A Fair Payout–or a Disaster Waiting to Happen

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In 2020 alone, approximately 7,300 companies filed for Chapter 11 bankruptcy according to the U.S. Government Accountability Office. Of those corporate debtors, 42 were found to have awarded pre-bankruptcy retention bonuses to a total of 223 executives, with the bonuses totaling approximately $165 million. These pre-bankruptcy bonuses were given to executives anywhere from five months to two days before the filing. Virtually none of the bonuses paid were approved by a court. Although these pre-bankruptcy bonuses seem like a minority among the 2020 Chapter 11 cases, they have been the topic of much recent discussion surrounding insolvent corporations. Not only do they raise questions about how many more executives may seek them if we face a more severe economic downturn, but they also raise significant concerns of corporate creditors who, as a result thereof, are often effectively forced to accept less than full payment on pre-petition debts owed to them. This article summarizes the current state of the law and potential code changes to combat perceived abuses.

I. The Handing Out of Executive Bonuses, Both Before and During Bankruptcy

Corporations have long used hefty bonuses to reward and incentivize executives, a phenomenon that has been particularly controversial for decades in connection with prominent bankruptcy cases such as *In re Enron Corp.,* Bankr. S.D.N.Y. Case No. 01-16034 and, more recently, *In re CEC Entertainment, Inc.*, Bankr. S.D. Tex. 20-33163, *In re Rental Car Intermediate Holdings, LLC,* Bankr. D. Del. Case No. 20-11247, *In re Neiman Marcus Grp. LTD LLC,* Bankr. S.D. Tex. Case No. 20-32519, and *In re Whiting Petroleum Corp.*, S.D. Tex. Case No. 20-32021, to name a few.

Prior to the 2005 amendments to the Bankruptcy Code (the "Code"), many corporations considering bankruptcy issued bonuses to senior management executives to retain those individuals whose services were believed to be critical for the reorganization process. These benefits were often part of the corporation's Key Employee Retention Plan (KERP) and served as motivation for upper management to remain with the company throughout the bankruptcy. The bankruptcy courts would determine whether these "pay-to-stay" bonuses were appropriate and of "sound business judgment" on a case-by-case basis.

In recent years, it has become standard practice for many corporations to pay executive bonuses just weeks or even days before a Chapter 11 filing. This practice is predicated on the theory that bankruptcy laws will not apply until the corporation is actually in bankruptcy and is alleged to serve as a means to retain valuable executives to stay on board and help reorganize the company.

However, recent developments require a corporate debtor to satisfy several factors pursuant to the more restrictive confines of Section 503(c) of the Code before the bankruptcy court will approve the KERP payment(s), discussed in greater detail below. The court in *In re Borders Group, Inc,* 453 B.R. 459, 470 (Bankr. S.D.N.Y. 2011), stated that "[a]ttempts to characterize what are essentially prohibited retention programs as 'incentive' programs in order to bypass the requirements of section 503(c)(1) are looked upon with disfavor." Courts may scrutinize certain payment schemes set up by the debtor corporation which do not look like retention bonuses on their face, but "[i]f it walks like a duck (KERP) and quacks like a duck (KERP), it's a duck (KERP)," *In re Dana Corp.,* 351 B.R. 96, 102 n. 3 (Bankr. S.D.N.Y. 2006).

II. Section 503(c) of the Code

Section 503(c)(1) was enacted to create "a set of challenging standards" and "high hurdles" that failing corporations would need to overcome before retention bonuses could be paid. *In re Borders Grp., Inc.*, 453 B.R. at 470. Pursuant to Section 503(c)(1), a corporate debtor may not pay an executive a retention bonus unless: (i) the executive has a bona fide job offer from another business at the same or greater rate of compensation; (ii) the executive's services are essential to the survival of the corporation; and (iii) the retention bonus is not greater than ten times the amount of the average bonus payments given to non-management employees during the same calendar year or, if no such bonuses were given, no greater than 25 percent of the amount of any similar payment made to the executive during the calendar year preceding the year in which the payment is made. Effectively, Section 503(c)(1) limits the debtor corporation's ability to give insiders and executives certain awards and bonuses during the bankruptcy proceeding.

Notably, however, while Section 503(c)(1) may have alleviated certain abuse concerns occurring *throughout the course of the bankruptcy*, there is no similar restriction on a corporation issuing an executive bonus *in the days leading up to* the bankruptcy filing, which is the reason why these hefty bonuses continue to be paid by failing corporations.

One may wonder whether these executive bonuses "conveniently" paid out just prior to the company's bankruptcy filing should be analyzed under a framework like Section 503(c) of the Code. Alternatively, the question arises as to whether these corporations are simply benefitting from an end run around Section 503(c) and arguably making fraudulent transfers pre-petition.

III. Potential Solutions to Overcome Abuses Associated with Pre-Bankruptcy Executive Bonuses

To remedy these issues, the U.S. Government Accountability Office (GAO) recently recommended that Congress amend the Code to modify the "less-than-effective" version of Section 503(c) to restrict corporations from freely handing out bonuses pre-bankruptcy. As per the GAO's recommendation, the amendment should "clearly subject bonuses that debtors pay executives shortly before a bankruptcy filing to the bankruptcy court oversight and specify factors that courts should consider in order to approve such bonuses."

The recommended amendment raises concerns that bankruptcy courts will find that the pre-bankruptcy executive retention bonus amounts to a fraudulent conveyance, a concept articulated in Section 548 of the Code. The term "fraudulent conveyance" is used to describe transfers by an insolvent debtor for which it did not receive something of reasonably equivalent value in return. However, Bankruptcy Judge Laurie Selber Silverstein in *Jalbert v. Flanagan* (*In re F-Squared Inv. Mgmt., LLC*), 600 B.R. 294 (Bankr. D. Del. 2019) reminded us of potential limitations in place when seeking to unwind transfers and recover assets under Section 548.

In *F-Squared Inv. Mgmt., LLC*, the Trustee of a liquidation trust sued four employees of the corporate debtor who were paid bonuses which were in accordance with engagement agreements and the employee handbook while the company was insolvent. The Trustee sought to recover the bonus payments as fraudulent conveyances for the benefit of the estate and creditors. The Trustee's argument in this regard was straightforward: when the debtor paid the bonuses to its employees, the debtor was insolvent, was not paying its creditors, and was not obligated to pay such bonuses.

The Trustee's position—that paying the discretionary bonuses while leaving some creditors unpaid was unfair and fraudulent—seems more than reasonable. However, Judge Silverstein adopted the debtor's argument that the bonus payments were not, per se, a fraud upon creditors, concluding that the payments could potentially add value to the debtor's business. The court went on to emphasize that even a slight chance that a benefit might be conferred upon the debtor is sufficient to show some value has been received.

As suggested by the GAO in its recommendation referred to above, pre-bankruptcy retention bonuses could be subjected to Section 548 of the Code. Although, theoretically and as noted by the GAO, this tool could be employed by creditors' committees or even a trustee as an attempt to recover pre-bankruptcy bonuses, the strength of such argument is unclear at this point. As stressed by Judge Silverstein in *F-Squared Inv. Mgmt., LLC*, a determination of whether value is received by a debtor is an inherently factual determination to be made on a case-by-case basis looking into the circumstances of the transaction at the time it occurred. The Third Circuit, for example, follows a two-part inquiry to determine whether a transaction was for a reasonable equivalent value. *See In re F-Squared Inv. Mgmt., LLC,* 600 B.R. at 304. First, the court must make "an express factual determination as to whether the debtor received any value at all." *Id.* If so, the court will then determine, under a totality of circumstances, whether the value was reasonably equivalent to what the debtor gave up. *Id.* "Any value" is subject to "*any benefit*" the debtor may receive, either directly or indirectly, tangible or intangible. *Id.* (emphasis in original). Even the showing that "*some value*" has been conferred is sufficient. *Id.* (emphasis in original). Courts throughout other circuits employ a similar, if not identical, two-step inquiry. *See e.g., M&M Elec. Supply Co., Inc. v. Blais (In re Blais)*, AP No. 18-1034-MAF, 2021 WL 4483099, at *15-16 (Bankr. D. N.H. Sept. 30, 2021); S*tone v. Morton Cmty. Bank (In re Int'l Supply Co.),* 631 B.R. 331, 339 (Bankr. C.D. Ill. 2021); *In re All Terrain, LLC,* 625 B.R. 462, 472 (Bankr. D. Idaho 2020); *Gold v. Chaaban (In re Chaaban)*, AP No. 19-04294, 2020 WL 1183290, at *3 (Bankr. E.D. Mich. Mar. 10, 2020); *Feltman v. Wells Fargo Bank, N.A. (In re TS Emp't, Inc.),* 597 B.R. 494, 526 (Bankr. S.D.N.Y. 2019).

In mid-October 2021, the "No Bonuses in Bankruptcy Act of 2021" ("Act") was introduced in the House. This Act incorporates concerns and recommendations addressed by the GAO. The amendments to the Code proposed by the Act would modify Section 503 to prevent the bankrupt company from giving bonuses to employees earning $250,000 or more. The Act also modifies Section 547, which relates to preferences, to allow the trustee to claw back certain bonuses made within the six-month period immediately preceding a corporate debtor's Chapter 11 filing if the bonus would not have been allowed under Sections 503(c) or (d) of the Code. At this stage, the Act has been referred to the House Judiciary Committee but its future is unknown.

IV. Conclusion

Pre-bankruptcy executive bonuses have been the focus of much discussion in the corporate arena, stirring outrage among many. Yet little has been done to curb the payouts. The aforesaid discussed potential changes to the Code through the passage of the Act would prevent the payment of many executive retention bonuses pre-bankruptcy, but whether the law will pass remains to be seen.

Corporations considering a Chapter 11 filing that are unaware of or chose to ignore the possibility of these changes run the risk of an adversary proceeding being commenced during their bankruptcy case to challenge the issuance of such bonuses, potentially resulting in such payments being clawed back as preferential payments or fraudulent conveyances. Staying abreast of developments in this area is important for corporate debtors, as well as their creditors.

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