

**KEY EMPLOYEE COMPENSATION OUTSIDE THE ORDINARY COURSE OF
BUSINESS AND THE BANKRUPTCY CODE PRIOR TO AND AFTER THE
BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT**

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I. Introduction.

Tom Morrow has discussed the many and diverse motivations a business entity may have in offering a key employee retention, severance or other incentive plan regardless of the financial condition of the entity. These motivations are almost always more compelling where there is uncertainty regarding the financial success or life of the business. When the economy is good, which it is almost everywhere but Michigan, employees look to new opportunities where the job tenure is more certain and the new employer is either more willing or able to improve or even simply maintain compensation levels. As a result, such programs have become commonplace in bankruptcy reorganizations.

In many instances, a key employee retention plan (“KERP”), severance, performance bonus or other special compensation plan will have been instituted when the business entity first experiences financial distress, prior to a Chapter 11 filing. Key management would be the first to know and may therefore be the first to look for a better, safer opportunity, requiring immediate contracts or plans to induce them to stay. Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAFPCA”), these plans and contracts may be the easiest to protect. In the alternative, debtors have sought bankruptcy court approval of new programs, which they assert are necessary for the continuance of management in the context of the Chapter 11. In either case, the debtor has usually sought court approval to either continue the old incentive programs or approve the new post petition programs. These are generally among the “first day” motions.

II. Key Employee Retention Plans and Other Compensation Outside the Ordinary Course of Business Prior to BAFPCA.

Prior to BAFPCA, the debtor could seek to continue a prepetition KERP through assumption of executory contracts with the employees, or ask for approval of a new KERP program designed to be first effective after the petition. In the case of a KERP or other extraordinary compensation, which was offered prepetition pursuant to executory contracts, the test was the same as in other cases where debtors seek assumption of an executory contract under 11 U.S.C. §365. The test for approval is whether the assumption is a sound “business judgment”. See NLRB v. Bildisco & Bildisco, 465 U.S. 513, 523 (1984), Matter of JRT, Inc., 121 B.R. 314 (Bankr. W.D Mich 1990), Matter of McClouth Steel Corp., 20 B.R. 688 (Bankr. E.D. Mich 1982); Johnson v. Fairco Corp.,

61 B.R. 317 (Bankr. N.D. Ill., 1986) Sharon Steel Corp. v. National Fuel Gas Distribution Corp., (In re Sharon Steel Corp.), 872 F.2d 36 (3rd Cir. 1989) In re III Enterprises, Inc., 163 B.R. 453, 469 (Bankr. E.D. Pa. 1994) ("Generally, a court will give great deference to a debtor's decision to assume or reject a contract. A debtor need only show that its decision to assume or reject the contract is an exercise of sound business judgment - a standard which we have concluded many times is not difficult to meet.").

In the second instance, for postpetition KERPS, debtors would seek approval pursuant to 11 U.S.C. §363 (b)(1) of the Code. This section grants to the trustee, or debtor-in-possession, the right to use property of the estate outside the ordinary course of business. Again, generally, courts have held that the proposed KERP must be based upon the sound business judgment of management and the plan, or proposed compensation, must be fair and reasonable. This is the same analysis used in other instances where bankruptcy courts determine when estate property can be used outside the ordinary course of business. See, e.g., Committee of Equity Security Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063, 1070 (2d Cir. 1983); Stephens Industries, Inc. v. McClung (In re McClung), 789 F.2d 386, 390 (6th Cir. 1986); Fulton State Bank v. Schipper (In re Schipper), 933 F.2d 513, 515 (7th Cir. 1991); Myers v. Martin, (In re Martin), 91 F.3d 389, 395 (3rd Cir. 1996); Institutional Creditors of Continental Air Line, Inc. v. Continental Air Line, Inc., et al. (In re Continental Air Line, Inc.), 780 F.2d 1223, 1226 (5th Cir. 1986); In re Abbotts Dairies of Pennsylvania, Inc., 788 F.2d 143 (3d Cir. 1986) (implicitly adopting the "sound business judgment" test of Lionel Corp. and requiring good faith).

Therefore, whether the debtor seeks approval under §365, or §363, the court will carefully review the facts supporting the management's decision to institute the extraordinary compensation, but if there is reasonable support, bankruptcy courts generally are loathe to second guess management. In the context of KERPS or other incentive plans, the facts and motivations which have generally supported approval are the same facts and motivations cited earlier, by Tom Morrow, which are the catalysts for instituting KERPS in a non- bankruptcy context ("Catalysts"). The court will review these reasons, which have included:

1. The fact that employees possess unique knowledge, skill, experience and relationships with customers and suppliers.
2. A high prepetition attrition rate, due to resignations or downsizing, or a threatened loss of key employees, resulting in lack of depth in key management.
3. The cost of recruiting new employees including payment to executive search firms and the cost, both in time and money, relocating, training and orientation into the corporate culture.
4. The prepetition reduction in or loss of certain elements of compensation, such as pay cuts or loss of stock options which require some substitute compensation in order to retain and motivate key employees.

5. Low morale due to recent downsizing and anxiety over job loss due to sale or closure of the business

Additionally, courts have considered the following in determining if the structure of the compensation proposal and the process for developing the proposal meet the “sound business judgment” test (“Compensation Development Issues”):

1. 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?
2. Is the cost of the KERP reasonable in the context of the debtor’s assets, liabilities and earning potential?
3. Is the scope of the plan fair and reasonable, does it apply to all employees, does it discriminate unfairly?
4. Is the plan or proposal consistent with industry standards?
5. 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?
6. Did the debtor receive independent counsel in performing due diligence and in creating and authorizing the incentive compensation?

(See the following cases citing these Catalysts and Compensation Development Issues: In re Montgomery Ward Holding Corp., 242 B.R.147, 154 (D.Del. 1999); In re Aerovox, Inc., 269 B.R.74, 80-81 (Bankr.D.Mass. 2002); In re AmericaWest Airlines, Inc., 171 B.R. 674, 678 (Bankr. D. Ariz. 1994); In re Orion Pictures Corp., 4 F3rd 1095 (2nd Cir. 1993); In re The Colad Group, Inc., 324 B.R. 208 (W.D. N.Y. 2005); Matter of Interco, Inc., 128 B.R. 229, 234 (Bankr. E.D. Mo. 1991); In re Georgetown Steel Co., L.L.C., 306 B.R. 549 (Bankr. D.S.C. 2004); In re Allied Holdings, Inc., 337 B.R. 716 (Bankr. N.D. Ga. 2005)

Like most situations where the court applies the business judgment rule, this is not a difficult test for management to meet. If debtors could show that their decision to implement the plan is rational and the plan is reasonable, the plans were generally approved.

III. Compensation Outside the Ordinary Course of Business, Including KERPS, Under BAFCPA.

Congress was clearly unhappy with what it perceived as excessive key employee retention plans (KERPS) in Chapter 11 cases, and the willingness of bankruptcy courts to approve them. The result of this unhappiness is reflected in BAFCPA (without much reflection). BAFCPA Amendments 11 U.S.C. §503(c)(1) and (2), severely limits the approval of administrative claims for retention bonuses and severance payments to insiders. Further, under 11 U.S.C. §503(c)(3), all non-ordinary course transactions must be justified by the facts and circumstances of the case, including transfers and obligations incurred for the benefit of officers, managers and consultants hired after the petition. All of these amendments became effective 180 days following the BAFCPA enactment date, on April 19, 2005. (§1501 of BAFCPA). Therefore they are applicable to all cases filed after October 17, 2005.

Lest wily management attempt to circumvent the unclear mandate of Congress by making retention bonus payments prepetition, a trap has been set in the amendments to the fraudulent conveyance section of the Code. A benefit paid or obligation incurred to an insider under an employment contract, within two years prior to the bankruptcy petition, may be avoided as a fraudulent transfer unless it was made in the ordinary course of business and for reasonably equivalent value. The debtor need not be insolvent at the time the benefit is paid or the obligation incurred. 11 U.S.C. §548(a)(1)(B)(ii)(IV). Unlike the KERP amendments under §503, the KERP amendments to the §548(a), with the exception of the expansion to a two year look back, were effective upon the enactment date and therefore apply to all cases filed after April 19, 2005. (§1402 and §1213 of BAFCPA). The two year look back period in §548(a) is only applicable to cases filed one year after the enactment date. (see §§1402 and 1406 of BAFCPA.).

A. Retention Bonuses or Compensation.

Like many of the provisions of BAFCPA, Congress seeks to replace the discretion of the bankruptcy court with rigid tests, in language that is, at best, difficult to understand or apply in real world situations. 11 U.S.C. §503(c) provides that certain types of KERP payments shall be neither allowed nor paid. 11 U.S.C. §503(c)(1) provides as follows:

(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; . . .

Under this provision, only insiders of the debtor are implicated. Because the provision does not specify when the obligation is or must be incurred, the insider may not receive any payment to induce retention, whether the payment arises under a contract or a plan, and whether the contract or plan existed prior to the petition or was created post-petition. Any payment or obligation to an insider, to reduce retention, is prohibited unless the tests in (A), (B) and (C) are met.

Under (A), the insider must have a bona fide offer for greater “compensation”, not simply greater salary or pay. Therefore, in the event that the insider presents such a bona fide offer, the court must examine all benefits, including stock options and retirement plans. If the executive is offered equity in the reorganized debtor, how is that valued for purpose of this test? It is difficult to understand how this test will work in the real world. Where the insider is an executive with no significant ownership interest in the company and none is promised in the reorganized company, one must ask why such an insider would stay with a Chapter 11 company when offered a position with better overall compensation. Congress has created a veritable catch 22 for Chapter 11 management. The purpose of a KERP in a Chapter 11 proceeding is to retain executives, who have special skills, in an environment where there is increased stress and uncertainty with respect to job tenure because the company may not survive. In many instances, the KERP is proposed to retain key management where the assets of the company will be sold and management is required to stay in order to maintain the going concern value of the business. From the standpoint of the Chapter 11 employer, the desired benefit of a KERP is to keep the executives focused on the reorganization. Now, Congress requires the executive to spend precious time, when his employer is in a time of crisis, to search for a better job, with better overall compensation, reject that job offer, then prove to the court that the offer provides better overall compensation and that the employee was

crazy enough to reject it. One wonders if, adding insult to injury, the proofs would require the testimony of the rejected corporate suitor, who must come in and help explain why the executive rejected the better deal.

If an insider did seek approval of a retention benefit under 11 U.S.C. §503(c)(1), the services provided by the insider must be “essential to the survival of the business. There is no case law interpreting this language, but literally read, management would have to show, not just that the reorganization would be more successful, but that the business would not survive but for the continued employment of the insider. How long must the debtor survive? Must the business entity, itself, survive the reorganization? Could the survival simply be through the consummation of a liquidating plan? Is it enough that the debtor consummates a sale of substantially all of the assets pursuant to a §363 sale?

Once the insider has passed the above tests, the insider must establish that, although his services are “essential to the survival of the business” he is not being compensated accordingly. §503(c)(1)(C) provides alternative limitations on the insiders retention benefit. Under §503(c)(1)(C)(i), the insider retention benefit must be less than ten times the mean of any payment or obligation, which is similar in nature and was paid to nonmanagement employees in the calendar year of the insider’s retention payment or obligation. This section raises more questions than it answers. Who are nonmanagement employees? Is the distinction drawn based upon whether the employees are hourly or salaried? The calendar year reference is ambiguous. Does the court wait until the end of the calendar year or consider the payments in the months that have expired in the calendar year at the time of request for approval?

In the event that there were no such nonmanagement payments or benefits in the calendar year of the requested insider retention benefit, the insider must look to 11 U.S.C. §503(c)(1)(ii). Its important to note that this is not an independent alternative test from §503(c)(1)(C)(i). Under the plain meaning of (ii), if there are nonmanagement payments or benefits and the test under (i) is not met, the debtor doesn’t get to the alternative test. Assuming §503(c)(1)(ii) is applicable, the requested insider retention benefit must be less than 25% of any similar benefits paid to the insider in the calendar year prior to the requested retention benefit. The language of this test is the least ambiguous, but the concept contravenes the true purpose of a KERP. Presumably, the debtor company’s financial condition has been getting worse instead of better as it approaches bankruptcy. The goal is to retain the employee but the risks to continued employment and the stresses are increasing. Notwithstanding these conditions, the insider must receive less than he did in the prior year. The incentives for the employee to leave are most likely greater and yet the compensation must be less than one fourth of the prior year. This is the same employee who had to establish that he had a better offer. In summary, it is doubtful that debtor companies will seek approval of administrative claims under 11 U.S.C. §503(c)(1).

B. Severance.

11 U.S.C. §503(c)(2) is equally as troublesome. This section deals with approval of administrative claims for severance payments. Again, Congress has overreacted and attempted to deprive the bankruptcy court of all discretion in these determinations. 11 U.S.C. §503(c)(2) provides:

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;*

. . .

Interestingly, this section refers only to payments and not to obligations. The statute requires a two prong test for approval of severance to an insider. The provisions require that the severance payment be part of a program generally applicable to full time employees. The meaning of “program” is unclear. Could the severance benefits in the collective bargaining agreement be part of the company’s severance program which includes different terms for salaried workers, or do the terms have to be substantially similar?

The second prong of the test requires that the insider payment be not greater than 10 times the amount of the mean severance pay given to nonmanagement in the calendar year of the payment. Again, what is the definition of nonmanagement? Is the distinction between hourly and salaried employees? Is Congress attempting to mandate that all employees have some severance if insiders receive such payments or is it saying that the severance provisions must have some similarity? Unfortunately, because both §503(c)(2) and (3) preclude both the allowance or payment of retention and severance compensation, these sections may preclude the court from approving the assumption of long standing executory retention and severance plans and programs which employees have relied upon in the months or years leading up to the bankruptcy petition.

C. Other Transfers or Obligations Incurred Outside the Ordinary Course of Business, Including Benefits for Post-Petition Heirs.

The last section which purports to deal with bonus and incentive plans is 11 U.S.C. §503(c)(3) which provides as follows:

(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. . . .

It is important to note that this section does not relate only to bonus and incentive plans for post petition hires and consultants. There is no language that limits this section to compensation claims. The court is directed that all transfers which are outside the ordinary course of business must be “justified by the facts and circumstances of the case”. Transfers and obligations incurred for the benefit of those hired by the debtor post petition are simply included in all other non-ordinary course transactions which are subject to this test. Is this a new test? Unless Congress is directing the court to hear the facts, make its own independent judgment, and not rely upon, or give deference to, the business judgment of management in approving all non-ordinary course transactions, this looks suspiciously similar to the old “sound business judgment” test. The reference to post petition hires and consultants is almost gratuitous, because it does not distinguish the analysis a court must make with respect to those transfers from any other postpetition non-ordinary course use of estate property. Finally, as Collier’s points out, the test in §503(c)(3) appears to be no more stringent a test than that one which courts must apply in approving any administrative expense under §503(b)(1)(A). Any expense must be an actual, necessary cost or expense of preserving the estate. *4 Colliers on Bankruptcy §503.17[3] (15th ed. 1982)* It therefore appears that §503(c)(3) leaves the court with discretion with respect bonus and incentive plans which are not primarily motivated by retention or in the nature of severance. This presents an opening to reward management with performance bonuses, stock options in the reorganized debtor, significant increases in pre and postpetition salaries, and other creative plans, as long as the debtor can show the catalyst for the plan, program or contract is not retention or severance.

In summary, the tests set forth in §503(c)(1), relating to retention benefits will be almost impossible to meet for reasons discussed above. The two pronged test in §503(c)(2) for severance payments will be almost as difficult. It is likely that many debtors will attempt to structure their compensation plans based upon performance. Finally, it is likely that many companies will attempt to make such transfers prepetition, so that the recipient must simply take the risk of avoidance under the new fraudulent conveyance provisions.

D. Post BAFCPA Cases and 11 U.S.C. §503(c).

This writer could find only two cases post BAFCPA dealing with the approval of employee incentive plans or contracts. Neither of these cases are reported. The first is Orius Corp., et al. Case No. 05-63876 (Bankr. N.D. Ill. 2005). In that case the debtor sought approval of several executory executive employment contracts, implemented only days before the Chapter 11 petition. Orius had also entered into a purchase agreement for the sale of substantially all of its assets shortly before the petition. The executive employment contracts contained “Success Incentive Bonuses” and “Stretch Incentive Bonuses” which were approved by the lenders of the debtor. The “Success Bonuses” were based upon the company meeting certain sale milestones, such as getting the

bidding procedures approved, and obtaining certain recoveries based upon the debtor's August 2005 balance sheet. The executives would only receive this bonus if and when the milestones were reached. The bonus would be reduced when milestones were delayed. In addition, if the executives exceeded the financial milestones set by the lender, they would receive the "Stretch Bonus". The creditors committee objected to the motion, asserting that the requested assumption of contracts entered into just days before the petition date was simply a thinly disguised effort to avoid the prohibitions of 11 U.S.C. §503(c). Counsel for Orius advised this writer that the creditors committee withdrew its objection because it concluded that the bonuses were, in fact, performance based. Judge Bruce W. Black entered the order approving the assumption of the executives' contracts.

The second case is In re Nobex Corporation, 2005 WL 3763169 (Bankr. D. Del.) Again, the debtor sought approval for payment of postpetition sale related incentives to two senior executives. The debtor planned to sell substantially all of its assets within a period of four months. It asserted in its pleadings that it was "imperative that the Debtor's senior management undertake every effort to support the due diligence process and the marketing of the assets and to induce other parties into submitting competing bids." The bid procedures were already approved. The pleadings outlined the special skills of the two executives and asserted that they were the only personnel with the necessary skill and experience to implement the bid procedures and produce the maximum return on the debtor's assets. Each executive was to receive a percentage of the sale, which would be increased as the sale price reached certain milestones. The highest percentage possible for the combined bonus of the executives was 12.5% (8.5% and 4%). The debtor asserted that the compensation was not offered to induce retention or provide severance compensation. The debtor further asserted that the board of directors had exercised sound business judgment in their proposed use of estate property outside of the ordinary course of business pursuant to 11 U.S.C. §363(b). It further admitted that the executives were "insiders" but asserted that the proposed bonuses met the requirements of 11 U.S.C. §503(c)(3).

The debtor referred to Montgomery Ward, supra, and other unreported Delaware cases which have held that employee retention and incentive programs are valid exercises of management's sound business judgment. It then reiterates that management, in conjunction with its consultants, has determined that only these two executives can implement the bid procedures approved by the court, which would maximize the return to the estate.

In a motion filed concurrently (shortening the time on this motion), the debtor asserted that the loss of either of the executives may hinder the debtor's ability to complete the sale and therefore there must be an expedited approval of the contracts. The US trustee asserted that this was an admission that a major catalyst to the executive contracts was the debtor's fear that the executives would leave and the bid procedures would not be implemented. The trustee, therefore, objected that these were proposed retention bonuses which did not meet the requirements of §503(c)(1). The trustee also argues that §503(c)(3) cannot be the basis for granting debtor's relief because the executives were not hired after the filing date. Finally, the trustee argued that, even 11

U.S.C. §503(c)(3) could be the basis for approval the bonuses were not justified by the facts and circumstances of the case because; the debtor did not detail the special skills of the executives, the combination of the executive bonuses and the investment banker commissions exceed 20% of the sale proceeds, the executives already had a fiduciary duty to the debtor and were therefore not likely to leave, if the executives did leave, others could take their place or a trustee could be appointed who would complete the sale for a 3% commission and, finally, the combined commissions and bonuses exceeded 40% of the unsecured trade debt. The unsecured creditors committee originally objected to the debtor's motion but later joined in the process of reviewing the compensation plans and withdrew its objection.

The court approved the two contracts in Nobex based upon the following:

1. The two executives had special skills and expertise that were critical to implementation of the sale procedures, including their special understanding of the science of the business and their knowledge of the books and records of the business.
2. The duties of the executives have been expanded.
3. The debtor consulted with its professionals and the committee in determining the incentives were necessary, and the committee participated in the negotiation of the incentives.
4. The sale efforts of the executives would extend beyond their ordinary course duties and the debtor would not likely be able to otherwise maximize the value realizable through a sale.
5. The executives had committed to continue their employment even if no incentive pay is offered.
6. The incentives arise out of the debtor's specific situation and desire to aggressively implement the proposed sale procedures and aggressively market its assets in a way that only these two executives can accomplish.
7. The proposed sale incentives were the exercise of "sound business judgment by the debtor and were not proposed to retain the executives and or to provide severance.
8. The sale incentives were therefore justified by the facts and circumstances of the case.
9. The court found that the debtor had met its burden under §363 and §503(c)(3).

The debtor was able to thread the needle to accomplish its goal. The debtor took the position that, while the debtor's officers agreed they would stay notwithstanding the failure to receive the sale incentives and without retention bonuses or severance pay; their ordinary course duties would not require them to fulfill all of the duties required under the sale procedures. Therefore, the debtor could not force the executives to perform the extraordinary functions and the sale process would not be as effective. The court found that no one else could implement the bid procedures better and it had independent corroboration of that fact, and the fact that the incentives were reasonable and necessary, from debtor's professionals, and more importantly, the unsecured creditors committee. This case will probably form the roadmap for future postpetition requests for key employee compensation which is outside the ordinary course of business. The debtor must put on proofs that the key employees would have stayed anyway, but that the new compensation is due to some new duties or demands. Otherwise, the debtor is stuck with the significantly reduced extraordinary compensation for key executives or the almost insurmountable tests mandated by §503(c)(1) and (2).

IV. BAFCPA Amendments to the Fraudulent Conveyance Provisions Relating to Employment.

The use of the fraudulent conveyance provisions of 11 U.S.C. §548 to avoid excessive compensation is nothing new. These actions were determined in the same way that all constructive fraud cases were handled. The trustee was required to establish that the debtor received less than reasonably equivalent value for the services rendered and that the debtor was insolvent, rendered insolvent, or had insufficient assets to operate or pay its debts when they came due. Generally, these actions involved compensation that was blatantly excessive. These cases were more compelling because the insider usually took the excessive compensation when the debtor was insolvent or the compensation rendered the debtor insolvent. With BAFCPA, Congress singles out compensation paid to insiders under employment contracts and imposes upon those transfers a more stringent constructive fraud test than for any other transfers. The fraudulent conveyance provisions of the code, under 11 U.S.C. §548 (a)(1) have been amended as follows: (the amendments are underlined):

(a)(1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily . . . -

(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;

(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or

(IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business. . . .

Under these amendments, for fraudulent transfer purposes, transfers or obligations incurred to insiders under employment contracts are distinguished from all other types of transfers. If they are made for less than reasonably equivalent value, they are avoidable. Unlike all other transfers, it does not matter whether the debtor is solvent at the time of the transfer, or immediately after the transfer, has sufficient capital after the transfer or can pay its debts as they come due after the transfer. It is unclear why the scope of the class of this penalty was limited to insiders with contracts, as opposed to any extraordinary compensation or incentives. The question is how broadly the court will interpret the term “employment contract.” Can it be an oral or written contract? Is the agreement a true contract if the employee may be terminated without cause?

The major factual issue in these matters will obviously be whether the debtor received less than reasonably equivalent value. It is likely that the court will look to many of the same factors which it looks to in approving extraordinary compensation under §363. If the court finds that the debtor had exercised good business judgment, then, in all likelihood, the court should find that reasonably equivalent value, in the form of the insider services, was received. Court approval in these cases would seem to be more likely where independent consultants and other disinterested persons were involved in the process of determining the compensation under the particular contract. Where the insiders have simply determined their own compensation, without significant independent consultation and review, the case should be a much more difficult one to make, especially where the company failed to meet its goals, whether prior to or within a reorganization. Many of these actions will be initiated by trustees, and where the debtor has failed to meet its goals, the trustee will have the benefit of 20/20 hindsight. This could be especially damaging if the incentives were structured and promoted with representations, or at least the stated or implied expectation, that the executive would lead the company to meet specific financial goals.

The removal of the requirement of debtor’s insolvency, lack of assets with which to operate or pay its debts, as a condition to establishing a constructive fraud would not have been as important a modification if BAFCPA had not also extended the look back period to two years for all cases filed after one year from the enactment date. Most business debtors have been insolvent, or have had cash flow problems precluding them from paying debts during most of the year prior to the bankruptcy. While the debtor’s

financial condition was certainly an issue to be established in constructive fraudulent conveyance actions, one or more of the tests could be generally be met, leaving the primary focus on whether the debtor received reasonably equivalent value, as it is under BAFCPA. This, however, may not have been the case in the second year prior to the bankruptcy. If the insolvency or other named financial infirmities of the debtor had remained a condition for avoidance, this issue may have been a more commonly litigated one because the financial fortunes of a company can easily dramatically change in a period of two years. This is obvious, anecdotally, if one looks at fortunes of telecom companies between 1999 and 2001.

Query: It is a common practice by owners of closely held corporations to remove net profits at year end, as a bonus. This is especially the case in pass through corporations like limited liability companies and sub s corporations. Generally, the companies enjoy a balance sheet solvency when this is done. If within two years, the debtor experiences financial difficulty and is required to file a bankruptcy petition will the court hold that such distributions are payments under an employment contract and thus avoidable?

APPENDIX

The following materials are helpful references in understanding the issues addressed in these materials:

American Bankruptcy Institute Law Review, Spring, 2003, A. Michele Dickerson, Approving Employee Retention and Severance Programs; Judicial Discretion Run Amuck? 11 Am. Bankr. Inst. L. Rev. 93

Emory Bankruptcy Development Journal 2004, George W. Kurey, Hijacking Chapter 11, 21 Emory. Dev. J. 19

Benefits Practice Center, Executive Compensation Library, Journal Reports: Law and Policy 2005, Gary M. Kaplan, Executive Compensation Issues Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005