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# DEBTORS MAY NOT BE ABLE TO KEEP THE KEIP

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**In two recent decisions,[2] the United States Bankruptcy Court for the Southern District of New York denied motions by large chapter 11 debtors to approve executive bonus plans designated as key employee incentive plans ("KEIP"), finding that the proposed KEIPs actually were disguised and impermissible retention or "pay to stay" bonus plans for insiders. These are the first opinions to reject so-called KEIPs following a recent line of cases that have approved KEIPs for insiders.**

These decisions demonstrate that simply meeting case-specific milestone targets, such as consummation of a plan of reorganization or sale within targeted time frames, is an insufficient performance metric to justify characterizing a bonus program as a true insider incentive plan under section 503(c)(3) of the Bankruptcy Code, as opposed to a retention or "pay to stay" plan subject to section 503(c)(1) of the Bankruptcy Code. Rather, an executive bonus program will be properly characterized as a KEIP only if the debtor proves that the vesting of the bonus awards is closely and directly tied to achieving truly challenging financial and operational goals. Furthermore, these cases reveal that courts will closely scrutinize bonus programs for senior executives even when, as in many cases, major creditor constituencies support a debtor's efforts to implement those programs.

In *Hawker Beechcraft*, the debtors were engaged in the business of manufacturing and servicing business jets, trainer/attack aircraft for military use and other assorted aircraft under the Hawker and Beechcraft brands. Unable to satisfy its obligations, the company terminated thousands of employees and, prior to the filing of its chapter 11 case in May 2012, entered into a restructuring support agreement ("RSA") with an overwhelming majority of its secured creditors and unsecured bondholders ("Consenting Creditors"). The RSA contemplated the continuation of most of the business units and the conversion of all prepetition debt into equity ("Standalone Transaction") under a chapter 11 plan of reorganization ("Plan"). The RSA included various milestones for, among other things, filing, confirming and consummating the Plan.

Pursuant to the RSA the debtors were permitted to pursue a sale or other alternative transaction (a "Third-Party Transaction") in an effort to maximize value for stakeholders. Accordingly, the debtors engaged in a dual-track process pursing both the Standalone Transaction and marketing the business to prospective investors. In July 2012, shortly after the chapter 11 cases were filed, the Debtors received a proposal, subject to due diligence and other conditions, from Superior Aviation Beijing Co., Ltd. to purchase substantially all of the Debtors' assets, excluding the Debtors' defense business, for $1.79 billion in cash.

In early July 2012, the debtors filed a motion seeking authority to implement both a key employee retention program (the "KERP") for 31 junior-level managers as well as the KEIP for eight senior-level executives who were admittedly "insiders" within the meaning of section 101(31) of the Bankruptcy Code. The KEIP contained two mutually exclusive paths for the senior executives to obtain a bonus, depending on whether the Debtors consummated the Standalone Transaction or a Third-Party Transaction. Under both paths, the senior executives could earn up to 200% of their annual base salaries or an aggregate of approximately $5.3 million. With

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respect to the Standalone Transaction, 50% of the bonus would be vested if the Plan was consummated by certain dates and the other 50% would be vested if certain cash flow targets were satisfied. As for a Third-Party Transaction, each senior executive would receive a bonus equal to 200% of his or her annual base salary if a sale was approved and consummated within certain dates and resulted in a purchase price of at least $1.79 billion. In the event a sale resulted in a purchase price of less than $1.79 billion, the bonus would be adjusted downward. Moreover, under either a Standalone Transaction or Third-Party Transaction, the senior executives were required to remain employed by the company as of the date the transaction closed.

Although the official committee of unsecured creditors and the Consenting Creditors all supported approval of the KEIP, the International Association of Machinists, AFL-CIO (the "IAM"), which represented nearly 45% of the debtors' workforce, and the Office of the United States Trustee ("UST") objected to the KEIP. The IAM and UST argued that the KEIP was a disguised retention program for insiders that did not satisfy the strict requirements (including evidence that the insider has a bona fide job offer for the same or equal compensation) under section 503(c)(1) of the Bankruptcy Code. After conducting an evidentiary hearing, at which time the debtors presented testimony of their chief executive officer, financial advisor and compensation consultant, Judge Stuart Bernstein reserved decision.

On August 24, 2012, Judge Bernstein issued an opinion denying the KEIP. The Court determined that the bonus program was a disguised retention plan for insiders – not an incentive plan – and therefore was governed by the strict test outlined in section 503(c)(1), which the debtors admittedly did not address in their motion. At the outset of its analysis, the Court noted that a proposed KEIP should be examined "mindful of the practice that Congress sought to eradicate," namely, the "notion that executives were entitled to bonuses simply for staying" with a debtor through the bankruptcy process. The Court concluded that the KEIP was primarily retentive, rather than incentive, based for a number of reasons. First, the debtors failed to provide specific evidence as to the roles of each member of the senior management team "or why, individually or as part of the team, they will contribute services that are necessary to achieve the targets." Second, the Court found that under the facts of the case it was likely that certain of the bonus triggers would be readily satisfied because the time frame triggers and the lower-level financial targets were well within reach and, though not necessarily "lay-ups," they were "more like free throws than half court flings at the buzzer." In sum, the Court concluded that many of the performance targets were not sufficiently challenging to justify the characterization of the KEIP as a true incentive-based plan governed by the "facts and circumstances" test.

On August 28, 2012, less than a week after the issuance of the *Hawker* decision, Judge Martin Glenn issued a decision denying a proposed KEIP for insiders in the *Residential Capital, LLC* ("ResCap") chapter 11 cases. ResCap, like the debtors in *Hawker*, filed chapter 11 petitions in May 2012. ResCap is the fifth-largest servicer of residential mortgages in the country, servicing approximately $374 billion of domestic residential loans and lists more than $15 billion in assets and liabilities.

The ResCap KEIP sought to provide up to $7 million in "incentive" bonuses to 17 insiders with 63% of the bonuses vesting upon the closing of two sales of the debtors' principal assets without the need for reaching any additional financial targets. As in *Hawker*, the debtors argued that the KEIP was a true incentive plan subject to the comparatively easy-to-reach "facts and circumstances" test of section 503(c)(3) and did not even attempt to satisfy the strict requirement for approval of retention plans for insiders under section 503(c)(1). The debtors argued, among other things, that the targets were incentivizing because all similar types of cases involving businesses in the financial services industry resulted in liquidations rather than reorganizations or going-concern sales. They also attempted to justify the KEIP on the grounds that the responsibilities of the senior executives increased dramatically as a result of the chapter 11 process. As in *Hawker*, the key creditor constituents supported the KEIP but the UST objected on the grounds that, as in *Hawker*, the KEIP is primarily retentive in nature and, therefore, is a retention plan covered by 503(c)(1).

Judge Glenn denied the ResCap KEIP for reasons similar to those identified in *Hawker.* First, the Court cautioned that a "debtor's label of a plan as incentivizing to avoid the strictures of section 503(c)(1) must be viewed with skepticism" and that "the circumstances under which the proposal is made and the structure of the compensation package control." Second, the Court concluded that the evidence presented to support the proposition that the KEIP was primarily incentive driven was conclusory and not supported by concrete facts. Third, citing *Hawker* and two other opinions he authored, Judge Glenn concluded that as a general rule the achievement of case milestones such as the consummation of plan or sale

cannot by themselves support a finding that a bonus program is a true KEIP unless combined with "challenging financial and operational goals … tailored to the facts and circumstances of the case." Moreover, while the Court acknowledged that chapter 11 cases increase the workload of senior executives, these added responsibilities cannot justify the approval of a retention plan for insiders.

The *Hawker* and *ResCap* decisions are particularly noteworthy because bonus programs for insiders have become a common occurrence in large chapter 11 cases even after Congress enacted section 503(c) in 2005 in an effort "to limit a debtor's ability to favor powerful insiders economically at estate expense during a chapter 11 case."[3] These decisions indicate that courts will scrutinize so-called KEIPs for insiders even when major creditor constituency groups support the bonus plans. Bonus plans will pass muster as a true KEIP only when the debtor can demonstrate by concrete evidence, not self-serving and conclusory assertions, that the vesting of bonus awards is closely tied to challenging financial and operational targets.

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[2]*In re Hawker Beechcraft, Inc., et al.* (Case No. 12-11873 (SMB), Bankr. S.D.N.Y. August 24, 2012, Docket No. 512) and *In re Residential Capital, LLC, et al.,* (Case No. 12-12020(MG), Bankr. S.D.N.Y. August 28, 2012, Docket No. 1286), available at www.nysb.uscourts.gov.

[3]*In re Pilgrim's Pride Corp.,* 401 B.R. 229, 234 (Bankr. N.D. Tex. 2009).

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