Last in Line

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Key Employee Incentive Programs Make "Cents" for Creditors

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A study released in August should put a smile on the faces of troubled companies' bigwigs and creditors alike. Authored by Vidhan K. Goyal of the Hong Kong University of Science and Technology and Wei Wang of Queen's School of Business at Queen's University in Ontario, the study concluded that chapter 11 plans containing employee incentive programs lead to better results in bankruptcy than reorganization plans that do not contain incentive programs. These results may come as a surprise to critics of employee incentive programs who dismiss them as another form of corporate gluttony, but it appears that when it comes to chapter 11 cases and employee incentive programs, it may be necessary to spend money to make money.

One of the more interesting findings of the study is that while employee incentive programs result in better outcomes for reorganizing companies, key employee retention programs (KERPs) do not affect outcomes of reorganizing companies in a statistically significant way.[1] What should creditors take from these findings? When considering whether to vote in favor of a chapter 11 plan, creditors should view the inclusion of an employee incentive program positively because it will likely increase their recovery. If the plan includes a more traditional retention-only KERP, the plan will be less likely to receive bankruptcy court approval and the KERP will likely not affect creditor recoveries. Fortunately for creditors, the changes to the Bankruptcy Code forced debtors to replace or supplement traditional KERPs with employee incentive programs.[2]

History of Key Employee Retention and Incentive Programs

Before the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), the Bankruptcy Code did not specifically restrict KERPs. Instead, KERPs needed only to satisfy the requirements of § 503(b), which governs the allowance of administrative expenses in bankruptcy proceedings, and § 363, under which bankruptcy courts have authority to permit the use of bankruptcy property outside the ordinary course of business.[3] Thus, before 2005, KERPs were often included in reorganization and liquidation plans. The common use of KERPs in chapter 11 plans and the perceived abuse of these retention plans by corporate executives led Congress to adopt measures restricting KERPs with BAPCPA.[4] The motivation for these measures was described in a 2008 *ABI Journal* article: "Fairness is questioned when executives of big corporations receive large bonuses while their employees lose their jobs and retirees who invested in the companies' stock see their pensions drastically cut. With the addition of § 503(c), Congress took aim at this problem in three distinct ways."[5]

These three ways are codified in § 503(c), a subsection added by BAPCPA that places severe restrictions on the provision of retention bonuses to insiders. Section 503(c)(2) places restrictions on the provision of severance payments to insiders, and § 503(c)(3) prohibits transfers that are not in the ordinary course of business unless they are "justified by the facts and circumstances of the case." Most relevant to this discussion are the restrictions on retention bonuses to insiders.

To provide a retention bonus to an insider, the insider must have a *bona fide* job offer from another entity, the insider must be essential to the survival of the reorganizing business and the bonus must not be greater than 10 times the amount of the average bonus given to non-management employees during the same calendar year, or, if no such bonuses were given, it must not be greater than 25 percent of any bonus given to the insider in the prior calendar year.[6] These restrictions make it much more difficult for companies to include KERPs in their chapter 11 plans.[7] As a result of this difficulty and the fact that subsection (c) is silent as to incentive programs, the number of chapter 11 plans with traditional KERPs began to fall post-BAPCPA, while reorganization plans with employee incentive programs began to rise.[8]

Employee incentive programs, unlike retention programs, tie the ability of an employee to

1 Vidhan K. Goyal and Wei Wang, Provision of Management Incentives in Bankrupt Firms, at 31-32 (Aug. 8, 2012). For an ABI podcast on this topic, visit news.abi.org/podcasts/121-research-on-the-use-of-kerps-in-bankrupt-firms.

2 *Id.* at 3, n.2.

3 Zach Mosner and Karen Cordry, "Challenging the 'Lake Woebegon Syndrome': What Hath Congress Wrought with KERPs?," *ABI Journal*, Vol. XXV, No. 5, 12, June 2006.

4 Thomas J. Salerno, "Of KERPs and Bonuses: Let the Revolution Begin!," 14th Annual Southwest Bankruptcy Conference, Sept. 8, 2006, at 3 (quoting Sen. Edward M. Kennedy Fights to Protect Americans from a Flawed Bankruptcy Bill (Feb. 17, 2005), available at http://kennedy.senate.gov./~kennedy/statements/05/02/2005217D47.html ("[Sen. Kennedy] demanded that the new bankruptcy bill...'crack down on corporate executive who loot their companies at the expense of workers, retirees, creditors, and stockholders.'").

5 Clifford J. White III and Lisa A. Tracy, "The U.S. Trustee Program Enforces BAPCPA's Limitations on Executive Compensation," *ABI Journal*, Vol. XXVII, No. 2, 12, 57-58 March 2008.

6 11 U.S.C. § 503(c)(1).

7 Salerno, *supra* n.4, at 8 ("As a practical matter, these three requirements will likely eliminate the possibility of retention plans being approved under § 503(c)(1).").

8 Goyal and Wang, *supra* n.2 at 8, 11.

receive a bonus or a benefit to a business goal. Under a KERP/retention program, an employee is paid to stay with the business, whether that business eventually succeeds or fails. Under an employee incentive program, an employee is paid only if the business meets a predetermined goal—usually either a financial target or the amount of time it takes to confirm a chapter 11 plan and emerge from bankruptcy. It did not take long after the passage of BAPCPA for practitioners to recognize this important distinction and encourage companies to structure their compensation plans as employee incentive programs rather than retention programs to avoid the strict requirements of § 503(c)(1).[9] One byproduct of this switch is that creditors in incentive-plan cases are receiving larger recoveries.

Summary of the Study

The sample for Goyal and Wang's study was drawn from the UCLA-LoPucki Bankruptcy Research Database.[10] From 1996-2007, 497 public firms with reported assets of more than $100 million filed chapter 11 petitions.[11] Eighty firms were excluded from the sample because they were either dismissed, were still pending at the end of 2008, or involved financial firms, utilities or firms headquartered outside the U.S.[12] Accordingly, the study included data from 417 chapter 11 cases filed between 1996 and 2007.[13] Of the 417 firms in the sample, 39 percent adopted KERPs, with about half of that 39 percent offering additional incentives tied to specific goals.[14]

The study ultimately concluded that "KERPs do not materially improve outcomes for creditors."[15] It found that retention-only bonuses do not impact the likelihood of a firm's emergence from bankruptcy, the time that a firm spends in bankruptcy or the likelihood that the plan will adhere to the absolute-priority rule.[16]

Another important conclusion was that "incentive plans *significantly* improve outcomes for creditors."[17] A company's provision of incentive bonuses to key employees results in a greater likelihood of emergence from bankruptcy, significantly less time spent in bankruptcy, and a better chance of adhering to the absolute-priority rule.[18] Further, the nature of the incentives included in a company's plan affects the company's outcome, suggesting that incentives work as intended. The study specifically noted that "[w]hen key employees are offered bonuses that are tied to firm reorganization or firm performance upon reorganization, firms are more likely to reorganize. By contrast, when employees are paid bonuses tied to asset sales, firms are more likely to liquidate."[19]

The study included other interesting findings as well. For example, the amount of creditor control is predictive of whether a company will adopt retention and/or incentive bonuses. Both retention and incentive bonuses are more common in cases with a large amount of creditor control,[20] which suggests that creditors recognize the value of retaining key employees throughout the reorganization process. As the authors of the study noted, this finding is inconsistent with the view that companies adopt KERPs because their creditors are "ineffective in preventing managers from enriching themselves through the payment of bonuses."[21] Rather, the finding indicates that creditor control is positively related to a company's inclusion of incentive bonuses, and that such bonuses "generally improve outcomes for creditors."[22] Other less-surprising findings include KERPS being more common in cases in which there is "a greater likelihood of employee turnover," and KERPs being used less often by companies in distressed industries.[23]

[I]ncentivizing employees to remain with the company through emergence from bankruptcy is likely to increase creditor recoveries...you should strongly consider a plan containing employee incentives.

Why Do Incentive Programs Work?

Employee incentive programs likely result in better bankruptcy outcomes because they align the interests of managers and creditors, shorten the duration of the bankruptcy and limit stockholders' ability to obtain concessions from creditors.[24] As suggested by the data finding no link between retention programs and improved bankruptcy outcomes, retaining key employees is not enough for a successful reorganization or liquidation: Employees must be further motivated to help the company successfully emerge from bankruptcy. Tying the receipt of bonuses or benefits to company goals appears to provide the necessary motivation.

There are other possible explanations for the success of employee incentive programs. Incentivizing existing employees to stay through the bankruptcy process and assist the troubled company in reaching goals means less time spent recruiting and training replacements. Retaining experienced employees also means that the bankruptcy team will be familiar with the company, its processes, and its history of successes and failures. Existing employees will also likely feel a sense of company loyalty and responsibility for failures that replacement employees may not feel. Providing incentives for turning the company around may increase these feelings of loyalty and responsibility. Ultimately, some combination of these factors (and probably others) work together to result in less time in bankruptcy and better results for

9 MaryJo Bellew and Edith K. Altice, "Tackle § 503(c) by Structuring a 'MIP'—and Other Strategies to Have in Your Playbook," *ABI Journal*, Vol. XXVII, No. 3, 34, 76-79 April 2008.
10 Goyal and Wang, *supra* n.2, at 7-8.
11 *Id.* at 9.
12 *Id.*
13 *Id.*
14 *Id.* at 2-3.
15 *Id.* at 27.
16 Goyal and Wang, *supra* n.2, at 27.
17 *Id.* at 4 (emphasis added).
18 *Id.* at 4, 32.
19 *Id.*
20 *Id.* at 3, 31.
21 *Id.* at 32.
22 Goyal and Wang, *supra* n.2, at 32.
23 *Id.* at 3.
24 *Id.*

continued on page 91

from page 23

creditors when a chapter 11 plan includes an employee incentive program.

Reconsider Employee Incentive Programs

In a 2009 ABI Quick Poll, readers were asked to respond to the following statement: "Sen. Ted Kennedy is remembered for his 2005 KERP amendment to chapter 11. The law has been effective in limiting excessive executive compensation."[25] Thirty-seven percent of respondents disagreed strongly with this statement, while another 17 percent disagreed somewhat. Only 24 percent either agreed strongly or agreed somewhat. These poll results suggest that KERPs are viewed negatively as a means for executives to compensate themselves excessively, and that a majority of people believe that § 503(c) has not adequately addressed the issue of excessive executive compensation.

Perhaps this is because a majority of people have the wrong idea about employee retention and employee incentive programs. Goyal and Wang noted that "[r]etention bonus plans are commonly viewed as schemes through which managers enrich themselves."[26] However, the authors of the study found "no evidence that entrenched CEOs initiate these plans to pay themselves large bonuses."[27] Instead of viewing retention and incentive programs as a form of corporate greed, perhaps these programs should be viewed as sound corporate strategy to minimize the time spent in bankruptcy and to increase creditor recoveries. In fact, the findings of the study suggest that failing to include employee incentives in a reorganization or liquidation plan may harm creditors by lowering their ultimate recovery.

Conclusion

Goyal and Wang's findings may convince some haters of corporate bonuses that incentivizing employees is not necessarily a form of corporate greed—even if bonuses are paid with money that could otherwise be paid to creditors. As the study concludes, incentivizing employees to remain with the company through emergence from bankruptcy is likely to increase creditor recoveries. Though it may be counterintuitive, if you represent a creditor's interest in a chapter 11 case, you should strongly consider a plan containing employee incentives and, in the absence of incentive provisions, question their absence. Sometimes it takes money to make money. abi

25 These Quick Poll results were published in Inside ABI. *See ABI Journal*, Vol. XXVIII, No. 9, 98, November 2009 (archives available at http://news.abi.org/quick-polls/archive).

26 Goyal and Wang, *supra* n.2, at 1.

27 *Id.* at 4.

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