VIEWPOINT

The 'KERP' Is Dead; Long Live the 'MIP' - What Really Happened in In Re Nobex

By Ted Gavin, CTP

One of a series of opinion columns by bankruptcy professionals.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) that went into effect on October 17, 2005, brought many changes to the Bankruptcy Code. A key change, which has been the subject of several articles in the past 18 months, is the Code's treatment of key employee retention plans - a mechanism for providing financial incentives to managers and key employees of a debtor to keep them focused on the reorganization process.

The restrictions on KERPs contained in the new Section 503(c) were viewed as a safeguard against the leverage managers wielded over the reorganization process. Creditors complained that key managers could 'extort' large bonuses from debtors by threatening to leave. Louder still was the public outcry over bonuses paid to executives while employees and retirees were perceived as being unfavorably treated in the bankruptcy process. While it's left to the reader to determine exactly what Congress was trying to accomplish in formulating the new section, what we do know is this: debtors now had hoops to jump through before providing incentives to managers during a bankruptcy proceeding.

Section 503(c)(1) prohibits retention payments unless necessary because an employee has received a bona fide job offer at equal or greater compensation AND the employee is necessary to the survival of the business AND the amount to be paid is reasonable when compared to similar payments made or to the employee's salary. Severance payments to insiders are prohibited by 503(c)(2) unless the payments are made in conjunction with a payment scheme available to the debtor's non-management employees AND the payments made are not reasonable when compared to severance payments made to non-management employees during the prior year. Finally, 501(c)(3) prohibits payments made outside the normal course of business and without justification by the facts of the case.

Nobex Corp. filed its Chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware on Dec. 1, 2005, and subsequently filed motions to approve the sale of substantially all of its assets to Biocon Ltd., a stockholder and joint-venture partner who was also providing debtor-in-possession financing to the company. On December 9, the debtor filed a motion to approve the payment of sale-related incentive pay to the debtor's management - the first-such motion filed after the changes to the Code were enacted. This motion sought to pay the CEO and CFO incentives based on a percentage of the sale price of the company's assets because, as the debtor stated, these individuals were "the only personnel with the necessary skill and experience" to carry out the sales procedures as presented to the Court.

Certainly it is fair to reward managers who agree to forego seeking replacement employment when that reward is in exchange for a benefit to the estate's stakeholders - in this case the company's unsecured creditors. However, and this important detail is omitted from most published analyses of this case, the managers were to be rewarded based on the sale to the existing bidder under the sales terms as filed with the court, a bid that was non-contingent. The debtor's motion sought not to provide a future incentive, but to reward top management to do nothing more than what had already been done. Given the new limitations imposed by Section 503(c) of the Bankruptcy Code, the motion drew the expected response.

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The Official Committee of Unsecured Creditors was appointed in the Nobex case on December 15. Shortly thereafter, both the committee and the U.S. trustee filed objections to the incentive motion. The committee specifically noted in its objection that it was not adverse to a forward-looking incentive plan that focused management on maximizing the value received by a sale of the debtor's assets. The U.S. trustee's objection focused on more technical aspects of the motion as well as the restrictions inherent in Section 503(c).

Working closely with the committee and its professionals, the debtor agreed to revamp the incentive structure to provide incentives based on achieving value greater than the stalking-horse bid. The plan changed from a "retention plan" to a true "incentive plan," tied to measurable results and with specific financial rewards. This negotiated agreement was subsequently presented to the court and approved over the continuing objection of the U.S. trustee, becoming the first post-BAPCPA Management Incentive Plan (MIP).

In evaluating the revised incentive plan, the court noted that the compelling reasons for the approval of the incentive plan were:

1. The committee had negotiated changes to the plan and endorsed the modified structure;
2. The goal of the incentive was to achieve a sale price higher than the stalking-horse bid;
3. The incentive was not to induce retention, rather it only provided payment if higher value was achieved for the assets 6, and;
4. Section 503(c)(3) permitted the payments outside the normal course of business because they were justified by the facts of the case

In specifically noting that the plan was allowable under 501(c)(3), the door was opened for subsequent cases to use the "facts and circumstances of the case" to implement incentive plans on a routine basis. Critics of the changes to the Bankruptcy Code talked of the "chilling effect" they would have on hypothetical managers' willingness to continue their employment at a distressed company. Predicting a mass exodus of top managers who were no longer able to extract bonuses from debtors-in-possession, some called it "the Chief Restructuring Officer Employment Act of 2005." But were these fears realized?

Nobex set the stage for cases to come. The fine points of incentives continue to evolve on a case-by-case basis. Official committees now realize some increased influence over the bankruptcy process when they are able to craft creative incentives that reward managers who get better results for creditors, as occurred in Nobex. Managers have learned that, in sticking around through the bankruptcy process, they can still count on incentives - as long as they can produce results in exchange. As for the chief restructuring officers whose windfall hasn't happened yet, we still manage to stay busy.

(Opinions expressed are those of the author or authors, not of Dow Jones Newsletters.)

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