Cullen | Dykman

Corporate Executives & Bonuses on the Eve of Bankruptcy: Merely an Affront or a Fraud?

November 30, 2021

Michael H. Traison
Chicago/NYC – 312.860.4230

Bozena M. Diaz
NYC – 212.510.2227

Amanda A. Tersigni
Garden City – 516.357.3738

Since the beginning of the COVID-19 pandemic and in 2020 alone, approximately 7,300 companies filed for Chapter 11 bankruptcy.[1] Of those, forty-two awarded pre-bankruptcy retention bonuses to 223 executives, totaling approximately $165 million.[2] These pre-bankruptcy bonuses were awarded to executives anywhere from five months to two days before the filing. Virtually none of the bonuses paid were approved by a court.[3]

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 also they significantly concern corporate creditors who, as a result thereof, are often subsequently effectively forced to accept less than full payment on pre-petition debts owed to them.

To be clear, 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, I*n 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.

Lately, it has become standard practice for many corporations to pay executive bonuses within 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 remain on board and help reorganize the company.

Questionable executive bonuses are not novel. Prior to the 2005 amendments to the Bankruptcy Code (the "Code"), corporations issued bonuses to certain senior management executives to retain those whose services were believed to be necessary and essential 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 use its discretion to determine whether these "pay-to-stay" bonuses were appropriate and of "sound business judgment."

Nowadays, before approving KERP payment, the bankruptcy courts consider several factors the debtor must satisfy under more restrictive confines of Code Section 503(c).[4] 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.[5]

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 (10) 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 twenty-five percent (25%) 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" granted shortly before the company files for bankruptcy should be analyzed under a framework similar to Section 503(c) of the Code. Otherwise, are corporations facing an inevitable financial decline benefitting from an end run around Section 503(c) and arguably making fraudulent transfers pre-petition?[6]

Indeed, 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) and include a provision that restricts corporations from freely handing out bonuses pre-bankruptcy. As per GAO's recommendation, the amendment should "clearly subject bonuses debtors pay executives shortly before a bankruptcy filing to the bankruptcy court oversight and specify factors courts should consider in order to approve such bonuses." Click here to see the GAO's Report to Congressional Committees submitted in September 2021.

In mid-October, the "No Bonuses in Bankruptcy Act of 2021" (the "Act")[7] 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 prevent the bankrupt company from giving bonuses to employees earning $250,000 or more and would allow the trustee to claw back certain bonuses made within the six-month period before a corporate debtor files for Chapter 11 if the bonus would not have been allowed under Sections 503(c) or (d) of the Code.

Click here to see the current version of this bill as of October 12, 2021.

It is important for corporate clients to be aware of potential changes to the Code that would prevent the payment of pre-bankruptcy executive bonuses and to generally understand that any such payments made on the eve of bankruptcy are not viewed in favorable light. It is equally important for corporate creditors to be more fully aware of the issues that pre-bankruptcy bonuses create for them, and to consider speaking with counsel about whether any actions can be taken to challenge and/or recover any such payments or whether the bankruptcy law has evolved in a manner to prevent such payments from being made in the first place. For more information, please contact your Cullen & Dykman attorney or one of the authors listed below.

Please note that this alert is a general overview of developments in the law and does not constitute legal advice. If you have questions regarding these provisions, or any other aspect of bankruptcy law, please contact Michael H. Traison at 312.860.4230, Bozena M. Diaz at 212.510.2227 or Amanda A. Tersigni at 516.357.3738.

Footnotes

[1] U.S. Gov't Accountability Off., GAO-21-104617, "Bankruptcy: Enhanced Authority Could Strengthen Oversight of Executive Bonuses Awarded before a Bankruptcy Filing" (2021), https://www.gao.gov/assets/gao-21-104617.pdf?bcs-agent-scanner=9fa775d5-8c97-2a4b-b032-d4bc671b016b.

[2] *Id.*

[3] *See id.*

[4] "Attempts 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." *In re Borders Grp., Inc.*, 453 B.R. 459, 470 (Bankr. S.D.N.Y. 2011). Courts may scrutinize certain payment schemes set up by the debtor corporation which do not look like a retention bonus on its 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).

[5] *In re Borders Grp., Inc.*, 453 B.R. at 470.

[6] As discussed by the GAO, these pre-bankruptcy retention bonuses could be subjected to section 548 of the Code, which addresses fraudulent conveyances. This tool can be employed by creditors' committees as an attempt to recover pre-bankruptcy bonuses. *See supra* note 1, pp. 13, 16. However, the strength of such argument is unclear at this point. Is there any sense of value to pre-bankruptcy bonuses that the debtor can demonstrate? Or are these bonuses simply transfers to defraud creditors? Cullen & Dykman previously wrote an alert about a case in Delaware where the bankruptcy judge ruled that discretionary bonuses given by an insolvent employer were not *per se* fraudulent transfers because of the potential "value" to the employer when awarding such bonuses: When is a Bonus a Fraud? - Cullen and Dykman LLP (cullenllp.com).

[7] H.R. 5554, 117th Cong. (1st Session 2021), https://www.congress.gov/bill/117th-congress/house-bill/5554.

Practices

- Bankruptcy and Creditors' Rights
- Corporate
- Tax

Industries

- Business Reorganization and Financial Restructuring

Attorneys

- Michael H. Traison
- Bozena M. Diaz