Testimony of

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Vice Chair

on behalf of the

National Bankruptcy Conference

before the

Subcommittee on Commercial and Administrative Law

of the

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The National Bankruptcy Conference appreciates the opportunity to participate in these oversight hearings on executive compensation in chapter 11 cases and thanks the Subcommittee for its invitation. The topic is important to the administration of chapter 11 cases and preservation of jobs and value for all constituencies and equally important to maintaining fairness in reorganization. We commend the Subcommittee for focusing on this issue in its review of the 2005 bankruptcy amendments.

The Conference is a voluntary, non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are

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leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws. Attached to this statement is a Fact Sheet about the Conference, including a list of its Conferees. Also attached is a Background Report on Executive Compensation Issues that was prepared by the Conference's Employee Benefits and Compensation Committee (the "Background Report").

Executive compensation has occupied headlines recently, and not just in bankruptcy cases. *See* Background Report, at [28-32]; "Transparency: Lost in the Fog," *New York Times*, Apr. 8, 2007, at BU1. In chapter 11 cases, the principal focus has been on retention, severance and incentive plans, especially since the 2005 addition to the Bankruptcy Code of section 503(c). This section, which was added by section 331 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,[2] imposes restrictions on the ability of a chapter 11 trustee or debtor in possession to implement retention, severance, or incentive compensation plans for its "insiders."[3]

To start, a definition of terms might be helpful to an understanding of the issues that section 503(c) presents. In common parlance, retention plans usually involve payments to employees who stay with the company for defined periods of time, even if their employment is

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[2] Pub. L. 109-8, § 331, 119 Stat. 23, 102, (2005).

[3] "The term 'insider' includes—

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(B) if the debtor is a corporation—

(i) director of the debtor;
(ii) officer of the debtor;
(iii) person in control of the debtor;
(iv) partnership in which the debtor is a general partner;
(v) general partner of the debtor; or
(vi) relative of a general partner, director, officer, or person in control of the debtor;".

11 U.S.C. § 101(31).

not terminated. Retention plans are designed to give employees an incentive not to seek employment at another firm even though they may not be threatened with imminent loss of their jobs. Another job at a healthy company, even at reduced compensation, might seem more attractive than remaining with a chapter 11 debtor in possession, where employees face the stress and difficulty of operating a company in chapter 11 and the ultimate risk of being fired due to a reduction in the company's labor force or even liquidation of the enterprise.

A severance plan involves payments to employees upon the company's termination of their employment to cushion the impact of losing their job and to provide them time to seek alternative employment. In the bankruptcy environment, where, for many employees, the prospect of termination is on the immediate horizon, severance plans also serve the goal of retention by discouraging employees from seeking to leave the company in advance of being laid off. A severance plan is particularly appropriate where employees know they will be "working themselves out of their jobs," for example, by overseeing a liquidation or sale of the company. The better the employees perform in the liquidation or sale process, the faster they lose their jobs. All constituencies benefit from a swifter conclusion to the process. Retention and severance plans thus serve a common purpose in chapter 11 cases — keeping employees from seeking other employment for as long as the debtor company needs them.

An incentive plan, by contrast, is designed to motivate employees to achieve financial or other performance targets. The targets might be ordinary operating performance targets or targets relating to the reorganization or liquidation of the company. Although the incentive compensation will not be paid if the employee leaves the company before the relevant performance target has been met (which discourages the employees from leaving), an incentive plan's primary purpose is enhanced performance, not retention.

Incentive and severance plans are common among companies not in financial distress and often are required for a company to provide competitive compensation for middle and senior managers. *See In re Pliant Corp.*, Case No. 06-10001 (MFW) (Bankr. D. Del. Mar. 14, 2006) (prepetition incentive plan). Retention plans, though less common in the non-distress context, are also sometimes seen.

Properly designed, all three kinds of plans can enhance the viability and value of a business, and can serve a proper purpose in business in general and in reorganization cases in particular. *See In re AirWay Indus., Inc.*, 2006 WL 3056764 (Bankr. W.D. Pa. Oct. 3, 2006) (secured creditor underwrote incentive plan out of its own collateral proceeds to motivate employees to produce better recoveries). In chapter 11 cases, properly designed plans can be in everyone's interest because they preserve the business and jobs, and, ultimately, enhance creditor recoveries.

The difficulty, however, lies in ensuring that such plans are used in an appropriate way and are not excessive in light of their legitimate purposes. There is an obvious risk that such plans will be designed by managers to enhance their own compensation and will be more generous than strictly necessary to preserve the value of the business. While this risk exists at a non-bankrupt company, in a bankruptcy company, where other employees are being terminated or being asked to make sacrifices and creditors are incurring significant losses, there is a heightened concern over both unfairness and corporate waste.

In view of this potential for abuse, the National Bankruptcy Conference believes that bankruptcy procedures should be designed so that retention, severance, and incentive plans in chapter 11 cases are tailored to their legitimate objectives—preserving the debtor's business and enhancing its value—but are not excessive. In designing such procedures, however, care

must be taken not to sweep so broadly that appropriately tailored retention, severance and incentive plans are impossible to implement. If the standards for authorization of such plans are too rigid or impractical, the goals of reorganization, preservation of jobs and enhancement of value may be thwarted, or, perhaps worse, parties will have an incentive find creative ways of circumventing the rules to meet the economic needs of the business. The Conference believes an appropriate balance must be struck.

Section 503(c) ostensibly was designed to address the unfairness and waste issues by limiting overly generous “pay to stay” packages for the executives who themselves are setting the payments. However, in its current form the provision can be criticized on a number of grounds.

To start, the section imposes impractical requirements. It permits retention plans only on an employee-by-employee basis, because it requires a showing as to the unique circumstances of each employee that would be covered. It applies only when an employee already has “a bona fide job offer at the same or greater rate of compensation” and when the services of such employee are “essential to the survival of the business” – requirements that are unlikely ever to be met. If an employee sought out and received such a “bona fide job offer at the same or greater compensation,” it is unlikely the employee would choose to await the outcome of a hearing on a retention plan before deciding to accept the other offer. The “bona fide job offer” requirement defeats the principal purpose of a retention program, which is to keep employees from seeking other employment in the first place. The “essential to survival” requirement is difficult to meet in a moderate sized to large company, because the loss of any given employee will seldom be a genuine threat to the company’s ultimate survival. The loss of a key employee may hurt the company, and the loss of a large group of such persons may threaten

the company's survival, but it will be almost impossible to show that retaining a single individual is "essential to survival of the business."

Even if these facts could be shown, the section takes a formulaic approach to what payments may be made. This "one size fits all" approach limits the ability of the debtor in possession to design a retention program that is responsive to the needs of its operations, employees and competitive environment so that the objectives of the program to retain key employees can be achieved.

The section is also overbroad compared to the principal problem it was intended to address—senior executives lining their own pockets while other employees suffer. It can be read essentially to restrict even legitimate and necessary retention and severance programs for mid-level managers who have no control or influence over their own compensation but who can often provide substantial value to a company in distress if they stay and do their jobs.

Finally, ambiguities in the provision generate distracting and destabilizing litigation at the delicate early stages of a chapter 11 case over the distinction between prohibited "retention" plans and permitted "incentive plans," as well as over who is an "insider" covered by the section, and who is not. Such litigation highlights to employees the uncertainty of their status just when the company has an urgent need to calm its workforce due to the initial shock of the bankruptcy filing.

These and other effects of section 503(c) are described in greater detail in the Background Report submitted with this testimony and in the "Memorandum on the Impact of Section 503(c) of the Bankruptcy Code and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 on Executive Compensation," adopted by the Executive Compensation

Committee of the American College of Bankruptcy, which we understand has been submitted to the Subcommittee for inclusion in the record of this hearing.

Despite its flaws, however, there is no question that section 503(c) has served the salutary purpose of sensitizing courts, creditors, and U.S. trustees to the issues of inappropriate executive compensation packages and has properly shifted the compass toward a far more reasonable approach to the issue. The National Bankruptcy Conference would suggest, however, that in the interest of all participants in the reorganization process, especially the debtor in possession's non-management employees, a more nuanced and balanced approach to executive retention issues is needed -- an approach that preserves the new law's salutary effects, but also takes into account other important chapter 11 policies, like preserving and maximizing the value of a reorganizing debtor's business.

Our reorganization laws are premised on the idea that the value of an enterprise as reorganized often will exceed its liquidation value. Reorganizing permits the company to improve its operations, enhance its value, preserve jobs, and reduce sacrifices that need to be made by all constituencies. As this Committee recognized in proposing chapter 11 30 years ago:

> The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.[4]

The objective of maximizing the value of the enterprise is distinct from the question of how that value, once maximized, should be allocated among creditors, shareholders,

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[4] H. Rep. No. 595, 95th Cong. 1st Sess. 220 (1977); *see* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 527, 104 S. Ct. 1188, 79 L. Ed. 2d 482 (1984) ("the policy of Chapter 11 is to permit successful rehabilitation of debtors"); United States v. Whiting Pools, Inc., 462 U.S. 198, 203, 103 S. Ct. 2309, 76 L. Ed. 2d 515 (1983) ("Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if sold for scrap.").

employees, and other stakeholders. It is proper to ask whether the value of the enterprise is being equitably distributed, but it is self-defeating if the method of effecting an equitable distribution among the parties reduces the value that is available to distribute. Generally speaking, therefore, issues of equitable distribution should be resolved only after appropriate steps have been taken to preserve and maximize the value of the business. The Bankruptcy Code was designed to facilitate such maximization (for example by permitting sale of unproductive assets, assumption of beneficial contracts and rejection of burdensome ones) and to encourage negotiations over the equitable distribution issue, with ultimate recourse to the court if the distribution issue cannot be consensually resolved.[5]

Labor issues in general, and executive retention and severance plans in particular, pose difficulties in the chapter 11 context because they typically intermingle and often create a conflict between the equitable allocation of sacrifice among employees and other constituencies on the one hand and the objective of maximizing reorganization value on the other. The Conference believes, however, that these apparently conflicting objectives can in fact be reconciled in the case of executive retention, severance, and incentive plans if a somewhat different approach from the one taken in section 503(c) is adopted. In the view of the Conference, this approach should take into account several basic principles:

- First, the approach adopted should recognize that each case presents a unique combination of demands on management, employees, and creditors, and that a one-size-fits-all formula to address executive retention and

[5] *See* Richard Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 Bus. L. 441 (1984).

severance is too constraining to accomplish the bankruptcy objectives of maximizing value of the debtor's business and preserving jobs.

- Second, the approach adopted should also recognize that, for the vast majority of employees—those who do not control decisions relating to their own compensation—appropriate retention, severance, and incentive plans are matters that should be resolved by negotiation between the debtor in possession and the stakeholders in the case.
- Third, the approach adopted should assure relevant parties adequate time to familiarize themselves with the underlying facts and needs of the business and to negotiate and resolve the issues or put them before the bankruptcy court.
- Finally, the approach adopted should address the basic fairness issue: preventing a limited number of senior management decision makers to reward themselves by designing for themselves excessively generous retention and severance arrangements while other employees and creditors are being called upon to accept sacrifices.

The NBC suggests two principal changes from current law that would help implement these principles:

- First, procedural limitations should be imposed to prevent adoption of compensation plans for senior officers of the company at such an early stage in the case that the constituencies (including those representing hourly employees) are not yet ready to participate in the negotiation of reasonable and balanced solutions. Any proposed program for senior

officers should be debated by the parties and considered by the bankruptcy court in broad daylight and only after all key constituencies have had the opportunity to scrutinize the program and express their views. A reasonable minimum notice period should be imposed to allow a creditors' committee to be formed and to provide the committee and other parties a fair opportunity for review of the proposed program, and, if agreement is not reached, for there to be a fair opportunity for the parties to be heard before the court..

- Second, limitations on retention, severance, and incentive plans like the ones in section 503(c) should be specifically targeted against those senior executives who are in a position to make self-serving compensation decisions, and a more traditional business judgment test, which focuses on preservation of the value of the business, should be applied to authorization of such plans with respect to other employees.

The reasons for this more targeted approach are straightforward. A large company may have dozens of officers, such as vice presidents, a treasurer, a controller, and assistant vice presidents and treasurers, elected to officer positions by the board, who might be considered "insiders" covered by the current limitations in section 503(c). The real risk, however, of over-reaching, over-compensation and abuse lies not with this larger group of employees, but rather with the senior executives who play a role in setting compensation, usually the chief executive officer and a few other top executives.

The SEC has addressed this risk in the non-distress context by requiring disclosure of compensation of the top five most highly compensated executive officers. *See* Item

402(a), SEC Regulation S-K. This group generally would not include, for example, the star sales manager, the key engineer, the plant manager or the like, who may technically be an "officer" or "insider" of the company but who has no role in setting compensation. Adoption of the SEC dividing line to determine whose compensation is subject to heightened scrutiny in a chapter 11 case would help to assure fairness and avoid abuse, while at the same time not placing at excessive risk the important bankruptcy objectives of preserving the business, enhancing its value and ultimately increasing the likelihood of a successful reorganization that will minimize the hardships to be borne by all parties.

Limiting the restrictions of section 503(c) to the senior executives in control of compensation decisions will permit debtors in possession, where necessary and appropriate, to offer the incentives necessary to keep key middle managers and star performers focused on their jobs, without generating expensive, time-consuming, and distracting litigation. The process would likely be self-regulating and self-limiting, because CEO's and other senior executives are unlikely to propose excessive compensation for mid-level officers or junior employees if they are prohibited from providing excessive compensation for themselves. Regulating the top of the compensation pyramid is the best way to assure that other employees are offered only what is genuinely necessary to retain their services in the interest of the business.

Once again, I would like to thank the Chair and the rest of the Subcommittee for inviting the National Bankruptcy Conference to testify in these important hearings. The Conference would be pleased to consider this issue further if the Subcommittee desires, and we would be prepared to formulate detailed drafting proposals if the Subcommittee would find that helpful.

National Bankruptcy Conference

A non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws.

History. The National Bankruptcy Conference (NBC) was formed from a nucleus of the nation's leading bankruptcy scholars and practitioners, who gathered informally in the 1930's at the request of Congress to assist in the drafting of major Depression-era bankruptcy law amendments, ultimately resulting in the Chandler Act of 1938. The NBC was formalized in the 1940's and has been a resource to Congress on every significant piece of bankruptcy legislation since that time. Members of the NBC formed the core of the Commission on the Bankruptcy Laws of the United States, which in 1973 proposed the overhaul of our bankruptcy laws that led to enactment of the Bankruptcy Code in 1978, and were heavily involved in the work of the National Bankruptcy Review Commission (NBRC), whose 1997 report initiated the process that led to significant amendments to the Bankruptcy Code in 2005.

Current Members. Membership in the NBC is by invitation only. Among the NBC's 60 active members are leading bankruptcy scholars at major law schools, as well as current and former judges from eleven different judicial districts and practitioners from leading law firms throughout the country who have been involved in most of the major corporate reorganization cases of the last three decades. The NBC includes leading consumer bankruptcy experts and experts on commercial, employment, pension, mass tort and tax related bankruptcy issues. It also includes former members of the congressional staff who participated in drafting the Bankruptcy Code as originally passed in 1978 and former members and staff of the NBRC. The current members of the NBC and their affiliations are set forth on the second page of this fact sheet.

Policy Positions. The Conference regularly takes substantive positions on issues implicating bankruptcy law and policy. It does not, however, take positions on behalf of any organization or interest group. Instead, the NBC seeks to reach a consensus of its members - who represent a broad spectrum of political and economic perspectives - based on their knowledge and experience as practitioners, judges and scholars. The Conference's positions are considered in light of the stated goals of our bankruptcy system: debtor rehabilitation, equal treatment of similarly situated creditors, preservation of jobs, prevention of fraud and abuse, and economical insolvency administration. Conferees are always mindful of their mutual pledge to "leave their clients at the door" when they participate in the deliberations of the Conference.

Technical and Advisory Services to Congress. To facilitate the work of Congress, the NBC offers members of Congress, Congressional Committees and their staffs the services of its Conferees as non-partisan technical advisors. These services are offered without regard to any substantive positions the NBC may take on matters of bankruptcy law and policy.

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