KEIP AND KERP

NAVIGATING INCENTIVE AND RETENTION PLANS IN CHAPTER 11

KEIP AND KERP

KEIPs (Key Employee Incentive Plans) and KERPs (Key Employee Retention Plans) can bring controversy to a bankruptcy case, because the Bankruptcy Code limits the types of payments a debtor can make to its employees under such plans.

WHAT IS A KEIP?

A KEIP is a program designed to **incentivize** a particular performance (preferably measurable) from a set group of employees. A KEIP usually incorporates specific performance targets that any subject employee must achieve in order to receive payment under the KEIP.

Examples of some common performance targets include the completion of certain tasks, such as the consummation of a 363 sale, or the achievement of certain financial metrics.

WHAT IS A KERP?

A KERP is a program designed to **retain** a set group of employees. A KERP usually contemplates the payment of a fixed lump sum, either on a one-time basis or a fixed, regular basis. In order to qualify to receive the lump sum, a subject employee merely has to remain employed by the debtor company through a date certain, or through an event certain (for example, the consummation of a 363 sale).

KERP

Changes made in connection with the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) made it more difficult for chapter 11 debtors to offer KERPs to management and other key employees. Sections 503(c)(1) and 503(c)(2) of the Bankruptcy Code strictly limit severance and KERP payments to "insiders."

In addition, section 503(c)(3) of the Bankruptcy Code requires that transfers or obligations outside the ordinary course of business to **any** person or entity, including officers, managers, or consultants hired post-petition, be “justified by the facts and circumstances of the case.”

CODE SECTION 503(C)(1)

(c) Notwithstanding subsection (b), there shall neither be allowed, nor paid— (1) a transfer made to, or an obligation incurred for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtor's business, absent a finding by the court based on evidence in the record that— (A) the transfer or obligation 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;

(B) the services provided by the person are essential to the survival of the business; and

(C) either— (i) the amount of the transfer made to, or obligation incurred for the benefit of, the person is not greater than an amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made or the obligation is incurred; or

(ii) if no such similar transfers were made to, or obligations were incurred for the benefit of, such nonmanagement employees during such calendar year, the amount of the transfer or obligation is not greater than an amount equal to 25 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 or obligation is incurred;

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CODE SECTION 503(C)(2)

(c) Notwithstanding subsection (b), there shall neither be allowed, nor paid—

(2) a severance payment to an insider of the debtor, unless— (A) the payment is part of a program that is generally applicable to all full-time employees; and

(B) the amount of the payment is not greater than 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made; or

CODE SECTION 503(C)(3)

(c) Notwithstanding subsection (b), there shall neither be allowed, nor paid—

(3) other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition.

CODE SECTION 503(C)(3)

While Section 503(c)(1) refers to transfers to insiders, Section 503(c)(3) includes no such limitation, and the phrase "officers, managers, or consultants" would appear to include persons who fall outside the applicable statutory definition of "insider." See 11 U.S.C. § 101(31)(B).

(31) The term "insider" includes - (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…

KEIP VS. KERP

Because of Section 503(c)(1)'s limitations on retention plans being offered to insiders, a debtor may instead attempt to implement an incentive plan for its senior management. Incentive plans are not subject to the restrictions of Section 503(c)(1). Instead, incentive plans are governed by Sections 363(b)(1) and 503(c)(3).

THE BUSINESS JUDGMENT TEST

Different courts apply different tests to determine whether a KEIP is justified by the facts and circumstances, and some courts hold that the facts and circumstances test of Section 503(c)(3) is identical to the business judgment test under Section 363(b)(1).

A KERP IN KEIP'S CLOTHING?

Congress added Section 503(c) to the Bankruptcy Code in 2005 to "eradicate the notion that executives were entitled to bonuses simply for staying with the Company through the bankruptcy process." A court "must examine a proposed [incentive plan] . . . and determine whether the proposed targets are designed to motivate insiders to rise to a challenge or merely report to work." **A plan that does not require affirmative action beyond that contemplated prepetition is not incentive, but is retentive and cannot be approved under the more lenient standards for incentive plans**. A court must determine whether the debtor has proposed **a retentive plan disguised as an incentive plan** in order to circumvent the requirements of Section 503(c)(1). "Although a purported [incentive plan] may contain some retentive effect, that does not mean that the plan, overall, is retentive rather than incentivizing in nature." **The burden of proof that the incentive plan is not a retentive plan lies with the proponent of the plans.**

In re Patriot Coal Corp., 492 B.R. 518, 531 (Bankr. E.D. Mo. 2013) (citations and quotations omitted) (emphases added).

KEIP: LESSONS LEARNED FROM THE GTAT APPEAL

The dispositive question is whether the bankruptcy court correctly determined that the KEIP is a retention plan rather than some other kind of obligation outside of the ordinary course of business. If so, the court correctly decided not to approve it, pursuant to 11 U.S.C. § 503(c)(1). If not, the court erred by using § 503(c)(1) rather than § 503(c)(3) to evaluate the KEIP.

KEIP: LESSONS LEARNED FROM THE GTAT APPEAL

The problem with the bankruptcy court's decision in this case is that it ruled that the KEIP was a disguised retention plan without making any findings on the key question, i.e., whether the KEIP incorporates targets that are difficult to achieve. The reported decisions in cases in which bankruptcy courts have been called upon to determine whether a compensation program is a legitimate incentive plan or a disguised retention plan generally contain detailed analyses of the plans at issue. See, e.g., Patriot Coal, 492 B.R. at 532-33; Residential Capital II, 491 B.R. at 86-87; Hawker Beechcraft, 479 B.R. at 313-15. Here, there is none of that. Rather, the bankruptcy court relied exclusively upon statements from witnesses concerning the importance of GTAT's executive team to the success of its reorganization.

KEIP: LESSONS LEARNED FROM THE GTAT APPEAL

To sum up, the bankruptcy court's failure to properly analyze the structure of the compensation package in GTAT's proposed KEIP is an error of law that requires remand.[6] On remand, the bankruptcy court is instructed to determine whether the proposed KEIP has sufficiently stringent metrics to qualify as an incentive plan for the purposes of 11 U.S.C. § 503(c).

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KERP: LESSONS LEARNED FROM THE GTAT APPEAL

In any event, Patriot Coal, Residential Capital II, and Global Aviation all stand squarely for the proposition that retention programs for non-insiders should be evaluated under the § 503(c)(3) "facts and circumstances" test. That said, the court must also note that in each of those three cases, the "facts and circumstances" test was treated as equivalent to the business judgment test that courts apply under § 363(b)(1). See, e.g., Patriot Coal, 492 B.R. at 531 (citing Velo Holdings, 472 B.R. at 212; In re Dana Corp. (Dana II), 358 B.R. 567, 576 (Bankr. S.D.N.Y. 2006)). That is where this court parts company with Patriot Coal, Residential Capital II, and Global Aviation and instead, relies upon In re Pilgrim's Pride Corp., 401 B.R. 229 (Bankr. N.D. Tex. 2009).

KERP: LESSONS LEARNED FROM THE GTAT APPEAL

supra, ¶ 503.17[4], at 503-116. This court is persuaded by Pilgrim's Pride that 11 U.S.C. § 503(c)(3) directs courts to give more scrutiny to the business judgment of debtors than is permitted under the § 363(b)(1) business judgment test.

LESSONS LEARNED FROM THE GTAT APPEAL

To determine whether a compensation plan is "justified by the facts and circumstances of the case," 11 U.S.C. § 503(c)(3), courts typically consider the Dana factors:

Is there a reasonable relationship between the plan proposed and the results to be obtained, i.e., will the key employee stay for as long as it takes for the debtor to reorganize or market its assets, or, in the case of a performance incentive, is the plan calculated to achieve the desired performance?

Is the cost of the plan reasonable in the context of the debtor's assets, liabilities and earning potential?

Is the scope of the plan fair and reasonable; does it apply to all employees; does it discriminate unfairly?

Is the plan or proposal consistent with industry standards?

What were the due diligence efforts of the debtor in investigating the need for a plan; analyzing which key employees need to be incentivized; what is available; what is generally applicable in a particular industry?

Did the debtor receive independent counsel in performing due diligence and in creating and authorizing the incentive compensation?