TO CATCH A KERP: DEVISING A MORE EFFECTIVE REGULATION THAN § 503(C)

ABSTRACT

Key Employee Retention Plans ("KERPs") fell under congressional scrutiny in the early part of the decade after several large corporations filed for bankruptcy protection in the wake of widespread internal fraud. Chapter 11 debtors often design KERPs as bonuses paid to the debtor corporation's executives for the purpose of retaining them during the chapter 11 reorganization. Members of Congress criticized corporate executives for receiving sizeable bonuses from bankrupt corporations while corporate employees and stockholders lost jobs, benefits, and investments. In 2005, Congress added § 503(c) to the Bankruptcy Code, a provision meant to combat corporate fraud through the regulation of KERPs.

This provision has been ineffective, however, for two reasons. First, because the regulations of § 503(c) are cumbersome and overly restrictive, judges have allowed debtors to escape scrutiny under § 503(c) through a loophole in the provision. This loophole allows corporations to circumvent the regulation by classifying payments to executives as "incentivizing payments" rather than as "retention payments," thus allowing these payments to escape § 503(c) analysis. Second, when courts have applied § 503(c), the regulation would scrutinize retention payments without addressing corporate fraud or compensation discrepancy between executives and wage-level employees.

Not only does § 503(c) fail to address the problems Congress designed it to solve, it also imposes unnecessary hurdles on bankrupt corporations seeking a successful reorganization. For these reasons, lawmakers should reconsider how it regulates KERPs. Instead of targeting retention payments unrelated to corporate fraud and compensation discrepancies, Congress should directly target those abuses it hopes to eliminate.

INTRODUCTION

At the turn of the century, a number of business bankruptcy cases filled the media with stories of scandal, heated legal battles, and tension between

wealthy executives and struggling employees. Cases such as Enron and WorldCom made headlines for the shocking dishonesty of corporate executives and the unfortunate repercussions that wage-level employees suffered from the effects of widespread corporate fraud.[1] Even in bankruptcies where no evidence of fraud emerged, as in the case of United Airlines, great disparities between the effects of bankruptcy on executives and wage-level employees came to light.[2] The media criticized corporate executives for cutting costs through wage-level employee pay cuts. While CEOs and CFOs filled their pockets with sizeable bonuses, former employees sold their houses and dropped healthcare coverage to try to make ends meet.[3]

Fueled by these injustices, Congress called for a review of the Bankruptcy Code. The tumultuous atmosphere in 2005 led legislators to implement the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"),[4] "one of the most comprehensive overhauls of the Bankruptcy Code in more than 25 years."[5] The U.S. Trustee Program, which oversees the national bankruptcy process, supported this measure because it provided trustees with new tools to ensure the integrity of the bankruptcy system.[6]

One of these new tools was a provision designed to address the disparity of compensation between executives and other employees of corporations in bankruptcy, when executives often garnered bonuses and lucrative severance packages while employees lost jobs, healthcare benefits, and retirement funds. The provision, which eventually became § 503(c) of the Bankruptcy Code, regulates and caps the compensation that corporate executives receive in bankruptcy as part of a retention package.[7] By limiting the size of these key employee retention plans ("KERPs"), Congress sought to protect wage-level

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[1] *See infra* Part I.C.1–3.

[2] *See infra* Part I.C.1–3.

[3] *See infra* Part I.C.1–3.

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

[5] *Implementation of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: Hearing Before Subcomm. on Com. and Admin. Law of H. Comm. on Judiciary*, 109th Cong. 7 (2005) (statement of Rep. Chris Cannon, Chairman, Subcomm. on Com. and Admin. Law) [hereinafter *Hearing on Implementation of BAPCPA*]. "I can report that combating fraud and abuse in the bankruptcy system has remained a key priority." *Id.* at 18 (statement of Clifford J. White, III, Acting Director, Executive Office for U.S. Trustees).

[6] U.S. Trustee Program/Dept. of Justice, Bankruptcy Abuse and Consumer Protection Program of 2005, http://www.usdoj.gov/ust/eo/bapcpa/index.htm (last visited Feb. 6, 2009).

[7] *See* 11 U.S.C. § 503(c) (2006).

employees by preventing the type of executive self-dealing that occurred in the Enron and WorldCom bankruptcies, but the provision has been ineffective.[8]

Section 503(c) regulates KERPs with a three-element approach. The first element requires a corporation to show that an executive has a job offer at another corporation with compensation at the same or greater rate before a corporation can pay that executive a bonus for remaining in its employ.[9] The second element requires that the debtor prove the executive is essential to the survival of the corporation.[10] The third and final element of § 503(c) caps retention payments and severance packages exceeding a statutory threshold.[11] These three elements, however, create unworkable standards that judges have been hesitant to apply for two reasons. First, the provision's job offer requirement creates an incentive for managers to seek other employment at a time when the bankrupt corporation needs their knowledge and skills most.[12] Second, the cap imposed by § 503(c)'s third element is calculated with a restrictive, if somewhat ambiguous formula.[13]

Because bankruptcy judges recognize the corporation's need to retain company management, especially in times of financial crisis, they have accepted an argument that exploits a loophole in the provision.[14] Specifically, debtors have successfully argued that the payments they propose are not "retention payments," but "incentive payments" tied to performance goals and bankruptcy benchmarks that the debtor corporation must meet for an executive to receive the payment.[15] When bankrupt corporations characterize their executive payments as incentivizing plans, rather than retention plans, they circumvent § 503(c)'s requirements and scrutiny.[16] Judges allow debtor corporations to characterize their plans and circumvent § 503(c) because that section would otherwise regulate retention plans out of existence, regardless of how beneficial those plans would be to the bankrupt corporation, its employees, and its creditors.[17] Section 503(c)'s onerous terms and its selective

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[8] See 151 CONG. REC. S2321–22 (daily ed. Mar. 9, 2005) (statement of Sen. Edward Kennedy).
[9] 11 U.S.C. § 503(c)(1)(A).
[10] *Id.* § 503(c)(1)(B).
[11] *Id.* § 503(c)(1)(C).
[12] *See infra* Part II.B.1.
[13] *See infra* Part II.B.1.
[14] *See infra* Part II.A.3.
[15] *See infra* Part II.B.2–3.
[16] *See infra* Part II.B.2–3.
[17] *See infra* notes 28 and 29 and accompanying text.

enforcement have made it ineffective in limiting the payments that corporate executives can receive in bankruptcy.[18]

Part I of this Comment explains why corporations create KERPs and how such plans were regulated before Congress enacted § 503(c) in 2005. It then explains the events in 2005 that led to the implementation of § 503(c). Part II contrasts § 503(c)'s intended design with its actual application. Part III suggests more effective ways of resolving the problems KERPs present.

I. THE HISTORY AND CONTROVERSY BEHIND KERPS

The controversy behind KERPs is part of a larger debate over executive compensation. Some scholars argue that market constraints on arm's-length negotiations between corporate boards of directors and managers effectively regulate executive salaries.[19] Others doubt that these negotiations are truly made at arm's length.[20] According to this argument, executive salaries could easily rise—or have already risen—beyond the value that the executive brings to the corporation.[21]

In bankruptcy, executive compensation raises three additional concerns. First, corporate executives in bankruptcy are usually the same group that managed the corporation into its financial crisis. Second, compensation to key executives takes money away from creditors, shareholders, and wage-level employees. Third, as executives receive larger salaries, the corporation has less money to operate the struggling business and pay its creditors. Given these concerns, why should corporations offer sizeable bonuses to executives for merely remaining with a corporation throughout its bankruptcy? This Part first answers this question and discusses the rationale behind KERPs. It then

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[18] *See infra* Part II.C.

[19] Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71, 73 (2003). In this view, the goal of the board of directors is to maximize shareholder gains. The board tries to attract talented managers who will increase the value of the corporation. However, the board tries to maximize the value the manager will bring to the corporation by limiting the level of compensation for the manager. *Id.*

[20] *Id.* at 73–74 (arguing that "directors usually have an incentive to favor the CEO" because CEOs are central figures in the process of nominating (and renominating) directors and that the board does not usually have the kind of "independent information and advice on compensation practices necessary to effectively challenge the CEO's pay").

[21] Kevin J. Murphy & Ján Zábojník, *Managerial Capital and the Market for CEOs* 1 (Working Paper, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984376 ("[T]he base salaries and bonuses of chief executive officers . . . has increased from about $900,000 in 1970 to nearly $3,300,000 in 2005.").

explains the system of checks on retention payments that existed prior to 2005. Finally, this Part describes the climate of extensive corporate fraud that brought these retention payments under congressional scrutiny.

A. *Rationale for KERPs*

Despite the recent criticism of KERPs, they have been widely accepted by corporations, stockholders, creditors, and bankruptcy judges since the 1990s.[22] When a corporation declares bankruptcy, current executives become vital for the survival of the corporation because of their experience with the company. In contrast, retaining an executive position in a bankrupt corporation may become less attractive for executives, especially in high-profile and heavily-scrutinized cases. To encourage key employees to remain with the company, corporations offer incentives—usually sizeable payments in the form of salaries, bonuses, and stock options. KERP critics contrast the lofty payments to executives with the losses that company employees suffer in bankruptcy, including pay cuts and layoffs.[23] Proponents of KERPs, however, argue that the payments are necessary to persuade key executives to remain with the corporation. They argue that without these executives managing the corporation throughout its bankruptcy, the corporation will fail, resulting in more losses to creditors, stockholders, and employees.[24] As one judge noted, "Even if a company cannot show it will 'fail' due to the loss of the employee, successful reorganization usually depends on maximizing the value of the enterprise, which may depend on retention of key managers."[25]

In bankruptcy, some of the debtor corporation's employees are essential keys necessary for the company to survive chapter 11 reorganization. Generally, these key employees have substantial experience in the industry and with the corporation, so they understand the inner workings of the business. With this knowledge, debtor corporations hope that these key employees can resolve the company's financial difficulties and navigate the corporation out of bankruptcy.

Key employees of bankrupt corporations, however, face "intense job insecurities," including fears of personal financial losses if they remain with

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[22] George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19, 75 (2004).

[23] 151 CONG. REC. S2341–42 (daily ed. Mar. 9, 2005) (statement of Sen. Herb Kohl).

[24] 151 CONG. REC. S2341 (daily ed. Mar. 9, 2005) (statement of Sen. Arlen Specter).

[25] *In re* Dana Corp. (*In re Dana Corp. II*), 358 B.R. 567, 576 n.11 (Bankr. S.D.N.Y. 2006).

the corporation.[26] Additionally, an executive's career prospects are uncertain if the debtor corporation fails to survive bankruptcy.[27] If the executive loses employment with the debtor corporation, whether it is because the reorganization fails or the corporation fires the executive, the executive may find it difficult to find a new job. Because of heightened stress and uncertainty surrounding corporate bankruptcies, executives in bankrupt corporations have strong incentives to seek employment at a more stable, successful corporation.

These incentives pose serious problems for bankrupt corporations looking to retain and depend upon their management throughout bankruptcy. A common problem for debtor corporations appeared in *In re Aerovox*, where the board of directors determined that "continuity of management [was] needed to preserve the value of the company."[28] The board "feared that if the Key Employees were to find alternative employment, the value of the company would erode, adversely affecting creditors."[29] Indeed the president and chief executive officer of Aerovox testified that he and three other executives would pursue other job opportunities if the corporation could not offer financial incentives and security for remaining with the corporation.[30]

Before Congress enacted BAPCPA in 2005, a debtor corporation would often retain needed managers with KERPs, which involved lucrative salaries and immediate bonuses.[31] Aerovox was no different when it proposed a KERP that paid upper management a bonus of three months' salary, to be paid either when the corporation terminated the executive's employment or liquidated the corporation's assets.[32] It argued the KERP was necessary to its reorganization and offered three specific justifications:

> 1) to keep the eligible employees. . . in the Debtor['s] employ; 2) to compensate the eligible employees . . . for assuming "additional administrative and operational burdens imposed on the Debtor by its Chapter 11 case;" and 3) to allow the eligible employees . . . to use

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[26] Adam C. Rogoff, Ronald R. Sussman & Jeffrey L. Cohen, *Struggling with Executive Compensation Incentives in Chapter 11 Under the New Code*, 2006 ANN. SURV. BANKR. L. 385, 385.

[27] *In re* Aerovox, Inc., 269 B.R. 74, 80 (Bankr. D. Mass. 2001).

[28] *Id.* at 79.

[29] *Id.*

[30] *Id*. at 80.

[31] Kuney, *supra* note 22, at 75.

[32] *In re Aerovox*, 269 B.R. at 77. The corporation agreed to pay on the earliest of "a) involuntary termination of the employment; b) the sale of all or substantially all of the Debtor's assets; or c) June 6, 2002." *Id.*

> "their best efforts to ensure the maximization of estate assets for the benefits of creditors."[33]

Debtors also attempt to retain talented executives with attractive severance packages.[34] Severance packages guarantee the departing executive that he or she will receive payment from the corporation if terminated without cause.[35] Executives would be unwilling to remain with a corporation if their jobs were at risk every time a disagreement arose between the board of directors and the management or if disgruntled creditors used their influence in the reorganization to terminate an executive's employment. Severance packages require the corporation to incur a cost if it chooses to end an executive's employment contract. This cost creates incentives for the corporation to retain the executive and provides executives with security that their employment with the debtor corporation is less likely to be terminated.

Because executives' jobs are much more difficult and much less secure when their corporations are in bankruptcy, executives are motivated to seek alternative employment when their corporation enters bankruptcy. Nevertheless, corporations want to retain executives to manage the company throughout bankruptcy because of the experience these executives bring with them. Retention plans and severance packages offer incentives for executives to stay in a demanding, stressful, and insecure position with a debtor corporation.

B. Pre-BAPCPA Checks on KERPs

Section 503(c) was unnecessary before BAPCPA because there were already at least four distinct checks, both legal and nonlegal, on insiders who hoped to compensate themselves unfairly while driving nonmanagement employees' salaries and benefits into the ground. First, secured creditors, especially lenders, already hold leverage in any corporate bankruptcy because the DIP often looks to these creditors for cash during reorganization. Second,

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33 *Id.* at 76 (citations omitted).

34 Kuney, *supra* note 22, at 83.

35 *See id.*

> [T]hese provisions may provide a great[] benefit to the debtor-corporation and its creditors. Beneficiaries of a severance package have an incentive to perform their jobs well—theoretically increasing the debtor's chances of a successful reorganization and creditors' chances of receiving a larger percentage of their claims—because they will receive nothing should their employment be terminated for cause.

Id. Departing executives usually receive nothing when terminated for cause, however. *Id.*

unsecured creditors must approve any plan for reorganization, including executive compensation agreements. Third, debtors and creditors must always obtain court approval before the implementation of a reorganization plan, and a court can withhold approval of a plan for reorganization if it does not believe that the plan followed from proper business judgment. Fourth, corporate executives, in their role as managers, are motivated to emerge from reorganization successfully and cannot do so without the approval of creditors and the court.

Before 2005, secured creditors were motivated to block unfair executive compensation plans. Because secured creditors have such a significant interest in the success of a chapter 11 corporation, it is unlikely that these creditors would allow a wasteful plan for executive compensation to pass through the courts without challenging it. Though these creditors have more protection than unsecured creditors, secured creditors still face a risk of losing vast sums of money in a chapter 11 case. For example, assets can depreciate and even disappear should the company downward spiral into a chapter 7 case. Additionally, secured creditors often lend cash to the debtor corporation after it files for bankruptcy to help its reorganization, and these creditors have an interest in ensuring the debtor does not hinder its ability to pay those loans in full because of its excessive compensation plans.[36]

Unsecured creditors also play an important role in ensuring that the plan for reorganization, including the plan for executive compensation, is fair.[37] Before creditors approve a plan, they must vote as a class of claims whether to accept or reject a plan.[38] Although one or two unsecured creditors may not be sufficient to bar a reorganization plan from being accepted by the court, the debtor must show that any class rejecting a proposed reorganization plan will receive at least as much as that class would if the company went into a chapter

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[36] Kuney, *supra* note 22, at 81.

> One thing . . . is clear: Because the debtor must obtain secured creditor consent or prove adequate protection of the secured creditor's interest in cash collateral, the secured creditor's cooperation is critical in gaining approval of the plan. This fact provides the lender or secured creditor with additional leverage with which to affect the direction of the case and to negotiate secured creditor protections into cash collateral agreements, loan agreements, and even plans.

Id.

[37] 11 U.S.C. § 1129(a) (2006).

[38] Creditors are divided into classes based on the type of claim that they have. Any impaired class—a class which is receiving less than the entire amount of what the debtor owes them—must approve of a plan, and their treatment under the plan, before the court can accept the plan for reorganization. *Id.* § 1126.

7 liquidation.[39] By withholding their approval of a plan, unsecured creditors could thus object to an employee compensation package they perceive to be unfair.

Before 2005, courts also held considerable power over corporate executives who sought to overpay themselves as part of a retention payment. Courts evaluated KERPs under § 363(b), which requires notice and a hearing before a debtor in possession can use company assets other than in the ordinary course of business.[40] Courts held that KERPs and other forms of management compensation were expenses paid out of the ordinary course of business.[41] Section 363(b) provides a balance between the debtor's need to manage the corporation on a day-to-day basis, while ensuring protection for creditors if the debtor wants to spend assets out of the ordinary course of business.[42] The standard courts applied in these cases was the business judgment standard.[43] Courts recognized that a business judgment "should be accepted by the court unless it is shown to be 'so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, or whim or caprice.'"[44] In

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39 *Id.* § 1129(a)(7)(A)(ii).

40 *Id.* § 363(b)(1) ("The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . . .").

41 *In re* Crystal Apparel, Inc., 220 B.R. 816, 832 (Bankr. S.D.N.Y. 1998).

> It is unrealistic to believe that upper management can act with dispassion in fixing their own compensation . . . during the turbulence of a Chapter 11 case. The creditors and any committees are entitled to scrutinize such agreements before they become binding.
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> Entering into a "golden parachute" contract is not a daily occurrence for any given corporation. Indeed such an event might not even occur as often as once a year. Seeking court approval for what is an exceptional event for any given corporation, even if it is generally accepted corporations do enter into these types of agreements regularly, imposes little burden on the debtor.

Id.

42 *See id.* at 830.

> The purpose of requiring notice and hearing if a transaction is other than in the ordinary course of business is so that creditors, who have a vital interest in maximizing realization from assets of the estate, have an opportunity to review the terms of the proposed transaction and to object if they deem the terms and conditions are not in their best interest.

Id.; see also In re The Leslie Fay Cos., 168 B.R. 294, 301 (Bankr. S.D.N.Y. 1994) ("These provisions were 'designed to allow a trustee (or debtor-in-possession) the flexibility to engage in ordinary transactions without unnecessary oversight, while protecting creditors by giving them an opportunity to be heard when transactions are not ordinary.'" (quoting *In re* Roth Am., Inc., 975 F.2d 949, 952 (3d Cir. 1992))).

43 *In re* Global Home Prods., LLC, 369 B.R. 778, 783–84 (Bankr. D. Del. 2007).

44 *In re* Logical Software, Inc., 66 B.R. 683, 686 (Bankr. D. Mass. 1986) (quoting Lubrizol Enter., Inc. v. Richmond Metal Finishers, Inc. (*In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1047 (4th Cir. 1985)). Many courts have adopted this language from *In re Richmond Metal Finishers*. *See, e.g.*, *In re* Pomona Valley

the past, courts would generally give deference to the business judgment of the corporation, as long as the court considered the plan "fair and reasonable."[45]

Corporate managers also have incentives not to exploit their company's bankruptcy and overcompensate themselves with excessive compensation plans. Because executives may enjoy continued employment and payment from the debtor corporation when it emerges from bankruptcy, they usually will want the corporation to survive. Executives will thus make more money using sound business judgment to ensure their company's successful emergence from bankruptcy than they would by causing that company's failure in chapter 7 liquidation. Furthermore, the Enron, WorldCom, and United Airlines cases demonstrate that executives engaging in unethical, illegal, or imprudent self-dealing will face tight media scrutiny in their corporation's public bankruptcy proceedings.[46]

These legal and nonlegal checks existed before Congress enacted § 503(c) in 2005 and already imposed a number of barriers preventing corporations from establishing exorbitant executive retention plans. Though these checks may not have given creditors and judges perfect control over KERPs, interested parties could object to wasteful executive compensation plans. When none objected, this system allowed the court to defer to the debtor corporation's business judgment.

C. The Climate in 2005: The Impetus Behind § 503(c)

By 2005, KERPs and severance packages had become a common part of corporate bankruptcy and generally garnered approval from creditors and judges alike.[47] KERPs came under public and congressional scrutiny at the start of this century, however, when several highly-publicized cases highlighted the disparity between the sizeable bonuses that executives earned in bankruptcy and the losses that employees suffered when the corporation cut

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Med. Group, Inc., 476 F.3d 665, 670 (9th Cir. 2007); *In re* Surfside Resort & Suites, Inc., 325 B.R. 465, 469 (Bankr. M.D. Fla. 2005); *In re* Friedman's, Inc., 336 B.R. 891, 896 (Bankr. S.D. Ga. 2005); *In re* Cadkey Corp., 317 B.R. 19, 22–23 (Bankr. D. Mass. 2004); Phar-Mor, Inc. v. Strouss Bldg. Assocs., 204 B.R. 948, 954–55 (Bankr. N.D. Ohio 1997); *In re* Harborview Dev. 1986 Ltd. P'ship, 152 B.R. 897, 899 (Bankr. D.S.C. 1993).

[45] *In re* Aerovox, Inc., 269 B.R. 74, 80 (Bankr. D. Mass. 2001). "Bankruptcy courts will approve key employees retention programs if the Debtor has used proper business judgment in formulating the program and the court finds the program to be 'fair and reasonable.'" *Id.* (citing *In re* Interco, Inc., 128 B.R. 229, 234 (Bankr. E.D. Mo. 1991)).

[46] *See infra* Part I.C.1–3.

[47] *See supra* notes 42–45.

their wages and jobs in an effort to save money. Two of the most publicized cases, Enron and WorldCom, revealed corrupt practices that drove the companies into bankruptcy, resulting in devastating losses for Enron and WorldCom employees. Another case, the United Airlines bankruptcy, did not include allegations of corporate fraud, but it did illustrate the disproportionate impact of bankruptcy on wage-level employees as compared to executives. The prominence of these companies and their stories fueled Congress's decision to regulate KERPs in 2005.[48]

1. *The Enron Bankruptcy*

On December 2, 2001, Enron filed what was at that time the largest corporate bankruptcy,[49] including a sixteen thousand-page disclosure of the state of the corporation.[50] In the ensuing weeks, the truth about executive dishonesty, deceitful accounting, and debt hiding came to light.[51] The Enron disclosure also revealed that during the twelve months prior to bankruptcy, Enron paid $310 million to 140 of its executives and granted $435 million in stock options and restricted stock.[52] At the other end of the spectrum, Enron owed its five thousand laid-off employees around $140 million in severance packages, for which they received only a $34 million settlement.[53] Ten days after Enron filed for chapter 11 bankruptcy, congressional committees heard

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48 *See infra* Part I.C.4.

49 Richard A. Oppel, Jr. & Andrew Ross Sorkin, *Enron Corp. Files Largest U.S. Claim for Bankruptcy*, N.Y. TIMES, Dec. 3, 2001, at A1.

50 Mitchell Pacelle, *Enron's Disclosure of Awards to Top Officials Draws Outrage*, WALL ST. J., June 18, 2002, at C18.

51 *What Was Enron?*, WALL ST. J., Dec., 12, 2001, at A18 (describing Enron's corporate structure as "a huge hedge fund masquerading as a trading firm"). One of the abuses that Enron executives engaged in was using corporate funds to make risky investments, while concealing massive corporate losses in private partnerships. In October, 2001, it was discovered that "$1.2 billion of its market value had disappeared as a result of these 'related party' transactions with private partnerships that signaled the beginning of the end." *Id.* A few weeks after this disclosure, after losing the faith and support of investors, Enron was forced to declare bankruptcy. *Id.*

52 Pacelle, *supra* note 50.

> In the filing, Enron valued payments to [former Chairman of Enron Kenneth Lay] at $104 million. That includes a salary of $1.1 million, a $7 million bonus, long-term incentive payments of $3.6 million, $10 million to buy two annuity contracts, and loan advances of $81.5 million. . . . In addition, the filing said, Mr. Lay exercised stock options valued at $34.4 million, and received restricted stock valued at $14.7 million.

Id.

53 *Id.*

testimony about the conditions causing Enron's collapse; listed among these conditions were loopholes and deficiencies in the Bankruptcy Code.[54]

Enron filed its motion for executive retention payments on March 29, 2002, asserting that it could not successfully reorganize without these executives and that their talents were crucial to company survival.[55] The contemplated amount of these retention payments was not to exceed $40 million.[56] The Securities and Exchange Commission challenged the executive compensation plan, stating that Enron had not shown any proof in its motion of the need for these retention payments.[57] Over the SEC's objections and despite evidence of corruption in the corporation, the court approved the executive compensation plan.[58] The fact that the court in the Enron case approved a KERP in the midst of such a hostile, resistant political climate demonstrates how much judges recognized the importance of allowing bankrupt corporations to offer retention payments to their key managers.

2. *The WorldCom Bankruptcy*

Enron's was not the only bankruptcy to receive such publicity. When WorldCom filed its petition on July 21, 2002, it surpassed Enron as the largest corporate filing for bankruptcy in the United States.[59] This petition came on the heels of a WorldCom announcement that there was evidence of "accounting irregularities that would result in adjustments to its financial statements totaling more than $3.8 billion."[60] Among the causes of the

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[54] *Protecting the Pensions of Working Americans: Lessons from the Enron Debacle: Hearing Before H. Comm. on Health, Educ., Labor, and Pensions*, 107th Cong. 21 (2002) (statement of Rep. Ken Bentsen); *The Enron Collapse: Impact on Investors and Financial Markets: J. Hearing Before H. Subcomm. on Capital Markets, Ins., and Gov't Sponsored Enters. and Subcomm. on Oversight and Investigations of Comm. on Fin. Servs.*, 107th Cong. 9 (2001) (statement of Rep. Michael G. Oxley, Chairman of the H. Fin. Servs. Comm.); *Lessons Learned from Enron's Collapse: Auditing the Accounting Industry: Hearing Before H. Comm. on Energy and Com.*, 107th Cong. 50 (2002) (statement of Rep. Frank Pallone, Jr.).

[55] Rogoff, Sussman & Cohen, *supra* note 26, at 390. The plan consisted of 1,285 eligible employees who would receive quarterly bonuses as long as they remained employees of Enron. *Id*.

[56] *Id.* The remaining components of the plan were an incentive-based component not to exceed $90 million and a severance component not to exceed $7 million. *Id.* at 391.

[57] *Id.* The SEC also argued that the motion should have given the "identities, functions, or specific importance of the personnel covered by the proposed compensation plan." *Id.*

[58] *Id.*

[59] *The WorldCom Case: Looking at Bankruptcy and Competition Issues: Hearing Before S. Comm. on the Judiciary*, 108th Cong. 2 (2003) (statement of Richard Thornburgh, Bankruptcy Examiner, Kirkpatrick & Lockhart, LLP) [hereinafter *Hearing on WorldCom Bankruptcy and Competition Issues*].

[60] *Id.* at 3. The court-appointed examiner of WorldCom reported that the WorldCom bankruptcy was not only due to egregious false accounting, but also to "additional deceit, deficiencies and a disregard for the most basic principles of corporate governance." *Id.* at 4.

WorldCom bankruptcy were the corporation's lack of control over its debt level and a lack of concern for its ability to pay off this debt.[61]

A few months after the scandal began making headlines, WorldCom filed a proposal for executive compensation that included a $25 million bonus plan to induce executives to remain with the corporation.[62] WorldCom argued that this plan was necessary not only to "counter poaching of its employees by competitors"[63] but also to bolster waning morale among employees.[64] Among the objections to the retention plan was the argument that WorldCom had not shown the court enough evidence that this plan would be necessary and effective.[65] Moreover, at best, the KERP would only boost the morale for those 329 employees benefiting from the plan,[66] but not for the 64,000 nonmanagement employees not benefitting.[67] As in the Enron case, the judge approved the WorldCom plan, despite the clear evidence of corporate fraud.[68] This is yet another indication of how important judges believed it was for a debtor corporation to retain its management during financial crisis.

Although management and the courts sought to retain key personnel during WorldCom's bankruptcy, other employees experienced massive layoffs, as WorldCom cut over 22,000 jobs.[69] Adding to the difficulties these employees endured was the fact that, in bankruptcy, employee severance payments were capped at $4,650.[70] Although this saved WorldCom $36 million, stories of former employees losing their homes and healthcare coverage spread across headlines.[71] Employee retirement funds also dwindled as the corporation's stock value fell around the time of the bankruptcy.[72] As in the Enron case, the

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[61] *Id.* at 5.

[62] *Judge Approves Bonus Plan for WorldCom Employees*, N.Y. TIMES, Oct. 30, 2002, at C4. The plan made 329 employees eligible for a bonus of up to $125,000 for remaining in their WorldCom positions for at least 60 days after the confirmation of a plan for reorganization. On top of this bonus, key employees could receive a second bonus if they could arrive quickly at a plan confirmation. *Id.*

[63] *Id.*

[64] Rogoff, Sussman & Cohen, *supra* note 26, at 393.

[65] *Id.*

[66] *Id.*

[67] *Id.* at 394. This objection was brought by a shareholder who noted that because the bonus was not linked to a benchmark or goal for the key employees to reach, the KERP would most likely do nothing more than give nonmanagement employees and the public negative perceptions about WorldCom's reorganization plan. *Id.*

[68] *Id.*

[69] Christopher Stern, *WorldCom Plans New Job Cuts*, WASH. POST, Jan. 16, 2004, at E1.

[70] Shawn Young, *Without a Net*, WALL ST. J., Sept. 30, 2002, at A1.

[71] *Id.*

[72] *Id.*

Senate held hearings about the WorldCom bankruptcy, asking how Congress could revise the Bankruptcy Code to combat the injustice that resulted from this catastrophic bankruptcy.[73]

3. The United Airlines Bankruptcy

United Airlines filed for chapter 11 bankruptcy in December 2002.[74] In May 2003, it initiated new labor contracts with its wage-level employees, cutting $2.56 billion in costs for the airline.[75] In November 2004, United's chief executive officer, Glenn Tilton, saved an additional $2 billion for the company by cutting pensions and further reducing salaries.[76] According to Damon Silvers, associate general counsel for the AFL-CIO, "United flight attendants, who before the bankruptcy had incomes typically in the [$30,000s] . . . took pay cuts of 17 percent."[77] Highlighting the disparity, Silvers noted that Tilton received $39 million in stock and $840,000 as a cash bonus.[78] In 2005, Tilton was reportedly the highest-paid executive at a major domestic airline, taking home $1.1 million in salary and bonus.[79] United employees criticized him for receiving such compensation while they took substantial pay cuts.[80] Exacerbating the situation was the fact that, at the time, Tilton still could not project a date for United Airlines to emerge from bankruptcy, even after passing the record for the longest airline bankruptcy since 1989.[81]

Though no evidence of fraud emerged in the United Airlines case, the disparity between executive compensation and employee losses was

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[73] *Hearing on WorldCom Bankruptcy and Competition Issues*, *supra* note 59, at 1 (statement of Richard Thornburgh, Bankruptcy Examiner, Kirkpatrick & Lockhart, LLP) (expressing the concern that WorldCom would "emerge from bankruptcy with much of the fruits of its widespread fraudulent conduct intact" and in this respect, the bankruptcy laws seemed to condone illegal behavior, giving debtor corporations "not only a fresh start, but a head start").

[74] *Timeline of United Airlines' Bankruptcy*, USA TODAY, Feb. 1, 2006, http://www.usatoday.com/travel/flights/2006-02-01-united-timeline_x.htm.

[75] *Id.*

[76] *Id.*

[77] *Executive Compensation in Chapter 11 Bankruptcy Cases: How Much is Too Much? Hearing Before H. Subcomm. on Com. and Admin. Law and H. Comm. on the Judiciary*, 110th Cong. 9 (2007) [hereinafter *Hearings on Executive Compensation in Chapter 11*] (statement of Damon Silvers, Associate General Counsel, American Federation of Labor and Congress of Industrial Organizations (AFL-CIO)).

[78] *Id.*

[79] Micheline Maynard, *How to Succeed in Business, Without Really Succeeding*, N.Y. TIMES, May 15, 2005, at B1.

[80] *Id.*

[81] *Id.*

significant. As is true in most cases, though, an executive would prefer to cut expenses through employee pay cuts rather than forgoing a bonus that produces an incentive for the executive to remain with the debtor corporation. The United Airlines bankruptcy demonstrates that evidence of fraud is not necessary for executive compensation schemes to appear exorbitant and unfair.

4. Legislative History

Faced with the fears and insecurities of employees nationwide in the wake of these highly-publicized bankruptcy scandals, Congress proposed and enacted § 503(c) as part of BAPCPA.[82] In a 2006 bankruptcy decision dealing directly with the issue of KERPs, Judge Lifland described how § 503(c) came to fruition as a "last-minute addition to the bill" made by Senator Edward Kennedy.[83] Senator Kennedy denounced the "glaring abuses of the bankruptcy system by the executives of giant companies like Enron Corp. and WorldCom Inc. . . . who lined their own pockets, but left thousands of employees and retirees out in the cold."[84] These executives, Senator Kennedy chided, "milked their companies for billions of dollars, left them bankrupt, and caused millions of employees to lose their jobs, their pensions and their health benefits."[85]

Those opposed to this provision argued that there was no need for this measure absent evidence of "fraud, mismanagement, and conduct contributing to the debtor's insolvency."[86] These senators argued that the proposal would hinder the ability of companies that were not at fault from holding on to those key executives whose talents and knowledge about the company could be essential to successful reorganization.[87] Honest corporations would suffer under § 503(c) without any showing of mismanagement or poor decisions on

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82 *Id.*

83 151 CONG. REC. S2201 (daily ed. Mar. 8, 2005) (statement of Sen. Edward Kennedy).

84 *Id.*

85 *Id.*

86 151 CONG. REC. S2341 (daily ed. Mar. 9, 2005) (statement of Sen. Orrin G. Hatch).

87 *Id.* In debate, Senator Arlen Specter read a letter he received from the Association of Insolvency and Restructuring Advisors into the congressional record that voiced concern regarding the future of KERPs in bankruptcy:

> Whether there currently is or is not sufficient judicial scrutiny of KERPs is a valid question, insofar as the overall bankruptcy system allows debtors a fair amount of flexibility in exercising reasonable judgment—but there must be an approach better than handcuffing the judiciary and stakeholders in bankruptcy cases by essentially precluding all use of KERPs.

Id.

the part of the executives. Over these objections, § 503(c) took effect in October 2005.[88]

In the early part of the decade, corporate bankruptcies made headlines for their size, repercussions, scandals, and the postpetition losses to company employees. The heavily-publicized cases of Enron and WorldCom fostered congressional debate about the need for revisions in the Bankruptcy Code to prevent future disasters. These revisions included § 503(c), which poses difficult hurdles to corporations using KERPs and caps the retention payments these KERPs may provide. Advocates of § 503(c) expected it to resolve the discrepancies between highly-paid corporate executives and wage-level employees who suffer pay cuts and the loss of benefits and pension plans.[89] Still, many opposed the implementation of § 503(c) as an overbroad and inflexible measure to resolve a problem that could be solved in more nuanced and effective ways, using methods that target abuse of the system rather than retention payments themselves.[90] Critics of § 503(c) argue that the KERPs may prove to be crucial to the survival of debtor corporations.

II. SECTION 503(C): HOW IT REALLY WORKS, AND HOW IT DOESN'T REALLY WORK

This Part examines how Congress designed § 503(c) to work and how it does not work as designed when applied in real world cases.[91] It then shows how debtors and judges alike have avoided applying § 503(c) by categorizing debtors' executive compensation plans not as retention plans, but as incentive plans. In doing so, judges and debtors have managed to bypass § 503(c) since its enactment. Instead of applying § 503(c) to KERPs characterized as incentive plans, courts apply the more lenient standard of § 363(b) to executive compensation proposals. As this Part explains, Congress's commendable motivations for passing § 503(c) have been thwarted by judges who find that section too complicated and severe to enforce.

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88 *Hearing on Implementation of BAPCPA*, *supra* note 5, at 1 (statement of Rep. Chris Cannon, Chairman, Subcomm. on Com. and Admin. Law).

89 *See supra* note 23 and accompanying text.

90 *See supra* notes 24–25 and accompanying text.

91 Section 503(c)(1) restricts KERPs, while § 503(c)(2) restricts severance packages. Section 503(c)(3) serves as a "catch-all" for "other transfers . . . that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to . . . officers, managers, or consultants hired after the date of the filing of the petition." 11 U.S.C. § 503(c)(3) (2006); *see* Rogoff, Sussman & Cohen, *supra* note 26, at 397.

A. How § 503(c) Works

Section 503(c)(1) places a strict limitation on the compensation a debtor corporation can offer an insider in bankruptcy by eliminating all transfers to insiders "for the purpose of inducing such person to remain within the debtor's business" unless the insider's situation and the transfer meet the requirements set forth in the remainder of the provision.[92] Courts have rejected a literal interpretation of the statute as illogical because "[a]ny payment to an employee, including regular wages, has at least a partial purpose of retaining the employee."[93] To avoid the absurdity of including all compensation payments within the § 503(c) limitations, courts apply § 503(c) only to payments made for the "*primary* purpose of inducing" the executive to remain with the corporation.[94] Despite this judicial interpretation, § 503(c)(1)'s broad language eliminates all KERP payments unless circumstances surrounding the transfer pass the two hurdles set forth in the remainder of the provision.

1. The Job Offer Hurdle

The first of these hurdles is the "job offer" hurdle in § 503(1)(A). The debtor corporation must show that the payment is "essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation."[95] This job offer hurdle effectively bars a debtor corporation from using any KERP because it is improbable that "an insider of the debtor would seek out alternative employment, secure an offer of such employment for an equal or greater wage than she currently enjoys, and then leverage that offer . . . to meet the legal standard for the right to work for a Chapter 11 debtor."[96]

Even if an executive is able to acquire "bona fide job offers," it is unlikely that he or she could acquire them without actively seeking them out, a task which would be both time consuming and distracting. Any time or energy a bankrupt corporation's executive spends hunting for a new job is time and energy that executive could have spent helping his or her bankrupt company

[92] 11 U.S.C. § 503(c)(1). "[T]here shall neither be allowed, nor paid—a transfer made to . . . an insider . . . for the purpose of inducing such person to remain with the debtor's business, absent a finding by the court . . . ." *Id.*

[93] *In re* Nellson Nutraceutical Inc., 369 B.R. 787, 802 (Bankr. D. Del. 2007) (noting that applying a "sole purpose" standard would be too stringent).

[94] *Id.*

[95] 11 U.S.C. § 503(c)(1)(A).

[96] Rogoff, Sussman & Cohen, *supra* note 26, at 396–97.

through reorganization. Nevertheless, if an executive seeks, finds, and secures a position in another company at "the same or greater rate of compensation" as his or her current position with the bankrupt corporation, the executive has little or no incentive to remain with the debtor corporation. A competing job offer at the same compensation in a stable corporation is more attractive than an executive position with the debtor, a position fraught with uncertainty, stress, and scrutiny.[97] Moreover, few, if any, executives would remain with a bankrupt corporation after procuring an offer at a greater rate of compensation with a thriving company. These incentives expose a fundamental problem with the job offer hurdle.

The fundamental problem with the job offer hurdle is that it encourages disloyalty when the debtor corporation most needs loyalty from its executives. Ultimately, the job offer hurdle punishes executive loyalty by denying KERP payments to those loyal executives wanting to remain with the company regardless of the bankruptcy. Moreover, the job offer hurdle rewards disloyalty by allowing KERP payments to those executives who wish to leave the corporation and have diverted their own time and energy to hunting for another executive position. By allowing KERPs only to executives who have competing job offers, § 503(c)(1)(A) encourages executives not otherwise interested in other jobs to search for alternative employment. Thus, the job offer hurdle encourages disloyalty at a highly-demanding time in the company's bankruptcy.

Section 503(c)(1)(A)'s job offer hurdle contradicts the spirit and rationale behind KERPs. Corporations offer retention payments to create an incentive for key employees to remain not only employed by the corporation, but also focused and concerned with the corporation's success. To require executives to begin actively seeking new positions at the outset of the corporation's bankruptcy frustrates the purpose of the incentive. Rather than having a provision that detracts from executive focus at a crucial time in the development of the reorganization plan, § 503(c) should encourage insiders to concentrate on the task at hand—stabilizing the struggling corporation.

2. *The "Essential to Survival" Hurdle*

Section 503(c)(1)'s second hurdle is the "essential to the survival" hurdle.[98] This hurdle requires debtor corporations to demonstrate that "the services

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[97] *Id.* at 385–86.
[98] 11 U.S.C. § 503(c)(1)(B).

provided by the [insider] are essential to the survival of the business."[99] Even before Congress enacted § 503(c), however, creditors and courts generally accepted the idea that the central management of a corporation is a fundamental element in the success of the reorganization.[100] The essential to survival hurdle therefore likely does not pose an effective barrier to allowing most KERPs.

In a heated case, however, the essential to survival hurdle provides disgruntled creditors a tool to oppose the retention of a debtor's executive on the grounds that the executive is not essential. Debtor corporations may find it difficult to prove that a certain executive is essential to its survival or that reorganization would be unsuccessful if the corporation lost the executive.[101] Moreover, management must be concerned not with mere survival of the corporation, but with "maximizing the value of the enterprise."[102] To maximize its value, the corporation must retain all of the talent that it can. If an executive's KERP payment takes less from the company than the executive would earn for the company, the KERP adds value to the enterprise even though the corporation may not have been able to show that retaining the key executive was essential to the corporation's survival.

3. *The Ceiling on Retention Transfers*

If the insider passes both of the hurdles in § 503(c)(1)(A) and (B), the debtor corporation may offer the insider a KERP. This KERP, however, will be subject to the ceiling set out in § 503(c)(1)(C), which caps the amount of permissible KERP payments.[103] Section 503(c)(1)(C)(i) caps KERP payments by applying a formula to each payment.[104] The formula disallows any payment that exceeds ten times the amount of a "transfer or obligation of a similar kind" to a nonmanagement employee during the preceding calendar year.[105]

This formula is ambiguous because its reference to "transfers or obligation of a similar kind" is capable of many reasonable interpretations. One

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[99] *Id.*

[100] *See, e.g.*, *In re* Aerovox, Inc., 269 B.R. 74 (Bankr. D. Mass. 2001).

[101] *In re* Dana Corp. (*In re Dana Corp. II*), 358 B.R. 567, 576 n.11 (Bankr. S.D.N.Y. 2006) ("Even if a company cannot show it will 'fail' due to the loss of the employee, successful reorganization usually depends on maximizing the value of the enterprise, which may depend on retention of key managers.").

[102] *Id.*

[103] 11 U.S.C. § 503(c)(1)(C)(i)–(ii).

[104] *Id.* § 503(c)(1)(C)(i).

[105] *Id.*

interpretation of this language might limit transfers or obligations of a similar kind to those payments given "for the purpose of inducing [the nonmanagement employee] to remain within the debtor's business."[106] Depending on the structure of the corporation, it is likely that the corporation would not have offered retention payments to nonmanagement employees because retaining specific employees below the central management of the corporation is often not essential. Financially unsound corporations probably would not incur unnecessary expenses to induce nonessential employees to remain employed by the company. Another interpretation of the formula's reference to "transfers or obligations of a similar kind" might limit the language to any sort of payment beyond an employee's salary, such as a signing bonus or other additional payment.

If the debtor corporation did not make any transfers or obligations of a similar kind, § 503(c)(1)(C)(ii) applies a higher ceiling to the proposed KERP payment. This higher ceiling disallows KERP payments that exceed twenty-five percent of "any similar transfer or obligation" made "for any purpose" during the preceding calendar year.[107] Section 503(c)(1)(C)(ii)'s higher ceiling is thus even more ambiguous because it not only incorporates the ambiguous "transfers or obligations of a similar kind" from § 503(c)(1)(C)(i), but it adds more ambiguity by referring to any "similar transfer" made "for any purpose." This language does not resolve how KERP payments governed by § 503(c)(1)(C)(ii)'s higher ceiling differ from the types of payments governed by § 503(c)(1)(C)(i).

Courts have yet to attempt to apply the ceiling's formula in a meaningful way[108] because most of the KERP cases since 2005 turned on other issues.[109]

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[106] *Id.* § 503(c)(1).

[107] *Id.* § 503(c)(1)(C)(ii).

> [I]f no such similar transfers were made to . . . such nonmanagement employees during such calendar year, the amount of the transfer . . . [cannot be] greater than an amount equal to 25 [twenty-five] percent of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider for any purpose during the calendar year before the year in which such transfer is made . . . .

Id.

[108] *But see* Chesapeake Knife & Tool Co. v. Chekt, Inc., No. 06-10480-DK, 2006 WL 4671820, at *1 (Bankr. D. Md. July 11, 2006). In *Chesapeake Knife & Tool Co.*, the court applied § 503(c)(1)(C) to a proposed KERP and ultimately approved it. *Id.* The court in this case merely stated that the payment would be a retention payment, yet stated that it met the requirements of § 503(c). *Id.* The court did engage in an exercise whereby it addressed each of the three requirements of § 503(c), showing how the retention payment met the requirements. *Id.* However, because the company was so small in this case, this explanation likely

The formula for determining the ceiling on KERP payments thus remains ambiguous.

Members of Congress supporting § 503(c)(1)(C) assumed that setting a cap on executive retention payments would ameliorate the disparity between key employee gains and wage-level employee losses in bankruptcy.[110] However, any money that remains in corporate coffers will not necessarily go toward saving employee jobs and benefits. Most likely, this money either will be spent on running the business or will end up in the pockets of unsecured creditors. A court has no power to mandate that corporate executives use these funds toward any specific purpose, like saving jobs or paying benefits. Moreover, even two of the most hard-lined advocates of restricting executive compensation, Lucian Bebchuk and Jesse Fried, do not suggest setting caps on executive compensation.[111] Thus, the assumption that a cap on KERPs would rectify the issue of wage-level employee losses is unfounded, making this regulation more symbolic than constructive.

4. Restrictions on Severance Packages

Just as § 503(c)(1) restricts retention payments, § 503(c)(2) restricts severance packages.[112] Section 503(c)(2) disallows any severance package payment that is not "part of a program that is generally applicable to all full-time employees" and exceeds "10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made."[113] These restrictions are less ambiguous than those applying to KERPs because though § 503(c)(2) caps the amount of any severance payment, it only requires that the severance payment be applicable to all employees. By not imposing a potentially insurmountable hurdle, like § 503(c)(1)(A)'s job offer hurdle imposes on KERPs, § 503(c)(2)'s restrictions on severance packages are better tailored to solve the problem Congress intended to address.

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would not have been helpful in trying to apply the provision to a much larger bankruptcy, like Enron or WorldCom.

109 *See, e.g.*, *In re* Nellson Nutraceutical, Inc. 369 B.R. 787, 802 (Bankr. D. Del. 2007); *In re* Global Home Prods., LLC, 369 B.R. 778, 785 (Bankr. D. Del. 2007); *In re* Dana Corp. (*In re Dana Corp II*), 358 B.R. 567, 575 (Bankr. S.D.N.Y. 2006).

110 151 CONG. REC. S1988 (daily ed. Mar. 3, 2005) (statement of Sen. Richard Durbin).

111 *See* Bebchuk & Fried, *supra* note 19.

112 11 U.S.C. § 503(c)(2).

113 *Id.* § 503(c)(2)(A)–(B).

The requirements of § 503(c) are strict, especially in their application to executive retention payments. Once a court classifies a debtor's compensation plan as a retention plan, it becomes very difficult for a debtor to satisfy the KERP test laid out in § 503(c)(1). Debtors, then, are motivated to circumvent the regulation, and they have found a loophole in the provision that allows them to do so.

B. How Debtors and Courts Have Circumvented § 503(c)

Although § 503(c) implements a rigorous test to determine whether a KERP is acceptable under the Bankruptcy Code, the "entire analysis changes if a bonus plan is not primarily motivated to retain personnel or is not in the nature of severance."[114] The first question in any § 503(c) challenge to an executive compensation plan is whether the plan is, in fact, a payment "for the purpose of inducing [the executive] to remain within the debtor's business."[115] If the payment is for this purpose, then it will be governed by § 503(c)(1)'s requirements. In contrast, if a judge does not interpret the payment plan to be a retention payment, then § 503(c)(1) does not apply, and the court applies the far more lenient § 363(b) standard to evaluate the payment.

Section 363(b) prohibits any use of corporate property outside of the ordinary course of business without notice and a hearing by the bankruptcy court.[116] One court has determined that executive payment schemes are outside of the ordinary course of business because executing these types of contracts is "not a daily occurrence for any given corporation."[117] When deciding questions posed under § 363(b), courts use the lenient business judgment rule, which only requires the debtor to offer "proof that there is a broad business purpose for the action."[118] Under this rule, courts approved KERPs before BAPCPA and continue to approve all other executive payments that do not fall under § 503(c). Section 363(b) and the business judgment rule thus allow debtors and bankruptcy courts to circumvent the requirements of § 503(c).[119]

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114 *In re Global Home Prods.*, 369 B.R. at 785.
115 11 U.S.C. §503(c)(1).
116 *Id.* § 363(b).
117 *In re* Crystal Apparel, Inc., 220 B.R. 816, 832 (Bankr. S.D.N.Y. 1998).
118 *In re Global Home Prods.*, 369 B.R. at 783–84.
119 *See infra* notes 126–30 and accompanying text.

1. In re Nobex Corp.

The first reported case that addressed an executive compensation plan under BAPCPA was *In re Nobex Corp.*,[120] which filed its chapter 11 petition in late 2005.[121] Nobex, a "private, development stage biopharmaceuticals company," wished to sell substantially all of its assets under an "orderly sale process."[122] Nobex's proposed "stalking horse bid" was $3.5 million, which would require it to market its assets aggressively.[123] To facilitate its sale, Nobex planned to retain its two-person senior management team, offering them "certain sale-related incentives" as part of their compensation for exercising due diligence in promoting the corporate assets to buyers and soliciting purchase offers.[124] The court agreed that the senior management team and their "full experience, expertise, and enthusiastic involvement" were essential to a successful outcome of the orderly sale process.[125]

In light of its finding that the senior management team would play a crucial role in maximizing the value of Nobex's assets, the court applied the business judgment rule and agreed the sale-related incentives were appropriate exercises of business judgment.[126] To apply the business judgment rule to the compensation plan, the court had to determine the plan was not a retention or severance plan under § 503(c), but instead a payment outside of the ordinary course of business under § 363(b).[127] Because the plan did not "provide for incentive compensation . . . unless the gross sale price achieved exceed[ed] the proposed stalking horse bid," the court held it was not an employee retention plan and, thus, it was not subject to § 503(c).

Since *In re Nobex*, courts have followed its holding and avoided retention issues by characterizing payments to executives as something other than those governed by § 503(c)[128]—payments made "for the purpose of inducing [the

[120] *In re* Nobex Corp., No. 05-20050, 2006 WL 4063024, at *1 (Bankr. D. Del. Jan. 19, 2006).
[121] Rogoff, Sussman & Cohen, *supra* note 26, at 398.
[122] *In re Nobex*, 2006 WL 4063024, at *1.
[123] *Id.* at *2.
[124] *Id.* at *1.
[125] *Id.* The court noted that "[t]he experience and skills of [the senior management team were] especially important in this specific case in view of their knowledge and understanding of the science and technology of the Debtor's pharmaceutical assets." *Id.* at *2.
[126] *Id.*
[127] *Id.* at *2–3.
[128] *See generally In re* Nellson Nutraceutical, Inc., 369 B.R. 787 (Bankr. D. Del. 2007); *In re* Global Home Prods., LLC, 369 B.R. 778 (Bankr. D. Del. 2007); *In re* Dana Corp. (*In re Dana Corp. II*), 358 B.R. 567 (Bankr. S.D.N.Y. 2006).

executive] to remain with the debtor's business."[129] Because courts interpret § 503(c) to apply only to payments with the primary purpose of retaining a key employee, claimants must show retention as an element of any payment they wish to disallow under § 503(c). In *In re Nobex*, the court could have construed the compensation as a retention payment by putting more weight on the fact that the payment—which exceeded any previous salary payments—probably helped persuade the senior management team to remain with the corporation.[130] Recognizing that these executives were "[c]ritical to the Debtor's successful implementation of the sale procedure," the court avoided any question of retention payment under § 503(c) by classifying the payment as an incentive-based plan.[131] This trend of classifying executive payments as incentive-based plans has continued since *In re Nobex*.[132]

2. In re Global Home Products

In 2007, the bankruptcy court in *In re Global Home Products* addressed an executive payment of a corporation that was not selling substantially all of its assets, but was continuing to operate under chapter 11.[133] Before Global Home Products, a designer and manufacturer of specialty products, filed for bankruptcy in early 2006,[134] it had an incentive program for management employees and a sales bonus program for nonmanagement employees.[135] After filing its petition, Global Home Products submitted a proposal to implement a "Management Plan," which would award each eligible employee "on a quarterly basis and as a percentage of their base salary, up to four . . . potential incentive payments" if the employee met certain objectives.[136] Global Home Products also wanted to implement a "Sales Bonus Plan," which would give sales managers "up to . . . 30% of their annual salaries based on the annual percentage increase of annual sales for their division . . . plus . . . a 15% Target

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[129] 11 U.S.C. § 503(c)(1) (2006).

[130] Rogoff, Sussman & Cohen, *supra* note 26, at 399. In *In re Nobex*, § 503(c) may have done nothing more than cause the debtor and the court to recharacterize the payments as something other than retention payments. *In re Nobex*, 2006 WL 4063024, at *1. Before 2005, the debtor could have submitted the proposal under the heading "retention/severance plan for management." Rogoff, Sussman & Cohen, *supra* note 26, at 399.

[131] *In re Nobex*, 2006 WL 4063024, at *1.

[132] *See generally In re Nellson Nutraceutical*, 369 B.R. at 787; *In re Global Home Prods.*, 369 B.R. at 778; *In re Dana Corp. II*, 358 B.R. at 567.

[133] *In re Global Home Prods.*, 369 B.R. at 780.

[134] *Id.*

[135] *Id.*

[136] *Id.*

Bonus Percentage payment" if the managers met certain objectives.[137] When Global Home Products sought to incorporate these plans into their reorganization, a labor union objected.[138] The union objected on the grounds that the plans violated § 503(c) and that the plan proposal came "at a time when management [was] seeking to extract deep concessions from the employees and retirees" represented by the union.[139]

Despite the union's objections, the court determined that the plans were in fact incentivizing plans, rather than KERPs.[140] Thus, the payment fell outside of the scope of § 503(c).[141] In determining the plans were not KERPs, the court compared them to Global Home Product's prepetition bonus system and found them "virtually identical."[142] The court noted that although all compensation has a retentive effect on employees, that fact did not "reduce the [c]ourt's conviction that [the] Debtor's primary goal [was] to create value by motivating performance."[143] Because the court did not categorize this proposal as a retention plan and therefore did not apply § 503(c), the court applied the business judgment rule under § 363(b) instead and found that the challenged plans followed from proper business judgment.[144]

3. In re Dana Corp.

In 2006, *In re Dana Corp.* became the first case to reject an executive compensation plan under § 503(c).[145] Dana Corporation was a "leading supplier[] of modules, systems and components for original equipment manufacturers and service customers in the light, commercial and off-highway vehicle markets."[146] When it filed for bankruptcy, Dana had approximately 44,000 employees.[147] Like many debtor corporations, it sought the court's approval to assume the employment contracts for its chief executive officer and senior executives.[148] The creditors' committee and others objected,

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137 *Id.* at 781.

138 *Id.* The objecting labor union was USW, or the United Steel, Paper and Forestry, Rubber, Manufacturing, Energy, Allied Industrial and Service Workers International Union. *Id.*

139 *Id.* at 782.

140 *Id.* at 786.

141 *Id.* at 783.

142 *Id.* at 786.

143 *Id.* ("All companies seek to retain employees they value by fairly compensating them.").

144 *Id.* at 786.

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

146 *Id.* at 572.

147 *Id.*

148 *Id.*

arguing that the agreements between the chief executive officer, the executives, and the corporation violated § 503(c).[149]

Dana responded to the objection, following the trend established in the earlier KERP cases, and argued that company survival depended on its ability to retain its executives by giving them adequate compensation.[150] Dana's proposal included salaries, annual bonuses, and additional "completion bonuses" for achieving certain targets or goals for corporate successes during bankruptcy.[151] Salaries for the executives ranged from $500,000 to $600,000, and the chief executive officer's salary remained at its prepetition figure of $1,552,500.[152] Dana also proposed severance packages for its executives.[153]

The court initially rejected Dana's proposal, characterizing the issue in the case as a determination of whether the executive contracts constituted a KERP "subject to limitations of section 503(c) of the Bankruptcy Code or [whether it

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[149] *Id.* Other objectors to the debtor's motion included "the U.S. Trustee, the Creditors' Committee, the Equity Committee, the *Ad Hoc* Noteholders' Committee and the Unions." *Id.*

[150] *In re* Dana Corp. (*In re Dana Corp. I*), 351 B.R. 96, 99 (Bankr. S.D.N.Y. 2006).

> According to the Debtors, the Executives should be compensated and incentivized to lead Dana and achieve an expedient and successful reorganization of the Debtors. "Dana needs assurance that it will have its executive team in place to work, independently, through this difficult and demanding restructuring effort and that its management team will be sufficiently protected so that the members can dedicate themselves to the objectives of maximizing values for all of the Debtors' competing constituents without distraction from the imminent risk to their futures."

Id.

[151] *Id.*

[152] *Id.* To evaluate this case from a § 503(c)(1)(C) perspective, it is important to take a close look at the actual numbers. First, the hard numbers are indispensable for considering whether compensation proposals will pass § 503(c)(1)(C) scrutiny. Second, examining the numbers in this case and in Dana's November 2006 appeal demonstrates the type of detailed and complicated analysis that goes into a § 503(c) evaluation. Dana proposed that the "AIP [executive] bonuses . . . range from $336,000 to $528,000" and that the CEO's bonus equal $2,070,000, which was also unchanged from his prepetition incentive compensation. *Id.* For the target completion bonus, Dana proposed two components:

> First, there is a fixed component, which is awarded without regard to performance or creditor recovery, payable in cash on the effective date of a plan of reorganization . . . if the Executive is still employed by Dana. This component ranges from $400,000 to $560,000 for the Executives and is $3,100,000 for [the CEO]. . . . The second component is an uncapped, variable component based on the Total Enterprise Value of the Debtors . . . six months after the Effective Date. For example, [the CEO] earns an additional $4,133,000 if the Debtors' TEV goes down to $2 billion (Threshold Completion Bonus), but if TEV remains at $2.6 billion, [the CEO] would earn $6,200,000 ("Target Completion Bonus").

Id.

[153] *Id.*

could] be construed to be an *incentivizing* 'Produce Value for Pay' plan to be scrutinized through the business judgment lens of section 363."[154] The court denied Dana's attempt to circumvent § 503(c)(2) "by characterizing the amounts being paid to the Executives upon involuntary dismissal or resigning for good reason as 'payments in exchange for non-compete agreements.'"[155]

The court also concluded that the completion bonuses were not truly incentive plans; rather, they were essentially guaranteed to the executives merely for remaining with the corporation until the "Completion Date," regardless of the outcome of the reorganization plan.[156] The judge determined that the performance benchmarks in the proposal were so low that the plan had the practical effect of a retention plan, regardless of how the debtor characterized it.[157] Looking beyond the debtor's characterization, the court devised what is now an oft-quoted dictum about KERPS: "If it walks like a duck (KERP) and quacks like a duck (KERP), it's a duck (KERP)."[158]

After the court rejected Dana's first plan, Dana negotiated with stakeholders and developed a new plan for the court's consideration.[159] Instead of offering incentives merely to retain key employees, Dana provided tougher benchmarks for the corporation to reach before these executives could receive bonuses.[160] Though the new plan's bonuses still amounted to sizeable payments drawn from company funds, the new plan offered more protection to

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[154] *Id.* at 98.

[155] *Id.* at 102. Presiding over the court in *In re Dana Corp. I*, Judge Lifland described § 503(c)(2)'s standard as follows:

> [A] severance payment to an insider may not be approved by this Court unless the Debtors have established that the payment is part of a program generally applicable to all full time employees and the amount of the payment is not more than ten times the amount of mean severance given to non-management employees in that calendar year.

Id. at 103.

[156] *In re* Dana Corp. (*In re Dana Corp. II*), 358 B.R. 567, 574 (Bankr. S.D.N.Y. 2006).

[157] *In re Dana Corp. I*, 351 B.R. at 102.

[158] *Id.* at 102 n.3. Interestingly, the court also concluded that § 503(c) does not prevent the court from analyzing executive compensation plans under the business judgment rule as well:

> While it may be possible to formulate a compensation package that passes muster under the section 363 business judgment rule or section 503(c) limitations, or both, this set of packages does neither. In so holding, I do not find that incentivizing plans which may have *some* components that arguably have retentive effect, necessarily violated section 503(c)'s requirements.

Id. at 103.

[159] *In re Dana Corp. II*, 358 B.R. at 574.

[160] *Id.*

stakeholders because its tougher benchmarks required the corporation to show a certain degree of success before it could compensate its insiders.[161]

The court recognized the protection that the new plan's benchmarks offered and approved Dana's new plan.[162] In approving the new plan, the court recognized "the potential limitations of [§ 503] as it applies to 'pay to stay'" KERPs and noted, "[V]iewing compensation packages holistically, a *true* incentive plan may not be constrained by 503(c) limitations. . . . [M]erely because a plan has some retentive effect does not mean that the plan, overall, is retentive rather than incentivizing in nature."[163]

In re Dana Corp. demonstrates that § 503(c) has failed. As one notable critic of § 503(c), Representative Chris Cannon of Utah, has argued

> [T]he Dana Corp. case shows in one important, real-life example how the KERP's [sic] provisions have underserved the needs of Chapter 11 companies for flexibility in structuring executive compensation packages that can keep the right management teams in place. . . . [It] shows that experienced bankruptcy courts see the same thing and are straining to interpret the code in a way that would help keep Chapter 11 companies from becoming Chapter 7 economic shipwrecks.[164]

Representative Cannon's comments refer to the standard courts use to evaluate executive compensation plans explained in *In re Dana Corp*. If a plan appears to merely retain executives, the court will subject the plan to § 503(c)'s requirements, which will probably prohibit the plan. Debtor corporations, however, are free to create incentive-based plans for their executives. If a plan appears on the whole to be an incentivizing plan, the court will apply § 363(b)'s business judgment standard, which is a much more deferential standard. As Representative Cannon noted above, courts recognize that § 503(c) is too strict in limiting executive compensation plans and, in response, have circumvented the statute to provide more flexibility for corporations that are trying to reorganize. This result has rendered § 503(c) ineffective.

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[161] *Id.*

[162] *Id.* at 571.

[163] *Id.*

[164] *Hearings on Executive Compensation in Chapter 11*, *supra* note 77, at 4 (statement of Rep. Chris Cannon).

C. The Ineffectiveness of § 503(c)

Congress sought to regulate KERPs with BAPCPA in 2005, when most employees and retirement-fund holders still faced the consequences of the major bankruptcies of the earlier part of the decade.[165] When Senator Kennedy added § 503(c) to BAPCPA, he made an emotional plea, contrasting corporate executives profiting from bankruptcy with employees and retirees suffering significant harms inflicted from corporate fraud and mismanagement.[166] Before Congress added § 503(c) to BAPCPA, opponents raised two objections: first, it included corporations in which there was no evidence of fraud, and second, it set unworkable constraints on all employee retention payments.[167]

These, however, were not the only problems arising after BAPCPA. Section 503(c) has in fact proven to be a very strict regulation on KERPs, and debtors and judges alike have recognized this. Because § 503(c) prohibits an executive payment characterized as primarily retentive in nature, debtors have avoided § 503(c) by arguing that their proposed plans are not retentive, but are tied to incentives. When tied to certain benchmarks or objectives, even though these types of payments may be as exorbitant as they were before BAPCPA, they cannot be classified as retention plans and therefore prohibited by § 503(c). Judges have accepted debtors' characterizations of executive payments as incentive-based, as long as the incentives are not so insignificant as to make the payment guaranteed.

With bankruptcy courts applying the more deferential business judgment rule to KERPs nationwide, § 503(c) has hardly made an impact on executive payments in bankruptcy. In fact, its only impact seems to be forcing debtors to recharacterize their executive payment proposals as incentive-based plans, rather than as retention plans. This development is striking because § 503(c) would not apply to KERPs in cases like Enron and WorldCom—the very KERPs that § 503(c) was designed to catch—as long as those debtor corporations managed to tie executive bonuses to corporate goals. Additionally, because § 503(c) has no provision regarding the limitation of executive payments in the event of fraud or mismanagement, corporations like Enron and WorldCom would have no more difficulty in avoiding § 503(c)'s requirements than any other debtor corporation. Unfortunately for those

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[165] *See supra* Part I.C.4.

[166] *See supra* notes 83–85 and accompanying text.

[167] *See supra* notes 86–87 and accompanying text.

employees and retirees that suffered in the wake of the largest corporate bankruptcies ever declared, they are left "out in the cold."[168]

III. SOLUTIONS TO THE § 503(C) PROBLEM

Although § 503(c)'s advocates hoped it would prevent some of the executive abuses that occurred in 2005,[169] the provision has not produced its intended effect because it is too strict and too broad to be feasible. If today's KERPs require more regulation than those approved before Enron, WorldCom, and BAPCPA, § 503(c) is not providing that regulation. This Part suggests solutions to this problem by tailoring a more focused, nuanced, and effective method of regulating employee retention payments.

A. *Narrow and Focus KERP Regulation*

Congress enacted § 503(c) with the twin goals of combating corporate fraud and improving the disparity between executive gains and employee losses when corporations declare chapter 11 bankruptcy. Section 503(c), however, is not tailored to achieve those goals. In fact, § 503(c) exacerbates the problems it is designed to solve because it produces a false sense of security about corporate fraud and compensation disparities. It has also caused new problems because it is overbroad and applies in circumstances where debtor corporations are prudently trying to retain their talented management. Rather than retaining § 503(c)'s ineffective and overbroad regulation, lawmakers should consider repealing it and focusing on laws that directly target corporate fraud, lay-offs, and salary disparities.

Unemployment and the disparity between corporate executive and wage-level employee salaries are issues that exist outside of bankruptcy. These issues are only underscored in bankruptcy, when corporations are more focused on streamlining the corporation, rather than saving jobs and compensating employees fairly. However, the KERP regulation does nothing to resolve these problems in bankruptcy. If Congress is seeking a way to save jobs or protect workers' salaries during bankruptcy, it should create incentives for corporations to maintain jobs and salaries, rather than punishing executives by eliminating retention payments.

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[168] *In re* Dana Corp. (*In re Dana Corp. II*), 358 B.R. 567, 575 (Bankr. S.D.N.Y. 2006).

[169] *Id.*

Furthermore, if Congress wants to prevent corporate fraud via KERPs, it should use resources beyond bankruptcy courts and the Bankruptcy Code. Evidence of fraud and wrongdoing often emerges when a corporation declares bankruptcy and managers must disclose information about its inner-workings.[170] Corporate managers can be held criminally and civilly liable for their misdeeds.[171] Although the automatic stay in § 362(a)(1) halts lawsuits against the debtor corporation itself,[172] bankruptcy courts can allow plaintiffs to sue third parties, such as insiders and executives, who contributed to losses that the plaintiffs sustained due to fraud, mismanagement or bad faith.[173] Bankruptcy courts, however, may prevent such suits against insiders by extending the automatic stay to these third parties to avoid creating distractions for insiders whose focus should be on the debtor corporation's bankruptcy.[174] Because the decision to stay such suits is in the bankruptcy court's discretion, a court should deny this stay to insiders when evidence of fraud or mismanagement emerges. Congress could also remove bankruptcy court's discretion to stay these suits.

Furthermore, Congress should remember that cases like Enron and WorldCom are outliers, as fraud is not present in most corporate bankruptcies. When fraud is present, executive dishonesty cannot be regulated or prevented by merely limiting the amount that the corporation can pay to retain executives and insiders. To regulate corporate fraud, Congress should employ laws that deter those specific acts, rather than attempting to target it through the circuitous route of bankruptcy courts and the Bankruptcy Code.

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[170] *See, e.g.*, Carrie Johnson, *Enron's Lay Dies of Heart Attack*, WASH. POST, July 6, 2006, at A1. Enron's chairman, Kenneth Lay, faced the prospect of spending the rest of his life in prison after a jury convicted him of "conspiring to inflate the energy company's stock price and misleading investors and employees who lost billions of dollars in its 2001 bankruptcy." *Id.* The prosecution requested a $43.5 million judgment against him for his role in the widespread fraud uncovered in the Enron corporation in 2001. *Id.*

[171] *See* Sarbanes-Oxley Act § 302, 15 U.S.C. § 7241 (2006) (establishing corporate responsibility for accuracy in financial reporting); *id.* § 906, 18 U.S.C. § 1350 (providing criminal penalties for individuals fraudulent or misleading financial reports).

[172] 11 U.S.C. § 362(a)(1) (2006). Bankruptcy petitions act as a stay against

> the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title.

Id.

[173] Kuney, *supra* note 22, at 94.

[174] *Id.* at 94 n.338 ("[S]uits against non-debtor insiders . . . [are] harmful to the reorganization process.").

B. Deference

Another possible solution to the problem of regulating KERPs is to repeal § 503(c) and return to the system of checks existing before BAPCPA.[175] This system had the benefit of allowing courts to defer to the business judgment of the debtor. After negotiating with creditors, the debtor can devise an appropriate payment scheme that suits the needs of the corporation. Although the debtor is in the best position to determine what an individual employee is worth, creditors holding important interests at stake in the debtor's reorganization are better equipped than courts and the legislature to recognize when an executive is being overpaid. These creditors can vote down plans that impair their own interests. No strict ceiling, constraint, or formula—like those § 503(c) employs—can capture all the subtleties and case-specific facts relevant in assessing the value of an employee to the debtor, creditors, and other employees. Thus, a system of deference promotes the flexibility that corporations need to manage themselves out of bankruptcy.

Such a system of deference, however, did not provide sufficient regulations to prevent insiders in Enron and WorldCom from reaping exorbitant bonuses.[176] Despite evidence of widespread fraud, each debtor managed to give its executives sizeable retention payments. Even in cases of fraud, corporations may prefer a dishonest executive with experience to a trustworthy manager without an understanding of the company. Creditors and judges also may hesitate to object to retention plans when doing so may actually cause reorganization to fail. Furthermore, because executive payment is only one part of a successful reorganization, creditors may even tolerate exorbitant executive compensation if it would help their own chances at a higher return on their bankruptcy claim.

Congress enacted § 503(c) to attack cases like Enron and WorldCom. A better-tailored regulation of corporate fraud would retain a general system of deference but create tools for creditors and judges to use in cases of abuse. In such cases, these tools would provide creditors with more leverage to oppose retention plans and judges with additional means to prevent unwarranted retention payments. When evidence of mismanagement does not exist, however, the court would be free to apply the business judgment rule to any proposed retention payments.

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[175] *See supra* Part II.B.

[176] Although, it is clear that § 503(c) would not have prevented the KERPs in Enron and WorldCom either. *See supra* Part II.C.

Another improvement in regulating KERPs may be to eliminate retention payments altogether when there is clear evidence of fraud.[177] This solution would encourage insiders not to engage in corporate fraud and would ensure that more funds remain with the debtor corporation. This solution, however, also has the disadvantage of encouraging insiders to abandon the corporation when it declares bankruptcy. Though it may seem counterintuitive that a corporation would want to retain an insider who was guilty of corporate abuses, deceitful insiders who know the structure of the business may be better options than an unknowledgeable management.[178] Another disadvantage to this solution is that it would still leave the door open for incentive payments to deceitful insiders. Though a provision could preclude all bonuses to dishonest managers—both retentive and incentivizing in nature—this would probably guarantee that the debtor loses the very insiders it hoped to retain. Though these proposals may resolve the issue of exorbitant bonuses in instances of corporate fraud, cases like United Airlines, in which there was no fraud, would go unresolved in a system of deference.[179]

The central question is not whether any amount that corporations offer their executives as a retention payment is too much, but whether these executives are worth what the corporation is paying them. Unfortunately, this question may be beyond any meaningful regulation because an employee's worth can only be assessed by the corporation that pays that employee. The business judgment standard may be the only reasonable means of balancing the need for debtor flexibility with the protection of creditor and wage-level employee interests. Though checks on insider payments would not be perfect under a

[177] This would be essentially the same result as applying § 503(c) only to cases of fraud because this provision would probably strike down any proposed retention payment. However, if Congress intended § 503(c) to eliminate retention payments in cases of corporate abuse, § 503(c) should state so directly.

[178] *See In re* Nartron Corp., 330 B.R. 573, 591 (Bankr. W.D. Mich. 2005).

> There is a strong presumption in Chapter 11 cases that the debtor-in-possession should be permitted to remain in control of the corporation absent a showing of need for the appointment of a trustee. It is well settled that the appointment of a trustee should be the exception rather than the rule. The corporation's current management is "best suited to orchestrate the process of rehabilitation for the benefit of creditors and other interests of the estate." This strong presumption is rooted in the debtor-in-possession's familiarity with the business both before and after the filing of bankruptcy. Nevertheless, in the appropriate case, the appointment of a trustee is a power which is critical for the court to exercise in order to preserve the integrity of the bankruptcy process and to insure that the interests of creditors are served.

Id. at 591–92 (citations omitted); *see also In re* Marvel Entm't Group, Inc., 140 F.3d 463, 471 (3d Cir. 1998); *In re* Sharon Steel Corp., 871 F.2d 1217, 1225 (3d Cir. 1989); *In re* V. Savino Oil & Heating Co., 99 B.R. 518, 524 (Bankr. E.D.N.Y. 1989).

[179] *See supra* notes 74–81.

scheme of deference, creditors would have the ability to raise objections to prevent unreasonable retention plans from passing through the courts.

Section 503(c) fails to regulate KERPs effectively because it is too strict and provides a gaping loophole that has allowed debtors to bypass the provision altogether. Judges are quick to classify executive payments as incentive payments, rather than retention payments, to avoid applying § 503(c)'s other constraints. Because it contains this loophole, § 503(c) does not achieve its intended results of ensuring fair treatment of employees and other bankruptcy stakeholders by limiting executive compensation, especially in cases of corporate fraud. A more useful provision would either regulate KERPs when there is evidence of mismanagement or create a more workable standard to which debtors and judges would be willing to adhere.

CONCLUSION

Section 503(c) has proven to be an ineffective method of regulating executive compensation. Unreasonably stringent constraints in § 503(c) make it almost impossible for a corporation to offer KERPs. By exploiting a loophole in the provision, debtors have successfully argued that their key employee payment schemes are not retentive in nature, but are based on the key employees attaining certain benchmarks before they become eligible for incentive-based bonuses. If a plan is not primarily retentive in nature, it does not fall under the strict regulation of § 503(c), but under the business judgment rule and § 363(b). Because judges avoid applying § 503(c), and instead apply the less stringent business judgment rule, § 503(c) has been an ineffective means of regulating executive retention payments.

In the end, issues of corporate fraud and unemployment exist whether or not corporations are in bankruptcy. The KERP regulation is an ineffective method of ameliorating these problems. Rather than imposing the requirements of § 503(c) on debtor corporations, lawmakers should seek to

finely tune regulations to penalize fraud and motivate executives to protect workers' jobs and salaries. Legislation targeted to achieve those ends is much more likely to effect the results Congress intended in enacting § 503(c).

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