Oversight Hearing of the Subcommittee on Commercial and Administrative Law
U.S. House of Representatives Committee on the Judiciary
"Executive Compensation in Chapter 11 Bankruptcy Cases: How Much Is Too Much?"

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Written Statement of Mark S. Wintner

By way of background, I am a partner in the law firm of Stroock & Stroock & Lavan LLP and head of the Firm's ERISA and Employee Benefits Group. I have specialized for over three decades on a broad range of employee benefit and compensation issues, and have worked extensively on the employee benefit and compensation aspects of bankruptcy and reorganization proceedings. Specifically, I have been involved in advising debtors, official creditor committees, ad hoc bondholders committees and individual and groups of creditors, investors and purchasers on benefits and/or compensation matters in numerous Chapter 11 reorganization proceedings, including Delta Airlines, Brooklyn Hospital, Dana Corp., Loral Space & Communications, Anchor Glass, Columbia Gas, Piper Aircraft, LTV Steel, Pan Am, Federated Department Stores, Wheeling-Pittsburgh, Coleco, Flushing Hospital, Raytech and W.R.Grace.

I also lecture frequently on employee benefit and compensation matters in bankruptcy and have been a speaker for the American Bar Association (ABA), Practicing Law Institute (PLI), ALI-ABA and the Society of Actuaries, among others. I am a member of the American College of Employee Benefits Counsel and the ABA Joint Council of Employee Benefits.

The views stated herein are solely those of the author, and do not necessarily reflect the views of my Firm or any of its partners or of any Firm clients, past or present.

The very title of the hearing, "Executive Compensation in Chapter 11 Bankruptcy Cases: How Much is Too Much," suggests that there may be an objective standard which would enable bankruptcy courts and interested parties in Chapter 11 cases to discern when executive compensation crosses the line from "enough" to "too much." In my opinion, there is no feasible way of making such a judgment and, moreover, if there were it would vary from company to company, would not apply uniformly to different executives within the same company and would certainly change over time.

As the Subcommittee is aware, the subject of executive compensation in Chapter 11 cases was addressed by Congress just two years ago, as part of the Bankruptcy Abuse Prevention and Consumer Protection Act (the "Bankruptcy Reform Act"). The Bankruptcy Reform Act added Section 503(c) to the Bankruptcy Code, effective for Chapter 11 cases filed on or after October 17, 2005. Section 503(c) acts as a limitation on the authority conferred under Section 503(b) to allow administrative expenses of the Chapter 11 debtor's estate. Section 503(c) directs that even if a claim for compensation would otherwise satisfy the 503(b) requirements for administrative expenses, the claim

will not be allowed (by the Bankruptcy Court) nor paid (by the debtor) if it falls into any of the three paragraphs of subsection (c), summarized below:

(1) covers retention compensation to be paid to an insider of the debtor, such as the debtor's directors, officers or other persons in control of the debtor, unless the bankruptcy court makes a finding based on the record that such payment is (i) essential to retaining the insider because the person has a bona fide job offer from another business at the same or greater rate of compensation and (ii) the services provided by the person are essential to the survival of the business. In addition, the court may only approve retention compensation programs that are capped at no greater than ten times the amount of similar payments provided to non-management employees, or if no such similar payments were made, no more than 25% of the amount of any similar payments made to such insider for any purpose during the year prior to the year in which such payment is to be made;

(2) covers severance to be paid to an insider of the debtor, unless (i) the payment is part of a program that is generally applicable to all full time employees and (ii) the amount of the payment does not exceed ten times the amount of the mean severance pay given to non-management employees during the calendar year in which the severance payment to the insider is made;

(3) covers post-petition transfers or obligations incurred for the benefit of officers, managers or consultants, if such transfers or obligations are outside the ordinary course of business and not justified by the facts and circumstances. This provision would apply to incentive compensation and bonus plans.

The focus of this statement is on the type of compensation programs commonly referred to as key employee retention plans, or KERPs, and in particular, performance based KERPs. Prior to the enactment of the Bankruptcy Reform Act, KERPs had been used to provide certain high-level employees of a debtor with compensation to induce them to stay with a debtor throughout a reorganization, in addition to the employee's base salary. These programs covered a wide range of benefits from severance pay to retention arrangements to success bonuses. They may have been structured to pay out if an employee remained employed through a particular date or event (sometimes referred to as a "stay bonus"), upon the occurrence of reaching certain business targets, or if the company terminated the employee. Historically, a debtor would use a KERP for employees that it considered integral to the operation (and if applicable, the reorganization or wind-down) of the company, and that it felt were necessary to retain during the uncertain times of the reorganization, much like a company outside of reorganization would use an incentive program to retain employees during uncertain times such as a downsizing or merger. Before the Bankruptcy Reform Act, bankruptcy courts applied the business judgment rule to the proposed KERP (i.e., the court would typically approve a KERP if it was persuaded that the debtor used sound business judgment, there was a legitimate business justification and the compensation program was fair and reasonable).

As discussed above, Section 503(c) of the Bankruptcy Code severely limits the amount of retention compensation and severance which can be paid to the debtor's insiders. In effect, the limitations on retention (or stay) payments and on severance as set forth in Section 503(c)(1) and (2), respectively, have already answered the question as to how much is too much for those types of payments. However, KERPs which are performance driven can still be reconciled with the new law.

Since Section 503(c) became effective less than two years ago, the decisions (published and unpublished) analyzing and applying the Section 503(c) restrictions are limited, however, even with this limited case law, it is beginning to come clear how courts have viewed the changes to the Bankruptcy Code. The case law has focused on whether the proposed plan is a "pay to stay" compensation plan, primarily used to retain employees and thereby subject to the limits of Section 503(c), or a "pay for value" compensation plan, primarily used as an incentive for employees to reach certain goals and a reward upon attainment of those goals and, therefore, subject to the standards of the business judgment rule.

One of the first cases to discuss Section 503(c) was In re Nobex Corp., No. 05-20050, 2006 Bankr. LEXIS 417 (Bankr. D. Del. Jan. 19, 2006). In that case, the debtor sought to pay its chairman (acting as its chief executive officer) and its vice president of finance and administration incentive bonuses in addition to their regular compensation. The incentive bonuses were to be paid only in the event of a sale of the debtor and only if the sale price exceeded a certain threshold. The debtor argued that the chairman and vice president were necessary for a successful sale of the company and that they were committed to their employment even if no incentive compensation was paid. The court found that the plan was not an inducement for the chairman and vice president to stay with the debtor, but rather an inducement to increase the price received by the debtor in a sale, which would ultimately result in a greater recovery for creditors. The plan was approved by the court using the business judgment standard, not the Section 503(c) standard.

In the case of In re Calpine Corp., No. 05-60200, the court approved a compensation program that included four different types of incentive payments. The program provided for payment of (i) bonuses upon the debtor's emergence from Chapter 11, (ii) bonuses based on the debtor's achievement of certain performance goals established by the debtor in consultation with various creditor constituencies, (iii) a supplemental bonus to non-insiders who performed a critical function at the debtor and were at significant risk of being hired by another company and (iv) a discretionary bonus to non-insiders. The court approved the latter two components of the compensation program outside of Section 503(c) because the payments were to non-insiders. The court also held that the emergence bonus and performance bonus were outside of Section 503(c) because they were incentive plans not retention plans.

In In re Dana Corp., 351 B.R. 96 (Bankr. S.D.N.Y. 2006), the court rejected the debtor's proposed compensation program for senior officers. Notably, this was the same court that approved the Calpine program months earlier. The Dana compensation program, as initially presented, included a completion bonus that paid out

on the debtor's emergence from bankruptcy, without regard to the actual performance of the company. The court held that since nothing was required of the employees other than remaining with the company through emergence, and it did not meet the requirements of Section 503(c), it was an invalid retention program. As Judge Lifland stated in the Dana opinion, "If it walks like a duck (KERP) and quacks like a duck (KERP), it's a duck (KERP)." Dana subsequently revised its program to include performance criteria and sought approval of the revised plan. With these significant changes, the court approved the program.

In the recent decision of In re Global Home Products, LLC, 2007 Bankr. LEXIS 758 (Bankr. D. Del. March 6, 2007), the debtor sought approval of a management incentive plan which would award certain eligible employees a bonus equal to a percentage of base salary on a quarterly basis if minimum EBITDAR (Earnings Before Interest, Taxes, Depreciation and Rent) and/or cash flow objectives were achieved. The management plan was very similar to prior year incentive plans. The court analyzed and approved the plan outside of Section 503(c), holding that the plan was intended to incentivize management, not retain them. As part of its analysis, the court considered that in the prior year, under a similar plan, no bonuses were paid since the targets were not met.

Retaining or attracting key employees, directors or consultants is important for any company, whether in or out of Chapter 11, but Chapter 11 debtors have additional problems in this regard, most notably the inescapable fact that the future of the company is more uncertain than usual and that they cannot offer equity compensation during the reorganization proceeding. The Bankruptcy Reform Act has significantly curtailed the use of retention (or stay) bonuses and severance as meaningful incentives. Therefore, in addition to market competitive salaries and annual bonuses, performance based KERPS are the most significant means for a debtor to compensate insiders and remain competitive with other prospective employers. The ability to do so is not only important to debtors and insiders themselves, but to the creditors and other interested parties whose recoveries depend upon maximizing the value of the debtors.

The early experience with Section 503(c) is that the bankruptcy courts, after taking into account the view of the various creditor constituencies and other interested parties, are developing a workable set of rules which will enable insiders to be compensated on a competitive basis, but only if their performance has been beneficial to the estate. There is no need to impose limits on that process, particularly so soon after the Bankruptcy Reform Act. Any attempt to impose a one-size fits all absolute dollar or percentage limit on "pay for value" KERPs will frustrate the ability of the interested parties to design incentive compensation suitable for the particular needs of the debtor and be detrimental to the Chapter 11 process.