The Judges' Book

Volume 4 Article 4

2020

Bankruptcy Law: The Effect of Banning Key Employee Retention Plans

Jared Ellias

Follow this and additional works at: https://repository.uchastings.edu/judgesbook

Part of the Judges Commons

Recommended Citation

Ellias, Jared (2020) "Bankruptcy Law: The Effect of Banning Key Employee Retention Plans," *The Judges' Book*: Vol. 4 , Article 4.
Available at: https://repository.uchastings.edu/judgesbook/vol4/iss1/4

This Article is brought to you for free and open access by UC Hastings Scholarship Repository. It has been accepted for inclusion in The Judges' Book by an authorized editor of UC Hastings Scholarship Repository. For more information, please contact wangangela@uchastings.edu.

Bankruptcy Law:
The Effect of Banning Key Employee Retention Plans

Jared Ellias[1]

In 2005, the perception that wealthy executives were being rewarded for failure led Congress to ban Chapter 11 debtors from paying "retention" bonuses to senior managers. Prior to the reform, which was tucked into the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), Chapter 11 debtors routinely paid retention bonuses to senior managers through "Key Employee Retention Plans" ("KERPs"). Debtors justified these bonuses as necessary to keep talented executives working hard to turn the firm around. However, many critics at the time viewed these bonuses as signs that managers were abusing their control of Chapter 11 debtors to extract excessive levels of compensation. After the amendment became effective, bankruptcy judges could authorize bonuses for senior managers only when linked to specific performance goals, such as increasing revenue or moving the firm through the bankruptcy process. Thus "Key Employee Incentive Plans" ("KEIPs") became an important part of the Chapter 11 landscape, displacing the earlier era of KERPs.

This Chapter summarizes the first comprehensive analysis and empirical study of how the 2005 law changed corporate bankruptcy practice. The data suggest that the reform appears to have had little substantive effect on executive compensation, primarily due to two flaws that undermined the reform. First, the new law only regulated payments characterized as bonuses during the period firms are in Chapter 11 bankruptcy. Firms could easily sidestep the new law by paying managers before or after the bankruptcy case, and many appear to have done so. Second, the institutions of bankruptcy law have struggled to administer the law. A rule that bans retention bonuses while allowing incentive bonuses requires a bankruptcy judge to make a fact-intensive determination about the "challengingness" of a proposed bonus plan. Unfortunately, bankruptcy judges often lack the information and expertise necessary to perform this inquiry. Although creditors would appear to be well-situated to assist the judge and scrutinize executive compensation themselves, they have little economic incentive to quibble over relatively small bonuses

1. Summarized and excerpted from Jared Ellias, *Regulating Bankruptcy Bonuses*, 92 S. CAL. L. REV. 653 (2019).

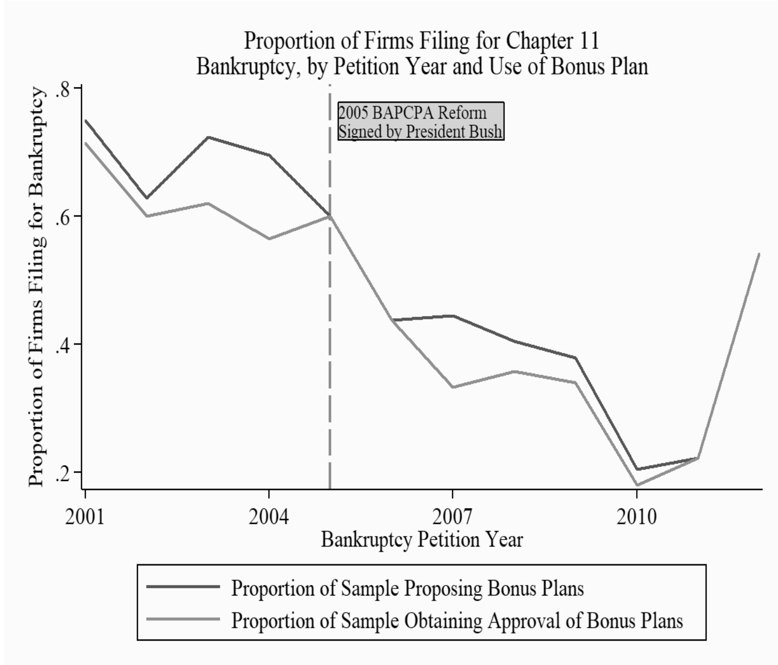
when doing so might anger the managers with whom they need to negotiate over more important Chapter 11 issues.

My empirical study draws on a sample of large Chapter 11 debtors that filed for bankruptcy between 2001 and 2012. I examined the pay practices of all major corporate bankruptcies during that period and I closely examined the period prior to the reform from 2003 to 2005 and then the period after the reform was well-entrenched, from 2009 to 2010. For each of these cases, I, along with a team of research assistants, examined all of the significant pleadings filed in the case, with special attention to the pleadings discussing bonus plans, as well as the firm's financial statements and subsequent filings in the bankruptcy case and with the SEC to determine whether the bonus goals were, in fact, achieved. The larger sample consists of 408 debtors that filed for bankruptcy between 2001 and 2012. The sample that we studied more closely consists of 41 firms that filed for bankruptcy and sought permission to pay retention bonuses to senior managers between January 1, 2004, and April 20, 2005, immediately prior to BAPCPA becoming effective (the "Pre-BAPCPA Sample"); and 57 firms that filed for bankruptcy between January 1, 2009, and December 31, 2010, when the new law had matured and lawyers had developed practices and procedures to comply with it.

Finding #1: Debtors Became Far Less Likely to Seek to Pay Bonuses to Senior Managers and Tied Bonuses to Performance Goals

As a threshold matter, the passage of the 2005 reform correlated with a steep decline in the likelihood that large Chapter 11 debtors make use of bankruptcy bonus plans. Figure 1 illustrates the decline.

FIGURE 1



As the graph shows, more than 80% of Chapter 11 debtors in 2001 paid bonuses to their senior managers in bankruptcy. That number fell to less than 40% in 2007. Of course, it is hard to know for sure whether this change is the result of firms not using bonus plans in bankruptcy that would have "but-for" the reform or whether the difference is a result of a shift in the composition of Chapter 11 debtors or changes in corporate pay practices that happened at the same time. However, it is probable that at least some firms decided not to try the more costly and time-consuming process of paying incentives bonuses as opposed to the relatively straightforward creation of a blanket retention bonus scheme. A regression analysis controlling for some observable aspects of each Chapter 11 debtor—firm size, firm industry, the law firm advising the debtor—still results in a negative association between the reform and the likelihood that a Chapter 11 debtor would seek court permission to pay bonuses to senior managers during their time in bankruptcy.

Moreover, when bonus plans were proposed, they were nearly always "incentive" plans tied to performance goals. In 46% of cases, post-reform

bonus plans were tied to operational goals like increasing revenue or EBITDA, up from 23% of the bonus plans approved by bankruptcy courts tied prior to BAPCPA. In 86% of cases, proposed post-reform bonus plans were tied to bankruptcy-related targets such as confirming a plan of reorganization by a certain date. The size of the bonus plans remained similar at about $2 million in constant 2010 dollars, although the post-BAPCPA bonus plans are more tilted towards senior managers as firms started to create retention bonus plans for lower-level employees, which are still allowed by BAPCPA, while reserving the incentive plans for senior managers.

Finding #2: The Process of Obtaining Judicial Approval of a Bonus Plan Became More Litigious and Expensive After BAPCPA, but the Litigation Process Seldom Produced Helpful Information for the Bankruptcy Judge

Importantly, the evidence shows that the legal process of getting a bonus plan approved changed significantly after the reform. Even though proportionately fewer debtors sought to pay Chapter 11 bonuses to senior managers, the debtors that did file motions seeking to pay bonuses became far more likely to draw objections from creditors and the Department of Justice's Office of the United States Trustee. Table 1 summarizes the legal arguments made by objectors and shows how they changed after the reform.

TABLE 1. Summary of Creditor and US Trustee Arguments Objecting to Proposed Bonus Plans

Argument Made in Objection	*Any Objector*	*Official Committee*	*Secured Creditor*	*Unsecured Creditor*	*US Tr.*
Disguised Retention Plan	60%	33%	9%	3%	44%
Post-Reform Change	N/A	N/A	N/A	N/A	N/A
Incentives Not Clearly Defined?	47%	19%	9%	5%	37%
Post-Reform Change	70%	38%	277%	126%	692%
Incentives Not Hard Enough to Achieve?	42%	18%	5%	5%	26%
Post-Reform Change	126%	88%	N/A	126%	1031%
No Need for Bonuses in this Case	60%	26%	12%	5%	42%
Post-Reform Change	97%	62%	428%	126%	352%
Bonuses are Too High (Generically)	40%	14%	11%	7%	19%
Post-Reform Change	33%	-14%	13%	201%	314%
Bonuses are Too High (for Industry)	26%	9%	5%	2%	9%
Post-Reform Change	182%	26%	N/A	N/A	N/A
Bonuses are Too High (based on this Company's history)	19%	7%	2%	2%	9%
Post-Reform Change	-8%	-50%	-25%	N/A	277%
All Legal Arguments	67%	33%	12%	7%	47%
Post-Reform Change	69%	79%	32%	201%	307%

As Table 1 shows, official committees of unsecured creditors became much more litigious after the 2005 reform. They filed written objections to 33% of the proposed bonus plans, a 79% increase from the pre-reform sample. Categorizing the objections, the most common legal argument—expressed in every case in which the official committee objected—was that the bonus plan was a disguised retention plan, violating the 2005 reform. This observed litigation is obviously only a small part of their influence, as they almost certainly negotiated in the shadow of their right to object and may have influenced many bonus plans in unobserved ways.

However, creditor objections seldom presented particularized criticisms of the proposed bonus plan. Creditors did file objections to the proposed bonus plans alleging that the compensation level exceeded industry standards in 26% of cases (as compared to 9% before the reform),

but that was only 40% of the cases for which an objection was filed. More importantly, creditors only offered evidence from an opposing expert in 8% of cases (as compared to 11% prior to the reform). For the five cases where the official committee complained about the bonus plan exceeding industry standards, one offered evidence from other Chapter 11 cases, one simply pointed to the dire climate of the industry, two complained that the numbers were high without supporting evidence of "competitive compensation in the [company's] industry," and one asked for management to provide more information. In no objection in the smaller sample was the judge provided with concrete numbers that could be used to compare the bonus plan to an industry standard.

Other official committee objections in the sample served as a similar opportunity for the official committee to negotiate the plan of reorganization through litigation. The lack of substance in some of these objections suggests that the objection itself is better understood as a chance to express a partisan view about how the Chapter 11 case should proceed. For example, in the bankruptcy of Trico Marine Services, the official committee informed the court that it objected because the committee was at loggerheads with management over how the case would proceed.[2] In the bankruptcy of NEFF Co., the official committee complained that the Management Incentive Plan incentivized management to approve a plan favored by senior lenders and not "explore alternative plan strategies."[3] Similarly, in the Hayes Lemmerz bankruptcy, the creditors' committee complained that bonuses should not be paid "for merely confirming a plan quickly for the benefit of the Debtors' secured lenders who . . . were involved in the design and approval of the [bonus plan]."[4]

The biggest change after the reform is that the U.S. Trustee became

---

2. Official Comm. of Unsecured Creditors' Obj. to Debtors' Mot. to Shorten Notice Relating to Their (I) Mot. for Approval of Exec. Comp. & Emp. Incentive Plan for Non-Debtor OpCo Subsidiaries & (II) Mot. to File Related Exh. Under Seal at 2-3, *In re* Trico Marine Servs., Inc., 450 B.R. 474 (Bankr. D. Del. 2011).

3. Debtors' Reply to the Obj. of the Official Comm. of Unsecured Creditors to Mot. of the Debtors for Entry of an Order Approving the Debtors' Key Emp. Incentive Plan at 2, *In re* NEFF Co., No. 10-12610 (Bankr. S.D.N.Y. Jun. 28, 2010). In response, the debtors moved the "emergence incentive award" to the plan of reorganization. *Id.* at 3.

4. Obj. of the Official Comm. of Unsecured Creditors to Debtor's Mot. for Order Approving the Implementation of Key Emp. Incentive Plan & Short Term Incentive Plan at 2, *In re* Hayes Lemmerz Int'l, Inc., No. 09-11655 (Bankr. D. Del. Aug. 14, 2009).

far more litigious than had been the case prior to the reform, objecting to almost half of filed bonus plans, a 300% increase from the pre-reform sample.[5] The U.S. Trustee's objections mostly had a flavor of "there is no need for this bonus plan," with conclusory allegations against the bonus plan that were not usually supported by detailed analysis. Another noteworthy change in the U.S. Trustee's litigation activity after the 2005 reform is that the written objections became visibly more alike, with similar allegations and complaints about the bonus plans. Using text-analysis methods, I found that U.S. Trustee objections filed after the reform were much more similar to each other—as in, likely coming from a common template—than the objections filed prior to the reform.

While the objections rarely contained information that would help the judge determine if a proposed bonus plan actually required management to accomplish a challenging incentive goal, all of the litigation likely contributed to an important observed change after the reform: the fees associated with bankruptcy bonus plans increased significantly. To estimate the size of the increase, I reviewed all of the debtors' counsel's bills and identified the time entries corresponding to work on a bankruptcy bonus plan. Pre-reform, the median debtor's counsel billed $30,484 (mean of $65,198) for work on a bankruptcy bonus plan in constant 2010 dollars. Post-reform, the median debtor's counsel billed $86,410.79 (mean of $140,218) for their work on their debtor's bonus plans, an increase of 64%. For comparison's sake, the debtor's counsel's bill for the entire bankruptcy case was $5,191,576 in the post-reform sample, as compared to $3,449,969 pre-reform—an increase of 33% in constant dollars. The costs associated with a bankruptcy bonus plan grew twice as fast as the debtor's counsel's fees as a whole, suggesting that the new standard significantly increased the amount of legal work the debtor's attorneys needed to do to comply.

---

5. In one case, the Debtor complained that the U.S. Trustee's objection "appears to be based on a form and ignores the evidence [the debtor] submitted." Tronox's Resp. to the Obj. of the U.S. Tr. to Tronox's Mot. for Entry of an Order Approving Tronox's Key Emp. Incentive Plan at 2, *In re* Tronox, Inc., 503 B.R. 239 (Bankr. S.D.N.Y. 2009).

Finding #3: The Incentive Plans Approved by the Bankruptcy Courts Appear to Pay Bonuses As Often As Pre-BAPCPA Retention Plans And The Evidence Suggests that The Level of Chapter 11 Executive Compensation Remained Similar

Perhaps a surprising aspect of the post-BAPCPA incentive plans approved by bankruptcy courts is that they paid bonuses to senior managers just as often as the pre-2005 retention plans did. While I was only able to track whether bonuses were likely paid out for a subset of the bonus plans that I studied closely, I generally found, as Table 2 shows, the plans paid out at a similar rate and that some goals (such as bonuses tied to sales of the firm) were nearly always achieved. Of course, I cannot eliminate the possibility that these bonus plans incentivized managers to work harder and accomplish value-maximizing bankruptcy-performance objectives.

TABLE 2. Incentive Plan Target Achievement Rate, Before and After the 2005 Reform

	Post-2005 Reform Targets Achieved?			*Pre-2005 Reform Targets Achieved?*		
	Yes	*No*	*Unknown*	*Yes*	*No*	*Unknown*
EBITDA Targets?	19%	19%	63%	11%	33%	56%
Asset Sales Targets?	69%	23%	8%	67%	33%	N/A
Whole Firm Sale Targets?	82%	11%	6%	38%	63%	N/A
Plan Confirmation Targets?	61%	32%	7%	73%	27%	N/A
Emergence?	81%	13%	6%	67%	22%	11%
Any Target Hit?	94%	6%	N/A	89%	11%	N/A

Additionally, when I looked at the overall level of executive compensation that CEOs earned in Chapter 11, I found no statistically significant change despite the significantly larger number of Chapter 11 debtors that did not implement Chapter 11 bonus plans. The lack of evidence suggesting there was a change poses a puzzle: Why did the overall level of compensation not drop along with the usage of bonus plans?

One potential answer is that Chapter 11 debtors recognize that the process of paying bonuses in bankruptcy is now more expensive and litigious and simply evade the rule. For example, I observed some firms that implemented bonus plans tied to Chapter 11 goals prior to the petition

date. I found others that simply bundled a Chapter 11 bonus plan into the plan of reorganization, which judges have found to be a way to sidestep BAPCPA since plans are approved under Section 1129 instead of Section 503(c). While I cannot provide comprehensive statistics on these types of regulatory evasion, the evidence suggests that these efforts might not be uncommon among sophisticated debtors.

* * * * *

In conclusion, BAPCPA appears to have made the process of paying managers bonuses during the bankruptcy case significantly more expensive and litigious, but the evidence does not suggest that it had a substantive effect on the level of compensation that senior executives receive for helming a Chapter 11 debtor. These findings raise an important question for the future: Are creditors better off with BAPCPA, where the increased litigation costs might be offset by value-maximizing incentive targets for managers?

***