

BUSINESS REORGANIZATION ALERT

Ramifications of Bankruptcy Code Revisions Concerning Key Employees

By Steven B. Zuckerman, Esq.
and Arthur J. Spector, Esq.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") contains substantial amendments to the current Bankruptcy Code. One of the more significant business implications of the Act is the limitations it places on executive retention and severance programs, which are fairly standard in large Chapter 11 bankruptcy cases.

In order to stabilize a debtor's operations and motivate key salaried employees who are expected to make substantial contributions to the success of a Chapter 11 debtor's ongoing business or restructuring efforts, bankruptcy courts have frequently allowed debtors to adopt a "key employee retention plan," or KERP. A typical KERP will contain bonuses and other incentives to encourage executives and other employees to remain with a bankrupt entity as it reorganizes or liquidates.

The Act, on its face, makes the prospect of instituting a KERP more challenging, especially for "insiders" (which includes directors, officers and person(s) in control of the debtor) as it provides that a KERP benefiting an "insider" may not be approved by a bankruptcy court unless evidence is shown that the insider has a bona fide offer of employment from another business at the same or greater rate of compensation, the retention of the individual is "essential to the survival of the business," and the KERP

package does not exceed 10 times the mean of similar payments made to nonmanagement employees "for any purpose during the calendar year" or, if no such payments were made, 25 percent of any similar transfer made to the insider in the prior year. The Act also limits severance payments to insiders. Under the Act, severance to an insider must be pursuant to a program available to all full-time employees, and may not exceed 10 times the "mean severance" available to nonmanagement employees during the preceding year. Despite the sweeping changes to KERPs under the Act, there are serious questions as to the practical implications of these changes as a result of the apparent shift in the statutory authority governing KERPs. While there is no specific authority for KERPs in the current Bankruptcy Code, several courts have authorized KERPs under Code Section 363, which provides that a debtor in possession, after notice and a hearing, may use, sell, or lease property of the estate "outside the ordinary course of business." Courts typically require debtors to establish a sound business purpose for the implementation of a KERP and require that the program is fair and reasonable.

Under the Act, the provisions relating to KERPs are set forth in Section 503 of the Bankruptcy Code, which deals with the allowance of administrative expenses. It is unclear why Congress did not include the KERP amendments in Section 363, which has historically been the Code section relied upon to authorize KERPs. Indeed, the placement under Section 503 seems inapt and impractical as that section provides that an entity **may file** a request for payment of an administrative expense.

Since the Act does not require debtors to seek authorization of KERPs under amended Section 503, it appears that debtors may still seek approval of KERPs under Section 363. The plain meaning of amended Section 503 begs the question whether it will have any practical impact on KERPs so long as entities affected by such plans do not file a request for payment under Section 503. Congress created further

confusion regarding the interplay between Section 363 and amended Section 503 by adding subsection 503(c)(3), prohibiting transfers or obligations that are "outside the ordinary course of business" to officers, managers or consultants hired after the petition date.

Nevertheless, that Congress chose to place these KERP limitations in Section 503 instead of Section 363 makes it unclear to what extent these amendments will actually impact KERPs.

For practical purposes, if courts disagree that Section 363 may still be employed to authorize KERPs, there may still be a way to retain key employees while evading the new KERP restrictions under the Act. Before the company files a chapter 11 case, key employees could resign and reemerge as a professional to be employed by the debtor under Section 327 of the Bankruptcy Code, either individually or through a turnaround firm to be employed by the debtor. Key employees may also enter into lucrative employment agreements on the eve of bankruptcy and then seek the assumption of such agreements under Section 365 of the Bankruptcy Code.

In conclusion, it is likely that Congress included these amendments to address its concern that management employees do not receive a disproportionate amount of the funds proposed to be paid under the program. However, these changes seem too far-reaching and, if strictly enforced, may result in the denial of a KERP that would be necessary for reorganization. Nevertheless, that Congress chose to place these KERP limitations in Section 503 instead of Section 363 makes it unclear to what extent these amendments will actually impact KERPs. At this early stage, it appears that a creative practitioner has several means to try to circumvent these perhaps well-meaning but possibly counter-productive amendments. Bankruptcy Court suggests that the BAPCPA cap on homestead exemption does not apply to Florida residents. ■





ARTHUR J. SPECTOR

Arthur Spector is a shareholder and serves as the team manager for the firm's Business Reorganization Team, resident in the firm's Fort Lauderdale office.

Mr. Spector was a United States Bankruptcy Judge in the Eastern District of Michigan for eighteen years (1984-2002), where he was Chief Judge the last three years. He authored 170 published judicial opinions, including 25 in the Dow Corning case alone.

Before taking the bench, Mr. Spector was engaged in the general practice of law in Bay City, Michigan, with an emphasis on bankruptcy and litigation. From 1974 through 1976, Mr. Spector

served as an assistant district attorney in New York County, New York.

Mr. Spector is a contributing editor for NORTON BANKRUPTCY LAW & PRACTICE II. He has authored numerous law review articles and monographs. Mr. Spector was an adjunct Professor of Law at the Thomas M. Cooley Law School in Lansing, Michigan, and instructed at law schools, and innumerable professional and judicial seminars.

He is a member of the American Bankruptcy Institute and of the National Conference of Bankruptcy Judges,

where he served on the Board of Governors and committees.

Mr. Spector earned his juris doctorate cum laude in 1974 at the Boston University School of Law and his Bachelor of Arts degree at the City College of New York in 1971. He has achieved an AV rating in Martindale, Hubbell.

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STEVEN B. ZUCKERMAN

Steven B. Zuckerman received his undergraduate degree, cum laude, from Boston University in 1995 and his law degree, cum laude, from University of Miami School of Law in 1998. He is licensed to practice before all state courts in Florida and the United States District Court for the Southern District and Middle District of Florida. While at University of Miami, Mr. Zuckerman was a member of the Business Law Review and International Moot Court.

Prior to joining Berger Singerman, Mr. Zuckerman was Vice President and Associate General Counsel for an early stage technology company. As a member of the Business Reorganization Team, Steven is actively involved in the representation of debtors, creditors' committees, and bankruptcy

trustees. He has been involved in cases with thousands of claims and unsecured debt exceeding \$1 Billion. Active in his community, Mr. Zuckerman participated in the Miami Chamber of Commerce's Leadership Miami program, is a mentor to minority law students at the University of Miami School of Law and is active in local politics. He is also the co-founder of "Leaders of Tomorrow," a network of the next generation of business leaders in South Florida.

Mr. Zuckerman is a member of the Bankruptcy Bar Association and the Dade County Bar Association, and his practice areas include bankruptcy, litigation and commercial transactions. Mr. Zuckerman was born in Queens, New York on April 17, 1974.

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attorneys at law

BUSINESS REORGANIZATION TEAM

PAUL A. AVRON	(305) 714-4357
DOUGLAS A. BATES	(305) 714-4361
LESLIE GERN CLOYD	(954) 377-0414
JAMES H. FIERBERG	(305) 714-4370
DEBI GALLER	(305) 714-4397
JORDI GUSO	(305) 714-4375
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BRIAN G. RICH	(954) 712-5120
GRACE E. ROBSON	(954) 712-5110
PAUL STEVEN SINGERMAN	(305) 714-4343
ARTHUR J. SPECTOR	(954) 713-7511
STEVEN B. ZUCKERMAN	(305) 714-4362