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Report to Congressional Committees

September 2021

BANKRUPTCY

Enhanced Authority Could Strengthen Oversight of Executive Bonuses Awarded before a Bankruptcy Filing

GAO@100

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GAO-21-104617

GAO@100 Highlights

Highlights of GAO-21-104617, a report to congressional committees

September 2021

BANKRUPTCY

Enhanced Authority Could Strengthen Oversight of Executive Bonuses Awarded before a Bankruptcy Filing

Why GAO Did This Study

In response to potential abuses involving executive bonuses, Congress amended the Code in 2005 to restrict debtors in Chapter 11 from paying executives retention bonuses for staying through bankruptcy and, to a lesser extent, incentive bonuses to achieve performance targets. Recently, some large companies have paid their executives considerable bonuses during bankruptcy. House Report 116-455 included a provision for GAO to review Code provisions on bonuses and a selected number and amount of court-requested and approved bonuses in fiscal year 2020.

This report reviews (1) Bankruptcy Code provisions on employee bonuses, (2) selected stakeholder views on such provisions, and (3) employee bonuses awarded by companies before or after filing for bankruptcy in fiscal year 2020. GAO reviewed the Code, academic literature, and legal analyses; interviewed 12 academics, attorneys, and an organization selected for their bankruptcy expertise; and analyzed bankruptcy filings and related data using Westlaw Edge and other sources.

What GAO Recommends

Congress should consider amending the Bankruptcy Code to clearly subject bonuses debtors pay executives shortly before a bankruptcy filing to bankruptcy court oversight and to specify factors courts should consider to approve such bonuses.

View GAO-21-104617. For more information, contact Michael E. Clements at (202) 512-8678 or clementsm@gao.gov

What GAO Found

Chapter 11 bankruptcy allows a company (debtor) to restructure its debt—so that it may continue to operate—and generally retain its executives. Section 503(c) of the Bankruptcy Code (Code) restricts retention bonuses for executives and, to a lesser extent, executive and non-executive incentive bonuses during bankruptcy. For instance, to pay an executive a retention bonus, the Code requires the debtor to meet three requirements, including that the executive has another job offer at the same or greater compensation. Also, debtors must obtain court approval to pay employee bonuses during bankruptcy—a process that gives creditors an opportunity to raise objections. However, the Code generally does not govern executive retention bonuses paid before a bankruptcy filing (pre-bankruptcy bonuses).

Academics and attorneys GAO interviewed largely viewed Section 503(c) as less-than-effective because debtors can work around its restrictions on executive retention bonuses both before and during bankruptcy. For example, debtors can pay retention bonuses before filing (when there are generally no restrictions), or they can pay incentive bonuses during bankruptcy (that have fewer restrictions). Some stakeholders viewed Section 503(c) as overly restrictive, but others viewed it as helping to prevent abusive bonuses. Nearly all stakeholders GAO interviewed viewed pre-bankruptcy bonuses as problematic. For example, they said that these bonuses reduce the debtor estate's value for creditors but are awarded without notice to creditors or court approval.

Based on court dockets for the approximately 7,300 companies that filed for Chapter 11 bankruptcy in fiscal year 2020, GAO found the following:

- Less than 1 percent (70) of debtors requested court approval to pay employee bonuses, and the courts approved nearly all the requests.
- Debtors awarded around $571 million to more than 16,600 executive and non-executive employees through court-approved bonuses.
- Creditors or U.S. Trustees (who administer and monitor Chapter 11 cases) raised objections in 50 percent of all bonus requests, including 68 percent of executive incentive bonus requests, which frequently led debtors to modify their plans (for example, by lowering bonus amounts).
- None of the debtors requested court approval for executive retention bonuses during bankruptcy; 42 debtors awarded pre-bankruptcy retention bonuses—totaling about $165 million—from 5 months to 2 days before filing.

According to some attorneys GAO interviewed, Section 503(c) makes it nearly impossible to award executives retention bonuses during bankruptcy, so debtors use pre-bankruptcy bonuses as a workaround. As noted above, GAO found that none of the 7,300 Chapter 11 debtors that filed in fiscal year 2020 requested executive retention bonuses during bankruptcy but 42 awarded such bonuses shortly before filing. This practice may undermine Section 503(c)'s restrictions and decrease the ability of creditors, U.S. Trustees, and the courts to prevent bonuses that are inconsistent with the section's requirements.

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Figures

Abbreviations

Code	U.S. Bankruptcy Code
SEC	Securities and Exchange Commission

441 G St. N.W.
Washington, DC 20548

September 30, 2021

The Honorable Jeanne Shaheen
Chair
The Honorable Jerry Moran
Ranking Member
Subcommittee on Commerce, Justice, Science, and Related Agencies
Committee on Appropriations
United States Senate

The Honorable Matt Cartwright
Chairman
The Honorable Robert B. Aderholt
Ranking Member
Subcommittee on Commerce, Justice, Science, and Related Agencies
Committee on Appropriations
House of Representatives

In response to potential abuses involving bonuses for executives of large companies during bankruptcy, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 to restrict such bonuses.[1] However, some academics and bankruptcy attorneys have questioned whether some companies that file for Chapter 11 bankruptcy may be working around the U.S. Bankruptcy Code's (Code) restrictions on bonuses, such as by awarding retention bonuses to executives shortly before filing for bankruptcy.

Chapter 11 of the Code allows a company (debtor) to restructure its debts—so that it may continue to operate—and generally retain its executives to assist with the restructuring. In some cases, Chapter 11 debtors may seek to pay certain employees retention or incentive bonuses to help preserve the debtor's business or increase the value of the debtor's estate.[2]

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[1]Pub. L. No. 109-8, § 331, 119 Stat. 23, 102-03 (2005) (codified at 11 U.S.C. § 503(c)). The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 amended the Bankruptcy Code.

[2]A retention bonus generally involves a payment to an employee who stays with the company for a defined period of time. An incentive bonus generally is designed to motivate employees to achieve financial or other performance targets.

House Report 116-455 included a provision for us to review the Code's provisions that allow the payment of employee bonuses in Chapter 11 bankruptcy and the incidence and magnitude of such bonuses in fiscal year 2020.[3] This report reviews (1) the extent to which the Code governs the award of employee bonuses by Chapter 11 debtors, (2) selected stakeholder views on the effectiveness of the Code's provisions on employee bonuses and proposed changes to the Code, and (3) the extent to which companies that filed for Chapter 11 bankruptcy in fiscal year 2020 paid or requested court approval to pay bonuses to their executive (insider) and non-executive (non-insider) employees.[4]

For the first objective, we reviewed the relevant Code provisions and legislative history. We also analyzed court cases and digests of court decisions interpreting the Code's restrictions on employee bonuses. We reviewed relevant legal analyses, research, and related materials on Chapter 11 bankruptcies and employee bonuses that we identified through internet searches. We interviewed officials from the U.S. Trustee Program and the Securities and Exchange Commission (SEC).[5]

For the second objective, we interviewed a non-random, non-generalizable selected sample of 11 law professors and bankruptcy attorneys, including members of the American Bar Association's Business Bankruptcy Committee, and the National Bankruptcy Conference (which

[3]H.R. Rep. No. 116-455 (2020) (accompanying H.R. 7667, 116th Cong. (2020)).

[4]Section 503(c) of the Code restricts certain types of bonus payments to "insiders." 11 U.S.C. § 503(c). For a debtor that is a corporation, the Code's definition of an insider includes any director, officer, or person in control of the entity. 11 U.S.C. § 101(31)(B)(i)–(iii). We use "executive employees" to refer to insiders and "non-executive employees" to refer to non-insiders.

[5]The U.S. Trustee Program is a litigating component of the Department of Justice whose mission is to promote the integrity and efficiency of the bankruptcy system for the benefit of debtors, creditors, and the public. According to officials from the U.S. Trustee Program, U.S. Trustees have standing to participate in every individual and business bankruptcy case in the 88 federal judicial districts under their jurisdiction. Under the Code, SEC is a party in interest in Chapter 11 cases and takes legal positions on matters impacting public investors.

advises Congress on bankruptcy issues).[6] We selected the individuals for their knowledge about or experience with the Code's provisions applicable to employee bonuses or based on referrals. We reviewed their biographies and publications to consider their potential biases. We generally used a semi-structured question set for our interviews. We reviewed legal analyses that included criticisms of and proposals to amend the Code's provisions applicable to executive bonuses. We identified such information through internet searches and referrals. We also interviewed staff and reviewed written materials from the U.S. Trustee Program about objections U.S. Trustees have raised about employee bonuses requested by Chapter 11 debtors.

For the third objective, we used Westlaw Edge's dockets database and key word searches to identify debtors that requested court approval to pay employee bonuses in Chapter 11 cases filed in fiscal year 2020.[7] We supplemented such searches with information from the U.S. Trustee Program, SEC's Electronic Data Gathering, Analysis, and Retrieval database, and media articles to identify potentially missing cases. For each debtor, we electronically searched its court docket using key terms to identify filings related to employee bonuses. We then reviewed the filings and recorded and analyzed the relevant information. We also used the court filings and SEC reports to identify bonuses that companies paid before filing for bankruptcy.[8] To assess the completeness of Westlaw's

[6]The Business Bankruptcy Committee of the American Bar Association provides resources for legal professionals dealing with business issues, including educational programming and involvement in developing and reviewing proposed bankruptcy legislation and rules. The views of the committee members with whom we spoke do not represent the views of the American Bar Association. The National Bankruptcy Conference is a non-profit, non-partisan, self-supporting organization of approximately 60 attorneys, law professors, and bankruptcy judges who are leading scholars and practitioners. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws. Appendix II contains a letter from the National Bankruptcy Conference responding to questions we posed on bonuses in Chapter 11 bankruptcy.

[7]Although certain severance payments may be considered bonuses, we excluded them from the scope of our review.

[8]House Report 116-455 also directed us to identify selected debtors under Chapter 11 during fiscal year 2020 that requested or were granted permission to pay bonuses to employees. We scoped our review to identify debtors that filed for Chapter 11 bankruptcy in fiscal year 2020 and awarded their executives retention bonuses within 9 months of filing for bankruptcy. Because of disclosure and data limitations, our review may not have necessarily identified all companies that filed for Chapter 11 in fiscal year 2020 and that awarded their executives pre-bankruptcy bonuses within 9 months of filing for bankruptcy.

and SEC's databases, we reviewed relevant documentation, interviewed knowledgeable officials, and manually tested for missing information. We determined the two databases were sufficiently reliable for identifying Chapter 11 debtors that requested court approval for employee bonuses. Appendix I contains a detailed description of our objectives, scope, and methodology.

We conducted this performance audit from October 2020 to September 2021 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Chapter 11 Bankruptcy Overview

Chapter 11 of the Code is used to reorganize a business, which generally includes corporations, sole proprietorships, and partnerships.[9] One of its purposes is "to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders."[10] Upon filing for Chapter 11 bankruptcy, judgments and other activities are suspended and may not be pursued by creditors against the debtor.[11] Chapter 11 generally allows a debtor, subject to court approval, to assume or reject any executory contracts to which it is a party.[12]

[9]Individuals also may file for Chapter 11 bankruptcy. In a Chapter 11 case, a debtor may file a liquidating plan, which often allows the debtor to liquidate the business under more economically advantageous circumstances than a Chapter 7 liquidation.

[10]H.R. Rep. No. 95-595, at 220 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6179.

[11]11 U.S.C. § 362(a).

[12]11 U.S.C. § 365(a). Executory contracts are those where performance obligations remain for both parties and failure to perform would be deemed a breach.

The debtor initially has the exclusive right to file a reorganization plan.[13] Chapter 11 sets the rules under which creditors negotiate with the debtor and vote on the plan. Confirmation of a plan generally discharges a debtor from any debt that arose before the date of confirmation.[14] The confirmed plan creates new contractual rights, generally replacing or superseding pre-bankruptcy contracts.

Under Chapter 11 and upon filing, the debtor usually remains "in possession," has the powers and duties of a trustee, may continue to operate its business, and may, with court approval, borrow certain new money.[15] Debtors in possession have the right, with the court's approval, to employ attorneys, accountants, appraisers, auctioneers, or other professionals to assist the debtor during its bankruptcy case. Debtors in possession remain in place until the reorganization plan is confirmed, the debtor's case is dismissed, or converted to liquidation under Chapter 7, or a Chapter 11 trustee is appointed.[16]

[13]11 U.S.C. § 1121(b). This exclusivity period generally lasts for 120 days but may be extended or reduced by the court for cause. 11 U.S.C. § 1121(d). The debtor has 180 days after the petition date or entry of the order for relief to obtain acceptances of its plan. 11 U.S.C. § 1121(c)(3). The court may extend or reduce this acceptance exclusive period for cause. 11 U.S.C. § 1121(d). If the exclusive period expires before the debtor has filed and obtained acceptance of a plan, other parties in interest in a case, such as the creditors' committee or a creditor, may file a plan. 11 U.S.C. § 1121(c).

[14]11 U.S.C. § 1141(d).

[15]"Debtor in possession" generally refers to the incumbent board of directors and executives that keep possession and control of the business while undergoing reorganization. According to a bankruptcy expert, the ability of the debtor to retain control over the reorganization makes bankruptcy a far more attractive option than otherwise would be the case. The expert noted that under bankruptcy law before 1978, management typically was replaced with a case trustee. According to the expert, a large number of companies would not file for business reorganization under the prior law because they would lose possession of their business. See, for example, David Skeel, *Debt's Dominion: A History of Bankruptcy Law in America* (Princeton, N.J., Princeton University Press (2001)).

[16]A party in interest or the U.S. Trustee can request the appointment of a case trustee at any time prior to confirmation of a plan in a Chapter 11 case. Moreover, the U.S. Trustee is required to move for appointment of a trustee if there are reasonable grounds to believe that any of the parties in control of the debtor participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting. 11 U.S.C. § 1104(e).

A Chapter 11 reorganization plan must designate classes of claims and interests for treatment under the reorganization.[17] A plan classifies claims holders according to their payment priority, which can be generally categorized in the following order: secured creditors, administrative expenses and unsecured creditors entitled to priority, general unsecured creditors, and equity security holders.[18] Specifically:

- A secured claim is guaranteed by collateral or a lien on property or assets belonging to the debtor. Because secured claims are guaranteed against the value of collateral or lien, secured creditors will receive payment in association with the value of their collateral or lien.
- Administrative expenses generally include post-petition expenses needed to preserve the bankruptcy estate, such as legal and other professional fees and operating expenses of the debtor's business. Bankruptcy courts can treat debtor-in-possession financing as an administrative expense. When a debtor needs funds to continue to operate, it may obtain such financing from a lender and give the lender a court-approved "superpriority" over other unsecured creditors or a lien on property of the estate.[19]
- Unsecured priority claims are not secured by collateral or a lien but given statutory priority over other types of unsecured claims. Unsecured creditors will receive recovery from the debtor's bankruptcy estate after distributions are made to secured creditors but are not guaranteed payment. An unsecured priority claim is debt that is entitled to special treatment in the bankruptcy process and will be paid ahead of non-priority claims.[20]
- General unsecured claims are debts that are not guaranteed by any collateral or lien on the debtor's bankruptcy estate and are not given special priority. Creditors who hold general unsecured claims are

[17]11 U.S.C. § 1123(a)(1). Alternatively, the debtor may file a Chapter 11 liquidation plan instead of a reorganization plan.

[18]The Code establishes a detailed, specific order of priorities for claims and expenses. 11 U.S.C. § 507. We have grouped these claims and expenses into broad categories for ease of discussion.

[19]After administrative expenses and priority claims are paid in full, remaining funds are made available to pay claims of general unsecured creditors.

[20]Examples of priority claims could include certain employee compensation owed, unpaid contributions to employee benefits plans, unsecured tax obligations owed to the government, and pending personal injury or workplace injury or death claims.

classified as non-priority claims. Appointed by U.S. Trustees (discussed below), the creditors' committee represents the interests of the entire class of unsecured creditors and serves to maximize its recovery under a reorganization plan. The committee may consult with the debtor in possession on administration of the case, investigate the debtor's conduct and operation of the business, and participate in formulating the reorganization plan.[21]

- Equity security holders (such as shareholders in a corporation) have the lowest priority and are the last to be paid, after all other debts are paid.

Federal Bankruptcy Courts and Oversight of Chapter 11 Cases

Congress has granted federal courts broad original and exclusive jurisdiction over bankruptcy cases, and the U.S. Trustee Program and SEC have varying levels of responsibility for oversight of Chapter 11 bankruptcy cases.

- Congress has granted federal courts broad original and exclusive jurisdiction over bankruptcy cases. Bankruptcy judges serve as judicial officers of the U.S. district courts and constitute the bankruptcy court for their respective districts. A bankruptcy judge may exercise authority with respect to any bankruptcy action, suit, or proceeding in their respective district. The U.S. court of appeals for each circuit appoints bankruptcy judges to renewable 14-year terms.
- The United States Trustee Program is a litigating component of the Department of Justice whose mission is to promote the integrity and efficiency of the bankruptcy system for the benefit of all stakeholders—debtors, creditors, and the public. According to officials from the U.S. Trustee Program, U.S. Trustees have standing to participate in every individual and business bankruptcy case in the 88 federal judicial districts under their jurisdiction.[22] Program officials told us the program carries out a broad range of enforcement, regulatory, and administrative activities, including employing an array of civil enforcement tools to detect and address fraud and abuse, referring suspected crimes to U.S. Attorneys, appointing and supervising

[21]If remaining funds are insufficient to fully satisfy the claims of a creditor class, the creditors are paid on a pro-rata basis. Creditors will receive payment from remaining funds, based on the size of their claims relative to the amount of total claims for the class. If no funds remain, as may be the case for general unsecured creditors, they may receive nothing.

[22]The U.S. Trustee Program has jurisdiction in all judicial districts except those in Alabama and North Carolina. In those six districts, bankruptcy court officials called Bankruptcy Administrators perform a similar function.

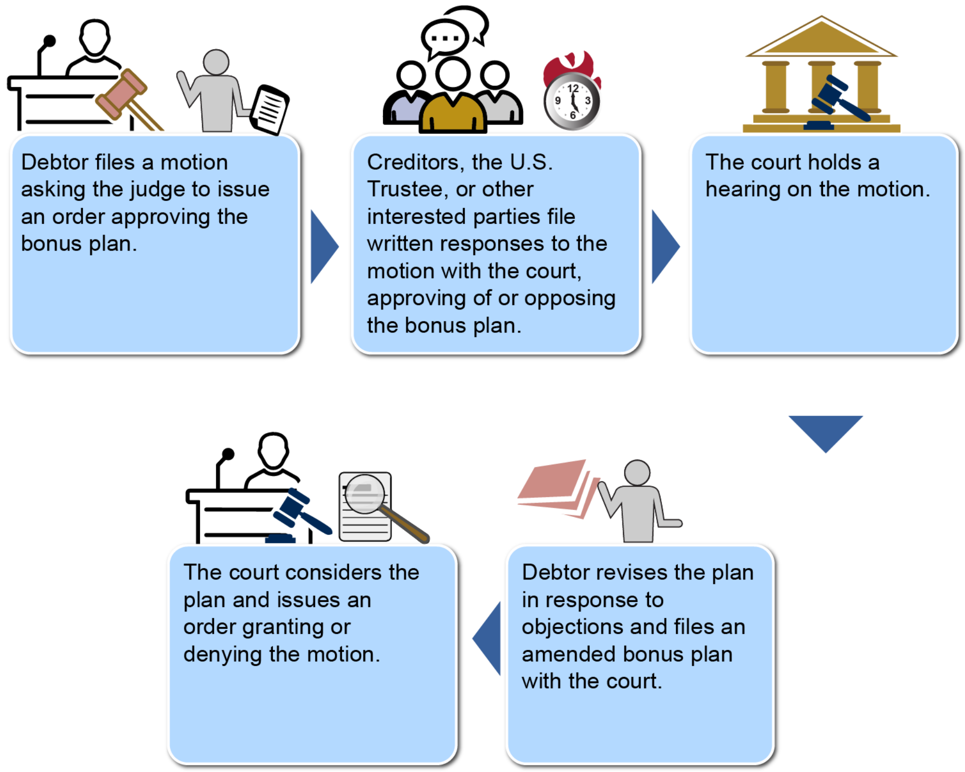
private trustees who administer bankruptcy cases, and identifying and raising issues for review on appeal to ensure consistent application of bankruptcy laws nationally. According to officials, in Chapter 11 cases, U.S. Trustees ensure that bankruptcy estates are administered promptly and efficiently and that professional fees are reasonable; appoint and convene creditors' committees; and review disclosure statements and applications for the retention of professionals.

- Under the Code, SEC is a party in interest in Chapter 11 cases. According to SEC officials, SEC takes legal positions on matters impacting public investors, such as the issuance of securities under Chapter 11 plans, formation of official equity committees, excessive compensation, and professional conflicts of interests.

Notice and Hearing Process for Court Approval of Employee Bonuses

Chapter 11 debtors must file motions to request court approval to pay their employees retention or incentive bonuses during bankruptcy. As shown in figure 1, these requests are subject to a notice and hearing process, which provides creditors and other parties the opportunity to object to the requests, and court approval.

Figure 1: Example of Debtor's Process for Requesting an Employee Bonus Plan in a Chapter 11 Bankruptcy



Source: GAO analysis of the Federal Rules of Bankruptcy Procedure and debtors' bankruptcy filings. | GAO-21-104617

According to several journal and legal articles, before the Code was amended in 2005, Chapter 11 debtors often filed motions to request court approval to pay their executives retention bonuses during bankruptcy.[23] Such articles stated that before 2005 the court approved a bonus request if it found the debtor used proper business judgment in formulating the bonus and the bonus was fair and reasonable.[24] According to the journal

[23]See, for example, Jared A. Ellias, "Regulating Bankruptcy Bonuses," *Southern California Law Review*, vol. 92, p. 653-701 (March 2019); Henry P. Baer, Jr. and Tony Miodonka, "Executive Compensation in Bankruptcy," *Practical Law* Practice Note 2-545-4565 (2013); and John J. Rapisardi, "Delaware Guides Debtor Firms Creating Comp Plans," *New York Law Journal* 238, no. 51 (Sept. 12, 2007).

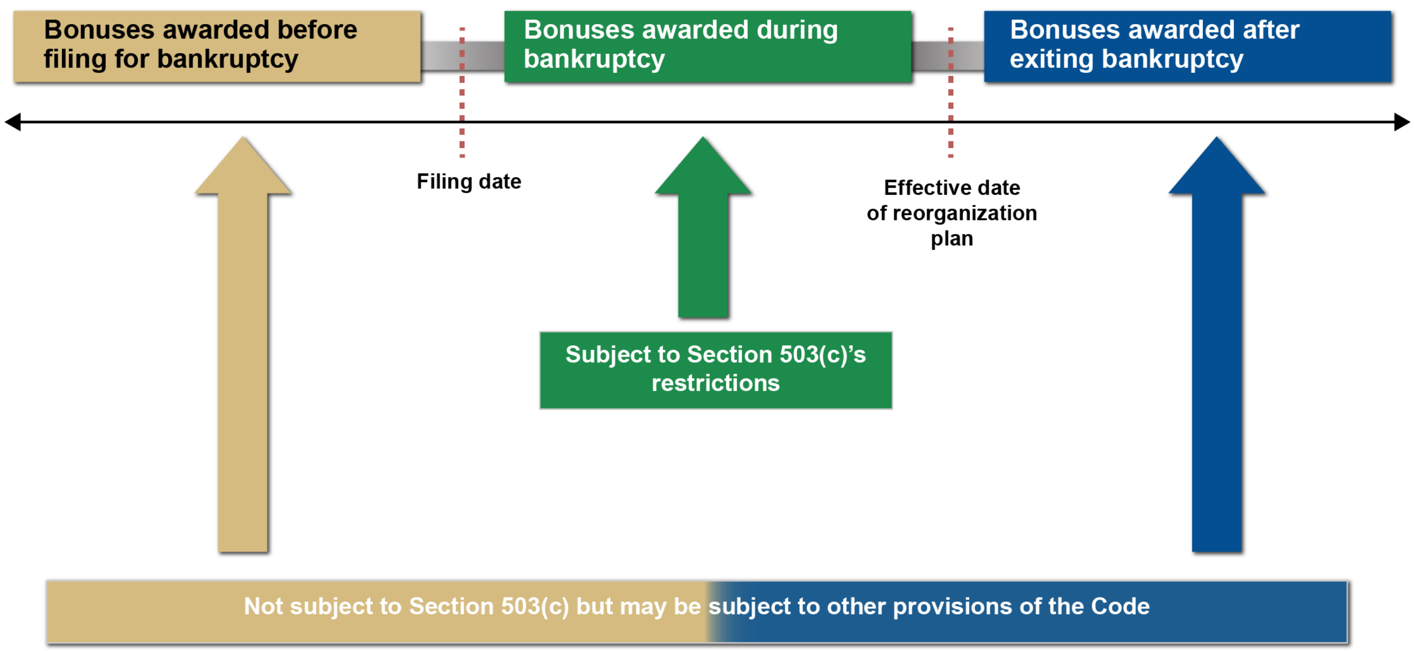
[24]See 11 USC § 363(b). Under the business judgement standard of Section 363(b), courts generally determine whether executive retention bonuses are fair and reasonable, and that the debtor's business decision was not so manifestly unreasonable that it could not be based on sound business judgement but only on bad faith.

and other legal articles, the bankruptcy courts generally applied the business judgment standard to create a presumption in favor of retention bonuses and generally resulted in the courts approving bonus requests unless they were found to be based on bad faith, whim, or caprice.

Extent to Which the Code Governs Employee Bonuses Largely Depends on Timing

The extent to which the Code governs employee bonuses in Chapter 11 bankruptcy largely depends on when the company implements them (see fig. 2). Companies may implement executive (insider) or non-executive (non-insider) employee bonuses before filing for bankruptcy, during bankruptcy, or after emerging from bankruptcy. Section 503(c) imposes restrictions on bonuses implemented during bankruptcy but not on bonuses implemented before filing or after emergence.[25] However, bonuses implemented before or after bankruptcy may be subject to other provisions of the Code that enable creditors or other stakeholders to recover or object to bonuses under limited circumstances.

Figure 2: Bankruptcy Code Provisions Governing Bonuses in Chapter 11



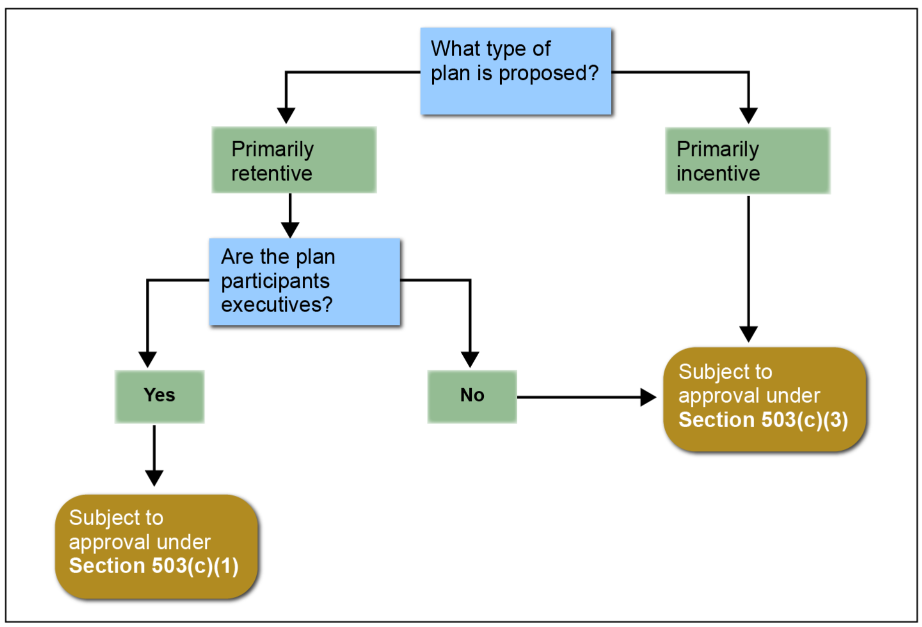
Source: GAO analysis of the Bankruptcy Code. | GAO-21-104617

[25]According to U.S. Trustee Program officials, debtors may hide employee bonuses awarded during bankruptcy in court filings, such as motions to sell assets, motions to pay employee wages, monthly operating reports, or plans of reorganization. Officials told us that these bonuses may be subject to Section 503(c) but may receive less scrutiny.

Section 503(c) of the Code Restricts Retention Bonuses and, to a Lesser Extent, Incentive Bonuses during Bankruptcy

Section 503(c) makes it more difficult for Chapter 11 debtors to obtain court approval to pay retention bonuses to executive employees during bankruptcy and, to a lesser degree, incentive bonuses to executive and non-executive employees.[26] As shown in figure 3, when reviewing a debtor's proposed incentive plan under Section 503(c), bankruptcy courts generally will determine whether the plan is primarily retentive and, if so, whether the plan covers executives. Plans that are primarily retentive and cover executives are subject to the restrictions of Section 503(c)(1), while incentive plans for executives or non-executives (as well as retention plans for non-executives) are evaluated under Section 503(c)(3).

Figure 3: Applicability of Section 503(c) of the Bankruptcy Code to a Debtor's Request for Court Approval of a Retention or Incentive Plan during Bankruptcy



Source: GAO analysis of the Bankruptcy Code and a Practical Law Practice Note. | GAO-21-104617

Note: We use "executives" to refer to insiders. Section 503(c)(1) of the Bankruptcy Code restricts certain types of bonus payments to insiders, which include directors, officers, or persons in control of the entity.

[26]Section 503(c) also includes provisions that govern other types of bonuses during a Chapter 11 bankruptcy, which include severance payments. We excluded severance payments from the scope of our review. Section 503(c) limits severance payments to executives under a program that is generally applicable to all full-time employees and sets a numerical cap based on severance pay given to non-management employees.

Section 503(c)(1) imposes several restrictions on retention plans covering executives (but not non-executives). Under the section, a debtor may not pay an executive a retention bonus to remain with the debtor unless

- the executive has a bona fide job offer from another business at the same or greater compensation;
- the executive's services are essential to the survival of the business; and
- the retention bonus is (1) not greater than 10 times the amount of the average bonus payments given to non-management employees during the same year or, if no such bonuses were given, (2) not greater than 25 percent of the amount of any similar payment made to the executive during the prior year.[27]

Section 503(c)(3) governs most other types of bonuses, including incentive bonuses, and imposes less specific restrictions on such bonuses. Section 503(c)(3) is a "catchall" provision that prohibits payments of bonuses that are made "outside the ordinary course of business and not justified by the facts and circumstances of the case."

In light of the Code's restrictions on executive retention plans, some debtors alternatively developed and sought court approval for incentive plans covering executives and, in some cases, non-executive employees. In contrast to a retention bonus, an incentive bonus is based on an executive or other employee achieving specified financial or other performance targets. In the 2006 case *In re Dana Corp*, the Bankruptcy Court for the Southern District of New York laid out factors that bankruptcy courts may consider when reviewing incentive plans under Section 503(c)(3).[28] The Dana factors consider the following:

- 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?
- Is the cost of the plan reasonable in the context of the debtor's assets, liabilities, and earning potential?

[27] 11 U.S.C. § 503(c)(1).

[28] 358 B.R. 567, 576-77 (Bankr. S.D.N.Y. 2006).

- Is the scope of the plan fair and reasonable; does it apply to all employees; does it discriminate unfairly? Is the plan or proposal consistent with industry standards? 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?
- Did the debtor receive independent counsel in performing due diligence and in creating and authorizing the incentive compensation?

Section 503(c) Does Not Govern Pre-Bankruptcy Retention Bonuses

According to several bankruptcy attorneys, compensation consultants, and academics we interviewed, retention bonuses recently have re-emerged as payments that debtors make to executives months or days before filing for Chapter 11 bankruptcy. However, pre-bankruptcy retention bonuses are not subject to Section 503(c) and thus do not offer creditors and other parties of interest an opportunity to comment or object and are not reviewed by the court.

Instead, public companies are generally required to disclose pre-bankruptcy bonuses awarded to certain executive officers and directors in SEC filings.[29] Public and private companies in bankruptcy also may disclose their pre-bankruptcy retention bonuses in court filings to be transparent and inform the court that they are not requesting approval for such payments. According to compensation consultants, pre-bankruptcy retention bonus agreements typically include provisions that require executives to pay back the bonuses if they terminate their employment before a specified date or are terminated for cause.

Although pre-bankruptcy retention bonuses are not subject to Section 503(c), such payments might be recovered under Section 548 of the Code as fraudulent transfers. However, debtors may face challenges meeting the statutory standard of proof in Section 548 actions. Generally, a fraudulent transfer in bankruptcy is a transfer or obligation of a debtor's property made within 2 years before filing for bankruptcy and made with actual intent to hinder, delay, or defraud any entity to which the debtor received less than reasonably equivalent value in consideration while the

[29]Under SEC Regulation S-K, a reporting company must provide "clear, concise and understandable disclosure of all plan and non-plan compensation awarded to, earned by, or paid to [certain] named executives officers…and directors." 17 C.F.R. § 229.402(a)(2) In addition, New York Stock Exchange and Nasdaq rules generally require a listed company to seek shareholder approval when it establishes or materially amends equity-compensation plans.

debtor was (or was rendered) insolvent.[30] Therefore, the debtor (or another party with standing to sue on behalf of the debtor's bankruptcy estate) only may recover certain pre-bankruptcy transfers incurred to or for the benefit of executives for which the debtor did not receive reasonably equivalent value, or in instances they can demonstrate actual intent to hinder, delay, or defraud. According to Trustee Program officials, a creditor (or a creditors' committee) must obtain court permission to pursue a fraudulent transfer recovery action on behalf of the estate.[31]

Code Governs Post-Emergence Bonuses That Are Incorporated into Reorganization Plans

Although the Code generally does not govern bonuses that debtors award to employees after exiting bankruptcy, it governs such bonuses when incorporated into a debtor's reorganization plan. During bankruptcy, some Chapter 11 debtors negotiated with their creditors to incorporate stock incentive plans (commonly called management incentive plans) in their reorganization plan.[32] If approved by the court (as discussed below), the reorganization plan authorizes or directs the reorganized debtor to implement the management incentive plan after emerging from bankruptcy. The plans are intended to attract, retain, or incentivize employees. According to several bankruptcy attorneys (and as discussed below), such plans typically reserve around 10 percent of the reorganized company's total common stock to be awarded to executives or other employees.

Several of the Code's provisions may govern management incentive plans incorporated into reorganization plans. Under the Code, a Chapter 11 reorganization plan may include any "appropriate provision not inconsistent with [other] applicable provisions."[33] This provision may authorize a debtor to include a management incentive plan as part of a reorganization plan, which is subject to court approval. Additionally, parties have argued that such management incentive plans may be

[30]The Code also allows the debtor to ask the court to recover any payment to or for the benefit of an executive under an employment contract that was made or incurred on or within 2 years before the bankruptcy filing, for which the debtor received less than a reasonably equivalent value in exchange for such payment, and was not made in the ordinary course of business. 11 U.S.C. § 548(a)(1)(B)(IV)

[31]According to U.S. Trustee Program officials, the U.S. Trustee does not have standing to pursue recovery actions under Section 548.

[32]For example, see Brian M. Resnick, Ron M. Aizen, and Adam L. Shpeen, "Management Incentive Plans under a Microscope," *American Bankruptcy Institute Journal*, vol. XXXVI, no. 12 (December 2017).

[33]11 U.S.C. § 1123(b)(6).

subject to the restrictions in Section 503(c). The court will confirm the reorganization plan, including a management incentive plan, only if it meets all applicable provisions.[34]

Selected Stakeholders We Interviewed Generally Viewed the Code as Less-Than-Effective in Addressing Bonuses but Had Mixed Views about Amending It

The 12 academics, bankruptcy attorneys, and organization we interviewed and whose publications we reviewed generally viewed Section 503(c) restrictions on executive retention and incentive bonuses as less-than-effective because debtors can work around the restrictions (for instance, by awarding bonuses before filing for bankruptcy).[35] These stakeholders had mixed views on what steps, if any, could be taken to address such bonuses. While they generally viewed pre-bankruptcy bonuses as problematic, they differed on specific potential changes to the Code to address the issue.

Selected Stakeholders Generally Viewed Code Restrictions on Bonuses as Less-Than-Effective Because Debtors Can Work around Them

Retention Bonuses before Bankruptcy

According to bankruptcy attorneys we interviewed and publications we reviewed, Section 503(c)(1)'s requirements are extremely rigorous. For example, the provision requires an executive to obtain a bona fide job offer from another business at the same or greater compensation to qualify for a retention bonus. According to stakeholders, to obtain such an offer, executives would need to search for a job offer at an inopportune time—that is, when the company is under financial distress. They added

[34] 11 U.S.C. § 1129(a).

[35] We interviewed a nonrandom, non-generalizable selected sample of five academics (such as law professors), six bankruptcy attorneys, and the National Bankruptcy Conference about the Code's provisions on bonuses. We also reviewed publications by other academics, bankruptcy attorneys, and compensation consultants about the Code's restrictions on employee bonuses. See appendix I for a more detailed discussion of our approach.

that if the executives were to obtain such an offer from a healthy company, it is unlikely they would remain with the bankrupt company.

According to academics and bankruptcy attorneys we interviewed and publications we reviewed, pre-bankruptcy retention bonuses for executives emerged as a response to Section 503(c)(1)'s strict limits on retention bonuses during bankruptcy. Despite the section's restrictions, these bonuses are negotiated between executives and the company's board of directors for the purpose of retaining the executives through bankruptcy. For example, two compensation consultants noted that an advantage of pre-bankruptcy bonuses is that the debtor can avoid the need to negotiate with creditors or obtain court approval, which can make such bonuses simpler, quicker, and cheaper than seeking a bonus during bankruptcy.

Creditors' committees may be able to use the Code's Section 548 to recover pre-bankruptcy bonuses as fraudulent transfers. According to U.S. Trustee Program officials, creditors' committees sometimes seek to obtain derivative standing to pursue a recovery action against executives who received pre-bankruptcy bonuses. According to the National Bankruptcy Conference, it is difficult for creditors to gain such standing and to show that a bonus was not given for reasonably equivalent value when the executive still works for the debtor. Two bankruptcy attorneys told us no creditors have recovered pre-bankruptcy bonuses in a high-profile case, but that the possibility remains in light of some of the high-profile bankruptcy cases in 2020 that included pre-bankruptcy bonuses. Also, U.S. Trustees told us that debtor-in-possession financing arrangements may include a provision that places a lien on recovery actions, so that creditors cannot challenge pre-bankruptcy bonuses under Section 548. They said that they often object to these arrangements and seek to preserve the right of creditors to pursue recovery actions.

According to compensation consultants, debtors commonly preserve the right to recover pre-bankruptcy bonuses paid to executives who leave before the end of the retention period or are terminated for cause. Bankruptcy attorneys noted that companies generally pay executives their pre-bankruptcy retention bonuses when the agreements are signed or shortly thereafter—thus, they face the risk of recovery if the executives do not fulfill the terms of the agreements. However, the National Bankruptcy Conference noted anecdotally that some debtors have been reluctant to enforce such provisions. In contrast, retention bonuses awarded during bankruptcy generally are paid after the employee meets the retention period, so debtors can withhold the retention bonus if the employee departs before the end of the retention period.

Incentive Bonuses during Bankruptcy

Academics and bankruptcy attorneys told us that debtors can work around the Code's restrictions on executive retention bonuses by alternatively crafting such bonuses as incentive bonuses. In other words, they told us that because executive retention bonuses are nearly impossible to implement during bankruptcy, debtors instead might request court approval of incentive bonuses for executives. In reviewing requests for incentive bonuses during bankruptcy, courts apply the facts and circumstances standard of Section 503(c)(3), which is less stringent than the Section 503(c)(1) restrictions.

Stakeholders also told us that debtors can pursue strategies through other types of bonuses to work around the Code's restrictions on executive retention bonuses. Examples stakeholders described included the following:

- In developing incentive plans for executives, debtors may set financial or other performance targets for earning bonuses so low that the incentive bonuses are, in effect, disguised retention bonuses.[36]
- Debtors may attempt to conceal the identities of and bonus amounts paid to executives and limit the ability of creditors to fully review whether bonus payments are subject to Section 503(c).[37]
- In developing retention plans for non-executive employees, debtors may seek to classify employees with officer titles as non-executives (based on their alleged lack of control rather than their title) to cover them under the retention plan.

[36]U.S. Trustee Program officials told us that many of their objections are caused by this issue.

[37]Section 107(b)(2) of the Code permits the court, on its own motion, and requires the court, on the request of a party in interest, to protect persons with respect to scandalous or defamatory matter contained in a paper filed in a bankruptcy case. 11 U.S.C. § 107(b)(2).

- Debtors may seek the court's deference for approving bonuses by arguing the "facts and circumstance" test is identical to the business judgment standard.[38]
- Debtors may terminate executives before filing for bankruptcy and rehire them as consultants to help them through bankruptcy, given their knowledge of the company.

While acknowledging debtors can work around the Code's restrictions on bonuses, stakeholders also stated that properly designed incentive bonuses are consistent with the intent of Section 503(c). Such bonuses are performance-based and therefore do not reward executives simply for staying with the debtor through bankruptcy.

Post-Emergence Bonuses

According to articles written by bankruptcy attorneys and compensation consultants, debtors can use management incentive plans to work around Section 503(c) requirements. Management incentive plans can be used to replace pre-existing equity incentive plans, which lose value after a reorganization. Some stakeholders note that the plans are useful to align the interests of executives with the reorganized company's shareholders. But other stakeholders view the plans as an unjustified executive inducement to which key secured creditors agree to gain management's support for their preferred reorganization plan at the potential expense of other parties, such as unsecured creditors or shareholders.

Creditors and U.S. Trustees have raised concerns about management incentive plans by objecting to Chapter 11 reorganization plans and disclosure statements. For example, bankruptcy attorneys note that common objections to the management incentive plans include that they were proposed in bad faith to enrich existing executives at the expense of

[38]As previously discussed, under the business judgement standard of Section 363(b), courts generally determine whether executive retention bonuses are fair and reasonable, and that the debtor's business decision was not so manifestly unreasonable that it could not be based on sound business judgement but only on bad faith. According to stakeholders, before the enactment of Section 503(c), courts generally afforded considerable deference to the business judgement of debtors' board of directors on the design and suggested implementation of executive retention bonuses. Additionally, according to a review of court decisions by a compensation consultant, some courts view the "facts and circumstances" test of Section 503(c)(3) as identical to the business judgment standard. But the review states that other courts hold that the "facts and circumstances" test establishes a heightened role for the court, which must determine whether the payments serve the interests of the creditors and the debtor's estate. See Margaret Black, Executive Compensation in Bankruptcy: Motivating Key Employees Through Corporate Financial Distress, *Trends & Issues*, Pearl Meyer & Partners, LLC (April 2020).

other parties or provided inadequate disclosure about the plans in the disclosure statement accompanying the reorganization plan. In addition, U.S. Trustees told us that they have successfully argued that management incentive plans are subject to Section 503(c).

Stakeholders Had Mixed Views on Whether to Amend Section 503(c)

Arguments for Amending Section 503(c)

Some academics and bankruptcy attorneys maintained that Section 503(c) should be substantially revised. Their arguments in favor of amendments include the following:

- **Section 503(c) is formulaic and limits flexibility.** The Code and bankruptcy process provide a system of checks and balances on executive control so that creditors, U.S. Trustees, and courts can weigh the costs and benefits of debtor activities in consideration of each case's facts and circumstances. Some stakeholders told us that fair and reasonable retention bonuses that are negotiated among debtors, executives, and creditors and approved by the courts can be useful for retaining key employees during the reorganization process.[39] However, they said the formulaic requirements of Section 503(c) limit the flexibility of the process. For example, one academic found that objections to bonus plans by creditors and U.S. Trustees usually focused on compliance with Section 503(c) rather than specific issues with the contents of the plans.[40]
- **Section 503(c) does not necessarily weigh costs and benefits.** Stakeholders told us that creditors will support bonuses that would preserve the value of the debtor's estate by a greater amount than the bonuses, but Section 503(c)'s requirements are not necessarily designed to weigh the benefits and costs of bonuses in helping debtors maintain business operations or preserve the value of their estate for the benefit of creditors. For example:
  - Section 503(c)(1) incentivizes executives to pursue other job offers when the debtor is under financial distress and most in need

[39]According to an academic, costly delays in the reorganization process led to the emergence of executive bonuses in the 1990s. David A. Skeel Jr., "Creditors' Ball: The 'New' New Corporate Governance in Chapter 11," *University of Pennsylvania Law Review*, vol. 152, no. 2, pp. 917-952 (December 2003).

[40]Jared A. Ellias, "Regulating Bankruptcy Bonuses," *Southern California Law Review*, vol. 92, p. 653-701 (March 2019).

of their leadership. Some academics and bankruptcy attorneys said that whether executives can obtain a comparable job offer does not prove they will produce greater value than their bonus. They also said executives likely would not turn down a comparable job offer from a healthy company.

- Section 503(c)(1) generally limits the amount of an executive retention bonus to no more than 10 times the average amount of bonuses paid to non-executives. However, several stakeholders told us it is illogical to link executive and non-executive compensation. First, according to stakeholders, debtors file for bankruptcy because they need to reduce costs. They may provide bonuses to their executives to reduce costs, which may require the executives to reduce the workforce to reorganize and emerge as a healthy company. The failure to achieve that outcome would mean all employees would lose their jobs. Second, if debtors do not pay their executives bonuses, they may not necessarily use those funds to maintain a larger workforce. Estate funds not used to pay executive bonuses would go back into the estate for distribution according to the priority list, and employees are generally unsecured creditors and low on the list.

- **Section 503(c) can increase costs.** Section 503(c)(3) allows debtors to pay their executives incentive bonuses but stakeholders said the provision can require debtors to expend the estate's resources to pay compensation consultants and attorneys extra fees to defend executive incentive bonuses.

Arguments for Retaining Section 503(c) in Its Current Form

In contrast, other academics and bankruptcy attorneys maintained that Section 503(c) does not need to be amended. Their arguments for maintaining Section 503(c) in its current form include the following:

- **Section 503(c) serves a useful purpose.** Some stakeholders argued that executives should not be allowed to receive bonuses simply for staying with the debtor through bankruptcy when non-executive employees are furloughed or lose their jobs. If Section 503(c) is causing debtors to request incentive bonuses instead of retention bonuses, then that outcome is desirable because the bonuses, if granted, will be based on financial or other performance targets that serve to benefit the debtor's estate and creditors. These stakeholders argued that the bar for receiving a bonus should be high.

- **Section 503(c) can help protect unsecured creditors.** According to some stakeholders, debtors and key creditors may have relationships that undermine the Code's checks and balances and lead such creditors to support executive bonuses based on self-interest. For example, a debtor's secured lenders may leverage their positions to influence the reorganization's outcome and negotiate key terms of the reorganization plan for their benefit. They also may play a direct role in the debtor's management. Thus, such stakeholders might agree to pay bonuses to executives to gain their support in the bankruptcy process. At the same time, unsecured creditors may not challenge the merits of an executive bonus because of the cost of making the challenge. That is, the cost of hiring attorneys, accountants, and compensation consultants to assess the reasonableness of executive bonuses can be high relative to the potential recovery for the lowest-priority unsecured creditors, such as non-executive employees and shareholders.[41]

Selected Stakeholders Viewed Pre-Bankruptcy Bonuses as Problematic but Had Mixed Views on Other Bonuses

Stakeholders Found Pre-Bankruptcy Bonuses Problematic but Views Differed on Code Changes

Academics and bankruptcy attorneys generally told us that a legislative response to pre-bankruptcy bonuses is warranted because of the greater risk of self-dealing—where executives may use their influence to enhance their compensation at the expense of creditors and shareholders. The stakeholders said executives have a stronger negotiating position regarding bonuses before filing for bankruptcy because of their influence over the decision of whether and when to file for bankruptcy. During this time, the company likely is in financial distress and the board of directors generally will rely on the executives to help determine the best course of action. As a result, they said that the executives could extract abusive retention bonuses from the board. While creditors, U.S. Trustees, and the courts serve as a check on executive bonuses during bankruptcy, they do not serve as a check on pre-bankruptcy bonuses.

Academics and bankruptcy attorneys had different views on how to address pre-bankruptcy bonuses and other methods used to work around

[41]As discussed previously, secured creditors are paid from the proceeds of collateral before any other claims. As higher-priority claims are paid in full, remaining funds are made available to pay administrative expenses and priority unsecured claims. Any remaining funds are used to pay general unsecured creditors. If remaining funds are insufficient to fully satisfy the claims of a creditor class, the creditors are generally paid on a pro-rata basis.

503(c) requirements. Some said a principles-based approach that gives courts the flexibility to ensure that retention bonuses are not abusive would be more effective than Section 503(c). They maintain that changes to Section 503(c)(1) that permitted some form of retention bonuses during bankruptcy could reduce the use of pre-bankruptcy bonuses. They said that encouraging debtors to request executive bonuses after filing for bankruptcy would be consistent with the Code's intent of providing greater transparency and oversight by creditors, U.S. Trustees, and the courts. For example, the National Bankruptcy Conference recommended replacing Section 503(c)(1)'s requirements with a flexible standard that is more stringent than the deferential business judgement standard and subjecting pre-bankruptcy bonuses to such a standard.[42]

Some stakeholders generally supported amending the Code to make it easier to recover pre-bankruptcy bonuses. For example, several of them supported amending Section 548 to allow executive bonuses granted within a certain time frame to be recovered, or avoided, if the bonuses would not have been allowed under Section 503(c). But two stakeholders said that debtors could work around such an amendment by awarding bonuses before the specified time frame. Some stakeholders also said that amending Section 547 or 548 to expand the parties allowed to seek avoidance of a pre-bankruptcy bonuses could be beneficial. But two other stakeholders raised concerns that such an amendment could lead to a proliferation of litigation.

Mixed Views on Legislative Response to Incentive Bonuses

Academics and bankruptcy attorneys we interviewed had mixed views on whether a legislative response to incentive bonuses was warranted. As discussed earlier, some stakeholders argue that debtors may work around Section 503(c)(1)'s restrictions by implementing incentive bonuses for their executives under Section 503(c)(3)'s less-stringent facts and circumstances standard. Some of these stakeholders maintained that Section 503(c) should be strengthened to provide clearer guidance for courts on the distinction between incentive and retention bonuses. For example, they generally supported revising the Code to

- expand the definition of insider for purposes of executive bonuses to include a specified number of the company's top-compensated employees and lower the threshold under which a bonus may exceed standard pay, or

[42]See appendix II for the National Bankruptcy Conference's May 27, 2021, letter to GAO.

- list the specific factors (such as those identified in *In re Dana*) that could be used to justify incentive bonuses under the facts and circumstances standard to produce a more consistent interpretation of Section 503(c)(3).

Other stakeholders told us that these legislative responses are unnecessary and could lead to unintended consequences. For example, expanding the definition of insider, as described, would effectively ban non-executive retention bonuses, which would hinder the ability of debtors to retain critical employees. Instead of expanding the definition of insider, one stakeholder proposed narrowing and clarifying the definition to focus on individuals who control the debtor's business or restructuring. Although stakeholders generally viewed the list of factors laid out in *In re Dana* for interpreting Section 503(c)(3) positively, some expressed concern that codifying those factors for incentive bonuses would limit court flexibility.

Mixed Views on Legislative Response to Bonuses in Prepackaged Bankruptcies

Academics and bankruptcy attorneys had mixed views on whether a legislative response to executive bonuses in prepackaged bankruptcies was warranted. A prepackaged bankruptcy generally begins with the filing of a plan of reorganization (which can include executive retention or incentive bonuses) that significant creditors already had accepted before the filing. The debtor then asks the court to approve the accepted plan.

- Many stakeholders generally said prepackaged bankruptcies have value because they serve to help the company emerge from bankruptcy quickly. They said that objections to bonuses resulting from negotiations or litigation between debtors, creditors, and U.S. Trustees would undermine that purpose.
- Other stakeholders said that allowing consideration of the reasonableness of bonuses by creditors or others in prepackaged bankruptcies would be valuable and should not significantly slow down the process.
- Some stakeholders proposed changes to the requirements for confirmation of the debtor's reorganization plan to allow for consideration of bonuses under Section 503(c) by creditors, U.S. Trustees, and courts.[43] But other stakeholders maintained that the

[43]Before confirmation of the reorganization plan can be granted, the court must be satisfied there has been compliance with all the requirements of confirmation in section 1129 of the Code. To confirm the plan, the court must find that the plan is proposed in good faith and complies with the Code, among other things.

proposal would slow down the reorganization process and unnecessarily reduce value from the debtor's estate.

Mixed Views on Legislative Response to Post-Emergence Bonuses

Academics and bankruptcy attorneys had mixed views on whether a legislative response to post-emergence bonuses, or management incentive plans, was warranted. Some stakeholders maintained that these bonuses are negotiated to preserve value and can facilitate a more efficient reorganization process. They noted that the creditors negotiating with the debtor to implement a management incentive plan will be equity shareholders of the newly reorganized company. Specifically, stakeholders stated that many reorganization plans include a provision to convert the debt of creditors into equity in the new company. Therefore, any post-emergence bonus in the reorganization plan that was negotiated with those secured creditors includes input from the shareholders of the new company.

Other stakeholders pointed out that management incentive plans can be a way for creditors with higher priority to bargain with executives to obtain support for the reorganization plan and can reduce recoveries of lower-priority creditors.[44] For example, bankruptcy attorneys noted that there have been cases in which management incentive plans significantly enriched executives of the new company. One academic maintained that post-emergence bonuses should be negotiated by post-bankruptcy boards of directors rather than during a bankruptcy case. Some stakeholders proposed changes to the requirements for confirmation of a reorganization plan that would allow for consideration of such bonuses under Section 503(c) by creditors, U.S. Trustees, and courts. Other stakeholders argued that because the adoption of the management incentive plan occurs after the debtor has emerged from bankruptcy, grants made under such a plan should not be subject to Section 503(c)'s restrictions.

[44]See Background for a discussion of claims priority in Chapter 11 bankruptcy. Generally, higher-priority claims are paid in full before remaining funds are made available for lower-priority claims.

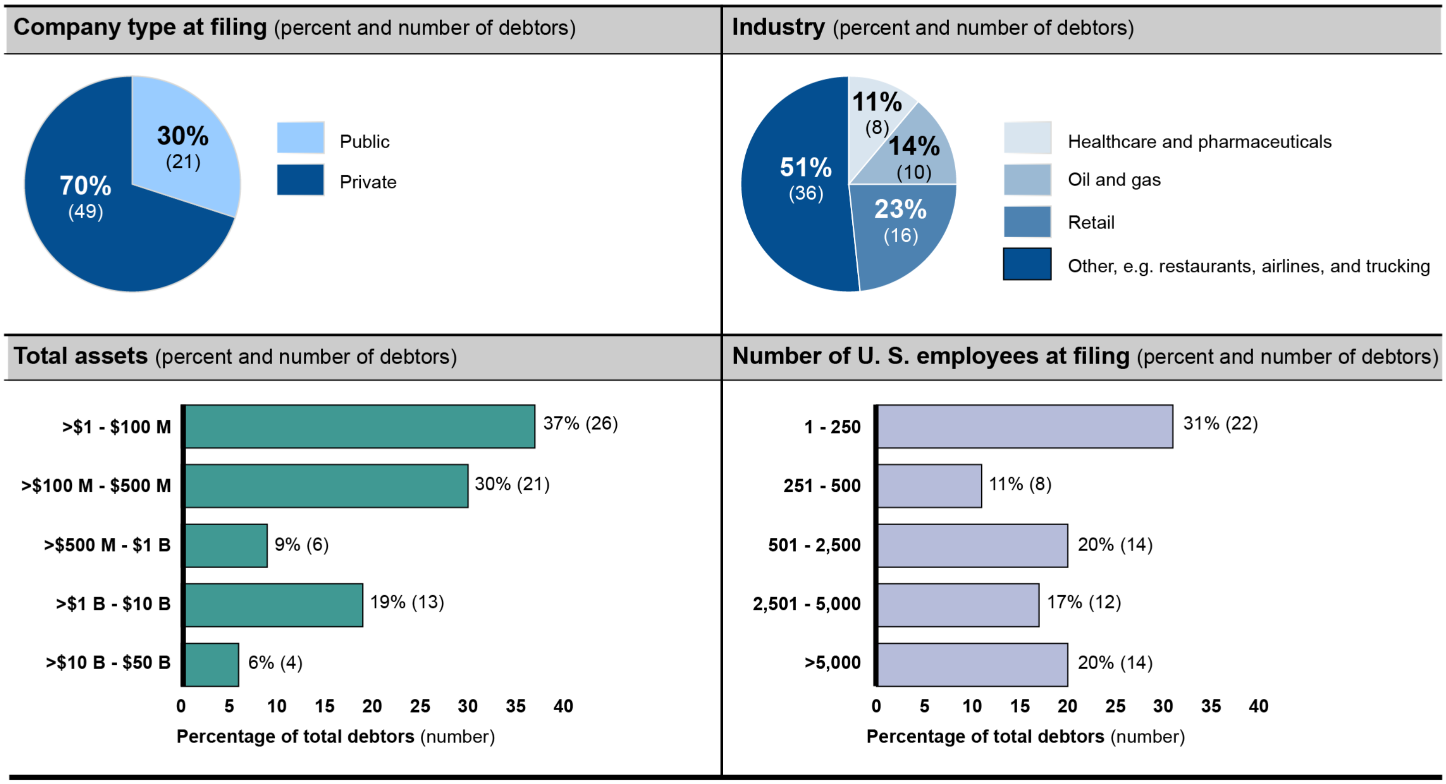
Very Few Bankruptcy Filers in Fiscal Year 2020 Requested Court Approval for Bonuses, and Some Possibly Worked around Bonus Restrictions

Less Than 1 Percent of Companies That Filed for Chapter 11 Bankruptcy in Fiscal Year 2020 Requested Court Approval for Bonuses

Based on our analysis of court filings, less than 1 percent (70) of the approximately 7,300 companies that filed for Chapter 11 bankruptcy in fiscal year 2020 requested court approval to pay executive or non-executive employee bonuses during bankruptcy.[45] A debtor must obtain court approval to implement a new bonus plan during bankruptcy, which subjects the bonus request to the notice and hearing process. As shown in figure 4, most debtors that requested court approval of employee bonuses were private companies with total assets of $500 million or less. The companies varied more in terms of number of employees and industry.

[45]We used Westlaw Edge and other sources to identify companies that filed for Chapter 11 in fiscal year 2020 and that requested court approval for employee bonuses (see app. I for additional information on our methodology, including its limitations). Based on our Westlaw Edge searches, we generally found that a low percentage of companies that filed for Chapter 11 bankruptcy in prior fiscal years requested court approval for bonus plans.

Figure 4: Characteristics of Companies That Filed for Chapter 11 Bankruptcy in Fiscal Year 2020 and Requested Court Approval of an Employee Bonus Plan



Legend: M = million; B = billion

Source: GAO analysis of S&P Global Market Intelligence data and bankruptcy filings. | GAO-21-104617

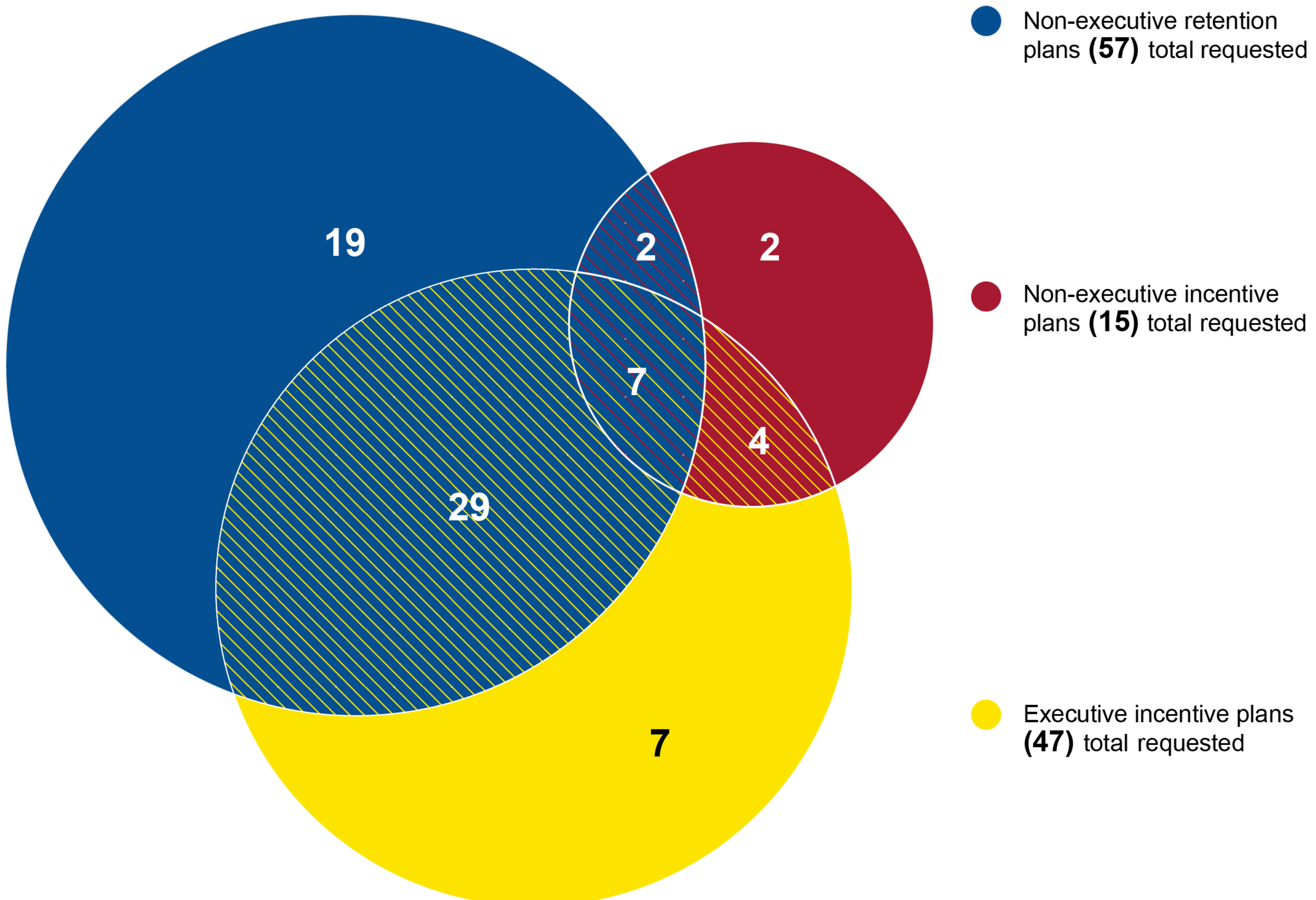
Note: Due to rounding, the total percentages may not add up to 100 percent.

As shown in figure 5, the types of employee bonus plans for which debtors requested court approval varied.

- The majority of debtors requested court approval for retention plans for non-executive employees (57 of 70); none requested court approval for a retention plan for executive employees.
- More than half the debtors requested court approval for incentive plans for executive employees (47 of 70), and a small percentage requested court approval for incentive plans for non-executive employees (15 of 70). As discussed previously, Section 503(c)(3) imposes less strict requirements on incentive plans covering

executives and non-executive employees than on retention plans covering executive employees.

Figure 5: Types of Employee Bonus Plans for Which Debtors Requested Court Approval after Filing for Chapter 11 Bankruptcy in Fiscal Year 2020



Source: GAO analysis of bankruptcy filings. | GAO-21-104617

Note: The number of debtors and number of requested plans are not equal, because some debtors requested more than one employee bonus plan.

In their court filings, debtors generally requested retention bonuses to retain non-executive employees who served key roles in preserving the debtor's business or incentive bonuses to motivate executive or non-executive employees to achieve specified targets, such as to maximize the proceeds of an asset sale.

Debtors were authorized to award a total of around $571 million to more than 16,600 executive and non-executive employees through court-approved bonus plans, as shown in table 1.[46] The bonus amounts and number of covered employees varied considerably among the 70 companies. Additionally, non-executive employees could earn, on average, around $20,000 if they met incentive plan targets, while executive employees could earn, on average, over $700,000 if they met targets.

Table 1: Number of Employees Covered and Value of Bonus Plans for Which Companies That Filed for Chapter 11 Bankruptcy in Fiscal Year 2020 Requested Court Approval

	Number of covered employees				Total plan amount				Bonus amount per employee	
Plan type	**Low**	**Median**	**High**	**Total**	**Low**	**Median**	**High**	**Total**	**Average**	**Maximum**
Non-executive retention plan	1	37	4,243	12,204	$23,885	$1,038,000	$79,400,000	$280,437,959	$22,822	$233,282
Executive retention plan	0	0	0	0	0	0	0	0	0	0
Non-executive incentive plan	3	56	2,191	4,109	$125,000	$2,548,225	$30,628,913	$82,906,505	$20,145	$900,000
Executive incentive plan	1	6	22	309	$26,316	$1,374,000	$36,091,167	$207,630,652	$701,455	$13,319,100
Total	**–**	**–**	**–**	**16,622**	**–**	**–**	**–**	**$570,845,116**	**–**	**–**

Legend: – = not applicable

Source: GAO analysis of data from debtors' bankruptcy filings. I GAO-21-104617

Note: Low, median, and high values are presented because distributions for covered employees and plan values generally are skewed (average and median are not equal). Incentive plan amounts are for the highest possible bonus in cases in which the employee could earn a range of potential bonuses. The plan amounts represent amounts courts authorized debtors to pay. The average bonus per employee omits bonus plans for which the debtor did not provide numbers of employees covered or bonus amounts.

[46]The total bonus amount represents the amount that the courts authorized the debtors to pay their employees but does not necessarily represent the amount debtors paid their employees. For example, under an incentive bonus plan, employees would not be paid their bonus until they earned it by meeting a performance target in the future. Additionally, some debtors did not provide specific information about the bonus amounts or number of employees covered under their plans; thus, our totals do not include such information.

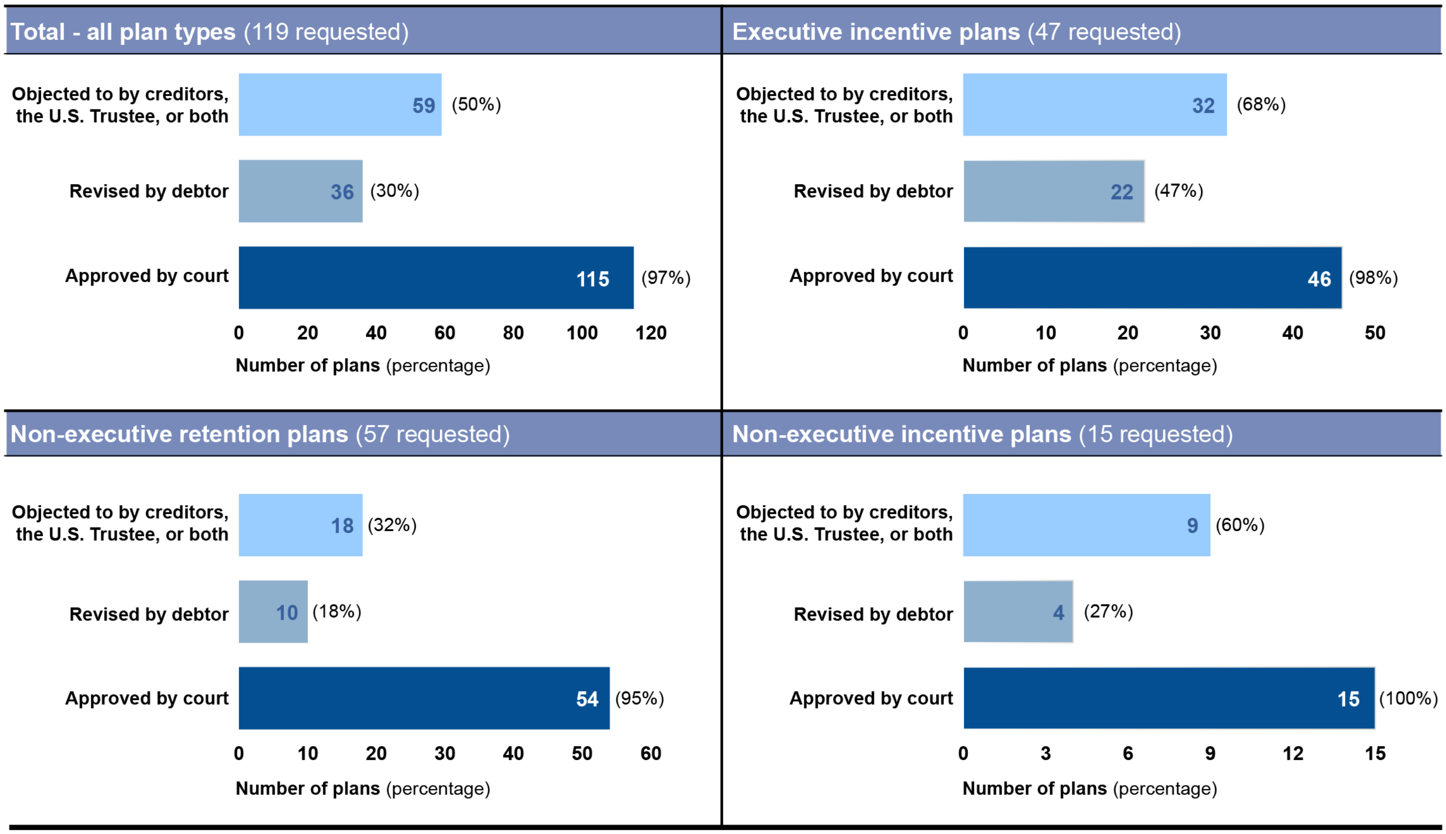
Objections to Bonus Requests Led to Changes in about One Third of Plans, but Courts Approved Nearly All Bonus Requests

Creditors and U.S. Trustees frequently objected to the bonus plans requested by Chapter 11 debtors in fiscal year 2020—leading debtors to revise about one third of the plans—but the courts approved nearly all bonus requests (see fig. 6). Specifically, out of 119 bonus plan requests, U.S. Trustees filed 48 objections to the requests and creditors filed 38 objections—often to the same plan.[47] They objected more frequently to executive incentive plans than to other types of bonus plans. In response, debtors revised 30 percent of the requested bonus plans—including 47 percent of the executive incentive plans. Courts approved 115 of 119 of the requested plans (97 percent).[48]

[47]According to U.S. Trustee Program officials, U.S. Trustees also work informally to address concerns with bonuses, which often results in the debtor revising the bonus plan without the need for U.S. Trustees to formally object in court.

[48]Four bonus plan requests were not approved by the courts. In all four cases, debtors withdrew their requests.

Figure 6: Objections and Approvals of Employee Bonus Plans Requested by Companies That Filed for Chapter 11 Bankruptcy in Fiscal Year 2020



Source: GAO analysis of data from debtors' bankruptcy filings. | GAO-21-104617

Note: In one case, no formal objections were filed, but the debtor revised the plan based on negotiations with creditors and the U.S. Trustee, so we included it in this analysis.

According to the court filings, creditors or U.S. Trustees objected to bonus requests based on a number of arguments, including that the

- requested retention plans for non-executive employees included executives (violating Section 503(c)(1) requirements);
- requested incentive plans for executive employees set easily achievable performance targets, essentially making them disguised retention plans and thus subject to review under Section 503(c)(1);

- requested retention or incentive plans did not sufficiently demonstrate that employees under the plan were critical to continuing business operations or exiting bankruptcy quickly;
- requested retention or incentive plans provided bonuses that were excessive or above market standards; or
- requested retention or incentive plans were not justified by the facts and circumstances of the case.

In cases in which creditors or U.S. Trustees objected to a bonus plan request, debtors subsequently revised 61 percent of the plans, including 69 percent of the executive incentive plans. For retention plans, revisions included lowering the number of plan participants, lowering the bonus amounts, or changing the timing of the payments. For incentive plans, revisions included enhancing the performance targets, lowering the bonus amounts, or modifying other plan terms. Such negotiations may indicate that the parties in interest and the courts are considering the benefits and costs associated with employee bonuses.

Some Companies Awarded Executives Retention Bonuses Shortly before Filing, Possibly Working around Section 503(c) Restrictions

We found that 42 companies awarded 223 executives about $165 million in retention bonuses shortly before filing for bankruptcy in fiscal year 2020 (see table 2).[49] These debtors either implemented a new bonus plan or amended an existing plan anywhere from 5 months to 2 days before filing for bankruptcy, for an average of 47 days before filing. In contrast, we found no evidence that any of the companies that filed for bankruptcy in fiscal year 2020 requested court approval for retention bonuses for executives. Of the 42 companies, 23 requested court approval for executive or non-executive bonuses after filing for bankruptcy and 19 did not.

[49]As discussed in appendix I, because of disclosure and data limitations, our review may not have necessarily identified all companies that filed for Chapter 11 in fiscal year 2020 and that awarded their executives pre-bankruptcy bonuses within 9 months of filing for bankruptcy.

Table 2: Executive Retention Bonuses Awarded by Debtors in Fiscal Year 2020 Shortly before Filing for Chapter 11 Bankruptcy

Debtor type	Number of bonus plans	Number of executives covered				Total plan amount				Bonus amount per executive	
		Low	Median	High	Total	Low	Median	High	Total	Average	Maximum
Debtors that requested additional bonuses after filing for bankruptcy	23	2	5	21	127	$120,000	$3,281,375	$16,900,000	$80,634,589	$510,859	$4,675,000
Debtors that only awarded pre-bankruptcy bonuses	19	3	5	21	96	$1,427,000	$3,221,875	$14,582,918	$85,055,000	$832,604	$6,397,750
Total	**42**	**–**	**–**	**–**	**223**	**–**	**–**	**–**	**$165,689,589**	**–**	**–**

Legend: – = not applicable

Source: GAO analysis of data from debtors' bankruptcy filings and Securities and Exchange Commission reports. I GAO-21-104617

Note: Low, median, and high values are presented because distributions for covered executives and plan values generally are skewed (average and median are not equal). The plan amounts represent amounts that the debtor approved shortly before bankruptcy (i.e., within 9 months before filing). The average bonus per executive omits bonus plans for which the debtor did not provide numbers of executives covered or bonus amounts.

In addition, 16 of the 23 debtors that awarded an executive retention bonus before filing, or 70 percent, also requested court approval for an executive incentive bonus after filing for bankruptcy. Creditors and U.S. Trustees objected to some of these requests, arguing that the pre-bankruptcy retention bonuses to executives should be considered and that the requested incentive bonus amounts should be lowered, among other things.

The findings of our review of debtors' bankruptcy filings are consistent with stakeholder views (as discussed earlier) that Section 503(c)(1)'s requirements are extremely rigorous and possibly have led some debtors to work around the provision by awarding their executives pre-bankruptcy retention bonuses. Specifically, while we found 42 debtors awarded their executives retention bonuses shortly before filing for bankruptcy, we did not find evidence that any of the approximately 7,300 debtors that filed for

Chapter 11 bankruptcy in fiscal year 2020 requested court approval for executive retention bonuses during bankruptcy.

Section 503(c)(1) may not be fully preventing debtors from paying executives retention bonuses simply for staying through the bankruptcy process. Pre-bankruptcy bonuses are subject to less transparency than bonuses awarded during bankruptcy because such transactions are generally not subject to the Code's notice and hearing process and court oversight. The absence of such transparency and checks means it could be easier for companies to award their executives retention bonuses before filing that are not aligned with Section 503(c)(1)'s requirements.[50]

Some Debtors Also Created Post-Emergence Bonus Plans

Nearly one third (27 percent) of the debtors that requested court approval of bonus plans also incorporated post-emergence employee bonus plans, also called management incentive plans, in their reorganization plans. Specifically, 19 debtors, in consultation with creditors, formulated management incentive plans to be implemented by the newly reorganized companies after the debtors emerge from bankruptcy. The management incentive plans reserved a pool of equity-based awards for executives or other employees that ranged from 3.5 to 15 percent of the newly reorganized company's outstanding stock, or 8.9 percent on average. In seven of the management incentive plans (37 percent), the debtors generally left the key terms and conditions of the plans solely to the discretion of the board of directors of the newly reorganized company. In the other cases, the debtors and creditors generally agreed beforehand to key terms and conditions, such as when the equity awards would be issued, which executives would receive such awards, and how much the executives would receive.

Conclusions

Properly designed retention bonuses for executives can help preserve a Chapter 11 debtor's business, increase the value of its estate to the benefit of creditors, or both. However, such bonuses can raise not only the risk of executives using their influence to enhance their compensation at the expense of others but also concerns about fairness when employees are being laid off and creditors are suffering losses. The Bankruptcy Code provides parties with the opportunity to negotiate bonuses that incorporate their interests.

[50]We found four cases in which creditors raised concerns about the potential for the executive retention bonuses awarded pre-bankruptcy to be preferential or fraudulent transfers. In one case, the creditor filed a motion to obtain derivative standing to pursue an avoidance action, which was pending at the time of our review.

Section 503(c)(1) may not be fully preventing Chapter 11 debtors from paying executives retention bonuses simply for staying through the bankruptcy process. Both our analysis of Chapter 11 cases filed in fiscal year 2020 and interviews with bankruptcy experts indicate that Section 503(c)(1) may have led some debtors to work around its restrictions by awarding bonuses to executives before filing for bankruptcy. Pre-bankruptcy bonuses are generally not subject to the Code's notice and hearing process and court oversight, and they are not always disclosed. The absence of such protections and consequent decrease in transparency could increase the risk of some debtors awarding bonuses inconsistent with the section's requirements to the detriment of creditors and shareholders.

Matter for Congressional Consideration

Congress should consider amending the U.S. Bankruptcy Code to clearly subject bonuses debtors pay executives shortly before a bankruptcy filing to bankruptcy court oversight and to specify factors courts should consider to approve such bonuses.

Agency Comments

We provided a draft of this report to the Director of the Executive Office for U.S. Trustees and the Chair of SEC for review and comment. They provided us with technical comments that we incorporated as appropriate.

We are sending copies of this report to the appropriate congressional committees, the Chair of SEC, and the Director of the Executive Office for U.S. Trustees. In addition, the report is available at no charge on the GAO website at https://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or clementsm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix III.

Michael Clements

Michael E. Clements
Director
Financial Markets and Community Investment

Appendix I: Objectives, Scope, and Methodology

This report examines (1) the extent to which the Bankruptcy Code (Code) governs the award of employee bonuses by Chapter 11 debtors; (2) stakeholder views on the effectiveness of the Code's provisions on employee bonuses and proposed changes to the Code; and (3) the extent to which companies that filed for Chapter 11 bankruptcy in fiscal year 2020 paid or requested court approval to pay bonuses to their executive and non-executive employees.

To examine the extent to which the Code governs employee bonuses awarded by Chapter 11 debtors, we reviewed the Code's relevant provisions and the legislative history of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which amended the Code to impose restrictions on employee bonuses. We also reviewed court cases and digests of court decisions interpreting the 2005 amendments to the Code. We reviewed relevant legal analyses, research, and related materials on Chapter 11 bankruptcies and employee bonuses that we identified through internet searches. Such information included journal articles, agency publications, and industry publications prepared by academics, bankruptcy attorneys, compensation consultants, and the Administrative Office of the Courts U.S. Courts. Finally, we interviewed officials from the U.S. Trustee Program and the Securities and Exchange Commission (SEC) about their roles in Chapter 11 cases.[1]

To examine stakeholder views on the effectiveness of the Code's provisions on employee bonuses and proposed changes to the Code, we interviewed a non-random, non-generalizable sample of five law professors; six bankruptcy attorneys, including members of the American Bar Association's Business Bankruptcy Committee; and the National

[1]The U.S. Trustee Program is a litigating component of the Department of Justice whose mission is to promote the integrity and efficiency of the bankruptcy system for the benefit of debtors, creditors, and the public. According to U.S. Trustee Program officials, U.S. Trustees have standing to participate in every individual and business bankruptcy case in the 88 federal judicial districts under their jurisdiction. Under the Code, SEC is a party in interest in Chapter 11 cases and takes legal positions on matters impacting public investors.

Bankruptcy Conference (which advises Congress on bankruptcy issues).[2] We selected the experts based primarily on their knowledge about or experience with the Code's provisions applicable to employee bonuses and referrals. We reviewed their biographies and publications to consider their potential biases. We generally conducted semi-structured interviews that asked the 11 experts about their views on the Code's provisions restricting bonuses and congressional and other proposals to amend such provisions.[3] To supplement the information we collected through our expert interviews, we reviewed legal analyses prepared by academics and bankruptcy attorneys that included criticisms of and proposals to amend the Code's provisions applicable to executive bonuses. We identified such information through limited internet searches and referrals. We also interviewed staff and reviewed written materials from the U.S. Trustee Program about objections they have raised about employee bonuses requested by Chapter 11 debtors.

To examine the extent to which companies that filed for Chapter 11 bankruptcy in fiscal year 2020 paid or requested court approval to pay bonuses to their executive and non-executive employees, we implemented a three-step approach.

- We conducted key word searches in Westlaw Edge's dockets database in consultation with a GAO librarian and Westlaw Edge staff to identify debtors that filed for Chapter 11 bankruptcy in fiscal year 2020 and requested court approval for employee bonuses.[4] To create our list of search terms (such as retention plan, incentive, and key employee), we reviewed Chapter 11 filings in which debtors requested court approval for employee bonuses, SEC filings, and journal articles and interviewed knowledgeable stakeholders. Westlaw Edge's search

[2]The Business Bankruptcy Committee of the American Bar Association provides resources for legal professionals dealing with business bankruptcy issues, including educational programming and involvement in developing and reviewing proposed bankruptcy legislation and rules. The National Bankruptcy Conference is a nonprofit, nonpartisan, self-supporting organization of approximately 60 attorneys, law professors, and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws.

[3]The National Bankruptcy Conference provided us with a formal letter, which is reproduced in appendix II.

[4]Although certain severance payments may be considered bonuses, we excluded such bonuses from the scope of our review.

function searches only the title of filings in the court docket.[5] If a debtor requested court approval for a bonus without using any of our search terms in the title of its filings, our search would not have captured the case.[6] To supplement our Westlaw searches and identify potentially missing cases, we obtained from the U.S. Trustee Program a list of cases in which it filed objections involving bonus requests by Chapter 11 debtors. We also reviewed media articles identifying Chapter 11 debtors that awarded employee bonuses. In addition, we conducted key word searches in SEC's Electronic Data Gathering, Analysis, and Retrieval database to identify companies that filed for Chapter 11 bankruptcy and awarded their employees bonuses in fiscal year 2020. To assess the completeness of Westlaw's and SEC's databases, we reviewed relevant documentation, interviewed knowledgeable officials, and manually tested for missing information. We determined the two databases were sufficiently reliable for identifying Chapter 11 debtors that requested court approval for employee bonuses.

- For the bankruptcy court cases that we identified, we developed a standardized protocol to review each case, and created a data collection instrument to input the data. The protocol included step-by-step instructions for reviewers, including court documents to review and data to be collected. We worked with a GAO methodologist and attorney to pretest our protocols. For each debtor, we electronically searched its court docket using our search terms to identify relevant filings. We reviewed the filings and recorded and analyzed relevant information in our data collection instrument, such as the type of bonus, types of employee receiving the bonus, and amount of bonus. Our cutoff date for reviewing the court dockets was May 15, 2021. We also used SEC filings and S&P Global Market Intelligence to collect information about each debtor's characteristics, such as its industry and whether the debtor was a public or private company.
- To identify bonuses that companies awarded to executives before filing for bankruptcy, we used our Electronic Data Gathering, Analysis, and Retrieval database and Westlaw Edge search results. We reviewed relevant SEC filings to determine whether a company revised its existing executive bonus plan or implemented a new

[5]A court docket is a record of all documents filed by the court, parties, or any other entity (e.g., amicus curiae) in a court proceeding. The docket will include all filings such as pleadings, briefs, declarations, exhibits, orders, and judgments.

[6]According to officials from the U.S. Trustee Program, debtors may hide employee bonuses awarded during bankruptcy in court filings, such as motions to sell assets, motions to pay employee wages, and monthly operating reports.

executive bonus plan within 9 months of filing for Chapter 11. Private companies generally are not subject to the same periodic SEC reporting requirements as public companies, but may disclose in their court filings whether they awarded their bonuses before filing for Chapter 11. For the Chapter 11 debtors that we identified, we reviewed certain of their filings (such as motions for prepetition wages, motions for employee bonuses, or disclosure statements) to identify companies that awarded employee bonuses shortly before filing for Chapter 11 bankruptcy. Because of disclosure and data limitations, our review may not have necessarily identified all companies that filed for Chapter 11 in fiscal year 2020 and that awarded their executives pre-bankruptcy bonuses within 9 months of filing for bankruptcy.

We conducted this performance audit from October 2020 to September 2021 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Letter from the National Bankruptcy Conference Responding to GAO Questions on Legislative Proposals Regarding Bonuses in Chapter 11 Bankruptcy

NATIONAL BANKRUPTCY CONFERENCE

A Voluntary Organization Composed of Persons Interested in the Improvement of the Bankruptcy Code and Its Administration

May 27, 2021

Michael E. Clements
Director
Financial Markets and Community Investment
Government Accountability Office
441 G St., NW
Washington, DC 20548

Re: Executive Compensation in Chapter 11

Dear Mr. Clements,

Thank you for the opportunity to address the questions of the Government Accountability Office ("GAO") regarding compensation of insiders and other employees of companies that are subject to chapter 11 of the Bankruptcy Code. In particular, the GAO requested the views of the National Bankruptcy Conference (the "Conference")[1] regarding several specific amendments to the Bankruptcy Code that may be considered by Congress. This letter provides the views of the Conference regarding these important issues. We have limited our comments to issues regarding the compensation of insiders, as we understand that the GAO has focused its examination on insider compensation.

To frame our recommendations and responses to GAO's questions, we have split this letter into three sections. ***First***, we provide a brief historical overview of senior executive compensation practices and legislation under the Bankruptcy Code. This includes a description of the Conference's congressional testimony in 2007, which is appended to this letter. ***Second***, we recommend certain changes to the treatment of executive compensation under section 503(c) of the Bankruptcy Code. Specifically, we recommend modifying the substantive standards for reviewing executive compensation, narrowing and clarifying the scope of section 503(c) to reach only the most highly compensated executives, applying section 503(c) to pre-petition payments or obligations made in contemplation in bankruptcy, and clarifying that section 503(c) does not apply to payments or obligations that are incorporated into a confirmed plan of reorganization. And ***third***, we respond to the specific questions raised in the GAO's request to the Conference. In particular, we strongly discourage Congress from adopting proposal number 2.g. of the GAO's request (to place management of "the bankruptcy process" in the hands of a trustee). Over forty years ago, the 95th Congress wisely rejected that approach and placed debtors in charge of their own reorganization in light of prior experience with equity receivers and mandatory trustees. Since 1978, debtor leadership in the reorganization process has been fundamental to the success of chapter 11 as a useful tool for business reorganization, and the imposition of a new mandatory trustee would be a radical and regressive departure from modern bankruptcy practice.

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1 The Conference is a voluntary, non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. It has provided advice to Congress on bankruptcy legislation for nearly 90 years. The Conference does not act on behalf of any specific client, organization or interest group, but rather seek to reach consensus among their members, who represent a broad spectrum of political and economic perspectives, based on their knowledge and experience. Enclosed as Exhibit A is a fact sheet, which provides further information about the Conference.

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Annexed to this letter as Exhibit B is a compilation of select provisions of the Bankruptcy Code. We welcome any additional questions the GAO may have and look forward to continuing working with the GAO.

I. HISTORICAL OVERVIEW

A. Reorganization under Chapter 11 of the Bankruptcy Code

The history of business reorganization dates to the Nineteenth Century, when the equity receivership emerged to prevent liquidations from destroying an extraordinary amount of what we now call going-concern value. For example, the secured creditors who held liens on different sections of a multi-jurisdictional railroad line could recover far greater value from their investments in an insolvent railroad company by taking over the equity in the railroad company itself, compared to the value they might recover from a piecemeal liquidation of the railroad's tracks, ties, and rolling stock. Meanwhile, preservation of a railroad enterprise meant preservation of jobs for trackmen, stokers, conductors, and engineers.

It remains true today that a successful business reorganization often preserves far more value and far more jobs than a liquidation. Chapter 11 of the Bankruptcy Code of 1978, like its predecessor statutes, reflects Congress's view that stakeholders will normally benefit from the value that an insolvent business can maintain when it is reorganized and not liquidated. As stated in the Bankruptcy Code's legislative history, "[t]he purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders." H.R. Rep. No. 95-595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179.

Chapter 11 achieves those goals by establishing a collective process, in a single forum, that leads to the approval and implementation of a plan of reorganization that binds all stakeholders. Creditors and other stakeholders hold specific procedural and substantive rights under the Bankruptcy Code, but it is the debtor who is normally responsible for driving the restructuring process forward and developing the plan of reorganization. In adopting this "debtor in possession" model, Congress eschewed the administrator-, trustee-, and judge-led models that were prevalent in pre-Code and non-U.S. bankruptcy regimes. Congress's view was that a debtor's existing board and management, with their knowledge of a business, can normally guide the debtor through the chapter 11 process more effectively than an administrator or trustee. *Cf.* 11 U.S.C. §§ 1107–1108 (vesting authority with debtor to operate business in the ordinary course without court approval); § 363(c)(1) (allowing debtor to use property in the ordinary course of business without court approval). Bankruptcy courts may appoint a trustee to manage a chapter 11 debtor's affairs, but only upon a showing of "cause" (such as "fraud, dishonesty, incompetence, or gross mismanagement . . . by current management") or a finding that appointment of a trustee would be "in the interests of creditors, any equity security holders, and other interests of the estate . . . ." § 1104(a).

At the same time, chapter 11 fosters a process of negotiation among the debtor and its stakeholders by providing those stakeholders with meaningful procedural and substantive protections. In most cases of substantial size, an official committee of unsecured creditors is

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appointed to represent the interests of unsecured creditors; it is funded by the debtor and has a broad mandate to investigate the debtor's affairs and to help develop a plan of reorganization. Other stakeholders may also, under appropriate circumstances, seek the appointment of a debtor-funded committee. Impaired creditors may vote on a proposed plan and may prevent confirmation by casting sufficient votes against it, unless the plan satisfies certain statutory requirements that are designed to protect creditors in a rejecting class. *Cf.* § 1129(a)(8), (b). Moreover, all creditors, equity holders, unions, retirees, regulators, and other stakeholders enjoy broad rights to participate in the chapter 11 proceedings and to organize into informal "ad hoc" groups.

Substantively, chapter 11 incorporates fundamental principles such as the absolute priority rule and the equal treatment of similar claims. Chapter 11 also reflects Congress's decisions to adjust rights and obligations, for example by affording limited payment priorities to taxing authorities, employees, and other enumerated creditors, and by enhancing the treatment of certain contracts (e.g., aircraft financings under section 1110, collective bargaining agreements under section 1113, and retirement benefits under section 1114).

The provisions of the Bankruptcy Code work together to support the central premises of chapter 11: (i) reorganization is normally in the best interests of all stakeholders, (ii) the business debtor is normally best suited to lead its own restructuring, and (iii) stakeholders should have significant but flexible procedural and substantive rights that allow them to shape the contours of the debtor-led restructuring. These premises, and the statutory provisions that support them, strike a delicate balance among the competing interests of a debtor and all of its stakeholders.

B. Bankruptcy Treatment of Senior Executive Claims Before 2005

From 1978 to 2005, the Bankruptcy Code contained no provisions that expressly limited the compensation of senior executives. A chapter 11 debtor was able to use, sell, or lease its assets in the ordinary course of its business without court approval, subject always to its own business judgment and fiduciary duties. However, bankruptcy court approval, following notice and a hearing, has always been required before a debtor may engage in transactions outside the ordinary course of business or pay pre-petition wage and benefit obligations.

Prior to 2005, debtors generally sought to continue their pre-petition wage and benefit programs during a chapter 11 case and were usually able to gain court approval under the "doctrine of necessity" to pay accrued pre-petition obligations under those programs. Larger debtors often sought court approval to honor pre-petition obligations under pre-petition key employee retention programs ("KERPs") or to adopt new KERPs to replace stock-based incentive programs that had lost their incentive value in insolvency. In all these cases, the proposed programs were subject to objections from parties in interest and a bankruptcy judge's review of the debtor's business judgment. *See, e.g.*, *In re Just for Feet, Inc.*, 242 B.R. 821, 825–26 (D. Del. 1999) (determining that the "doctrine of necessity" may authorize payment of pre-petition claims when necessary for a chapter 11 debtor's survival); *In re CoServ, L.L.C.*, 273 B.R. 487, 497 (Bankr. N.D. Tex. 2002) (same); *In re Ionosphere Clubs, Inc.*, 98 B.R. 175 (Bankr. S.D.N.Y. 1989) (granting authority to pay pre-petition wages); *In re Montgomery Ward Holding Corp.*, 242 B.R. 147, 153 (D. Del. 1999) (determining that "business judgment" standard under section 363 of the Bankruptcy Code is correct standard for reviewing a retention program); *In re Aerovox, Inc.*, 269 B.R. 74, 80 (Bankr.

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D. Mass. 2001) (granting debtor's motion to approve key employee retention plan, noting that a debtor's business decision "should be approved by the court unless it is shown to be 'so manifestly unreasonable that it could not be based upon sound business judgment, but only on bad faith, or whim or caprice'") (internal citations omitted).

Debtors typically addressed compensation of the most senior executives following emergence from chapter 11 through their chapter 11 plans. A chapter 11 plan may provide for, among other things, (i) assumption or rejection of a senior executive's pre-petition employment agreement, (ii) impairment of any claims that arise from the rejection of such an agreement, (iii) entry into new employment agreements for senior executives who will continue to work for the reorganized debtor, and (iv) establishment of new compensation and incentive programs for senior executives, including equity-based compensation programs. To allow creditors to cast informed votes on a proposed plan, section 1129(a)(5) of the Bankruptcy Code requires that the plan proponent disclose the identities of each director and officer of the reorganized debtor and of any insider[2] who will be employed or retained by the reorganized debtor. The plan proponent must also disclose the compensation to be granted to any such insider and must show that the appointment of each director and officer is consistent with public policy and with the interests of creditors and equity holders.

C. BAPCPA

Responding to certain perceived abuses of KERPs and severance compensation, Congress enacted four significant restrictions on insider compensation as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). *First*, section 503(c)(1) limits retention payments to insiders to situations in which the insider has a "bona fide job offer from another business at the same or greater rate of compensation," the person's "services . . . are essential to the survival of the business," and the amount of compensation fits within numerical caps that are based on retention benefits given to other employees. *Second*, section 503(c)(2) limits severance payments to insiders to payments under "a program that is generally applicable to all full-time employees" and sets a numerical cap based on severance pay given to non-management employees. *Third*, section 503(c)(3) requires all other transfers and obligations outside the ordinary course of business, including those incurred for the benefit of "officers, managers, or consultants," to be "justified by the facts and circumstances of the case." Courts have generally understood this standard to be higher than the "business judgment" standard that regulates most transactions outside the ordinary course of business. *In re Pilgrim's Pride Corp.*, 401 B.R. 229, 236–37 (Bankr. N.D. Tex. 2009); *but see In re Velo Holdings, Inc.*, 472 B.R. 201, 212–13 (Bankr. S.D.N.Y. 2012) (applying business judgment standard and noting split in authority). *Fourth*, the debtor (or another party with standing to sue on behalf of the debtor's bankruptcy estate) may

[2] Under the Bankruptcy Code, an "insider" of a corporation includes, but is not limited to, a director of the debtor, an officer of the debtor, a person in control of the debtor, a general partner of the debtor (i.e., a person who is a general partner in a partnership in which the debtor is a partner), and a relative of any of the foregoing. 11 U.S.C. § 101(31)(B). This and other relevant definitions are set forth in Exhibit B.

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avoid certain pre-petition transfers or obligations that were incurred to or for the benefit of insiders where the debtor did not receive reasonably equivalent value. 11 U.S.C. § 548(a)(1)(B)(IV).

Shortly after Congress adopted BAPCPA, Richard Levin testified before the House Subcommittee on Commercial & Administrative Law on behalf of the Conference in his capacity as the Conference's vice chair. In that testimony, Mr. Levin observed that properly designed incentive, retention, and severance plans for senior executives "can enhance the viability and value of a business and can serve a proper purpose in business in general and in reorganization cases in particular." *Executive Compensation in Chapter 11 Bankruptcy Cases: How Much is too Much?: Hearing Before the Subcommittee on Commercial and Administrative Law*, 110 Cong. 11, 21–26 (2007) (statement of Richard Levin, attached as Exhibit C). While compensation plans "can be in everyone's interest because they preserve the business and jobs, and, ultimately, enhance creditor recoveries," "[t]he difficulty lies in ensuring that these plans are used in an appropriate manner and are not excessive in light of their legitimate purposes." *Id.* In the Conference's view, compensation plans should be tailored to their legitimate objectives and should not be excessive. *Id.* The Conference also recognized that there may be heightened concerns over fairness and corporate waste in a bankruptcy case where creditors face significant losses and employees are losing jobs or taking pay cuts, especially if managers are allowed to design their own compensation programs. *Id.* Accordingly, the Conference supported, and continues to support, appropriate judicial oversight of senior executive compensation.

D. Flaws in Section 503(c)

Despite the Conference's support for appropriate oversight and regulation of senior executive compensation, the Conference also observed in its 2007 testimony that section 503(c) of the Bankruptcy Code has several flaws in its current formulation. *See id.* These flaws have persisted. Furthermore, executive compensation on the part of distressed companies has become less transparent and less amenable to judicial oversight in recent years, as debtors have avoided the strictures of section 503(c) by delivering retention bonuses to their senior executives prior to filing for bankruptcy. We believe that the proposed amendments to the Bankruptcy Code that the GAO has requested comment on will only exacerbate these unintended consequences. Rather than imposing additional mechanical restrictions on senior executive compensation, we believe Congress should amend section 503(c) in a manner that enhances a bankruptcy court's authority to examine senior executive compensation, thereby increasing transparency without unnecessarily restricting the bankruptcy court's ability to approve reasonable, properly designed compensation programs for senior executives that are consistent with the market and the needs of a particular case.

We see four primary issues with section 503(c) in its current formulation.

First, because the word "insider" is not defined precisely in the Bankruptcy Code, many cases have featured litigation over whether particular employees are "insiders." *See, e.g.*, *In re Borders Grp., Inc.*, 453 B.R. 459, 467–70 (Bankr. S.D.N.Y. 2011) (analyzing the definition of "insider"); *In re Foothills Texas, Inc.*, 408 B.R. 573, 577–83 (Bankr. D. Del. 2009) (same). This kind of dispute often arises when titles do not match responsibilities (e.g., employees who hold a "vice president" job title but are not authorized officers of the company) or when an employee has

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been appointed as a director or officer of a debtor's subsidiary out of convenience. In these cases, the Office of the U.S. Trustee often argues that title alone precludes such an individual from participating in a widely available retention program under section 503(c). Even when litigation is not filed, debtors often expend significant estate resources to convince the U.S. Trustee (or a creditors' committee) that the individual at issue is not in fact an "insider."

Second, the restrictions on retention and severance under section 503 have rendered those forms of compensation almost completely unworkable for companies in chapter 11, even though retention and severance plans are common compensation tools for healthy companies—including healthy companies that chapter 11 debtors must compete against. As described above, section 503(c)(1) allows a debtor to pay retention to an insider only if (among other onerous requirements) the insider has already obtained a bona fide job offer elsewhere at the same or higher compensation. In practice, a senior executive who has obtained a bona fide job offer will take the new job. The senior executive will not accept the delay and uncertainty of negotiating a retention bonus, presenting the retention package to creditors and other stakeholders for review, moving the bankruptcy court for approval of the retention, and obtaining court approval over any objections. Indeed, *no Conferee who participated in the preparation of this letter is aware of any debtor ever proposing a retention benefit under section 503(c)(1)*. As a result, section 503(c)(1) has effectively acted as a complete ban on retention payments to insiders.

Likewise, section 503(c)(2) restricts severance payments, which are also a common component of executive compensation packages. A severance payment must be "part of a program that is generally applicable to all full-time employees," and the amount may not exceed "10 times the amount of the mean severance pay given to non-management employees during the calendar year in which the payment is made."[3] These artificial restrictions have significantly curtailed, if not eliminated, the utility of severance in hiring or retaining senior executives for major stressed or distressed companies.

Third, section 503(c) has led to litigation over whether the restrictions on insider compensation also apply to payments under a confirmed and consummated chapter 11 plan, whether on account of an insider's pre-petition claims (under a pre-petition compensation arrangement) or as part of a post-emergence compensation program. These arguments have resulted in expensive litigation even where the overwhelming majority of a debtor's stakeholders have voted to accept a proposed chapter 11 plan (including its compensation components). This litigation reflects a fundamental disagreement whether section 503(c) imposes additional confirmation requirements beyond those of section 1129 (including the specific provisions of section 1129 that already relate to insiders and their compensation).

Fourth, the onerous restrictions of section 503(c) have driven companies to pursue other methods of providing senior executives with market-based compensation. Perceiving that section 503(c) may prevent a chapter 11 debtor from retaining key personnel, some distressed debtors have made retention payments prior to the commencement of chapter 11, subject to

[3] As a technical matter, it is often unclear to practitioners how to measure a severance payment against this cap when the calendar year has not yet ended.

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clawback if the executive leaves during the chapter 11 case. Although debtors must disclose these pre-petition payments, bankruptcy courts have very limited ability in practice to order the recovery of such payments, and bankruptcy courts do not have authority to pre-approve these pre-bankruptcy payments in the same way that bankruptcy courts reviewed post-petition retention payments prior to the enactment of section 503(c).[4] Accordingly, there is now less transparency and front-end oversight over retention payments to executives of chapter 11 debtors. Anecdotally, we also understand that some debtors have been reluctant to enforce clawback mechanisms against departed executives through litigation; by contrast, debtors that are able to deploy a traditional KERP can simply withhold retention payments from a departed executive.

II. RECOMMENDED CHANGES TO SECTION 503(C).

We recommend three primary changes to section 503(c).

First, Congress should replace the rigid requirements of paragraphs (1) and (2) of section 503(c) with a more flexible standard that is still more stringent than the deferential "business judgment" review that governed executive compensation before BAPCPA.

In making this recommendation, we recognize that fairness and equal sacrifice are important principles in chapter 11 and that not all creditors will receive a full recovery in bankruptcy. We also recognize that the GAO has presented its inquiry to the Conference following news stories regarding pre-bankruptcy payments to senior executives, sometimes where the same companies have taken action to reduce overall labor expenses. *See, e.g.*, Abha Bhattarai and Daniela Santamariña, *Bonuses before bankruptcy: Companies doled out millions to executives before filing for Chapter 11*, WASH. POST, Oct. 26, 2020. Congress, in adopting section 503(c), was responding to the pain and anger of employees who suffered pay cuts and layoffs even as bonus programs were being approved for top executives, and the most recent bankruptcy cycle comes in a broader social context of concerns over unfair wealth distribution, declining opportunity for ordinary people, and the decline of the American middle class. The Conference is not equipped to take a position on these broader societal issues or generally applicable non-bankruptcy legislation that may address them, but wishes to emphasize one point: pay inequity is not a bankruptcy-specific problem and it will not be solved through a statute that applies only to the handful of companies that go through a chapter 11 reorganization each year.

Some might argue that bankruptcy-specific legislation would be a good place to start at addressing what they see broader issues. But in fact, bankruptcy-specific limits on compensation would place a distressed company at a competitive disadvantage in recruiting and retaining managers just when it most needs a strong management team to overhaul its finances and operations. A successful reorganization, whether in or out of chapter 11, requires experienced senior executives who are competent to transform the company's business, willing to stick with the company through its reorganization, and incentivized to maximize the value of the enterprise

[4] BAPCPA's amendment to section 548, regarding prepetition payments to insiders, has not been an effective check on prepetition retention bonuses, as it is often difficult for a party to gain standing to sue under section 548 and then to show that a retention bonus was not given for reasonably equivalent value (especially when an executive has not, in fact, left his or her position with the debtor).

as a going concern. If a distressed company cannot hire or retain the right management team to lead the company through and out of a restructuring, the likely result is that the company will depend more heavily on outside consultants, attorneys, and bankers, at even greater cost to the business and its stakeholders—and at greater risk to rank-and-file jobs.

A bankruptcy court should be authorized to independently review all senior executive compensation to ensure that it is justified by the facts and circumstances of the case. We expect that the review of senior executive compensation would be guided by considerations similar to those that courts already apply to compensation programs under section 503(c)(3), such as (i) the relationship between the proposed compensation and the results to be obtained, (ii) the cost of the compensation in the context of the debtor's assets, liabilities, and earning potential, (iii) the scope of the compensation, including whether a proposed plan discriminates unfairly among employees, (iv) levels of compensation of the same type that have been awarded to other employees, (v) the debtor's independent professional advice and due diligence efforts, (vi) consistency with industry standards, (vii) the risk that an employee will find alternative employment, (viii) the employee's compensation history, both with the debtor and elsewhere, (ix) whether the employee is a new or existing hire, and (x) the employee's performance and the degree to which the employee bears responsibility for the debtor's financial condition. *See, e.g.*, *In re Dana Corp.*, 358 B.R. 567, 576–577 (Bankr. S.D.N.Y. 2006) (listing several of the above factors). Pure "pay-to-stay" retention plans, which are effectively banned under existing law, would be subject to the judicial review that this approach contemplates.

A replacement for section 503(c)(1)–(2) could also require that any request for bankruptcy court approval of senior executive compensation be accompanied by a sworn declaration from a member of the debtor's board (or similar governing body, if no board of directors exists) with responsibility for approving senior executive compensation. This declaration should contain, among other things, a summary of the declarant's role in decision-making regarding senior executive compensation, a statement that the declarant is disinterested in the compensation-related decisions (*i.e.*, that the declarant does not participate in the compensation program), the bona fides of developing the compensation program (including consultation with professional advisors), and the rationale for approving the compensation program.

To ensure that debtors do not simply replace one form of compensation with another, a replacement for section 503(c)(1)–(2) should apply to any post-petition incurrence of compensation obligations to covered executives, as well as the allowance or payment of pre-petition compensation obligations to covered executives, with the exception of (i) base compensation and benefits and (ii) non-administrative claims for severance under pre-petition contracts.

Second, Congress should narrow and clarify the category of persons covered by the provisions of section 503(c). Rather than rely on the definition of "insider," which, as discussed above, objecting parties argue picks up individuals who neither control the company's business nor the company's restructuring, Congress should rely on the established standard for senior executive compensation disclosures under the Securities Act. Under the Securities Act, public companies are required to make detailed compensation disclosures for the highest compensated employees. *See* 17 C.F.R. § 229.402. This set of employees generally includes those who are in

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control of the day-to-day operations of the business and, as a result, any restructuring of the business.

Third, the revised substantive requirements of section 503(c) should apply with equal force to pre-petition payments that were made, or obligations that were incurred, while the debtor was in contemplation of bankruptcy.[5] Congress could adopt a rebuttable presumption that a debtor was "in contemplation of bankruptcy" during the 90-day period leading up to the bankruptcy filing, much as section 547(f) currently presumes a debtor to have been insolvent during the same 90-day period. Importantly, however, we do not think that Congress should enact a "look-back" rule to section 503(c)(1)–(2) in its current form. If job candidates cannot trust that reasonable, market-level bonus plans will be preserved in bankruptcy, distressed companies may find it difficult to attract new senior managers. Pre-petition application of the existing rigid rules could have the perverse effect of (i) increasing the overall cost of senior executive compensation, if executives demand more base pay to compensate for uncertainty around their incentive plans and (ii) entrenching existing managers whose existing compensation plans would not be subject to the same review as new managers' plans.

An obligation incurred in contemplation of bankruptcy—such as a new employment contract or incentive plan—must be approved by the bankruptcy court. The proponent of the obligation (which may be the debtor-in-possession, the trustee or, perhaps, the applicable beneficiary) should bear the burden to show that the obligation satisfies the standards of section 503(c) during the case or the obligation should be ratified under a confirmed chapter 11 plan.

The debtor-in-possession or trustee (or, perhaps, the applicable transferee) should also be entitled to affirmatively seek approval of a pre-petition payment under the standards of section 503(c) during the case, and a confirmed chapter 11 plan should be able to release claims for the avoidance of pre-petition compensation, just as a plan can release other avoidance claims. Congress should also consider which entities should have standing to pursue an avoidance claim if the debtor-in-possession does not seek affirmative approval. On the one hand, a debtor-in-possession (which by default has sole standing to pursue claims on behalf of the estate) may be unlikely to pursue an avoidance action against current executives; on the other hand, granting automatic standing to any party in interest would give too much leverage to out-of-the-money case participants and would make it extremely difficult to settle these avoidance claims. In any event, avoidance of a pre-petition payment should be permitted only to the extent that the payment exceeds the amount that the debtor (or the transferee) can show would have been permitted during bankruptcy.

Fourth, Congress should clarify that section 503(c) does not extend to payments made or obligations incurred under a confirmed chapter 11 plan. In some plans, debtors have assumed specific pre-petition employment arrangements or have specifically allowed claims thereunder.

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5 The Bankruptcy Code already uses the concept of "in contemplation of bankruptcy" in other contexts. *See* 11 U.S.C. §§ 329(a), 526(a)(4); *see also* 18 U.S.C. § 152(7)–(8) (defining as criminal offenses certain fraudulent acts in contemplation of a bankruptcy case).

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Some parties (*e.g.*, the U.S. Trustee) have objected to such treatment on the ground that section 503(c) occupies the field and cannot be overridden by provisions in the confirmed plan. In the context of a chapter 11 plan, we think the better approach is to rely on the procedural and substantive rights of chapter 11 to serve as a check on unreasonable or abusive executive compensation.

If Congress is not interested in revisiting section 503(c) more holistically, then for the reasons discussed above and as we describe below, we caution against any amendment to the Bankruptcy Code that would create further categorical prohibitions against retention payments to employees. Such prohibitions would make it more difficult for stressed or distressed companies to attract and retain talent and would provide another difficult hurdle for those companies to clear as they look to reorganize, restructure, and operate as a going concern.

III. RESPONSES TO THE GAO'S QUESTIONS REGARDING SENIOR EXECUTIVE COMPENSATION.

A. Why, if at all, should the Bankruptcy Code's provisions applicable to retention or incentive bonuses be amended? How much weight should be given to public policy concerns about the loss of jobs and/or benefits for rank-and-file employees in comparison to the payment of executive bonuses during Chapter 11 bankruptcy?

Aside from the recommendations outlined above, the Bankruptcy Code's provisions on retention or incentive bonuses should not be amended. Both considerations raised by the GAO regarding the loss of jobs and benefits for rank-and-file employees and market-based compensation for executives are important to effectuate a successful reorganization of debtors and the continuance of the going concern.

Executives play a critical role in the restructuring process, and debtors need the flexibility to compensate those executives at a level that will ensure that those executives will stay with the debtor through the restructuring process. Accordingly, payment of appropriate compensation to executives is essential to maximizing the value of the debtor for all stakeholders consistent with the core goal of the Bankruptcy Code.

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B. A number of changes to the Bankruptcy Code have been proposed to further limit the grant of insider bonuses in Chapter 11 bankruptcy. Please provide your general thoughts on the possible costs and benefits of the proposed Code changes below:

1. Amend section 547 of the Bankruptcy Code (allowing trustees or the debtor-in-possession to seek avoidance of pre-petition transfers to insiders) so that any other party to the proceeding may seek avoidance of pre-petition transfers prior to the first hearing on the reorganization plan?

This proposal is unnecessary in light of the well-developed case law that allows a bankruptcy court to grant standing to parties other than the debtor to bring suit on behalf of the bankruptcy estate when a debtor-in-possession unjustifiably refuses to act. *See, e.g.*, *In re STN Enters.*, 779 F.2d 901, 904 (2d Cir. 1985); *Off. Comm. of Unsec. Creds. of Cybergenics Corp. v. Chinery*, 330 F.3d 548, 579 (3d Cir. 2003). Official committees of unsecured creditors routinely investigate the value of avoidance claims and seek standing to pursue those claims on behalf of the estate.

This proposal would also restrict the ability of companies to confirm their chapter 11 plans in a timely fashion. Existing law allows a chapter 11 plan to preserve causes of action (including under sections 547 and 548 of the Bankruptcy Code) for litigation after the debtor's emergence from bankruptcy. Furthermore, creditors can negotiate to preserve those causes of action as part of the chapter 11 plan, and even for those causes of action to be assigned to a litigation trust for the benefit of creditors. Moreover, debtors bear the burden of demonstrating that the release of any such causes of action through a chapter 11 plan is consistent with the standard applicable to settlements under Rule 9019 of the Federal Rules of Bankruptcy Procedure.

Allowing any party in interest to file a preference or other avoidance claim against insiders may also lead to costly disputes about which party among competing parties should have authority to pursue and settle the claim. Furthermore, parties may use such claims as unfair bargaining leverage in plan negotiations. All of these issues are likely to increase administrative expenses for debtors and consume court resources.

2. Amend section 548 of the Bankruptcy Code (allowing creditors to seek avoidance of fraudulent transfers if made or incurred within 2 years) to extend the avoidance period to 6 years?

The Bankruptcy Code's two-year lookback period is a uniform federal baseline for fraudulent transfer actions that arise in a bankruptcy case. However, the Bankruptcy Code also allows a debtor (or another party with standing) to pursue causes of action under non-bankruptcy law. *See* 11 U.S.C. § 544(b)(1). In nearly every circumstance, non-bankruptcy law includes a fraudulent conveyance statute similar to section 548 of the Bankruptcy Code, and these statutes are subject to state-law limitation periods that generally range from four to six years.

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We think that existing law strikes an appropriate balance between, on the one hand, providing debtors with a minimum capability to unwind fraudulent transfers and, on the other hand, deferring in most cases to the judgments of state legislatures how far to extend the reach of fraudulent transfer law. If Congress were to extend the federal lookback period to six years, it would override the decisions of the overwhelming majority of states that have imposed a shorter lookback period of four years. *See* 1 Collier on Bankr. ¶ 548.01B (16th ed. 2021) (illustrating that approximately 24 states, the District of Columbia, and the Virgin Islands have adopted the four-year lookback period in the 1984 Uniform Fraudulent Transfer Act); *see also id.* ¶ 548.01C (16th ed. 2021) (illustrating that another 21 states have adopted the four-year lookback period in the 2014 Uniform Voidable Transactions Act).

Although this proposal would apparently apply to *all* transactions (not just executive compensation), we note that the Bankruptcy Code's two-year lookback period is more than sufficient to cover payments to or obligations incurred to executives. Companies rarely, if ever, know they will be filing for chapter 11 protection more than two years prior to the commencement of a bankruptcy case. As such, changes to insider compensation more than two years prior to the bankruptcy are highly unlikely to be in anticipation of a bankruptcy filing or an attempted end-run around section 503(c).

3. Amend section 548 of the Bankruptcy Code to allow avoidance of any transfer to an insider on or within 90 days of filing if the transfer would not have been allowed under section 503(c); and, amend section 1129 so that the right to seek such avoidance under section 548 may not be discharged or released under the reorganization plan?

Avoidance

As set forth above, the Conference supports a statutory claw-back action for pre-petition payments in contemplation of bankruptcy that would not have been permitted during bankruptcy. However, we do not think that Congress should allow payments to be clawed back based on section 503(c)(1)–(2) in its current form. This type of categorical prohibition will subject an already troubled company to additional stress and put stressed or distressed companies at a severe disadvantage in the marketplace for senior executives. Thus, while we believe that a claw-back may be appropriate, it should be based on an amended section 503(c) that relies on a non-exclusive list of factors, such as those identified in *In re Dana*, 358 B.R. 567, 576–577 (Bankr. S.D.N.Y. 2006), rather than categorical prohibitions.

Rather than a rigid, 90-day look-back period, we suggest that the standard be more flexible – in contemplation of bankruptcy – but with a rebuttable presumption that payments made within 90 days before bankruptcy were in contemplation thereof. This will reduce the incentives for a debtor to delay its chapter 11 filing to wait out the 90-day period, if the debtor perceives a need to retain its executives and avoid the distraction of lawsuits under this new provision. Such a delay could harm creditors if, for example, the delay causes the debtor to need a greater amount of (expensive) post-petition financing.

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Prohibition on Releases of Avoidance Actions

A categorical prohibition on a release of this new avoidance claim under a plan would be unprecedented. No iteration of the Bankruptcy Code has ever prohibited a debtor from releasing or settling a particular type of claim, whether under a plan or during a chapter 11 case. To the contrary, section 1123(b)(3)(A) provides that a plan may "provide for . . . the settlement or adjustment of ***any*** claim or interest belonging to the debtor or to the estate . . .," without exception. (Emphasis added.) We see no reason to single out the proposed new avoidance claim as an exception to the ability to release claims under a plan—particularly given all of the protections and requirements that are built into the plan confirmation process.

Moreover, if a particular release is not consistent with the debtor's business judgment or does not satisfy the general legal standards for releases under the Bankruptcy Code and applicable case law, the bankruptcy court has discretion to reject the release. *See, e.g.*, *In re Spansion, Inc.*, 426 B.R. 114, 143 (Bankr. D. Del. 2010) (determining that the releases contemplated under the plan of reorganization were too broad); *In re Wash. Mut., Inc.*, 442 B.R. 314, 355 (Bankr. D. Del. 2011) (same); *In re Zenith Elecs. Corp.*, 241 B.R. 92, 111 (Bankr. D. Del. 1999) (same). Further, compromises under a plan are often beneficial to all parties and forbidding compromises by barring the inclusion of a release in a plan may be counter-productive to the ability of a debtor to negotiate an acceptable plan that resolves a valid claim on terms beneficial to the estate.

Finally, a blanket prohibition of releases would likely be ineffective. Debtors might simply settle potential avoidance actions for a nominal amount, executives of a distressed company would likely demand higher pay to compensate for the increased risk of clawback, and executives who continue with a debtor after bankruptcy could demand that the reorganized company indemnify them for any clawback. The net result would be increased burdens and professional expenses for a chapter 11 debtor, without any material increase in the prosecution of meritorious avoidance actions.

4. **Amend section 1129(a) of the Bankruptcy Code (regarding requirements for a court to approve a reorganization plan) so that insider bonuses included in pre-packaged reorganization plans are subject to court review to determine if they are: (a) reasonable when compared to bonuses paid at a comparable company and (b) proportionate compared to payments to the non-management workforce?**

This amendment is unnecessary and would be overly burdensome for debtors. A "prepackaged" chapter 11 case is one in which the debtor solicits votes on a plan and receives acceptances from impaired creditors *before* the chapter 11 case is filed, leading to a streamlined and very cost-effective process for confirmation and emergence. Normally, the only impaired creditors in these cases are financial creditors (banks, investment funds, etc.), and other claims are left unimpaired by the chapter 11 plan. Collective bargaining agreements and other contracts are not rejected or modified, pensions are not reduced, and vendors are not affected by the reorganization. In this context, additional restrictions on senior executive compensation would be unreasonably burdensome.

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Moreover, even if unsecured creditors are impaired under a plan, Congress should not override the views of creditors and other stakeholders who are impaired and entitled to vote on the plan of reorganization. If the creditor democracy votes in favor of the plan of reorganization, debtors should not be required to satisfy even higher standards. Stakeholders in a prearranged or prepackaged chapter 11 case spend many hours of due diligence on all issues related to the company, including its compensation programs. Often, the compensation programs are one of the most heavily negotiated provisions of a prepackaged or prearranged chapter 11 plan. Creditors and other stakeholders would not be willing to support a plan that contemplates unreasonable or above-market compensation for management.

As such, this proposed amendment would provide little benefit to economic stakeholders and would lead to burdensome litigation, likely from sources that have little or no economic interest in the enterprise (*e.g.*, the U.S. Trustee or out-of-the-money stakeholders looking to extract hold up value).

5. Amend section 503(c)(3) of the Bankruptcy Code (regarding requirements for paying insiders incentive bonuses) so that specific standards are set for paying incentive bonuses, such as: (a) reasonable relationship between the proposed plan and results to be obtained, (b) the bonus is part of a generally-applicable workforce incentive program, and (c) the bonus is not excessive in light of the company finances, consistent with industry standards, and prepared after due diligence, with aid of independent counsel, into the need for the plan and what is generally applicable in the industry?

As discussed above, we believe that a bankruptcy court's review of senior executive compensation should be governed by a non-exclusive list of factors, as many courts already are doing in applying section 503(c). However, we urge Congress not to adopt a mandatory or exclusive set of factors, as not all factors are relevant to all companies and some factors that are not enumerated in the proposed provision may be relevant. For example, throughout the COVID-19 pandemic, certain retail companies seeking chapter 11 relief have had to develop incentive plans that are not based on traditional financial metrics because those metrics have no meaning when all of the company's stores are shuttered. The existing statute has given bankruptcy courts the flexibility to recognize these unique circumstances instead of applying a mandatory, "one-size-fits-all" list of mandatory factors. *See, e.g.*, *In re Dana Corp.*, 358 B.R. 567, 576–577 (Bankr. S.D.N.Y. 2006) (noting that bankruptcy court has "discretion" in review of "bonus and incentive plans, which are not primarily motivated by retention or in the nature of severance," and listing factors that courts may consider in context of review); *see also In re FirstEnergy Sols. Corp.*, 591 B.R. 688 (Bankr. N.D. Ohio 2018) (citing *Dana*'s factors as "not exhaustive nor of inherently equal weight" in concluding that non-insider plan discriminated unfairly among employees and was not designed to achieve purpose); *In re Hawker Beechcraft, Inc.*, 479 B.R. 308 (Bankr. S.D.N.Y. 2012) (denying approval of "incentive" plan where performance targets matched expected performance under business plan).

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6. Amend section 107 of the Bankruptcy Code (allowing U.S. Trustees to access all information filed or submitted in bankruptcy) so that it is clear that executive bonus information may not be sealed from U.S. Trustees?

This proposed amendment is unnecessary because section 107(c)(3) of the Bankruptcy Code already provides the U.S. Trustee with "full access to all information contained in any paper filed or submitted" in a bankruptcy case, including payments made to insiders. Furthermore, debtors also report insider payments to the general public through the filing of statements of (pre-petition) financial affairs and (post-petition) operating reports, and key constituencies (such as the official committee of unsecured creditors) are normally able to review compensation plans on an unredacted basis.

7. Amend section 1107 of the Bankruptcy Code (allowing debtor to retain control of the company during Chapter 11 bankruptcy) so that the debtors' managers continue to run the company during bankruptcy but the bankruptcy process is managed by a trustee?

This far-reaching proposal would unwind more than forty years of progress in business bankruptcy practice under the Bankruptcy Code. *See* Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 35 (1995) ("A strong effort was made in the 1978 Act to improve the administration of bankruptcy cases. The Commission had recommended the use of a Bankruptcy Administrator. This suggestion was not adopted . . . . The new Chapter 11 left the debtor in possession, with a trustee to be appointed only for cause[.]"). *The Conference strongly believes that concerns over executive compensation in chapter 11 should not drive Congress to abandon the modern system of debtor-led bankruptcy or impose a new layer of substantial administrative expenses to chapter 11 cases.* The Bankruptcy Code, in its present form, provides bankruptcy courts and parties with adequate tools to monitor a debtor's management and ultimately to displace management in the extraordinary circumstances where a trustee-led process is appropriate.

The debtor-in-possession model has worked well for business reorganizations, and many other countries have significantly changed their insolvency regimes to follow chapter 11's debtor-centric approach. By contrast, the trustee- or administrator-led model has failed the test of experience every time it has been tried in the United States. Most recently, the reorganization provisions of the Chandler Act of 1938 required most large businesses to cede control over the restructuring process to an independent trustee, with close administrative oversight by the SEC. As a result, the number of reorganization proceedings plummeted, as managers of insolvent public companies often did all they could to avoid seeking relief under the chapter of bankruptcy law that had ostensibly been designed for them. *See* DAVID A. SKEEL, JR., DEBT'S DOMINION 125–126, 162–164 (2001). Congress repudiated this approach in the 1978 Bankruptcy Code, finding that a mandatory trustee was more harmful than helpful:

> [V]ery often the creditors will be benefited by continuation of the debtor in possession, both because the expense of the trustee will not be required, and the debtor, who is familiar with his business,

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> will be better able to operate it during the reorganization case. A trustee frequently has to take time to familiarize himself with the business before the reorganization can get under way. Thus, a debtor continued in possession may lead to a greater likelihood of success in the reorganization. Moreover, the need for reorganization of a public company today often results from simple business reverses, not from any fraud, dishonesty, or gross mismanagement on the part of the debtor's management. Even if the cause is fraud or dishonesty, very frequently the fraudulent management will have been ousted shortly before the filing of the reorganization case, and the new management, very capable of running the business, should not be ousted by a trustee because of the sins of former management.

H.R. Rep. No. 95-595, 95th Cong., 1st Sess. (1977), at 233.

Paradoxically, the suggested amendment would put the United States behind many of the countries (such as the United Kingdom, the Netherlands, and Germany) that have begun to modernize their legal regimes by abandoning administrator- or trustee-led insolvency regimes. *See, e.g.*, *UPDATE – Changes to Final German Restructuring Legislation: UK Restructuring Plan, German Scheme and Dutch Scheme*, MILBANK LLP & NAUTADUTILH (Feb. 2021), *available at* https://www.milbank.com/images/content/1/4/v2/149400/Client-briefing-Dutch-Scheme-UK-Restructuring-Plan-and-German-Sc.pdf (describing modifications to the Dutch Scheme, UK Restructuring Plan, and German Scheme, which now allow for debtors to remain in control of operations during restructuring); Alison Goldthorp, *UK: A Move to a More Debtor-Friendly Restructuring Regime?*, NORTON ROSE FULBRIGHT (May 2020), *available at* https://www.nortonrosefulbright.com/en-us/knowledge/publications/79e1841b/uk-a-move-to-a-more-debtor-friendly-restructuring-regime (discussing the United Kingdom's Corporate Insolvency and Governance Bill and concluding that the bill "gives directors a real chance to pursue a rescue outside an insolvency process, whilst remaining in control of the company").

C. Is there anything else that would be helpful for us to know about executive bonuses paid in chapter 11 bankruptcy? What other organizations or individuals would you recommend we speak with regarding our work?

Senior executives are critical to the success of a reorganization, and appropriate compensation is important to ensure that executives remain with the debtor(s) to guide them through the bankruptcy process. As discussed above, there are appropriate checks on senior executive compensation in the bankruptcy process that have developed in the sixteen years since the passage of BAPCPA. Indeed, bankruptcy courts have denied approval of senior executive compensation programs where those programs were, among other things, unreasonable and above-market, lacking in stakeholder support, or otherwise inconsistent with the Bankruptcy Code. *See, e.g.*, *In re Hawker Beechcraft, Inc.*, 479 B.R. 308 (Bankr. S.D.N.Y. 2012); *In re Dana Corp.*, 351 B.R. 96 (Bankr. S.D.N.Y. 2006). Moreover, bankruptcy courts already have tools available to unwind inappropriate prepetition payments to senior executives. *Off. Emp't-Related Issues Comm. of Enron Corp. v. Arnold* (*In re Enron Corp.*), 2005 WL 6237551, 2005 Bankr. LEXIS 3261, Adv. Nos. 03-3522, -3721 (Bankr. S.D. Tex. Dec. 5, 2005) (avoiding pre-petition bonus

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payments to insiders under sections 544, 547, and 548). Accordingly, we believe the system is functioning better than the tone of the questions and the recent articles in the media would suggest. That said, there is always room for improvement to the extent such improvement can be accomplished without doing harm to the foundational principles of reorganizing businesses for the collective benefit of all those having an interest in the enterprise.

In closing, we recognize the importance of these issues and truly appreciate the opportunity to address these questions. We are available to answer any additional questions and look forward to continuing to work with the GAO.

Sincerely,

Douglas Baird
Conference Chair
Douglas_Baird@Law.UChicago.edu
1 (773) 702-9571

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Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

Michael E. Clements at (202) 512-8678, or clementsm@gao.gov

Staff Acknowledgements

In addition to the contact named above, the following individuals made significant contributions to this report, Richard Tsuhara (Assistant Director), Philip Curtin (Analyst in Charge), Sarah Garcia, and Caroline Johnson. Also contributing to this report were Chelsea Carter, William Chatlos, Tamara Cross, Joseph Cruz, John Karikari, Josephine Perez, Barbara Roesmann, Jena Sinkfield, and Tyler Spunaugle.

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