REPRINT | FINANCIER WORLDWIDE MAGAZINE

FINANCIER WORLDWIDE corporatefinanceintelligence

REPRINTED FROM:
MARCH ISSUE 2013

DISTRESSED M&A AND INVESTING

Recent lessons on management compensation at various stages of the Chapter 11 process

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Setting compensation for senior management can be among the most contentious issues facing companies reorganising under Chapter 11 of the US Bankruptcy Code. Corporate debtors argue that such compensation—often in the form of base salary, bonuses, or stock of the reorganised company – helps retain and incentivise management, whose services are believed necessary to achieve a successful reorganisation. Creditors, by contrast, may be loath to support compensation packages that they perceive as enriching the very managers who led the company into bankruptcy.

This tension over management compensation, though long present in corporate bankruptcy cases, has been more pronounced since 2005, when the US Congress added Section 503(c) to the Bankruptcy Code. Section 503(c) limits bankrupt companies' freedom to give management retention bonuses, severance payments, or other ancillary compensation. For instance, under the current regime, a company cannot pay managers retention bonuses unless it proves to a bankruptcy court that the managers both provide essential services to the reorganising business and that they have alternative job offers in hand. Even then, the Bankruptcy Code caps the amount of the retention bonuses. Severance payments to managers are similarly restricted by Section 503(c).

Despite these restrictions, companies continue to search for ways to boost managers' compensation in and around the time of bankruptcy. They do so because retaining existing managers is often the best way to maximise the value of the company in a restructuring. Existing managers typically have valuable institutional knowledge and industry-specific experience that is hard to replace. They may also be vital to preserving relationships with customers, employees, and suppliers. Recognising their value, leaders of bankrupt companies often demand incentives to stay on during bankruptcy. Even where a company would prefer new management, it can be hard to recruit top people to a bankrupt company undergoing a restructuring. Companies must therefore choose how and when to compensate managers without running aground on Section 503(c) and related provisions of the Bankruptcy Code.

Pre-bankruptcy raises and bonuses

Recently, some companies have elected to pay managers' bonuses, or to raise their base salaries, before filing bankruptcy.

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Those payments can be made with limited oversight, as they are not subject to bankruptcy court approval. However, if a bankruptcy filing becomes necessary, those payments will receive close scrutiny from the company's creditors and a bankruptcy court. As a legal matter, payments made to corporate insiders within one year of a bankruptcy filing may be clawed-back into the bankruptcy estate. As a practical matter, news that executives received bonuses or pay raises shortly before filing bankruptcy may poison the debtor's relationship with its creditors at a time when cooperation will be key.

That is what happened in the ongoing bankruptcy of Twinkie-maker, Hostess Brands. Six months before filing for bankruptcy, Hostess raised the salary of its then-CEO by 300 percent (from approximately $750,000 to $2,550,000), and gave sizable raises to at least nine other top executives. When that news became public, Hostess's creditors were furious. They ran to the bankruptcy court demanding a formal investigation into the pre-bankruptcy raises. They also alerted the press, which ran stories decrying the 'payday before mayday' raises. For its part, Hostess claimed that the raises were approved long before it decided to file for bankruptcy. But in the face of creditor pressure and public embarrassment, Hostess ultimately agreed to rollback the raises. Thus, while the idea of rewarding management prior to a public bankruptcy filing can be alluring, companies must think carefully about the risks involved.

Key employee incentive programs in bankruptcy

Companies often elect to adjust management compensation after filing for bankruptcy, most commonly through a key employee incentive program (KEIP). As the name suggests, KEIPs focus on incentives, tying managers' pay in bankruptcy to productivity levels and performance goals. Because KEIPs are primarily incentivising rather than retentive, they do not fall within the highly restrictive subsection of Section 503(c) that applies to retention payments.

Rather, for a KEIP to pass legal muster under Section 503(c), it must be both truly incentivising and justified by the facts and circumstances of the case. Courts will look to see whether the proposed targets are designed to motivate executives to rise to a challenge, as opposed to merely report to work. The challenges must be real, requiring management to stretch to meet its performance goals. If the goals are easily achievable or inevitable, courts will deny the KEIP, as they have done in two recent high-profile bankruptcy cases.

Bankrupt mortgage-lender Residential Capital proposed a KEIP that would pay $7m in bonuses to top executives. But because the executives would earn 63 percent of the bonus simply upon completion of asset sales that had been negotiated pre-bankruptcy, the bankruptcy court ruled that the KEIP did not include sufficiently challenging performance goals. Similarly, in airplane-maker Hawker Beechcraft's bankruptcy, the court rejected a proposed KEIP that, in the court's estimation, "set[] the minimum bonus bar too low to qualify as anything other than a retention program for insiders".

While having a KEIP denied is not fatal to a restructuring (they can be changed and re-proposed), it is a temporary setback. To avoid that outcome companies should try to gather creditor consensus before proposing a KEIP, and make sure that the KEIP's targets are truly incentivizing and will not be perceived as 'lay-ups' by the bankruptcy court.

Executive compensation under a plan of reorganisation

The final opportunity to compensate management during a Chapter 11 process comes at the end of a case. That is when a company can seek court approval of new employment agreements or 'emergence bonuses' as part of its plan of reorganisation. A plan of reorganisation is a court-sanctioned agreement between corporate debtors and their creditors. Plans specify the amounts creditors will be paid from the company's bankruptcy estate and detail the company's post-bankruptcy business. To obtain court approval for plan-related payments to executives, the company must disclose the proposed payments to all parties-in-interest and demonstrate that they are reasonable under the circumstances. The reasonableness standard is easier to satisfy than

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the Section 503(c) standards that apply to retention payments, severance payments, and KEIPs.

In the recent restructuring of military contractor Global Aviation Holdings, the company sought to pay management bonuses through its plan of reorganisation. The bankruptcy court approved the payments, over objection, finding that they were adequately disclosed and reasonable under the circumstances. Notably, the court also held that Section 503(c) played no role in determining whether the bonuses should be approved. But while this strategy worked in the successful reorganisation of Global Aviation, in other cases managers may not be willing to devote months (or years) of their lives to a company in bankruptcy with only the hope that they will receive a bonus once the case concludes.

Conclusion

Companies preparing for bankruptcy should carefully evaluate their management compensation options. Raising salaries or providing bonuses before filing for bankruptcy may lead to intense public criticism during the case. Doing so through a KEIP in bankruptcy is arguably a better option, so long as the KEIP is crafted to comply with Section 503(c) of the Bankruptcy Code. Perhaps the safest option is to set management compensation through a plan of reorganisation, although practical and business realities may foreclose that option. ■

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