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## **Statutory Construction in Light of the 2005 Amendments**

**Examples of Ambiguity in**

**Key Employee Retention Provisions after the  
Enactment of New Section 503(c)**

**- and -**

**Reclamation of Goods Pursuant to Amended  
Sections 546(c) and 503(b)(9)**

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## KEY EMPLOYEE RETENTION PROVISIONS AFTER THE ENACTMENT OF NEW SECTION 503(C)

Pursuant to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “BAPCPA”), section 503(c) was added to the Bankruptcy Code, in order to address concerns over the “glaring abuses of the bankruptcy system by the executives who lined their own pockets, but left thousands of employees and retirees out in the cold.” Sen. Edward M. Kennedy, Statement on Bankruptcy Cloture Vote, March 8, 2005. However, while this may have been the goal of those Senators and Congressmen who sponsored the provision, its drafters, whether intentionally or not, worded it so poorly that, after a few months of enforcement of these provisions, it is unclear whether it effected any practical change at all.

### **I. Pre-BAPCPA Law**

Prior to the enactment of the BAPCPA, courts analyzed Key Employee Retention Programs (“KERPs”) pursuant to section 363(b) of the Bankruptcy Code as use of estate property outside of the ordinary course of business. Courts carefully examined compensation and retention programs under the facts and circumstances of each case and approved such programs if the debtor had used proper business judgment in formulating them. See In re Aerovox, Inc., 269 B.R. 74, 80-81 (Bankr. D. Mass. 2001); In re Regensteiner Printing Co., 122 B.R. 323, 326 (N.D. Ill. 1990). Additionally, debtors had to provide sufficient evidence substantiating that an employee retention or other bonus program was necessary to retain employees or to otherwise preserve the value of the estate. See, e.g., In re Club Dev. & Mgmt. Corp., 27 B.R. 610, 613 (B.A.P. 9th Cir. 1982); see also In re Montgomery Ward Holding Corp., 242 B.R. 147, 156 (D. Del. 1999).

### **II. BAPCPA Changes:**

The new section 503(c) sets out three separate tests for severance and retention programs. Section 503(c)(1) addresses retention payments to insiders; section 503(c)(2) address severance payments to insiders; and section 503(c)(3) is a catch-all provision covering all other programs. Section 503(c) reads in full 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;

(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; or

(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.

### **III. Room for Ambiguity**

There are several aspects of the new section 503(c) that are ambiguous or open to varying interpretations. Since the enactment of BAPCPA, commentators have speculated as to how debtors would be able to get around these provisions and adopt Key Employee Retention Plans ("KERPs"). It now appears that debtors may capitalize on the weaknesses of section 503(c) and argue (i) the employees are not insiders; (ii) the

purpose of the plan is not solely retention; and (iii) the plan therefore falls within the catchall provision, which appears merely to import the old business judgment test.

### **1. Definition of Insider**

The new section 503(c)(1) restricts payments made to “insiders” for the purpose of retention. Section 101(31) of the Bankruptcy Code defines an insider as including (where the debtor is a corporation): (i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor.

The legislative history of section 101(31), which contains the definition of “insider” under the Bankruptcy Code, states that insiders are persons of “sufficiently close relationship [to the debtor] that their conduct is subject to closer scrutiny than those dealing at arms’ length.” S. Rep. 95-989, 9th Cong. 2d Sess., reprinted in 1978 U.S. Code Cong. & Admin. News 5787, 5810. There is no reported case law interpreting the definition of “insider” as it applies to section 503(c)(1). However, courts interpreting “insider” in other contexts have indicated that the Bankruptcy Code does not require a mechanical definition of “officer” and that a title as a statutory officer is relevant but neither necessary nor sufficient to make someone an “insider”. *In re NMI Systems, Inc.*, 179 B.R. 357, 367-69 (Bankr. D.D.C. 1995). Also relevant are the person’s duties and responsibilities and to whom they report within the company. In *In re Refco Inc.*, No. 05-6006 (Bankr. S.D.N.Y. Jan. 10, 2006), Judge Drain found that section 503(c)(1) did not apply because none of the employees in the program were insiders – while they may have had sufficient authority pre-petition they currently did not have such authority.

Thus, there are no clear guidelines as to whom is an “insider” of a business of any degree of complexity. Section 503(c)(1) leaves open the question as to how deep into management employees are considered to be “insiders” subject to the requirements of that section.

### **2. Purpose of Retention**

Section 503(c)(1) only applies to payments made “for **the** purpose of inducing such person to remain.” 11 U.S.C. 503(c)(1) (emphasis added). Because the statute refers to the “purpose” of retention, some courts have required that retention must be the sole purpose in order to trigger the requirements of section 503(c)(1). Programs which very well may have been called Key Employee Retention Plans prior to the BAPCPA are now called something else – like “Emergence Incentive Plans”. These programs may tie earning a bonus to other performance-based factors such as creating certain levels of enterprise value, achieving levels of EBITDA, or emergence from bankruptcy by a specified date. Under these new plans, because it is not enough merely to stay with the debtor through confirmation or a specified date in order to earn the bonus, the “purpose” is determined to be not solely for retention.

For example, in In re Nobex Corp., Case No. 05-20050 (MFW) (Bankr. D. Del. Jan. 19, 2006), Judge Mary Walrath found that a plan did not fall within the purview of section 503(c)(1) because it was not an incentive plan disguised as a retention plan and it did not provide payment to senior management “solely for being retained.” See Laurie Selber Silverstein and Gabriel R. MacConaill, “A Fresh Obstacle to Retaining Key Employees,” *The National Law Journal* (March 7, 2006) (reporting Judge Walrath’s decision). Instead, with regards to a sale of substantially all the debtors’ assets, the plan tied incentive compensation to gross sale price achieved; the executives would receive incentive compensation only if such gross sale price exceeded the proposed stalking horse bid. In re Nobex Corp., Case No. 05-20050 (MFW) (Bankr. D. Del. Jan. 19, 2006).

More recently, in In re Calpine Corp., Case No. 05-60200 (BRL) (Bankr. S.D.N.Y. May 15, 2006), Judge Burton Lifland held that certain employment incentive programs did not fall within section 503(c)(1), rejecting claims by equity holders that they were disguised retention programs. There, program tied incentive compensation awards to (i) emergence from bankruptcy, (ii) the achievement of specific performance metrics, and (iii) an adjusted enterprise value, upon emergence, of at least \$5.0 billion. Id.

### **3. Calculations under Section 503(c)(1)(C)**

Although, to the authors' knowledge, courts have not yet had the opportunity to pass upon the calculations required under section 503(c)(1)(C), application of those standards is also far from clear. Under section 503(c)(1)(C) a payment made to an insider for purposes of retention must satisfy one of two formulas. The first formula, under section 503(c)(1)(C)(i), compares payments to the insider to similar payments made to "nonmanagement employees" during the same calendar year in which the insider payments is made or the obligation incurred. "Nonmanagement" is not a defined term under the Bankruptcy Code. It is therefore unclear whether Congress intended for "nonmanagement employees" to be non-"insiders" or whether some other definition applies. It is also unclear how one would apply this test early in the year at which time it may be uncertain how much will be paid to non-management employees.

If there are no similar payments to non-management employees within the same calendar year, section 503(c)(1)(C)(ii) states that the payments to the insider under the plan may not be more than 25% higher than similar payments made to that insider during the calendar year *before* the insider payment was made or the obligation incurred. One difficulty with this section is that, particularly in large cases, the bankrupt corporation often hires brand new management when it goes into bankruptcy. It would therefore be impossible to compare current insider payments to previous insider payments. Also, the incentive plan adopted in bankruptcy is often different than the bonus program which had been in effect prepetition.

#### **4. The Catch-All Provision**

Section 503(c)(3) prohibits other types of transfers if they are outside the ordinary course of business and "not justified by the facts and circumstances of the case". This is the provision pursuant to which the debtors in both Nobex and Calpine sought approval for incentive programs, claiming that they did not fall within section 503(c)(1). Although there has not yet been reported case law interpreting section 503(c)(3), in Nobex, Judge Walrath indicated that she saw section 503(c)(3)'s standard as a "reiteration" of section 363(b)'s business judgment standard pursuant to which courts analyzed compensation programs prior to the enactment of BAPCPA. Transcript of January 12, 2006 Hearing, In re Nobex Corp., Case No. 05-20050 (MFW) (Bankr. D. Del. Jan. 20, 2006).

## RECLAMATION OF GOODS PURSUANT TO AMENDED SECTIONS 546(C) AND 503(B)(9)

### **I. Introduction**

Pursuant to section 546(c), a seller can reclaim (demand and obtain the return of) goods sold and delivered on credit terms to an insolvent buyer in the ordinary course of business, contingent upon the seller sending a written reclamation demand within a specified time period.

Under the prior version of section 546(c), a seller's reclamation rights arose under state law, namely section 2-702(2) of the Uniform Commercial Code (UCC). A seller's state law reclamation rights continued after the buyer filed bankruptcy, because the automatic stay arising under the Bankruptcy Code does not prevent a seller from pursuing or enforcing a reclamation claim. Once the bankruptcy proceeding began, the prior version of section 546(c) preserved a seller's state law reclamation rights, but established certain additional requirements the seller needed to follow that were not otherwise required under state law. Most significantly, the seller was given an additional 20 days after the petition date to file a reclamation claim which it would have filed under UCC section 2-702(2) as of the petition date.

Although it appears that the new provisions were intended to expand reclamation rights, particularly by expanding the reach-back period for reclamation, it is not clear whether Congress accomplished that objective. The amendments under BAPCPA complicate matters because they are ambiguous as to (i) the extent, if any, to which state reclamation law will still apply; (ii) whether there is a new federal right of reclamation; (iii) how to apply the requirements of the so-called reach-back period for filing a postpetition notice of reclamation; and (iv) whether and when reclamation rights give rise to an administrative claim.

### **II. Relevant Statutory Provisions**

#### **A. Changes to Sections 546(c) and 503(b) Related to Reclamation**

Pursuant to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "BAPCPA"), sections 546(c) was amended as follows:

(c)(1) Except as provided in subsection (d) of this section and in section 507(c), and subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of the trustee under sections 544 (a), 545, 547, and 549 are subject to the right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods if the debtor has received such goods while insolvent, within 45 days before the date of the commencement of a case under this title, but such a seller may not reclaim such goods unless such seller demands in writing reclamation of such goods—

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(A) not later than 45 days after the date of receipt of such goods by the debtor; or

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(B) not later than 20 days after the date of commencement of the case, if the 45-day period expires after the commencement of the case.

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(2) If a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in section 503(b)(9).

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Additionally, BAPCPA added section 503(9) to the Bankruptcy Code:

Deleted: with such a right of reclamation that has made such a demand only if the court—(A) grants the claim of such a seller priority as a claim of a kind specified

(b) After notice and a hearing, there shall be allowed, administrative expenses, other than claims allowed under section 502(f) of this title, including—

Deleted: of this title; or (B) secures such claim by a lien

... (9) the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business

## **B. Section 2-702(2) and (3) of the UCC**

State law reclamation rights arise under Sections 2-702(2) and (3) of the UCC,

which provide as follows:

(2) Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply. Except as provided in this subsection the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

(3) The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course or other good faith purchaser under this Article (Section 2-

403). Successful reclamation of goods excludes all other remedies with respect to them.

### **III. Summary of Changes to Reclamation Provisions in the Bankruptcy Code**

#### **A. Applicability of State Law**

##### **1. Pre-BAPCPA**

Prior to BAPCPA, section 546(c) provided that the rights and powers of a debtor in possession under sections 544(a), 545, 547, and 549 are “subject to any statutory or common law right of a seller that has sold goods to the debtor . . . to reclaim such goods.” In this way, section 546(c) merely preserved the rights that a seller had under state law or UCC 2-702(2) and (3) (which provide for a reclamation period of 10 days after the receipt of the goods).

##### **2. BAPCPA Changes and Room for Ambiguity**

Pursuant to BAPCPA, section 546(c) was modified to remove the reference to the “statutory or common law right” of the seller. It is unclear what Congress intended by this deletion, particularly where Congress provided no explanation in the legislative history for the change. Does the change mean that section 546(c) no longer merely incorporates the state law right of reclamation, but rather creates a brand new federal bankruptcy law right? If so, does the body of case law interpreting sections 2-702(2) and (3) of the UCC any longer apply? Pursuant to the UCC, the reclamation rights of a seller are subject to the rights of a buyer-in-the-ordinary course (a term which would include a secured creditor with a floating lien on inventory) and the UCC’s timeline and other requirements for sending notice of reclamation. See U.C.C. § 2-702(2), (3). Additionally, courts did not allow reclamation of goods that had been commingled with other goods or were not identifiable. See, e.g., In re Charter Oil Co., 54 B.R. 91, 92-93 (Bankr. M.D. Fla. 1985) (goods must be identifiable and in possession of debtor on date of demand); see also In re Flagstaff Foodservice Corp., 32 U.C.C. Rep. 1479, 1485 (Bankr. S.D.N.Y. 1981); In re Daylin, Inc., 596 F.2d 853, 856 (9th Cir. 1979).

In order to be the object of a reclamation action, goods must be identifiable and in the possession of the debtor on the day of demand. Was it Congress's intent to remove these defenses as well?

## **B. The Reclamation Reach-Back Period**

### **1. Pre-BAPCPA**

Under section 2-702(2) of the UCC, sellers must make reclamation demands within 10 days after the buyer receives the goods. However, if the buyer misrepresents its solvency to the seller, the seller has an unlimited time to make a reclamation demand.

Prior to BAPCPA, the Bankruptcy Code established two different time periods for making a reclamation demand after the buyer entered bankruptcy. The first time period was extensive with the UCC 10-day period: A seller could reclaim goods that the buyer received within 10 days of the demand. The second time period extended the 10-day period when the buyer's bankruptcy filing occurred within the 10-day period. This covered goods received within the 10 days before the filing and gave the seller up to a full 20 days from the time the buyer received the goods to make a reclamation demand.

### **2. BAPCPA Changes**

Under BAPCPA, new section 546(c) expands the reclamation reach-back period in two different ways. First, the look-back period before bankruptcy during which goods may be subject to reclamation is expanded from 10 days to 45 days. Second, the grace period, which gives a seller additional time after a bankruptcy filing during which to file its notice of reclamation, is expanded from 10 days to 20 days. As a result, sellers now have as much as 65 days after the buyer receives the goods (if the buyer received the goods, 45 days prior to the petition date) in which to send a demand letter. The seller is also given up to 20 days after the bankruptcy filing to send its reclamation demand where the 45-day reclamation demand period expires after the bankruptcy filing (i.e., for goods received within 45 days of bankruptcy).

### **3. Room for Ambiguity**

The new section 546(c) provides for two grace periods that may apply to a reclamation demand: 45 days after the date of receipt of the goods, under subsection

546(c)(1)(A), or 20 days after the bankruptcy filing “if the 45-day period expires after the commencement of the case,” under subsection 546(c)(1)(B). The body of section 546(c)(1) already limits reclamation to goods received “within 45 days before” the date of the bankruptcy filing. Therefore, there could be litigation as to which period should apply. Presumably subsection 546(c)(1)(A) would not have been added to the Bankruptcy Code if it would have no effect. For example, if the buyer received the goods on the tenth day prior to the bankruptcy filing, must the seller send its reclamation within 20 days of the bankruptcy filing (as provided in section 546(c)(1)(B)) or within 35 days of the filing (45 days after the date of receipt, as provided in section 546(c)(1)(A)). The statute is not clear that it should be the latter.

### **C. New Administrative Claim**

#### **1. Pre-BAPCPA**

Prior to BAPCPA, former section 546(c)(2) provided that “the court may deny reclamation to a seller with such right of reclamation that has made such a demand only if the court (A) grants the claim of such seller priority as a claim of the kind specified in section 503(b) of this title; or (B) secures such claim by a lien.”

#### **2. BAPCPA Changes**

Pursuant to BAPCPA, this provision of 546(c)(2) was deleted and replaced by the following: “If a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in section 503(b)(9).” New section 503(b)(9) in turn allows the seller an administrative expense claim equal to “the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor’s business.”

#### **3. Room for Ambiguity**

The effect of this change may be that sellers who *do* provide timely notice under 546(c)(1) are now limited to their reclamation right for recovery of the goods and can no longer receive a lien or administrative claim for value of the goods. However, the legislative history of BAPCPA provides no indication that this was Congress’s intent.

Moreover, section 546(c)(2) states that a seller who does not provide notice may “still” assert a claim under 503(b)(9), indicating that the intent was to *expand* the right to an administrative claim to *include* those who fail to provide proper notice. Moreover, section 503(b)(9) itself does not limit the administrative claim to sellers who have not given notice.

Additionally, the new section 503(b)(9) does not indicate what would happen if the seller timely asserts a reclamation claim under section 546(c) as to goods received within 45 days of the bankruptcy, but where the buyer received such goods more than 20 days before the bankruptcy filing (*i.e.*, before the 20 day reach-back period in 503(b)(9)). The new section 546(c) removed language giving sellers an administrative claim and instead appears to allow an administrative claim to arise only pursuant to section 503(b)(9). Was the intention to leave sellers who have complied with the notice requirements under section 546(c) with only a reclamation right but not an administrative claim, for goods received between 20 and 45 days prior to the bankruptcy filing?