Federal Ch. 11 Watchdog Stays Resolute Against Bonuses

By **Andrew Scurria**

Law360, New York (October 07, 2014, 9:24 PM ET) -- Energy Future Holdings Corp. will seek permission Wednesday to dole out $20 million in executive bonuses despite protests from the U.S. government's bankruptcy watchdog, which attorneys say remains fiercely opposed to such payments regardless of whether creditors approve.

Paying bonuses to the management of a bankrupt company offers obvious benefits to the debtor, namely retaining those workers with the deepest institutional knowledge who can best execute a turnaround. But with the U.S. Bankruptcy Code limiting debtors' ability to make payments for purely retentive purposes, debtors have for years been dressing up bonuses as performance-based incentives, then tying the payments to targets so low they are virtually guaranteed.

The U.S. trustee's office customarily objects to bonus requests on those grounds, although whether such efforts hold much of an upside for a company's creditors and other stakeholders is an open question in the bankruptcy community. A successful objection may save an estate a few million dollars, but it comes at the risk of seeing key employees defect.

"The UST is going to act on public policy grounds," said Ted Gavin of turnaround shopGavin Solmonese LLC. "So their view is that any type of retention program or any type of incentive program that is outsize relative to what the non-executives are getting is a problem on public policy grounds, and therefore they will object."

EFH took heat from the UST for proposing to continue certain prepetition bonus programs and to offer additional payments to several dozen members of its top brass if certain assets fetch a high-enough price at auction. U.S. Bankruptcy Judge Christopher S. Sontchi is set to conduct a one-day trial on the issue, which no other stakeholders have weighed in on.

Such disputes often don't involve creditors, which can strike their own arrangements with debtors to insert protective language and oversight mechanisms into a payment plan to

make sure the money is well-spent, Gavin said. EFH has characterized the bonuses as a "fair and reasonable exercise of the debtors' business judgment" tied to difficult performance metrics.

Bonuses were far easier to pay in bankruptcy before 2005, when Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act. The law effectively did away with key employee retention plans, which paid workers not to leave, and ushered in the era of key employee incentive plans.

The BAPCPA made justifying an incentive plan considerably more difficult, but it hardly changed debtors' need to keep key employees on the payroll during reorganizations. The top managers of a bankrupt company generally face significant reputational risk if things go south and have ample opportunity to find comparable work elsewhere.

Consequently, companies are faced with a need to funnel money to executives without running afoul of the BAPCPA restrictions. The typical solution, according to Jerry Bregman of Ezra Brutzkus Gubner LLP, is to present bonus plans as incentive-based and then lowball the corresponding performance targets to make them easily achievable.

The UST's position, meanwhile, is that the same management that brought a company into bankruptcy should not escape the pain that shareholders and other employees feel in Chapter 11.

"That's why the UST is so frustrated, because they have this regime where they require that the actual targets be met, and people try to show that they are in fact being met. But what's really going on here is that you have a market pressure to keep the right people in the positions where they need to be," Bregman said. "It's about market compensation."

Many UST objections are resolved informally through voluntary amendments to an initial bonus plan, such as removing certain top executives from the eligible recipients or imposing tighter performance metrics for triggering payouts.

But the executive compensation issue garnered widespread public attention in the bankruptcy of American Airlines Inc. parent AMR Corp. last year, which proposed to pay a $20 million severance payment to its outgoing CEO after he shepherded a successful merger with US Airways Group Inc.

After some contentious wrangling, U.S. Bankruptcy Judge Sean H. Lane **sustained the UST's objection to the payout**, even though AMR's creditors' committee supported the request. In prepared congressional testimony last month UST Director Clifford J. White III said the decision "has implications for policing other provisions of the Bankruptcy Code when companies attempt to circumvent the law through the plan confirmation process."

The UST challenged more than proposed key employee retention plans in court, according to the testimony. An objection's chance for success depends partly on how other stakeholders feel about the issue, because judges realize that the UST has no economic interest in the outcome, Gavin said.

Still, the UST shows no signs of letting up even in situations where a bonus request has broad support, in part because its narrative has a populist appeal that can overshadow stakeholders' desire for a steady hand at the wheel throughout the bankruptcy, Bregman said.

As part of its mission, the UST has an obligation to enforce the statute as it's written and object to requests that don't offer management a meaningful performance incentive.

"It's a good sound bite issue that gives them positive press, but one could argue that this particular provision is one that really shouldn't be enforced," Bregman said.

The bankruptcy is In re: Energy Future Holdings Corp. et al., case number 1:14-bk-10979, in the U.S. Bankruptcy Court for the District of Delaware.

--Editing by Jeremy Barker and Edrienne Su.