

Is the Fox Guarding the Henhouse?

How to Stop KERP Abuse

Since 2001, media focus on key employee retention plans (KERPs) in mega-bankruptcies has revealed to the general public something bankruptcy attorneys have known for a long time: KERPs can enrich a debtor's undeserving upper management at the expense of its lower-level employees, creditors, and shareholders.

Ostensibly KERPs are designed to keep key employees from jumping ship after a company has filed for bankruptcy protection. If a company is to survive or maximize its liquidation value, the theory goes, certain key employees must remain part of the company. KERPs provide these employees with financial incentives to stay.

KERPs usually are proposed by a debtor's management. In fairness, this is largely unavoidable. Who else can identify key employees at the time of a bankruptcy filing? However, without proper scrutiny from the courts, this too often leads to multimillion-dollar bonus payments to keep employees on the payroll who were responsible for wrecking the company in the first place.¹

Once a company files for Chapter 11, U.S. Bankruptcy Code Section 363(d) provides that any use of company proceeds "other than in the ordinary course of business" requires notice, a hearing, and court approval. KERPs fall outside of "ordinary course of business" payments and therefore must be approved by a Bankruptcy Court.

An obvious test of the soundness of KERPs would be to ask whether their proposed beneficiaries are essential to the continued operation, reorganization, or liquidation



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of the debtor, and are likely to leave if they do not receive KERP benefits. A test similar to this was proposed in Congress in the Employee Abuse Prevention Act of 2002.² The bill did not pass, however, and the proposed test is not used by courts today.

Instead, courts look at whether a debtor exercised "proper business judgment" in formulating its KERP, which is not a difficult test to pass. In *In re Georgetown Steel Company, LLC*, the court noted, "It has been recognized that courts should approve the exercise of a debtor's business judgment unless it is so

manifestly unreasonable that it could not be based upon sound business judgment, but only on bad faith, or whim or caprice."³

In some cases, courts also will consider whether a proposed KERP is "fair and reasonable."⁴ As with the proper business judgment test, there is a presumption in the debtor's favor that a KERP is fair and reasonable. Given the presumptions in favor of proposed KERPs, it is no surprise that they are generally approved by bankruptcy courts.

Little Scrutiny

Who pays for KERPs? First, lower-level and other "non-key" employees do. In many cases, employees lose severance pay, pensions, and other benefits before or soon after a KERP is approved because funding for the retention plan takes precedence. Second, a debtor's creditors and shareholders also foot the bill for KERPs. To the extent that these retention plans do not add value to an estate, they are funded by creditors and/or shareholders whose recoveries upon reorganization or liquidation

are minimized or eliminated after a KERP is approved.

If KERPs were shown to add value by keeping companies afloat or maximizing liquidation values for creditors and shareholders, proponents would have a stronger argument for preserving the status quo. However, these things are impossible to demonstrate when, as in many cases, the KERP proposals receive little or no scrutiny while at the same time rewarding huge numbers of employees.⁵ An examination of two recent KERP approvals demonstrates their potential hazards.

Kmart Corporation. The Kmart Corporation bankruptcy shows how costly KERPs and “stay put” bonuses can be, and how their approval can leave the public with the impression that bankruptcy primarily benefits the very same executives responsible for a debtor’s financial misfortune.

Like other mega-bankruptcy cases of the past several years, Kmart’s filing was accompanied by accusations of fraud and mismanagement. By 2002, there were three government investigations into millions of dollars of loans and bonuses given to some of the company’s top executives during its financial downturn. In addition, Kmart was investigated by the Securities and Exchange Commission and the U.S. Attorney’s office for accounting fraud. In 2004, it publicly conceded employee misconduct and restated financial statements for 2001.

Kmart submitted its KERP application on January 22, 2002, the same day that it filed for Chapter 11 protection. While Kmart’s KERP benefited an astounding 9,000-plus employees, its most lavish benefits went to top management. For its CEO, executive vice presidents, and senior vice presidents — 46 individuals in all — the company proposed bonuses of up to \$17 million⁶ as part of the KERP.

More startling, perhaps, was the fact that the court approved an *additional* agreement naming James Adamson as CEO of Kmart. Between this agreement and the Kmart KERP, Adamson received a \$2.5 million “inducement payment;” an annual salary of \$1.5 million; weekly private plane service between his residences in Detroit, New York, and Florida; and a car and driver in Michigan and New York.⁷

Adamson received these payments despite the fact that he served on Kmart’s board of directors when it approved the multimillion-dollar loans and bonuses that became the subject of government investigations. He also headed the board’s audit committee in 2000 and 2001, the period of time for which Kmart came under investigation for accounting irregularities.

Apart from the fact that such payments appeared unseemly at a time when Kmart had laid off 22,000 employees, this money was apparently not well spent. Within a year, Adamson was fired. When Kmart finally came

out of bankruptcy in May 2003, creditors received stock worth a fraction of what they were owed, and holders of Kmart stock received nothing.

Network Access Solutions Corporation. The potential for KERP abuse is not limited to mega-bankruptcies. Network Access Solutions Corporation, an Internet service provider, filed for Chapter 11 on June 4, 2002. Less than a month later, the company filed a KERP motion to pay retention bonuses of \$300,000 to its CEO and \$250,000 to the COO.⁸ The two were brothers. The company argued that it could not afford to lose these two employees. Although the Internet bubble had long since burst and demand for officers of Internet service providers was close to nonexistent, the bankruptcy court granted the request over creditor objections.⁹

Less than six months later, “Network Access sold most of its assets for \$14 million, a fraction of [its] development costs.”¹⁰ As in Kmart, significant debts to creditors were left unpaid, and shareholders of Network Access received nothing. However, the CEO and COO, both of whom presided over the company’s demise, walked away with more than \$500,000 in bonus payments between them for little more than half a year’s work.

Suggested Reform

Outside the bankruptcy context, decisions about employee pay and bonuses are determined by the market. KERPs are not subject to these same market forces. They tend to be heavily top-weighted because they usually are proposed by the same people who benefit from them. These people are at a tremendous informational advantage over all who might challenge their proposals, particularly in the first days and weeks after a bankruptcy filing.

KERP proponents are not required to share this information with bankruptcy courts or creditors before making their applications. There is no need to show that the beneficiaries of the proposed KERPs are *essential* to a reorganization or maximization of value upon liquidation. Nor is there any need to show that there is a significant possibility that the beneficiaries will leave without this additional payment.

Unfortunately, courts are not required to scrutinize carefully whether KERPs will actually benefit an estate or whether they will simply give larger benefits to individuals who caused a company’s slide into bankruptcy in the first place.

As it stands now, the law only requires courts to decide whether a debtor, as proponent of a KERP, exercised proper business judgment and in some cases whether a plan is fair and reasonable. In both instances, there is a legal presumption in favor of KERP approval.

In some cases, circumstances are such that employee retention packages can add value to a bankrupt estate. Unfortunately, courts are not required to scrutinize carefully whether KERPs will actually benefit an estate or whether they will simply give larger benefits to individuals who caused a company's slide into bankruptcy in the first place.

There are many ways to strengthen the level of scrutiny given to KERPs. One is to mandate a test similar to that proposed in the failed Employee Abuse Prevention Act of 2002, which would have required bankruptcy courts to examine whether the beneficiaries of a KERP are essential to a reorganization or liquidation and whether there is a substantial likelihood that the proposed beneficiaries would leave the company if they were not offered substantial incentives to stay. Another is to delay KERP approvals until after creditors' committees are formed and have had an adequate opportunity to review the plan and the value of key employees.

Most importantly, the system should be reevaluated to ensure that KERPs are granted, only to the extent they are necessary to preserve and augment the value of an estate.

⁵ For instance, Enron's stay-put bonuses benefited 1,285 employees, while Kmart's benefited a whopping 9,705. Herriot at 617.

⁶ Order Under 11 U.S.C. Sections 105(a), 363(b)(1), and 365(a) Authorizing Debtors to Implement the Key Employee Retention Plan With Respect to Tiers I through III, *In re Kmart Corp.*, Case No. 02-B-02474 (Bankr. N.D.I.L. April 23, 2002.)

⁷ Nelson D. Schwartz, "Greed-mart. Attention, Kmart investors. The company may be bankrupt, but its top brass have been raking it in," *Fortune*, October 14, 2002, p. 139.

⁸ Motion For Order Pursuant To Sections 105(a), 363(b), and 503(b)(1) of the Bankruptcy Code, authorizing and approving employee retention and severance program, *In re Network Access Solutions Corp.*, 02-B-11611(July 3, 2002).

⁹ Order Pursuant to 11 USC Sections 105(a), 363(b)(1) And 503(b)(1), authorizing and approving modified employee retention and severance program, *In re Network Access Solutions Corp.*, 02-B-11611(July 3, 2002).

¹⁰ Matt Miller, "When failure pays," *The Daily Deal*, February 27, 2003.

¹ See, e.g., Allison K. Verderber Herriot, "Toward an Understanding of the Dialectical Tensions Inherent in CEO and Key Employee Retention Plans," 98 Nw. U.L.Rev 579, 617 (Winter, 2004) (discussing multimillion-dollar KERPs in the Enron, Kmart, WorldCom, and Global Crossing bankruptcies).

² S.2798, 107th Cong. (2002); H.R. 5221, 107th Cong. (2002); H.R. 5525, 107th Cong. (2002); s. 2901, 107th Cong. (2002); S. 2820, 107th Cong. (2002).

³ *In re Georgetown Steel Company, LLC*, 306 B.R. 549, 555 (Bankr. D.S.C. 2004) (citations omitted).

⁴ See, e.g., *In re A. Mechelle Dicerson*, "Approving Employee Retention and Severance Programs: Judicial Decisions Run Amuck?" 11 Am. Bankr. Inst. L. Rev. 93 (Spring 2003) (discussing the fair and reasonable test).

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