to be paid incrementally to the employee if still employed on specific target dates.⁷³ Twenty-five percent of the bonus would be paid on December 1, 2002; twenty-five percent on March 31, 2003; and fifty percent sixty days after confirmation of a plan of reorganization.⁷⁴

A similar type of bonus, which have been variously titled "success bonuses,"⁷⁵ "emergence bonuses,"⁷⁶ or "success fees,"⁷⁷ condition payment upon continued employment through a period culminating in achievement of a particular stage in the reorganization process.⁷⁸ Such target-event bonuses may be tied to a single event such as plan confirmation,⁷⁹ or they may be tied to the occurrence of the earliest of a number of alternate target events.⁸⁰ Under the KERP proposed in *In re Georgetown Steel Company*, for example, a key employee would be entitled to his or her "retention fee" if he or she remained employed by the debtor company until the earliest of "(a) the confirmation of a plan of reorganization; (b) the closing of a sale of substantially all of the assets of the Company; or (c) the employee's dismissal without cause, including as a result of the conversion or dismissal of the case, or the appointment of a Chapter 11 trustee."⁸¹ These types of alternate target-event bonuses sometimes also incorporate a specified date in the list of alternative targets.⁸²

⁷⁰ See *In re Montgomery Ward Holding Corp.*, 242 B.R. 147 at 151.

⁷¹ To the author's knowledge, this is not a commonly used term; together with "target-event bonus" used *infra*, it is coined for ease of classification in this Comment.

⁷² See Motion of Debtors Pursuant to Sections 363(b) and 105(a), *In re Worldcom*, *supra* note 64, para. 13.

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ See *In re Am. W. Airlines, Inc.*, 171 B.R. 674 (Bankr. D. Ariz. 1994).

⁷⁶ See *In re Geneva Steel Co.*, 236 B.R. 770 (Bankr. E.D. Mo. 1991).

⁷⁷ See *In re Georgetown Steel Co.*, 306 B.R. 549 (Bankr. D.S.C. 2004).

⁷⁸ See, e.g., *In re Georgetown Steel Co.*, 306 B.R. 549; *In re Geneva Steel Co.*, 236 B.R. 770; *In re Am. W. Airlines, Inc.*, 171 B.R. 674.

⁷⁹ See *In re Geneva Steel Co.*, 236 B.R. 770.

⁸⁰ See *In re Georgetown Steel Co.*, 306 B.R. at 552.

⁸¹ *Id.*

⁸² See, e.g., *In re Aerovox, Inc.*, 269 B.R. at 77 (Bankr. D. Mass. 2001) (bonus payable upon the earlier of "a) involuntary termination of employment; b) the sale of all or substantially all of the Debtor's assets; or c) June 6, 2002").

Still other debtors condition bonus entitlement upon the realization of particular performance goals. These bonuses often have the apparent goal of motivating key employees to move the company toward a speedy reorganization or liquidation of assets.⁸³ In Worldcom's KERP motion, for example, the debtors proposed "plan progress bonuses" in an amount equal to ten percent of a key employee's stay bonus.⁸⁴ One hundred percent of the plan progress bonus would be paid if a plan could be confirmed in December 2003; 150% would be paid if confirmation occurred in November 2003; 200% if confirmation occurred in October 2003; and 250% if confirmation occurred on or before September 30, 2003.⁸⁵ Similarly, in Enron's KERP, the debtors created a "Liquidation Incentive Pool" to motivate and retain key employees that would be working to liquidate some of the debtors' non-core businesses.⁸⁶ Under the program, bonuses would be paid to the key employees following each \$500 million collected from sales of assets.⁸⁷ These bonuses are also sometimes used to motivate key employees toward creating value for a reorganizing company or realizing high prices for a company's asset sales.⁸⁸

The types of termination pay arrangements that debtors propose in their KERPs are less varied than bonuses. Many debtors propose to institute new or modified company severance policies.⁸⁹ Some of the policies traditionally cover a broad base of employees and are tied to length of service.⁹⁰ Others are implemented exclusively for senior management and resemble comprehensive employment contracts.⁹¹ Debtors also sometimes propose to enter new

⁸³ See, e.g., Debtor's Motion for Approval of Key Employee Retention Program, *In re Enron Corp.*, *supra* note 53, para. 25-33; Motion of Debtors Pursuant to Sections 363(b) and 105(a), *In re Worldcom*, *supra* note 64, para. 14.

⁸⁴ Motion of Debtors Pursuant to Sections 363(b) and 105(a), *In re Worldcom*, *supra* note 64, para. 14.

⁸⁵ *Id.*

⁸⁶ Debtor's Motion for Approval of Key Employee Retention Program, *In re Enron Corp.*, *supra* note 53, para. 25-33.

⁸⁷ *Id.* at para. 27.

⁸⁸ See, e.g., *In re Interco, Inc.*, 128 B.R. 22 (Bankr. E.D. Mo. 1991); David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 928 (2003).

⁸⁹ See, e.g., *In re Aerovox, Inc.*, 269 B.R. 74; *In re Montgomery Ward Holding Corp.*, 242 B.R. 147 (D. Del. 1999); *In re Geneva Steel Co.*, 236 B.R. 770; Debtor's Motion for Approval of Key Employee Retention Program, *In re Enron Corp.*, *supra* note 53, para. 35-36.

⁹⁰ See *In re Montgomery Ward Holding Corp.*, 242 B.R. 147 (for upper management, severance ranging from one week of pay for every year of service to seventy-eight weeks of pay); Debtor's Motion for Approval of Key Employee Retention Program, *In re Enron Corp.*, *supra* note 53, para. 35-36 (two weeks of base salary per year of service; maximum eight weeks of base salary; minimum payment of \$4500).

⁹¹ See *In re Aerovox, Inc.*, 269 B.R. 74 (calculated one year after termination, an amount equal to lesser of: 1) annual salary at time of termination less amount earned by alternate employment in the twelve-month period following termination, 2) six months of salary); *In re Geneva Steel Co.*, 236 B.R. 770 (Bankr. D. Utah

employment contracts containing termination pay arrangements with their key employees⁹² or to assume employment contracts already in place.⁹³

The majority of KERP incentives are proposed and approved under Bankruptcy Code § 363(b)(1) as uses of estate property outside the ordinary course of business.⁹⁴ Courts have developed a fairly consistent standard for authorization. Generally, courts approve KERPs if (1) the debtor demonstrates a sound business judgment in proposing the program,⁹⁵ and (2) the program is reasonable and fair.⁹⁶ Where the assumption of a prepetition employment agreement is proposed as part of the KERP, that element must be evaluated as an executory contract under § 365,⁹⁷ but apart from compliance with the requirements of § 365, the proposed assumption is governed by the same business judgment rule as the rest of the KERP.⁹⁸

In applying the business judgment and fairness standards to KERPs, courts do not rely on per se rules but, rather, look to the facts and circumstances of each particular case.⁹⁹ A few important factors that courts often consider are

1999) (six months of salary if terminated for any reason other than death, disability, or cause, prior to date of substantial consummation of plan; nine months of salary if terminated within ninety days after date of substantial consummation).

⁹² See *In re US Airways, Inc.*, 329 B.R. 793 (Bankr. E.D. Va. 2005).

⁹³ See *In re Interco, Inc.*, 128 B.R. 229.

⁹⁴ See, e.g., *In re Georgetown Steel Co.*, 306 B.R. 549 (Bankr. D.S.C. 2004); *In re Aerovox, Inc.*, 269 B.R. 74; *In re Montgomery Ward Holding Corp.*, 242 B.R. 147. Although courts approving KERP motions do not generally note whether authorization is actually necessary for the implementation of KERPs, substantial precedent indicates that major changes to employee compensation beyond modest salary increases are outside the ordinary course of business and must be authorized under § 363(b)(1). See, e.g., *Bagus v. Clark (In re Buyer's Club Markets, Inc.)*, 5 F.3d 455 (10th Cir. 1993) (new postpetition severance policy not in ordinary course); *In re Crystal Apparel, Inc.*, 220 B.R. 816 (Bankr. S.D.N.Y. 1998) (modest postpetition increases to executive salaries were in ordinary course; entering into a new employment contract with golden parachute provision was not in ordinary course); *In re Media Cent., Inc.*, 115 B.R. 119 (Bankr. E.D. Tenn. 1990) (new postpetition severance policy not in ordinary course); *In re Century Brass Products, Inc.* 107 B.R. 8 (Bankr. D. Conn. 1989) (new postpetition severance policy not in ordinary course).

⁹⁵ See, e.g., *In re Georgetown Steel Co.*, 306 B.R. 549; *In re Aerovox, Inc.*, 269 B.R. 74; *In re Montgomery Ward Holding Corp.*, 242 B.R. 147.

⁹⁶ See, e.g., *In re US Airways, Inc.*, 329 B.R. 793; *In re Aerovox, Inc.*, 269 B.R. 74; *In re Am.W. Airlines, Inc.*, 171 B.R. 674 (Bankr. D. Ariz. 1994); *In re Interco, Inc.*, 128 B.R. 229.

⁹⁷ 11 U.S.C. § 365 (2000). Under § 365, the DIP may only assume a contract if, at the time of assumption, he or she first cures any defaults there might have already been on the contract, compensates the nondebtor party for any pecuniary losses that party might have incurred because of a previous default of the debtor, and provides the nondebtor party with adequate assurance of the debtor's future performance on the contract. § 365(b)(1)(A)-(C).

⁹⁸ See *In re Interco, Inc.*, 128 B.R. at 233-34.

⁹⁹ See, e.g., *In re Aerovox, Inc.*, 269 B.R. 74; *In re Am. W. Airlines, Inc.*, 171 B.R. 674; *In re Montgomery Ward Holding Corp.*, 242 B.R. 147; *In re Interco, Inc.*, 128 B.R. 229.

worth noting. First, for a KERP to pass the business judgment test, the debtor should at least show that the program aids reorganization¹⁰⁰ or the debtor's ability to maximize value in liquidation.¹⁰¹ Second, when termination pay arrangements are part of a KERP, such arrangements might not be approved if they fail to incorporate a mitigation provision preventing the executive from receiving a windfall if he or she secures new employment shortly after termination.¹⁰² Finally, objections that the program is not reasonable and fair in light of the reductions in benefits and sacrifices endured by nonmanagement employees before and throughout reorganization are usually unsuccessful.¹⁰³

Finally, before the addition of § 503(c) to the Bankruptcy Code, whether approved as § 363(b)(1) nonordinary course uses or § 365 assumptions of executory contracts, all elements of a KERP that were approved by the court would receive chapter 11 administrative priority.¹⁰⁴ Unless paid in full, a debtor's KERP obligations could bar the confirmation of a reorganization plan.¹⁰⁵ This was indeed their intended effect—to restore value and security to executive compensation packages by replacing incentive mechanisms devalued in bankruptcy with bonuses and termination pay arrangements that would be guaranteed full payment.

B. Wage and Benefit Priority: Caps and Time Restrictions

Like bonus and severance claims arising from KERPs, claims for wages and other compensation earned postpetition by employees not covered by a KERP are also afforded administrative priority.¹⁰⁶ However, for the hundreds or thousands of employees laid off in the months leading up to a company's bankruptcy or shortly after the company files its chapter 11 petition,

¹⁰⁰ See *In re Montgomery Ward Holding Corp.*, 242 B.R. at 155 (“the debtor carries the burden of demonstrating that a use, sale or lease will assist the debtor's reorganization”).

¹⁰¹ See *In re Georgetown Steel Co.*, 306 B.R. 554, 557 (Bankr. D.S.C. 2004) (noting that program would encourage key employees “to concentrate on their job duties rather than seeking new employment,” that key employees are critical to reorganization or maximization of value in liquidation, and that “there is no prohibition on a retention plan assisting in a potential liquidation of an entity”).

¹⁰² See *In re US Airways, Inc.*, 329 B.R. 793 (Bankr. E.D. Va. 2005); *In re Geneva Steel Co.*, 236 B.R. 770, 773–74 (Bankr. E.D. Mo. 1991).

¹⁰³ See *In re US Airways, Inc.*, 329 B.R. 793; *In re Georgetown Steel Co.*, 306 B.R. at 558; *In re Am. W. Airlines, Inc.* 171 B.R. at 676–78. *But see In re Geneva Steel Co.*, 236 B.R. at 773 (denying authorization to implement KERP; debtor's failure to discuss provisions of KERP with Steelworkers before proposing it to the court was not a use of sound business judgment).

¹⁰⁴ See 11 U.S.C. §§ 363(b)(1), 365, 503(b)(1), 507(a)(2) (2000); see also *In re US Airways, Inc.*, 329 B.R. 793; *In re Aerovox, Inc.*, 269 B.R. at 82; *In re Geneva Steel Co.*, 236 B.R. at 774.

¹⁰⁵ See *id.* § 1129(a)(9)(A).

¹⁰⁶ See *id.* § 503(b)(1)(A)(i).

administrative priority is largely irrelevant because these employees have earned little or no postpetition compensation. These employees rely on the special priority afforded under § 507(a) to employee claims for wages, salaries, commissions, vacation, severance, sick leave and employer contributions to benefit plans that are earned prepetition.¹⁰⁷ Like claims with administrative priority, claims with wage or benefit contribution priority enjoy some security in chapter 11 cases because a plan of reorganization cannot be confirmed unless it provides that claims with wage and benefit contribution priority will receive full payment to the extent of their priority.¹⁰⁸

There are, however, significant limitations on wage and benefit contribution priority. Before the enactment of the BAPCPA, allowed claims for wages, salaries, commission, severance, vacation, and sick leave pay were afforded third priority only if earned within ninety days before the debtor filed its bankruptcy petition.¹⁰⁹ Furthermore, the priority afforded to such claims under § 507(a)(3) was capped at \$4925 per individual claimholder.¹¹⁰ Similarly, allowed claims for contributions due to an employee benefit plan were afforded fourth priority only if they arose from services rendered within 180 days before the debtor's bankruptcy petition.¹¹¹ Section 507(a)(4) benefit contribution priority was also capped at \$4925 multiplied by the number of employees covered by the benefit plan and reduced by the aggregate amount paid to those employees under § 507(a)(3) wage priority.¹¹² To the extent, therefore, that any wage or benefit plan contribution was earned before ninety or 180 days prior to the bankruptcy petition, or that any wage or benefit plan contribution claim exceeded the caps on § 507(a)(3) or (4) priority, that claim would be considered a general unsecured claim that would likely receive very little or no payout in the reorganization plan.¹¹³ An employee creditor so impaired would not have to accept such a reorganization plan, but if the plan nonetheless received the requisite votes and otherwise met confirmation

¹⁰⁷ See *id.* § 507(a)(4), (5).

¹⁰⁸ *Id.* § 1129(a)(9)(B).

¹⁰⁹ § 507(a)(3), *amended by* Pub. L. No. 109-8, §§ 212, 1401(1) (2005) (moving wage priority to fourth at § 507(a)(4) and extending reach-back to 180 days).

¹¹⁰ *Id.*

¹¹¹ § 507(a)(4), *amended by* Pub. L. No. 109-8, § 212 (2005) (moving benefit contribution priority to fifth at § 507(a)(5)).

¹¹² § 507(a)(4), *amended by* Pub. L. No. 109-8, § 1401 (2005) (increasing cap to ten thousand dollars multiplied by the number of employees covered by the benefit plan and reduced by the aggregate amount paid to those employees under § 507(a)(4) wage priority).

¹¹³ See, e.g., *Yoder v. OH Bureau of Workers' Comp.* (*In re* Suburban Motor Freight, Inc.), 998 F.2d 338, 342 (6th Cir. 1993); *In re* U.S. Airways Group, Inc., 303 B.R. 793, 792 (Bankr. E.D. Va. 2005).

requirements, such an employee, as a dissenting creditor, would be afforded little comfort. Although plan confirmation demands that such a dissenting creditor receive at least as much as he or she would receive in a chapter 7 liquidation,¹¹⁴ general unsecured claims typically receive little to no payment in liquidation.¹¹⁵

In great contrast to the limitations and caps on wage and benefit contribution priority, before the enactment of the BAPCPA, the Code placed no caps or similar time limitations on administrative priority and therefore placed no caps or limitations on the priority afforded to claims arising from a KERP.¹¹⁶ This disparity of treatment between wage or benefit contribution claims and KERP claims left open the possibility that a DIP could pay multi-million dollar retention bonuses or promise equally generous termination payments to “key employees” while laying off hundreds or thousands of lower-ranking employees, who would receive vastly reduced severance, vacation, and sick-leave payments and pension, health and insurance plan contributions pursuant to § 507(a)(3) and (4) priority caps, and while further pressuring remaining employees to accept reduced wages and benefits. This possibility became a reality in cases like Polaroid, Kmart, Delphi, and numerous others.¹¹⁷

II. CONGRESS’S GOALS: PROTECTING WORKERS AND RESTORING FAIRNESS

Congress’s response to the wave of massive executive payouts and high costs to workers was to demand better protections for workers under the Bankruptcy Code. In 2002, for example, at a hearing of the Senate Judiciary Committee on “Lessons Learned from Enron’s Fall,” Senator Edward Kennedy articulated the inadequacy of protection for workers under the Code as exemplified by the plight of former Enron employees after Enron entered chapter 11 reorganization.¹¹⁸ Senator Kennedy recalled that the day before Enron filed its chapter 11 petition, Enron paid \$50 million in retention bonuses

¹¹⁴ § 1129(a)(7)(A).

¹¹⁵ See, e.g., *In re Wright*, 300 B.R. 453, 462–63 (Bankr. N.D. Ill. 2003) (general unsecured creditors in chapter 7 cases usually only receive pennies on the dollar for their claims); *In re Macomb Occupational Health Care*, 300 B.R. 270, 288 (Bankr. E.D. Mich. 2003) (in a chapter 7 case, a general unsecured claim may be paid pennies on the dollar or nothing at all).

¹¹⁶ See § 503 (2000), amended by Pub. L. No. 109-8, § 331 (2005) (adding § 503(c)).

¹¹⁷ See *supra* notes 4–15 and accompanying text.

¹¹⁸ *Accountability Issues: Lessons Learned from Enron’s Fall: Hearing of the S. Judiciary Comm.*, 107th Cong. (2002).

to derivative traders and \$55 million to 500 executives.¹¹⁹ In contrast, the day after it filed its petition, Enron laid off 4500 workers whose severance packages should have totaled \$150 million.¹²⁰ Noting that under the Bankruptcy Code wage priority, those workers received a total of only \$20 million, or approximately \$3000 each after taxes, Senator Kennedy explained that under the current bankruptcy law and even the revisions under consideration at the time, “[T]he workers weren’t protected.”¹²¹ Thus, Senator Kennedy called for reform, explaining:

[T]he point I’m trying to get at with regards to the existing bankruptcy law and the one that’s in conference—if we say we’re interested in being fair to workers, we’ve learned a powerful lesson—we shouldn’t have to keep relearning it—about what happens to workers under these circumstances If we fail to protect workers, even under our new bankruptcy law, I think it is a sham.¹²²

Bankruptcy policy has long demonstrated a special concern for alleviating some of the hardship caused by bankruptcy to employees of the debtor. Since the enactment of the Bankruptcy Act of 1898 (“Bankruptcy Act”),¹²³ bankruptcy law has afforded a high priority to payment of wages and commissions due employees of the debtor in compensation for prepetition work.¹²⁴ Under the Bankruptcy Act, wages and commissions up to six hundred dollars per qualifying claimant were entitled to full payment out of the bankruptcy estate before payment to any other creditors except those with administrative priority.¹²⁵ The purpose of this wage priority was to benefit wage earners “likely to be solely dependent for their livelihood on the wages received from their employer”¹²⁶ and therefore likely to “suffer serious hardship because of their employer’s bankruptcy if their wage claims are not

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² *Id.* Senator Kennedy’s call for reform was echoed in the testimony of Bruce Raynor, president of the Union of Needletraders, Industrial and Textile Employees, who noted, “Enron is a widely publicized example, but it goes on, Senator, every day, and something needs to be done to protect workers in bankruptcies instead of corporate executives.” *Id.*

¹²³ Bankruptcy Act of 1898, Pub. L. No. 696, 30 Stat. 544 (repealed 1978).

¹²⁴ Section 64(a)(2) of the Bankruptcy Act of 1898, *reprinted in* App. A-(a) COLLIER, *supra* note 25, at § 64.

¹²⁵ *Id.*

¹²⁶ *In re N. Atl. & Gulf S.S. Co.*, 192 F. Supp. 107, 109 (S.D.N.Y. 1961).

given priority.”¹²⁷ This social policy favoring protection of workers under the Bankruptcy Act persisted in the enactment of the Bankruptcy Code under the Bankruptcy Reform Act of 1978 (“Reform Act”)¹²⁸ as wages were again afforded high priority, following only administrative expense claims and claims arising between an involuntary petition and an order for relief.¹²⁹ Furthermore, worker protection was expanded under the Reform Act to expressly include severance, vacation, and sick leave pay,¹³⁰ as well as contributions to employee benefit plans such as pension plans and life or health insurance plans.¹³¹ This extension of wage and benefit contribution priority was intended once again to reflect Congress’s concern for the real effects of bankruptcy on employees who depend solely on the debtor for their livelihoods. The new benefit contribution priority, for example, was intended to reflect Congress’s recognition of “the realities of labor contract negotiations, under which wage demands are often reduced if adequate fringe benefits [such as employee benefit plans] are substituted.”¹³²

The legislative history of § 503(c) reveals that its enactment was part of Congress’s answer to the demands of the public and legislators like Senator Kennedy for renewed protections for workers under the Code in the face of current practices and abuses. Section 503(c) first appeared, in substantially the same form it is in now, in section 104 of a bill to establish the Employee Abuse Prevention Act of 2002 (“EAPA”).¹³³ The stated purpose of the EAPA was “[t]o protect employees and retirees from corporate practices that deprive them of their earnings and retirement savings when a business files for bankruptcy under title 11, United States Code.”¹³⁴

In addition to amending § 503 to include subsection (c), the EAPA included several other amendments designed to protect workers from insider looting of bankrupt companies. Section 202 would have increased the § 507 wage and benefit contribution priority caps to \$13,500.¹³⁵ Also, section 101

¹²⁷ *Id.* at 109; *see also* 4 COLLIER, *supra* note 25, at ¶ 507.05[1] (“The purpose of allowing a priority for wages is to alleviate hardship on workers who lose their jobs or part of their salary by bankruptcy. Employees are usually the hardest hit financially by a bankruptcy because the debtor/employer is typically the only source of income for the employees.”)

¹²⁸ Bankruptcy Reform Act of 1978, Pub. L. 95-598, 92 Stat. 2549 (codified at 11 U.S.C §§ 101-1330).

¹²⁹ Bankruptcy Reform Act of 1978, *reprinted in* App. A-(a) COLLIER, *supra* note 25, at § 507.

¹³⁰ *Id.*

¹³¹ *Id.*; *see also* H.R. REP. NO. 95-595, 1st Sess. (1977), 537-38, *reprinted in* 1978 U.S.C.C.A.N. 5963.

¹³² H.R. REP. NO. 95-595, 1st Sess. (1977), 537-38, *reprinted in* 1978 U.S.C.C.A.N. 5963.

¹³³ Employee Abuse Prevention Act of 2002, S. 2798, 107th Cong. (2002).

¹³⁴ *Id.*

¹³⁵ *Id.*

proposed to amend § 548 of the Code to give greater power to bankruptcy trustees or DIPs to avoid fraudulent transfers.¹³⁶ Particularly, the EAPA would have amended § 548 to allow avoidance of certain transfers or obligations made or incurred by the debtor within four years before the date of the filing of the petition instead of the then-existing one-year reach-back period.¹³⁷ Such an amendment presumably would be important for preventing or recovering massive prepetition retention bonuses like the ones that were the objects of such great public disapproval and controversy in the Enron debacle.¹³⁸

In the years of Congressional debate over bankruptcy reform leading up to the ultimate enactment of the BAPCPA, Congress made clear that the “corporate practices” the EAPA amendments were designed to protect employees from were precisely those practices engaged in by corporations such as Enron, Polaroid, Kmart and many others: paying enormous retention bonuses and severance payments to executives while, at the same time, eliminating or reducing the wages, severance, health and life insurance and other benefits of nonmanagement employees. Representative Bill Delahunt, for example, offered an amendment to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2003¹³⁹ that would have amended Code § 503 to include what are now the restrictions of § 503(c).¹⁴⁰ In support of the amendment, Representative Delahunt cited a need to demand “corporate responsibility” from corporations such as Global Crossing, where the chairman grossed \$512 million while the company was eliminating over 5000 jobs; Enron, where CEO Kenneth Lay grossed \$247 million while the company eliminated 5500 jobs; and Polaroid, where executives gave themselves over \$5 million in prepetition bonuses and incentive payments and \$6 million in postpetition retention bonuses while canceling retiree health and life insurance, terminating employee severance, and terminating retiree pension plans.¹⁴¹ Similarly, Senator Richard Durbin introduced an amendment to the 2005 BAPCPA that would extend the reach-back period for § 548 fraudulent transfer avoidance.¹⁴² The amendment mirrored section 101 of the EAPA and

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ Employees who were fired on the eve of the Enron bankruptcy with minimal severance payments sought recovery of many of the Enron prepetition bonuses as fraudulent transfers under § 548. *See, e.g.,* Eric Berger, *The Fall of Enron: Purpose of Enron Bonuses at Issue; Suits Claim Plot for a Select Few*, HOUSTON CHRON., July 23, 2003, at B1.

¹³⁹ H.R. 975, 108th Cong. (2003).

¹⁴⁰ *See* H.R. REP. NO. 108-40, pt. 1 (2003).

¹⁴¹ *Id.*

¹⁴² 151 CONG. REC. S1979, 1986.

reiterated its purpose “[t]o protect employees and retirees from corporate practices that deprive them of their earnings and retirement savings when a business files for bankruptcy.”¹⁴³ In support of the amendment, Senator Durbin cited companies that had recently filed for bankruptcy, such as Global Crossing, WorldCom, Adelphia, and Enron, calling them “synonomous [sic] with . . . immoral corporate conduct and unjust treatment of their shareholders, workers, and retirees.”¹⁴⁴ In explaining the purpose of the amendment, Senator Durbin stated:

[T]hese corporate insiders—whether Enron or Polaroid or WorldCom or others—were lining their own pockets, taking money out of the company destined for bankruptcy, and the ultimate losers were the employees and retirees. The amendment which I sent to the desk is an attempt to level the playing field for employees, pensioners, and others who find themselves shut out of court when companies they work for file for bankruptcy.¹⁴⁵

Finally, Senator Kennedy, who introduced the amendment to the 2005 BAPCPA that eventually passed as the new § 503(c),¹⁴⁶ also supported Senator Durbin’s amendment, noting that “[i]ncreasingly, the bankruptcy court has become a place where corporate executives go to get permission to line their own pockets and break their promise to their workers and retirees. That kind of abuse is terribly wrong, and it is our responsibility to prevent it.”¹⁴⁷

Thus, the legislative history shows that as Congress worked to incorporate provisions of the EAPA, such as the extension of the fraudulent transfer reach-back period under § 548 and restrictions on postpetition retention bonuses and severance payments under § 503(c), into the BAPCPA, Congress once again reiterated its purpose to provide better protections for workers under the Bankruptcy Code and demonstrated an intention to eliminate corporate practices perceived to be simply and deeply unfair.

¹⁴³ *Id.*

¹⁴⁴ *Id.* at 1987.

¹⁴⁵ *Id.* at 1988.

¹⁴⁶ See 151 CONG. REC. S2306, 2338 (Senator Hatch noting that Judiciary Committee accepted three amendments from Senator Kennedy, including one restricting payments to executives and businesses going through bankruptcy).

¹⁴⁷ 151 CONG. REC. S1979, 1990.

III. PAY TO STAY OR PAY TO PERFORM? THE NEED FOR CAREFUL DISTINCTION BETWEEN RETENTION AND PERFORMANCE INCENTIVES UNDER § 503(C)(1)

Regardless of whether § 503(c) will effectively eliminate the use of KERPs as we know them,¹⁴⁸ DIPs in the post-BAPCPA world will undoubtedly continue to seek court approval for any major postpetition changes to executive compensation they plan to make.¹⁴⁹ Many of these changes will raise the question of whether the restrictions of § 503(c) ought to apply. Particularly, in applying § 503(c)(1), courts will need to answer the threshold question: what kind of insider executive incentives should be considered “for the purpose of inducing such person to remain within the debtor’s business?”¹⁵⁰ In interpreting this threshold language, courts will need to make an important distinction between incentives given “for the purpose of inducing [an insider] to remain within the debtor’s business” (“retention bonuses”) and performance motivating incentives that are not designed primarily to induce the executive to remain but, rather, are designed to encourage the executive to reach particular performance goals. The latter should not be subject to the restrictions of § 503(c)(1).

Outside the context of chapter 11 reorganization, compensation experts recognize a definite distinction between compensation designed to retain employees and compensation designed to create performance incentives. In general, compensation experts agree that there are three primary goals of executive compensation—attraction, retention, and performance motivation.¹⁵¹

¹⁴⁸ See *supra* notes 23–24 and accompanying text.

¹⁴⁹ Failure to seek court approval, under § 363(b)(1), for major changes to executive compensation risks making any payments made under the new compensation package avoidable under § 549, which permits avoidance of postpetition transfers of estate property not authorized by the Code or the court. See 11 U.S.C. § 549 (2000); see also *supra* note 93.

¹⁵⁰ 11 U.S.C.S. § 503(c)(1) (LexisNexis 2006 & Supp. 2006).

¹⁵¹ See, e.g., COMPENSATION GUIDE § 27:1 (William A. Caldwell, ed., 2006) (“There are two primary considerations in forming executive compensation strategy. First, the organization needs to attract and retain superior executive talent Second, executives must be focused on and rewarded for implementing the organization’s business strategies.”); HR SERIES POLICIES AND PRACTICES § 164:4 (Thomson/West 2006) (“[t]he three HR primary goals of a compensation program are effective recruitment, retention, and motivation”); SIRKIN & CAGNEY, *supra* note 45, at §§ 5.01[2], 6.01[2] (explaining the importance, in designing compensation packages, of determining whether the primary goal of an equity-based compensation program or a cash program is to retain executives or to create incentives to achieve particular performance objectives); Jensen, Murphy, & Wruck, *supra* note 44, at 19 (“A well-designed remuneration package for executives . . . will accomplish three things: attract the right executives at the lowest cost; retain the right

Specific types of compensation, such as equity-based programs or cash plans, can be structured differently depending on whether they are aimed primarily at retention or performance motivation.¹⁵²

As previously noted, entry into chapter 11 reorganization can reduce the value of both retention and performance incentives.¹⁵³ Thus, it is not surprising that KERPs often provide for both retention bonus programs and performance incentive programs. One bankruptcy scholar explains that executive compensation in chapter 11 is designed to address two primary goals—persuading executives to stay and encouraging managers to “preserve rather than squander firm value” during bankruptcy.¹⁵⁴ Unfortunately, however, debtors’ KERP motions have often been less than clear in distinguishing between retention and performance incentives, tending to lump all incentives under a single title like “key employee *retention* program.”¹⁵⁵ Even some bankruptcy scholars, while recognizing performance incentives as a unique feature of KERPs, have conflated the concepts of retention and performance motivation.¹⁵⁶ Until the enactment of § 503(c)(1), in fact, there was little need for bankruptcy attorneys to take care to distinguish between retention and performance incentives in KERPs.

Under the new § 503(c)(1), however, there are good reasons for both bankruptcy attorneys and courts to take care in distinguishing between retention and performance incentives.

A. *The Potential to Cripple DIP Ability to Adequately Compensate Executives*

In recent years, the share of executive compensation in the United States that is attributable to some type of performance-based pay has greatly

executives at the lowest cost . . . ; and motivate executives to take actions that create long-run shareholder value and avoid actions that destroy value.”).

¹⁵² See, e.g., SIRKIN & CAGNEY, *supra* note 45, at §§ 5.01[2], 6.01[2].

¹⁵³ See *supra* notes 52–54 and accompanying text.

¹⁵⁴ Skeel, *see supra* note 88, at 926–27.

¹⁵⁵ See, e.g., Debtor’s Motion for Approval of Key Employee Retention Program, *In re Enron Corp.*, *supra* note 53; Motion of Debtors Pursuant to Sections 363(b) and 105(a), *In re Worldcom*, *supra* note 64.

¹⁵⁶ See George W. Kuney, *Hijacking Chapter 11*, 21 BANKR. DEV. J. 19, 88–89 (2004) (noting that “[p]erformance-based bonuses reward the beneficiary-employee for the increased and improved performance of the debtor’s business” but also referring to such bonuses as “the most effective and desirable type of retention bonus”).

increased.¹⁵⁷ One study shows, for example, that from 1992 to 2002, on average, the share of remuneration for CEOs at S&P 500 firms that was composed of base salary shrunk from 38% to 19%.¹⁵⁸ In contrast, the average share of remuneration composed of bonuses and stock options increased from 46% to 64%, reaching a high of 66% in 2000.¹⁵⁹ Recent surges in performance-based pay for executives has been tied, at least in part, to Congress's encouragement of the use of performance-based pay.¹⁶⁰ In 1993, Congress amended the Internal Revenue Code¹⁶¹ so that any compensation exceeding \$1 million paid to the CEO or any of the four other highest paid officers of a firm was no longer tax deductible as an ordinary business expense.¹⁶² Congress made an exception to this deductible cap, however, for commissions and "[o]ther performance-based compensation" that was "payable solely on account of the attainment of one or more performance goals."¹⁶³

In light of the significant portion of overall executive compensation comprised of performance incentives, as well as the severity of § 503(c)(1)'s restrictions, courts must take care to exclude legitimate performance incentives from § 503(c)(1)'s coverage. If § 503(c)(1) is broadly construed to apply to legitimate performance incentives, this new provision could have an effect far beyond Congress's intended elimination of overgenerous and unfair retention bonuses. Under § 503(c)(1), a transaction or obligation found to be "for the purpose of inducing [an insider] to remain within the debtor's business" will not be allowed unless: (1) the recipient has "a bona fide job offer from another business at the same or greater rate of compensation," (2) "the services provided by the person are essential to the survival of the business," and (3) the payment is not greater than ten times the mean amount of similar payments given to nonmanagement employees during the same calendar year or not greater than twenty-five percent of any similar payment made or promised to the insider during the previous calendar year.¹⁶⁴ These three requirements

¹⁵⁷ See, e.g., Susan J. Stabile, *Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance?*, 2 U. PA. J. LAB. & EMP. L. 227, 228 (1999); Jensen, Murphy, & Wruck, *supra* note 44, at 31.

¹⁵⁸ Jensen, Murphy, & Wruck, *supra* note 44, at 31.

¹⁵⁹ *Id.* The increased use of performance incentives has been almost entirely in the use of stock option grants; the share of compensation attributable to cash bonuses has remained relatively stable. See *id.*

¹⁶⁰ Jensen, Murphy, & Wruck, *supra* note 44, at 30.

¹⁶¹ I.R.C. §§ 1-9833 (2000).

¹⁶² § 162(m)(1), (3).

¹⁶³ § 162(m)(4)(B), (C).

¹⁶⁴ 11 U.S.C.S. § 503(c)(1) (LexisNexis 2006 & Supp. 2006).

amount to only a very narrow exception under which a retention payment to an insider executive might be allowed.¹⁶⁵ Some have even anticipated that the requirement that the insider's services are "essential to the survival of the business" will be "a nearly impossible standard to meet for companies that are not founder dominated and that are run by professional managers."¹⁶⁶ The application of these restrictions to legitimate performance incentives could have a crippling affect on the ability of DIPs to adequately compensate the debtor business's executives—with the possibility of affecting up to half or more of the total value of executive compensation packages.¹⁶⁷

Moreover, exempting legitimate performance incentives from the restrictions of § 503(c)(1) is not inconsistent with Congress's purposes in enacting § 503(c). Congress enacted § 503(c) in large part to eliminate corporate practices in reorganization that were perceived to be deeply unfair.¹⁶⁸ A major source of the sense of unfairness provoked by KERPs was the common perception that the very executives who had run a business into bankruptcy were receiving overly-generous court-approved bonuses simply for agreeing to remain with the debtor's business.¹⁶⁹ Legitimate performance incentives eliminate much of this sense of unfairness because they are not paid to an executive merely for remaining; rather, they are paid to encourage and reward actions that improve the performance of the debtor's business. In other words, they provide independent value in the preservation of the estate¹⁷⁰ beyond the mere retention of an executive.¹⁷¹ Thus, even some critics of KERPs have conceded that performance-based incentives are a less offensive form of bonus.¹⁷²

B. Standards for Identifying Legitimate Performance Incentives

For the reasons noted above, courts will likely have little difficulty in recognizing some need to distinguish between retention bonuses and

¹⁶⁵ See 4 COLLIER, *supra* note 25, at ¶ 503.17[1].

¹⁶⁶ *Id.*

¹⁶⁷ See *supra* notes 157–59 and accompanying text.

¹⁶⁸ See *supra* notes 118–47 and accompanying text.

¹⁶⁹ See, e.g., Kuney, *supra* note 156, at 90; see also Robert J. Keach, *The Case Against KERPs*, Paper for the American Bankruptcy Institute's Annual Spring Meeting (2003), <http://68.72.75.1/abidata/online/conference/03asm/Keach1.html> (last visited Aug. 29, 2006).

¹⁷⁰ See 11 U.S.C. § 503(b)(1)(A) (2000).

¹⁷¹ See Skeel, *supra* note 88, at 928 (“[S]imply paying managers to stay does not necessarily ensure they will reorganize the company efficiently. This is where pay-for-performance . . . comes into play.”).

¹⁷² See, e.g., Kuney, *supra* note 156, at 88–89.

performance incentives in applying § 503(c)(1). The Bankruptcy Court for the District of Delaware, for example, has already made this important distinction in one of the first cases applying § 503(c)(1).¹⁷³ The required care of courts in making such a distinction is, however, double-sided. In finding that § 503(c)(1) does not apply to performance incentives, courts must also take care to establish standards for determining what is a performance incentive rather than a retention incentive. Some bonuses, like target-date bonuses,¹⁷⁴ are obviously retention incentives, and no plausible argument can be made that they motivate executives to reach a particular performance goal. Other bonus programs, however, do not lend themselves to such a limpid distinction between retention and performance incentive. For example, one might ask, without immediate clarity: are target-event bonuses, which condition payment upon continued employment through a period culminating in achievement of a particular stage in the reorganization process,¹⁷⁵ performance incentives or retention incentives? To properly apply § 503(c)(1), courts must develop clear standards for determining what is a performance incentive and therefore not subject to the restrictions of § 503(c)(1).

The need for clear standards for identifying performance incentives that should be exempt from the restrictions of § 503(c)(1) is occasioned by more than the mere fact that bonus programs are often structured so that their function as retentive or performance-motivating is not obvious. Exempting performance incentives from the restrictions of § 503(c)(1) without careful standards for what qualifies as a performance incentive could open a gaping loophole in § 503(c)(1) that would allow DIPs to easily thwart Congress's purposes in enacting that provision. Outside the context of bankruptcy, some critics have pointed out that performance-based pay sometimes opens the door for "pay gimmicks" that look like performance incentives but really provide "guaranteed levels of compensation largely independent of management performance."¹⁷⁶ One commentator has noted that such manipulation of the

¹⁷³ See *In re Nobex Corp.*, No. 05-20050, 2006 Bankr. LEXIS 417 (Bankr. D. Del. Jan. 19, 2006). The court in *Nobex* did not establish any clear guidelines for distinguishing between retention and incentive payments. Factors that appear to have influenced the court were that (1) the executives in question had already committed to continue their employment with the debtor even if no incentive pay was authorized and (2) the structure of the incentive compensation provided for incentive compensation only if the gross sale price of the debtor's assets exceeded the proposed stalking horse bid. *Id.* at para. 11, 15.

¹⁷⁴ See *supra* notes 70–71 and accompanying text.

¹⁷⁵ See *supra* notes 75–82 and accompanying text.

¹⁷⁶ Joshua A. Kreinberg, Note, *Reaching Beyond Performance Compensation in Attempts to Own the Corporate Executive*, 45 DUKE L.J. 138, 150 (1995). Directors, for example, often reprize executive stock options after a market downturn or they set initial performance thresholds too low. *Id.* at 151; see also Susan

performance-based pay system ultimately contributes to “increasing the gap between executive pay and that of rank and file workers.”¹⁷⁷ A sloppy exemption from § 503(c)(1) for alleged performance incentives could open the door for creative debtors to employ similar gimmicks to disguise, as putative performance incentives, what are really guaranteed retention bonuses.

To ensure against abuse of a performance-incentive exemption for § 503(c)(1), courts must demand, at a minimum, that any alleged performance incentive lives up to the justification for its exemption: it must provide independent value to the estate beyond merely inducing the recipient to remain within the debtor’s business.¹⁷⁸ That is, it must truly motivate performance rather than providing the recipient with a guaranteed bonus payment.

One specific resource that courts might employ to determine whether an alleged performance incentive is legitimate are the federal regulations covering the performance-based pay exception to the one million dollar cap on corporate tax deductions for executive compensation.¹⁷⁹ Under federal regulations, to qualify as “performance-based compensation,” an incentive program “must be paid solely on account of the attainment of one or more pre-established, objective performance goals.”¹⁸⁰ Federal regulations specify that a performance goal “does not include the mere continued employment of the covered employee.”¹⁸¹ Furthermore, incentives will not qualify as performance-based compensation “if the payment of compensation under a grant or award is only nominally or partially contingent on attaining a performance goal.”¹⁸² Finally, in addition to certain procedural requirements, an objective performance goal must have been “substantially uncertain” at the time it was established.¹⁸³

J. Stabile, *One for A, Two for B, and Four Hundred for C: The Widening Gap in Pay between Executives and Rank and File Employees*, 36 U. MICH. J.L. REFORM 115, 138–41 (2002); Stabile, *Motivating Executives*, *supra* note 157, at 265.

¹⁷⁷ Stabile, *One for A, Two for B, and Four Hundred for C*, *supra* note 176, at 141.

¹⁷⁸ See *supra* note 170–71 and accompanying text.

¹⁷⁹ See I.R.C. § 162(m)(4)(C) (2000).

¹⁸⁰ TREAS. REG. § 1.162-27(e)(2)(i) (2006).

¹⁸¹ *Id.*

¹⁸² TREAS. REG. § 1.162-27(e)(2)(v). By way of example, the regulations further provide:

[I]f an employee is entitled to a bonus under either of two arrangements, where payment under a nonperformance-based arrangement is contingent upon the failure to attain the performance goals under an otherwise performance-based arrangement, then neither arrangement provides for compensation that satisfies the requirements of this paragraph (e)(2).

Id.

¹⁸³ *Id.* § 1.162-27(e)(2)(i).

Application of these federal regulations defining “performance-based compensation”¹⁸⁴ to bonuses proposed in KERPs can be helpful in distinguishing legitimate performance incentives from retention bonuses. The classification of simple target-event bonuses, for example, becomes clearer. Typical target-event bonuses, like the bonuses proposed in *In re Geneva Steel* entitling “all key employees to a bonus if they are still employed on the date of substantial consummation of [a] plan of reorganization,”¹⁸⁵ probably would not qualify as performance incentives that are exempt from the restrictions of § 503(c)(1) because they are contingent upon the “mere continued employment of the covered employee.”¹⁸⁶ Similarly, alternate target-event bonuses which include a date as one of the alternatives triggering payment¹⁸⁷ would not qualify as performance incentives because they are only nominally contingent on attaining a performance goal, in that one of the alternates (the date) is nonperformance based.¹⁸⁸ Alternates, like those in *In re Georgetown Steel*, providing for payment of a bonus upon the earliest of plan confirmation, a sale of substantially all the company’s assets, or conversion or dismissal of the bankruptcy case,¹⁸⁹ would probably also be considered to have a nonperformance element because conversion or dismissal of the bankruptcy case represents not a performance goal, but a failure. Thus, these types of bonuses would also fail to meet the requirements of a legitimate performance incentive. Finally, even bonuses that are, on their face, aimed at speedy plan confirmation¹⁹⁰ or asset liquidation,¹⁹¹ might not qualify as performance incentives if they set patently easy bonus-payout thresholds, for such goals could be considered not “substantially uncertain.”¹⁹²

Thus, through careful application of the standards for “performance-based compensation” set by the federal regulations governing corporate tax deductions, bankruptcy courts evaluating KERPs under § 503(c)(1) can better

¹⁸⁴ I.R.C. § 162(m)(4)(C).

¹⁸⁵ *In re Geneva Steel Co.*, 236 B.R. 770, 772 (Bankr. D. Utah 1999).

¹⁸⁶ See TREAS. REG. § 1.162-27(e)(2)(i).

¹⁸⁷ See, e.g., *In re Aerovox, Inc.*, 269 B.R. 74, 77 (Bankr. D. Mass. 2001) (bonus payable upon the earlier of “(a) involuntary termination of employment; (b) the sale of all or substantially all of the Debtor’s assets; or (c) June 6, 2002”).

¹⁸⁸ See TREAS. REG. § 1.162-27(e)(2)(v).

¹⁸⁹ See *In re Georgetown Steel Co.*, 306 B.R. 549, 552 (Bankr. D. S.C. 2004).

¹⁹⁰ See, e.g., Motion of Debtors Pursuant to Sections 363(b) and 105(a), *In re Worldcom*, *supra* note 64, para. 14; see also notes 83–85 and accompanying text.

¹⁹¹ See, e.g., Debtor’s Motion for Approval of Key Employee Retention Program, *In re Enron Corp.*, *supra* note 53, para. 25-33; see also notes 83, 86–88 and accompanying text.

¹⁹² See TREAS. REG. § 1.162-27(e)(2)(i).

ensure that they create only a narrow exemption for the restrictions of § 503(c)(1). This exemption would apply to only those incentives that truly motivate real performance goals such as speedy confirmation, asset liquidation, or maximization of a company's value.¹⁹³

IV. PAY TO GO? SECTION 503(C)(2) AND THE FALSE DISTINCTION BETWEEN SEVERANCE AND LIQUIDATED DAMAGES

Just as courts will need to interpret the threshold language of § 503(c)(1), courts will need to answer the threshold question, what qualifies as “severance,” in applying § 503(c)(2). If an executive termination pay arrangement is not considered severance, none of the restrictions of § 503(c)(2) will apply to it. As noted above, KERPs employ a number of compensation mechanisms to create secure termination pay arrangements for executives.¹⁹⁴ These include adopting new or modified severance policies, assuming individual employment contracts containing termination pay arrangements, and entering new individual employment contracts containing termination pay arrangements.¹⁹⁵

While there is little question that § 503(c)(2) applies to claims for payments pursuant to a traditional severance plan continued or adopted postpetition, whether § 503(c)(2) will apply to claims for payments arising from individual employment contracts assumed or entered into postpetition is less clear.¹⁹⁶ Some have suggested that a termination pay claim arising from an individual employment contract might be considered not as a claim for severance but, rather, as a claim for damages for the debtor's failure to fulfill the contract.¹⁹⁷ If a claim based on an individual employment contract is so construed as a claim for damages rather than a claim for severance, the restrictions of § 503(c)(2) will not apply to it.

The word “severance” in § 503(c)(2), however, should not be construed to exclude claims arising from individual employment contracts. Such a construction would be inconsistent with Congress's purposes in enacting

¹⁹³ See Skeel, *supra* note 88, at 948 (noting the potential for pay-to-perform bonuses to encourage value maximization in addition to or as an alternative to speedy reorganization or liquidation).

¹⁹⁴ See *supra* notes 89–93 and accompanying text.

¹⁹⁵ See *supra* notes 89–93 and accompanying text.

¹⁹⁶ See 4 COLLIER, *supra* note 25, at ¶ 503.17[2].

¹⁹⁷ *Id.*

§ 503(c)(2). Neither is such a construction required by the majority of relevant case law.

A. Remembering Congress's Purpose: Construing Severance to Protect Workers

Congress enacted § 503(c) to provide better protection under the Bankruptcy Code for nonmanagement employees of bankrupt companies.¹⁹⁸ The perceived need for this increased protection for workers arose, in part, because under the pre-BAPCPA Code, many companies in chapter 11 reorganization were receiving court approval for KERPs that promised to make very generous payments to executives while the same companies laid off thousands of employees and denied them severance, vacation pay, benefit contributions and other benefits.¹⁹⁹ This disparity in the treatment of nonmanagement employee claims for severance and other benefits versus the treatment of executive KERP claims was made possible by the fact that the pre-BAPCPA Code placed caps and time limits on the amount of an employee's prepetition severance or benefit claim that could receive third or fourth priority, but it placed no caps or time limits on the amount of an executive KERP claim that could receive first priority as an administrative expense.²⁰⁰

One means employed by KERPs to provide security for debtors' executives is the postpetition institution of generous severance policies for those executives.²⁰¹ Section 503(c)(2) provides Congress's intended protection for workers by ensuring that if a DIP wants to make large severance payments to an insider, the DIP will have to make good on a proportional severance plan for all full-time nonmanagement employees.²⁰² The amount of a severance payment to an insider cannot exceed ten times the mean severance payment given to nonmanagement employees in the same calendar year.²⁰³ To illustrate how such a rule provides better protection for nonmanagement employees, one might compare the respective fates, under the pre-BAPCPA Code and the new § 503(c)(2), of a nonmanagement employee with a prepetition severance claim for \$50,000 and an insider of the same company owed \$500,000 in severance

¹⁹⁸ See *supra* Part II.

¹⁹⁹ See *supra* Part II.

²⁰⁰ See *supra* Part I.

²⁰¹ See *supra* note 89 and accompanying text.

²⁰² See 11 U.S.C.S. § 503(c)(2) (LexisNexis 2006).

²⁰³ § 503(c)(2).

under a KERP. Under the pre-BAPCPA Code, regardless of how much or how little severance any nonmanagement employee received, the insider would have been assured full payment of the \$500,000 severance claim as an expense of administration.²⁰⁴ The nonmanagement employee, on the other hand, would only have been assured full payment of a maximum \$4925 priority severance claim (less if she did not earn the full \$4925 within ninety days before the debtor filed its petition); the other \$45,075 of her severance claim would have been a general unsecured claim for which she would likely receive little or no payment.²⁰⁵ Under § 503(c)(2), however, the results are much different. To be permitted to pay an insider a severance payment of \$500,000, a DIP would have to pay severance to all full-time nonmanagement employees terminated in the same calendar year, and the mean nonmanagement employee severance payment would have to be at least \$50,000.²⁰⁶

Some debtors, instead of instituting generous postpetition executive severance policies, propose in their KERPs to either enter into or assume executive employment contracts that provide for generous termination payments.²⁰⁷ Often, what can be accomplished by a generous severance policy can also be accomplished by an individual employment contract. For example, one might compare the severance policy proposed in *In re Aerovox*²⁰⁸ with contracts assumed in *In re Interco*.²⁰⁹ In either case the severance policy and contracts, respectively, provided mitigating circumstances according to which the amount of the affected executive's entitlement decreased. Under the policy proposed in *In re Aerovox*, the executive's entitlement to payment of her annual salary would be reduced by any amount she earned by alternative employment during the twelve months immediately following her termination.²¹⁰ In *In re Interco*, the debtor assumed employment contracts providing for payment of two years compensation if termination occurred early in the periods covered by the contracts, with payments "scaled down to one year ratably" if termination occurred later.²¹¹ Similarly, an executive's

²⁰⁴ See 11 U.S.C. §§ 503(b)(1), 507(a)(2), 1129(a)(9)(A) (2000); see also *supra* notes 37–39, 104–05 and accompanying text.

²⁰⁵ See § 507(a)(3); *In re Suburban Motor Freight, Inc.*, 998 F.2d 338, 342 (6th Cir. 1993); *In re U.S. Airways Group, Inc.*, 303 B.R. 784, 792 (Bankr. E.D. Va. 2003); see also *supra* note 56 and accompanying text.

²⁰⁶ See 11 U.S.C.S. § 503(c)(2) (LexisNexis 2006).

²⁰⁷ See *supra* notes 92–93 and accompanying text.

²⁰⁸ *In re Aerovox, Inc.*, 269 B.R. 74, 77 (Bankr. D. Utah 1999).

²⁰⁹ *In re Interco Inc.*, 128 B.R. 229, 233 (Bankr. E.D. Mo. 1991).

²¹⁰ *In re Aerovox, Inc.*, 269 B.R. at 77.

²¹¹ *In re Interco Inc.*, 128 B.R. at 233.

entitlement to payment can be conditioned upon termination for reasons other than death, disability or cause under a severance policy, as proposed in *In re Geneva Steel Company*,²¹² or the same condition can be imposed under an individual employment contract like the one assumed in *In re Interco*.²¹³

Because an individual employment contract can be substituted for an executive severance policy with ease, construing the term “severance” in § 503(c)(2) to exclude claims arising from individual employment contracts would render § 503(c)(2) virtually meaningless. If “severance” were construed to apply only to severance policies, § 503(c)(2) would place no restrictions on the debtor company that, in contemplation of bankruptcy, negotiates new employment contracts with generous termination payment provisions with its executives and then assumes those contracts in a postpetition KERP. Nor would § 503(c)(2) place any restrictions on the debtor company that proposes a KERP calling for the DIP to enter new employment contracts with generous termination payment provisions postpetition.

An extension of the previous example serves as a helpful illustration. Recall that under § 503(c)(2), to be permitted to pay an insider a severance payment of \$500,000 under a severance policy, a DIP would have to pay severance to all full-time nonmanagement employees terminated in the same calendar year, and the mean nonmanagement employee severance payment would have to be at least \$50,000.²¹⁴ If, however, the same DIP wanted to avoid making sizeable severance payments to all the full-time nonmanagement employees it laid off, it could negotiate a postpetition employment agreement with the insider that provided for a \$500,000 termination payment under essentially the same terms as the hypothetical severance policy. If § 503(c)(2) were construed to exclude individual employment contracts, the insider would be assured full payment of the \$500,000 as an expense of administration, and the DIP would have no obligation to make proportional severance payments to any nonmanagement employees. At most, the nonmanagement employee with a prepetition severance claim for \$50,000 would receive a § 507(a)(4) priority

²¹² *In re Geneva Steel Co.*, 236 B.R. 770, 772 (Bankr. D. Utah 1999) (each executive entitled to six months salary if terminated “for any reason other than death, disability, or cause prior to the date of substantial consummation of a plan of reorganization . . .”).

²¹³ *In re Interco Inc.*, 128 B.R. at 233 (executives entitled to either three years salary, bonuses, and fringe benefits, or to one to two years salary, if terminated for reasons other than death, disability, or cause). Under the contracts in *Interco*, some executives’ termination pay also could not be paid if termination was for retirement but could be paid if the executive voluntarily terminated his own employment for “good reason.” *Id.*

²¹⁴ See 11 U.S.C.S. § 503(c)(2) (LexisNexis 2006).

severance claim for \$10,000; the other \$40,000 of her severance claim would become a general unsecured claim for which she would likely receive little or no payment.²¹⁵

From this example, it becomes clear that if the word “severance” in § 503(c)(2) is construed to exclude claims arising from individual employment contracts, debtors will be able to simply bypass the proportionality requirement of § 503(c)(2) by negotiating or assuming individual employment contracts instead of adopting or modifying executive severance policies. Workers will be left with little more protection than they began with against large executive termination payments that rob the bankruptcy estate of funds that could be used to pay other creditors, particularly employees who are truly likely to “suffer serious hardship because of their employer’s bankruptcy.”²¹⁶ This cannot be the result Congress intended when it enacted § 503(c)(2), an amendment “[t]o protect employees and retirees from corporate practices that deprive them of their earnings and retirement savings when a business files for bankruptcy.”²¹⁷

B. The Majority and Minority Severance Rules

Despite Congress’s purpose in enacting § 503(c)(2), advocates of the proposal that § 503(c)(2) ought not to apply to claims arising from individual employment contracts will likely argue that a number of cases indicate that a termination pay claim arising from an employment contract is not severance but, rather, a claim for liquidated damages.²¹⁸ This argument will rely upon a number of cases arising out of the Second Circuit which do, in fact, hold that claims arising from individual employment contracts are not “severance” as the Second Circuit has defined it.²¹⁹ The holdings in those cases, however, result from the fact that the Second Circuit has adopted a minority approach which both narrowly defines severance and overgenerously awards administrative priority to severance claims.²²⁰ In a majority of circuits, courts recognize the existence of various types of severance and have developed

²¹⁵ See *id.* § 507(a)(4); *Yoder v. OH Bureau of Workers’ Comp. (In re Suburban Motor Freight, Inc.)*, 998 F.2d 338, 342 (6th Cir. 1992); *In re U.S. Airways Group, Inc.*, 303 B.R. 784, 792 (Bankr. E.D. Va. 2003).

²¹⁶ *In re N. Atl. & Gulf S.S. Co.*, 192 F. Supp. 107, 109 (S.D.N.Y. 1961).

²¹⁷ See Employee Abuse Prevention Act of 2002, S. 2798, 107th Cong. (2002).

²¹⁸ See 4 COLLIER, *supra* note 25, at ¶ 503.17[2].

²¹⁹ See, e.g., *In re Crystal Apparel, Inc.*, 220 B.R. 816 (Bankr. S.D.N.Y. 1998); *In re Jamesway Corp.*, 199 B.R. 836 (Bankr. S.D.N.Y. 1996); *In re Hooker Inv., Inc.* 145 B.R. 138 (Bankr. S.D.N.Y. 1992).

²²⁰ See *infra*, notes 270–75 and accompanying text.

different rules to apply to each type, including termination pay claims arising from individual employment contracts.²²¹

1. *The Majority*

Since before the current Bankruptcy Code, under the Bankruptcy Act of 1898, the majority of courts have recognized two primary types of severance: (1) pay at termination in lieu of notice and (2) pay at termination based on length of employment.²²² When a postpetition severance claim is based on a policy providing for pay at termination in lieu of notice, courts will award administrative priority to the entire claim.²²³ This rule originated in the landmark case of *In re Public Ledger*.²²⁴ There, the Third Circuit considered severance claims by a group of employees covered by a collective bargaining agreement that called for pay at termination in lieu of notice.²²⁵ Specifically, the agreement provided that “[t]wo working days’ notice shall be given a situation holder before being laid off;” or, if such notice was not given, the employer was required to pay the wages for the term of the required notice.²²⁶ The court awarded administrative priority to the entirety of each severance claim for this group, reasoning that because the trustee had both continued employment of the claimants under the terms of the agreement and chosen not to give notice, the severance pay was “wholly earned and accrued under the trustees’ management” and therefore presumed to be a necessary expense of administration.²²⁷ When, on the other hand, a postpetition severance claim is based on a policy calling for pay at termination based on length of employment, courts consider severance to be earned on a day-by-day basis and

²²¹ See, e.g., *Cramer v. Mammoth Mart, Inc. (In re Mammoth Mart, Inc.)* 536 F.2d 950 (1st Cir. 1976) (severance based on length of service); *In re Public Ledger, Inc.* 161 F.2d 762 (3d Cir. 1947) (different rules for severance based on length of service and severance tied to lack of notice); *Dullanty v. Selectors, Inc. (In re Selectors, Inc.)*, 85 B.R. 843 (B.A.P. 9th Cir. 1988) (asserting rules for severance claims arising from prepetition employment contracts in contrast to rules for other types of severance).

²²² See, e.g., *In re Roth Am., Inc.* 975 F.2d 949, 957 (3d Cir. 1992); *Kal W. Lines v. Sys. Bd. of Adjustment No. 94 Bhd. of Ry., Airline & S.S. Clerks (In re Health Maint. Found.)*, 680 F.2d 619, 621 (9th Cir. 1982); *In re Miami Gen. Hosp., Inc.*, 89 B.R. 980, 984 (Bankr. S.D. Fla. 1988); see also J. Benjamin Earthman, *Illusory Protection: The Treatment of Severance Packages in Business Bankruptcies*, 5 U. PA. J. LAB. & EMP. L. 33, 55–64 (2002); Roger J. Higgins, *Severance Pay and the Termination of Employees During Bankruptcy*, 19 No. 8 BANKR. STRATEGIST 1, June 2002, at 1.

²²³ See, e.g., *In re Elliot Wholesale Grocery Co.*, 98 F. Supp. 1017 (S.D. Cal. 1951); *In re Miami Gen. Hosp., Inc.*, 89 B.R. at 985; see also *In re Health Maint. Found.*, 680 F.2d at 621; *In re Selectors, Inc.*, 85 B.R. at 845; *In re Allegheny Intl., Inc.*, 118 B.R. 276, 279 (Bankr. W.D. Pa. 1990).

²²⁴ *In re Public Ledger, Inc.*, 161 F.2d 762 (3d Cir. 1947).

²²⁵ *Id.* at 770.

²²⁶ *Id.*

²²⁷ *Id.* at 770–71.

will only award administrative priority to that portion of the severance that was earned during postpetition employment.²²⁸ This rule also originated in *In re Public Ledger*. There, the court considered a second group of employees covered by a collective bargaining agreement calling for pay at termination based on length of employment.²²⁹ Their agreement provided that the employer would pay, to any member of the union that was discharged, “a sum of money in cash equivalent to: Two weeks’ pay if employed more than a total of six months and less than one year” and provided differently for employees who had been employed for longer periods.²³⁰ The court did not award administrative priority to the entireties of this group’s severance claims.²³¹ Rather, the court reasoned that under a severance provision based on length of employment, only a portion of the severance payment was earned under the trustee’s management because the severance was “money earned each day of the service,” which “mature[d] in time to the status of a due debt.”²³² Only that portion of severance that had been earned in postpetition service would receive priority as an administrative expense.²³³

Termination pay claims arising from individual employment contracts initially presented something of a problem for majority-rule courts because termination provisions in employment contracts tend to bear little resemblance to either termination pay in lieu of notice or termination pay based on length of service.²³⁴ Though some courts have awkwardly analogized claims based on employment contracts to one of the two primary types of severance,²³⁵ many courts avoid analogizing and, instead, follow the approach of the Bankruptcy Appellate Panel of the Ninth Circuit in *In re Selectors*.²³⁶ In *Selectors*, the court considered an administrative priority claim by the debtor’s former in-house counsel.²³⁷ The claim was based on an individual employment contract that provided, in a “parachute clause,” that the claimant would be paid a severance bonus of \$25,000 by the debtor if the employment agreement was

²²⁸ See, e.g., *In re Roth Am., Inc.* 975 F.2d 949, 957–58 (3d Cir. 1992); *In re Health Maint. Found.*, 680 F.2d 619 (9th Cir. 1982); *In re Mammoth Mart, Inc.*, 536 F.2d 950 (1st Cir. 1976).

²²⁹ *In re Public Ledger, Inc.*, 161 F.2d 762, 771 (3d Cir. 1947).

²³⁰ *Id.*

²³¹ *Id.* at 773.

²³² *Id.*

²³³ *Id.*

²³⁴ See, e.g., *In re Selectors*, 85 B.R. 843, 846 (B.A.P. 9th Cir. 1988); *In re Uly-Pak, Inc.*, 128 B.R. 736, 768 (Bankr. S.D. Ill. 1991).

²³⁵ See *In re Miami Gen. Hosp., Inc.*, 89 B.R. 980, 984 (Bankr. S.D. Fla. 1988).

²³⁶ *In re Selectors*, 85 B.R. at 843.

²³⁷ *Id.* at 844.

terminated by either party within ninety days of a change of control.²³⁸ Within a month after a change of control, the debtor filed a chapter 11 petition and then fired the claimant.²³⁹ In examining the claim, the court considered it a severance claim but declined to force it into either of the two majority-rule severance categories recognized by the Ninth Circuit.²⁴⁰ Because the clause provided for neither termination pay in lieu of notice nor termination pay based on length of service, the court found that the Ninth Circuit did not have a severance rule on point and evaluated the claim, instead, using the general test for administrative priority—asking whether the clause gave rise to an actual and necessary expense of preserving the estate.²⁴¹

The *Selectors* approach has been followed by most majority-rule courts evaluating termination pay claims arising from individual employment contracts.²⁴² These courts evaluate the claims arising from employment contracts as a separate type of severance that is examined under a general administrative priority test.²⁴³ Specifically, this test requires that the severance provision (1) arose out of a transaction with the estate and (2) benefited the estate.²⁴⁴ In the Third Circuit, for example, the Bankruptcy Court for the District of Delaware declined to apply the in lieu of notice/length of service rules to a claim arising from an employment contract that provided for an executive to continue receiving his salary and benefits for one year after termination if terminated without cause.²⁴⁵ The court explained that “length of service and termination in lieu of notice provisions in employment contracts do not exhaust the universe of types of severance pay clauses,”²⁴⁶ and it classified the clause before it as a third type of severance, which it dubbed a “‘termination without cause’ type of severance provision.”²⁴⁷ Because the court found that the claim for severance neither arose from a postpetition transaction nor was beneficial to the operation of the estate, it denied

²³⁸ *Id.*

²³⁹ *Id.*

²⁴⁰ *Id.* at 846.

²⁴¹ *Id.* The court found that the clause did not give rise to a necessary expense of preserving the estate because the consideration for the clause was the claimant’s willingness to give up his law practice to work for debtor. This consideration was a benefit to the prepetition debtor, not to the estate. *Id.*

²⁴² See, e.g., *In re Nomus-Am., Inc.*, No. 01-50255 11, 2002 Bankr. LEXIS 1657 (Bankr. M.D.N.C. Feb. 8, 2002); *In re M Group, Inc.*, 268 B.R. 896 (Bankr. D. Del. 2001); *In re Commercial Fin. Serv., Inc.*, 233 B.R. 885 (Bankr. N.D. Okla. 1999); *In re Uly-Pak, Inc.*, 128 B.R. 763 (Bankr. S.D. Ill. 1991).

²⁴³ See *supra* note 242.

²⁴⁴ See *supra* note 242.

²⁴⁵ *In re M Group, Inc.*, 268 B.R. at 900–01.

²⁴⁶ *Id.* at 901.

²⁴⁷ *Id.* at 900.

administrative priority.²⁴⁸ Similarly, a bankruptcy court in the Fourth Circuit applied the same analysis to an administrative expense claim arising from an employment agreement providing for six months of severance pay in the event of termination without cause.²⁴⁹

In addition to courts in the Third, Fourth, and Ninth Circuits mentioned above, courts in the Fifth, Seventh, and Tenth circuits have also adopted the *Selectors* approach to administrative expense claims arising from termination provisions in individual employment contracts.²⁵⁰ Far from excluding termination pay claims arising from employment contracts from the definition of severance, these courts instead understand such claims as a type of severance that can be evaluated using the general rules of administrative priority.

2. *The Minority*

Unlike the majority of courts, the Second Circuit courts tend not to classify termination pay claims arising from individual employment contracts as a type of severance.²⁵¹ Instead, these courts classify claims arising from termination provisions in employment contracts as liquidated damages.²⁵² In holding that termination pay claims arising from employment contracts are not severance, courts reason that, in the Second Circuit, “severance” is a narrowly defined “term of art.”²⁵³ They rely for this definition upon the definition of severance articulated in the seminal pre-Code case of *Straus-Duparquet*.²⁵⁴

²⁴⁸ *Id.* at 902.

²⁴⁹ *In re Nomus-Am., Inc.*, No. 01-50255 11, 2002 Bankr. LEXIS 1657, at *2 (Bankr. M.D.N.C. Feb. 8, 2002).

²⁵⁰ *See Lasky v. Phones for All, Inc. (In re Phones for All, Inc.)*, 262 B.R. 914, 917–18 (N.D. Tex. 2001) (claim arising from individual employment contract providing for severance pay, for the greater period of the remaining term of the contract or one year after termination, in the event of early termination or termination for good reason); *In re Commercial Fin. Serv., Inc.*, 233 B.R. 885, 890–93 (Bankr. N.D. Okla. 1999) (claim arising from contract providing for a lump sum payment of one year’s salary in the event of early termination without cause); *In re Uly-Pak, Inc.*, 128 B.R. 763, 766–68 (Bankr. D.S. Ill. 1991) (claim arising from contract providing for severance pay, for the debtor’s choice of either the balance of the contract term or a lump sum equal to 300% of the employee’s annual salary, in the event of termination for any reason other than willful misconduct).

²⁵¹ *See, e.g., In re Crystal Apparel, Inc.*, 220 B.R. 816, 836 (Bankr. S.D.N.Y. 1998); *In re Jamesway Corp.*, 199 B.R. 836, 840–41 (Bankr. S.D.N.Y. 1996); *In re Hooker Inv., Inc.*, 145 B.R. 138, 147 (Bankr. S.D.N.Y. 1992).

²⁵² *See, e.g., In re Jamesway Corp.*, 199 B.R. at 841; *In re Hooker Inv., Inc.* 145 B.R. at 147–48.

²⁵³ *See In re Crystal Apparel, Inc.*, 220 B.R. at 836.

²⁵⁴ *Straus-Duparquet, Inc. v. Local Union No.3, Int’l. Bhd. of Electrical Workers (In re Straus-Duparquet, Inc.)*, 386 F.2d 649 (2d Cir. 1967).

[A] form of compensation for the termination of the employment relation, for reasons other than the displaced employees' misconduct, primarily to alleviate the consequent need for economic readjustment but also to recompense him for certain losses attributable to the dismissal.²⁵⁵

In *Straus-Duparquet*, the Second Circuit declared a rule fundamentally different from the severance rules that have been applied by a majority of courts—the court would accord administrative priority to all severance claims arising postpetition, even if based on length of service.²⁵⁶ Faced with an administrative expense claim for severance based on the length of the affected employee's past service to the company, the court held that “[s]everance pay is not earned from day to day and does not ‘accrue’ so that a proportionate part is payable under any circumstances. After the period of eligibility is served, the full severance pay is due whenever termination of employment occurs.”²⁵⁷ Because the claimants were terminated “as an incident of the administration of the bankrupt's estate,” the entirety of their severance claims were considered an expense of administration and entitled to priority.²⁵⁸

Building on the *Straus-Duparquet* definition of severance, the Second Circuit courts have developed three basic elements of severance.²⁵⁹ First, to be classified as severance, the purpose of the payment must be to compensate the affected employee for the economic hardship of job loss.²⁶⁰ Second, the purpose of the payment should also be to reward the affected employee for past service to the company.²⁶¹ Third, if the payment is not for a fixed amount, it should increase based upon the employee's length of service to the company.²⁶²

²⁵⁵ *Id.* at 651; *see also In re Applied Theory Corp.*, 312 B.R. 225, 242 (Bankr. S.D.N.Y. 2004); *In re Hooker Inv., Inc.*, 145 B.R. at 149.

²⁵⁶ *See Straus-Duparquet, Inc.*, 386 F.2d at 651.

²⁵⁷ *Id.*

²⁵⁸ *Id.*

²⁵⁹ *See, e.g., In re Applied Theory Corp.*, 312 B.R. at 242–44; *In re Crystal Apparel, Inc.*, 220 B.R. 816, 836 (Bankr. S.D.N.Y. 1998); *In re Jamesway Corp.*, 199 B.R. 836, 840 (Bankr. S.D.N.Y. 1996); *In re Hooker Inv., Inc.*, 145 B.R. 138, 149–50 (Bankr. S.D.N.Y. 1992).

²⁶⁰ *See In re Applied Theory Corp.*, 312 B.R. at 243–44; *In re Jamesway Corp.*, 199 B.R. at 840; *In re Hooker Inv., Inc.*, 145 B.R. at 149–50.

²⁶¹ *See In re Applied Theory Corp.*, 312 B.R. at 242, 244; *In re Jamesway Corp.*, 199 B.R. at 840; *In re Hooker Inv., Inc.*, 145 B.R. at 149–50.

²⁶² *See In re Applied Theory Corp.*, 312 B.R. at 244; *In re Crystal Apparel, Inc.*, 220 B.R. at 836; *In re Jamesway Corp.*, 199 B.R. at 840; *In re Hooker Inv., Inc.*, 145 B.R. at 150.

Second Circuit courts have used this definition of severance to deny administrative priority to most postpetition termination pay claims arising from individual employment contracts.²⁶³ In *In re Jamesway*, for example, the debtor's former president and CEO filed an administrative expense claim for severance based upon his employment contract with the debtor.²⁶⁴ The contract provided that if the officer were terminated prior to the expiration of his contract employment term, he would be entitled to the greater of either the base salary that would have been payable to him had he completed his employment term or twice his existing base salary.²⁶⁵ The debtor filed a chapter 11 petition and subsequently terminated the claimant before the expiration of his employment term; the claimant claimed he was entitled to one million dollars, which was twice his base salary, as an administrative expense.²⁶⁶ The court found that the claim was not entitled to administrative priority because it lacked "typical characteristics of severance pay."²⁶⁷ Specifically, the court based its decision on the fact that the payments provided for in the contract were not consideration for the claimant's past service to the debtor; rather they were earned when he joined the debtor as "the inducement to get [the claimant] to give up his benefits at [his former employer]" and work for the debtor.²⁶⁸ Furthermore, the court noted that, rather than increasing with the length of the claimant's employment, the payments under the contract were designed to decrease during the claimant's first year under the employment term.²⁶⁹ Finally, the court found that the payments did not protect the claimant from the economic hardship of joblessness.²⁷⁰ This analysis in *In re Jamesway* is typical of the analysis that has been employed in the Second Circuit to deny administrative priority to a number of termination pay claims arising from individual employment contracts.²⁷¹

²⁶³ See, e.g., *In re Crystal Apparel, Inc.*, 220 B.R. at 836; *In re Jamesway Corp.*, 199 B.R. at 841; *In re Hooker Inv., Inc.*, 145 B.R. at 149–50.

²⁶⁴ *In re Jamesway Corp.*, 199 B.R. at 837–39.

²⁶⁵ *Id.* at 838.

²⁶⁶ *Id.* at 837–38.

²⁶⁷ *Id.* at 841.

²⁶⁸ *Id.*

²⁶⁹ *Id.*

²⁷⁰ *Id.* at 836.

²⁷¹ See, e.g., *In re Crystal Apparel, Inc.*, 220 B.R. 816, 836 (Bankr. S.D.N.Y. 1998) (change of control agreement not severance because not based on length of service); *In re Hooker Inv., Inc.*, 145 B.R. 138, 149–50 (Bankr. S.D.N.Y. 1992) (claim arising from employment contract not "severance" because (1) consideration for the payments was claimant's original, prepetition commitment to a five-year term of employment with the debtor, (2) the amount of the payments was inversely proportional to the length of service, and (3) "the provision for the payments seems designed more to encourage the Debtors to retain the Claimant than to protect the Claimant from the economic hardship of joblessness").

Although courts in the Second Circuit have expressly reasoned that termination pay claims arising from individual employment contracts cannot be considered severance because they do not fit the Second Circuit's narrow definition of "severance" as a term of art, they have also indicated that at least as much reason for denying the label of severance to claims arising from employment contracts is repugnance toward the idea of affording administrative priority to the entirety of such large claims as would be required if applying the generous *Straus-Duparquet* severance rule.²⁷² In *In re Hooker*, for example, after explaining that a termination pay claim for over \$4 million was not a severance claim under the Second Circuit's definition of severance, the court further noted that policy reasons precluded classifying the claim as severance.²⁷³ If the claim were classified as a claim for severance, *Straus-Duparquet* would have required that the entire \$4 million claim receive administrative priority.²⁷⁴ The court reasoned that if *Straus-Duparquet* applied to claims arising from individual employment contracts, the executive's time of discharge would be elevated to "talismanic significance":

[I]f it is post-petition by even one minute, the employee's termination pay claim would become an expense of administration even though the contract is subsequently rejected. No debtor could avoid the spectre of extraordinary post-petition liability except by firing all executives prior to filing.²⁷⁵

Similarly, in *In re Crystal Apparel, Inc.*, the court noted that under the *Straus-Duparquet* severance rule, a DIP could "become liable for large severance pay claims even though it kept its employees on but for a few weeks."²⁷⁶ After holding that two executive termination pay claims arising from individual employment contracts and calling for payment of 2.99 times the executives' base salaries were not severance as the Second Circuit had come to use the term, the court further noted that the claimants sought "nothing less than a windfall of significant size to the detriment of other creditors."²⁷⁷

The overgenerosity of the *Straus-Duparquet* rule upon which Second Circuit courts base their definition of severance weighs heavily against any suggestion that the Second Circuit's definition of severance ought to be applied

²⁷² See, e.g., *In re Crystal Apparel, Inc.*, 220 B.R. at 835–36; *In re Hooker Inv., Inc.* 145 B.R. at 150.

²⁷³ *In re Hooker Inv., Inc.*, 145 B.R. at 150.

²⁷⁴ *Id.* at 145.

²⁷⁵ *Id.* at 150.

²⁷⁶ *In re Crystal Apparel, Inc.*, 220 B.R. at 835.

²⁷⁷ *Id.* at 836.

to the term “severance” in § 503(c)(2). Because of its overgenerous awards of administrative priority to all severance claims, the Second Circuit’s *Straus-Duparquet* rule has been criticized by other courts as being inconsistent with the priority scheme established by Congress.²⁷⁸ In *In re Mammoth Mart*, for example, the court noted that such a rule affording administrative (first) priority for the entirety of a claim for severance based upon length of employment would be inconsistent with section 64(a)(2) of the Bankruptcy Act, which provided that wages earned in the three months prior to the petition were entitled to second priority up to a maximum of \$600.²⁷⁹ The adoption of the *Straus-Duparquet* rule, the court explained,

[W]ould undermine the values promoted by the Congressional scheme. Under it, individuals could, based solely upon their relationship with the debtor, recover ‘severance pay’ in excess of the \$600 and subject to no maximum. Moreover, they would recover these claims ahead of bona fide wage claims of other former employees (possibly exhausting the bankrupt’s assets in doing so) and without prejudice to any wage claims that the severance pay claims might themselves have.²⁸⁰

Courts have also made the same objection to the *Straus-Duparquet* rule as applied under the Bankruptcy Code’s § 507(a) priority scheme.²⁸¹ In *In re Allegheny International*, the court noted that to give administrative priority to the entirety of a severance claim based on length of employment would allow it to recover “ahead of bona fide wage claims of other former employees and without prejudice to any wage claim” that the severance claimant might have, “an injustice that Congress could not have intended.”²⁸²

One final factor that weighs against construing the term “severance” in § 503(c)(2) to exclude termination pay claims arising from individual employment contracts is that even courts in the Second Circuit have not unambiguously ruled out the possibility that such claims are for a type of severance.²⁸³ In a recent case, the Bankruptcy Court for the Southern District of New York denied administrative priority to claims by former executives for termination payments based on individual employment contracts and equal to

²⁷⁸ See *In re Mammoth Mart, Inc.*, 536 F.2d 950, 955–56 (1st Cir. 1976); *In re Allegheny Int’l., Inc.* 118 B.R. 270, 280 (Bankr. W.D. Pa. 1990).

²⁷⁹ *In re Mammoth Mart, Inc.*, 536 F.2d at 955.

²⁸⁰ *Id.* at 955–56.

²⁸¹ See *In re Allegheny Int’l.*, 118 B.R. at 280.

²⁸² *Id.* at 280.

²⁸³ See *In re Applied Theory Corp.* 312 B.R. 225 (Bankr. S.D.N.Y. 2004).

multiple years of their base salaries.²⁸⁴ The court denied administrative priority because it found that the payments were not designed to compensate for the economic hardship of job loss and did not depend on the employees' length of service, "like traditional severance pay."²⁸⁵ Instead of flatly ruling that the payments were not severance, however, the court carefully stated that the payments were "a very different *type* of so called 'severance,'"²⁸⁶ and "not the same *kind* of 'severance pay' whose payment was authorized by the Second Circuit in *Straus-Duparquet*."²⁸⁷ Such language suggests that, even in the Second Circuit, termination payments arising from individual employment contracts might rightly be considered severance in other contexts, including in the application of § 503(c)(2).

3. *The Superiority of the Majority Rule*

So far, the majority severance rules and the Second Circuit severance rules have not produced significantly different results when applied to administrative expense claims for termination pay arising from individual employment contracts.²⁸⁸ Both rules have operated to deny administrative priority to those claims—by their classification as a third and different type of severance in courts following the majority rule,²⁸⁹ and by their exclusion from the definition of severance in the Second Circuit.²⁹⁰ The significance of the difference between these rules lies in their potential application under § 503(c)(2). Both majority rule courts and Second Circuit courts have used their severance rules to deny administrative priority to claims arising from individual employment contracts that either have been rejected by the DIP or have been neither

²⁸⁴ *In re Applied Theory Corp.*, 312 B.R. at 230–31.

²⁸⁵ *Id.* at 243–44.

²⁸⁶ *Id.* at 242 (emphasis added).

²⁸⁷ *Id.* at 246 (emphasis added).

²⁸⁸ *See, e.g., In re Selectors, Inc.*, 85 B.R. 843 (9th Cir. B.A.P. 1988); *In re Nomus-Am., Inc.*, No. 01-50255 11, 2002 Bankr. LEXIS 1657 (Bankr. M.D.N.C. Feb. 8, 2002); *In re M Group, Inc.*, 268 B.R. 896 (Bankr. D. Del. 2001); *In re Commercial Fin. Serv., Inc.*, 233 B.R. 885 (Bankr. N.D. Okla. 1999); *In re Crystal Apparel, Inc.*, 220 B.R. 816 (Bankr. S.D.N.Y. 1998); *In re Jamesway Corp.*, 199 B.R. 836 (Bankr. S.D.N.Y. 1996); *In re Hooker Inv., Inc.*, 145 B.R. 138 (Bankr. S.D.N.Y. 1992); *In re Uly-Pak, Inc.*, 128 B.R. 763 (Bankr. S.D. Ill. 1991).

²⁸⁹ *See, e.g., In re Nomus-Am., Inc.*, 2002 Bankr. LEXIS 1657; *In re M Group, Inc.*, 268 B.R. 896; *In re Commercial Fin. Serv., Inc.*, 233 B.R. 885; *In re Uly-Pak, Inc.*, 128 B.R. 763; *In re Selectors, Inc.*, 85 B.R. 843.

²⁹⁰ *See, e.g., In re Crystal Apparel, Inc.*, 220 B.R. 816; *In re Jamesway Corp.*, 199 B.R. 836; *In re Hooker Inv., Inc.*, 145 B.R. 138.

assumed nor rejected by the DIP.²⁹¹ Both types of courts, however, have also acknowledged that if the DIP had assumed the employment contracts, the termination pay claims arising from them would have been administrative expenses.²⁹² As administrative expenses, these claims would be entitled to full payment unless the restrictions of § 503(c)(2) applied to them, and § 503(c)(2) will not apply to termination pay claims arising from individual employment contracts unless they are “severance.”²⁹³ Thus, if the majority rule is used to determine whether such claims are severance within the meaning of this new Code provision, the claims will be subject to the restrictions of § 503(c)(2) and will not be allowed unless proportional severance payments have been made to nonmanagement employees.²⁹⁴ Conversely, if the Second Circuit rule is used to determine whether the claims are severance within the meaning of § 503(c)(2), the claims will not be covered by the provision, and they will be allowed without any regard to whether nonmanagement employees have been paid a proportional amount of severance or any severance at all.²⁹⁵ As has been noted above, it is very unlikely that Congress intended the latter scenario to take place; Congress could not have intended debtors and insiders to be able to bypass the proportionality requirements of § 503(c)(2) so easily.²⁹⁶

Because of its potential to thwart Congress’s purposes in enacting § 503(c)(2), the Second Circuit definition of severance should not be used to determine whether termination pay claims arising from employment contracts are claims for “severance” as used in § 503(c)(2). Furthermore, the Second Circuit’s definition of severance should be rejected as a minority rule highly criticized for its inconsistency with Congress’s intent under the Bankruptcy Code’s priority scheme.²⁹⁷ A definition of severance that includes termination payments in lieu of notice, termination payments based on length of service, and termination payments arising from individual employment contracts is more consistent with the severance rules employed by courts in the majority of

²⁹¹ See, e.g., *In re Nomus-Am., Inc.*, 2002 BANKR. LEXIS 1657 (rejected); *In re M Group, Inc.*, 268 B.R. 896 (rejected); *In re Commercial Fin. Serv., Inc.*, 233 B.R. 885 (rejected); *In re Crystal Apparel, Inc.*, 220 B.R. 816 (neither assumed nor rejected); *In re Jamesway Corp.*, 199 B.R. 836 (neither assumed nor rejected); *In re Hooker Inv., Inc.*, 145 B.R. 138 (rejected); *In re Uly-Pak, Inc.*, 128 B.R. 763 (neither assumed nor rejected); *In re Selectors, Inc.*, 85 B.R. 843 (neither assumed nor rejected).

²⁹² See, e.g., *In re Commercial Fin. Serv., Inc.*, 233 B.R. at 891–92; *In re Hooker Inv., Inc.*, 145 B.R. at 150–51.

²⁹³ See 11 U.S.C.S. § 503(c)(2) (LexisNexis 2006 & Supp. 2006).

²⁹⁴ See *id.*

²⁹⁵ See *id.*

²⁹⁶ See *supra* notes 214–17 and accompanying text.

²⁹⁷ See *supra* notes 278–82 and accompanying text.

circuits.²⁹⁸ Finally, the term “severance” in § 503(c)(2) should not be construed to exclude termination payments arising from individual employment contracts because to do so would be to adopt a narrow definition of severance that has not been unambiguously adopted in any circuit.²⁹⁹

CONCLUSION

Before Congress passed the BAPCPA, many chapter 11 business reorganizations were plagued with a great disparity in the security available to insider executives and the security available to nonmanagement employees. While hundreds or thousands of nonmanagement employees of a given company in chapter 11 reorganization lost their jobs and received little or no severance or benefits, and many others accepted reductions in wages or benefits, Americans became outraged by court approval of supergenerous KERPs. A shadow hung over the United States bankruptcy system.

As KERPs grew in popularity and the disparity of which they were part became more glaringly evident, Congress realized that the Bankruptcy Code no longer provided adequate protections to the majority of employees of a bankrupt company. Furthermore, Congress recognized that the bankruptcy system had become a haven for deeply unfair corporate practices. Thus, Congress enacted § 503(c) to restore protections for nonmanagement employees under the Bankruptcy Code and restore some fairness to chapter 11 reorganizations. Section 503(c) strictly limits debtors’ ability to pay large postpetition retention bonuses or severance payments to executives and thus exhaust company funds that could otherwise be used to better compensate nonmanagement employees.

Fearing the end of KERPs, debtors and their executives will undoubtedly encourage courts interpreting the threshold language of both § 503(c)(1) and (2) to find significant loopholes that permit equally generous KERPs in only a slightly modified form. They may disguise guaranteed retention payments as performance incentives in hopes of gaining exemption from the restrictions of § 503(c)(1). They may also argue that claims arising from termination pay arrangements in individual employment contracts are claims for liquidated damages rather than severance and should therefore not be subject to the

²⁹⁸ See *supra* notes 242–50 and accompanying text.

²⁹⁹ See *supra* notes 283–87 and accompanying text.

restrictions of § 503(c)(2). Courts must be wary of these attempts to thwart Congress's purposes in enacting § 503(c).

Debtors in chapter 11 reorganization will inevitably point out to courts that there is a need for a distinction between retention and performance incentives when applying § 503(c)(1) to proposed executive bonuses. This Comment has shown that a true distinction does exist between the two types of incentives, and legitimate performance incentives, providing value to the estate beyond merely inducing an insider to remain with the debtor's business, should not be subject to the restrictions of § 503(c)(1). This distinction, however, must be carefully drawn to prevent its abuse to disguise what are truly guaranteed retention payments that provide no incentives for performance. Federal regulations defining "performance-based compensation" for corporate tax deductions are a good resource for courts seeking to identify legitimate performance incentives worthy of exemption from § 503(c)(1).

Finally, encouraged by prominent bankruptcy scholars and a number of Second Circuit cases, some debtors or their executive creditors will undoubtedly attempt to sway courts toward classifying termination pay claims arising from individual employment contracts as liquidated damages instead of as severance. Courts should not be persuaded by these attempts to avoid the strict proportionality requirements that § 503(c)(2) imposes on executive termination payments. Courts in the majority of circuits have never adopted a definition of severance that is so strict as to exclude termination pay claims arising from individual employment contracts. Though some courts in the Second Circuit have adopted a narrower definition of severance, they follow a minority rule that has long been criticized as inconsistent with Congress's intent, and recent cases show that even these courts are leaning toward a broader definition of severance. To give any meaning at all to § 503(c)(2), courts must include termination pay claims arising from individual employment contracts under its coverage.

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