TRENDING EXECUTIVE COMPENSATION ISSUES IN BANKRUPTCY[1]

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[1] The views expressed by Ms. Lambert do not necessarily reflect the views of the United States Department of Justice.

I. Overview

A. Spotlight on Executive Compensation Issues

Numerous articles in widely read newspapers such as the Wall Street Journal, Washington Post, and New York Times (as well as widely read media platforms such as Bloomberg and Reuters) have highlighted over the past two years the recent trend in executive bonuses being paid by companies either shortly before filing Chapter 11 or in connection with a proposed management incentive plan presented to the Bankruptcy Court during the Chapter 11 proceeding. Elected officials have also reacted to bonus payments to senior management in both high profile Chapter 11 cases as well as cash-strapped companies that elect not to file Chapter 11. Attached to these materials as Exhibit "1" is a letter from Senator Elizabeth Warren (D-Mass.) to the CEO of Genesis Healthcare Inc. regarding bonuses to its senior executives while operating skilled nursing facilities in which over 2800 residents died as a result of COVID-19. Senator Warren noted that Genesis had claimed to be cash-strapped and accordingly received $300 million in state and federal aid under the *Coronavirus Aid, Relief and Economic Security Act*. The then CEO, George Hager, was paid a retention bonus of $5.2 million dollars in October 2020. Mr. Hager subsequently announced his retirement in January 2021. A number of Senator Warren's colleagues share her outrage at overly generous compensation/bonus payments to top executives of companies that layoff large numbers of employees or shutter business lines due to undercapitalization. Although our presentation focuses solely on executive bonuses in bankruptcy cases, the opposition to what is perceived as overly generous compensation packages for executives transcends Chapter 11 and has prompted reactions across the political spectrum.

Executive compensation, bonuses, and severance packages have been fodder for the media, academics and politicians since the late 1990's and early years of this century. Senator Ted Kennedy led a bi-partisan effort prior to the enactment of BAPCPA in 2005 to limit excessive bonuses to top management, which he characterized as "glaring abuses of the bankruptcy system by the executives of giant companies." Those efforts lead to the enactment of Bankruptcy Code Sections 503(c)(1)-(3), which restricted the then-common practice of Chapter 11 debtors seeking approval early in the case for "Executive Retention Bonuses." The panel will address Congress's effort in 2005 to limit both the number of Executive Retention Bonus programs being approved in Chapter 11 cases, as well as the dollar amount of any bonus a Chapter 11 debtor could pay to its senior management. Suffice to say that practicing lawyers, academics, politicians, and journalists have criticized Bankruptcy Code Section 503(c) as being both ineffective and harmful to the reorganization process. Jared A. Ellias, a professor at UC Hastings College of the Law, has recently written extensively on executive bonuses in Chapter 11 and like many practicing bankruptcy lawyers and commentators, has observed that criticisms of the current version of Section 503(c) arise from a poorly drafted legislative fix to excessive executive compensation.

A recent study and report by the Government Accountability Office ("GAO") revealed that during 2020 forty-two (42) Chapter 11 debtors paid over $160 million in pre-bankruptcy bonuses to senior management within months, if not, weeks of the petition date.[2] These pre-bankruptcy

[2] Government Accountability Office, *Enhanced Authority Could Strengthen Oversight of Executive Bonuses Awarded Before a Bankruptcy Filing*, GAO-21-104617, dated September 30, 2021, available at https://www.gao.gov/products/gao-21-104617.

bonuses appear to have been a direct effort to circumvent the requirements of Section 503(c). Although creditors objected to pre-bankruptcy bonuses in several cases, a study by the Wall Street Journal noted that "aside from some isolated [Chapter 11] cases, creditors of bankrupt businesses have shown little appetite to demand that executives return some or all of the retention pay they received. Only a handful of creditor groups have raised formal objections to bonuses paid out after Covid-19 hit by companies that later went bankrupt." Peg Brickley, *Toys 'R' Us Creditors Call for Jury Trial on Executive Stay Pay*, The Wall Street Journal, May 5, 2021.[3] Creditor involvement and participation in a Chapter 11 proceeding is one of the fundamental assumptions underlying the Bankruptcy Code. If creditors of a large corporate debtor do not object to payment of pre-bankruptcy bonuses and incentives, one must ask whether the media uproar over pre-bankruptcy bonuses to C-suite executives is justified. More importantly, restructuring professionals must ask whether the current legislative efforts to curb pre-bankruptcy bonuses and incentives will (i) harm a company's reorganization efforts and (ii) provide an effective deterrent against what many view as a financial windfall for senior management.

Our panel discussion will address the different types of executive bonuses which have arisen in recent years and some of the recommendations on how to inject transparency without thwarting a financially distressed company's ability to reorganize.

B. The Role of Management Incentive Bonuses

A successful Chapter 11 reorganization requires the corporate Chapter 11 debtor to propose a plan of reorganization that complies with the statutory requirements for confirmation of that plan. A confirmable plan, however, is nothing more than the legal vehicle through which a corporate debtor implements its short- and long-term post-confirmation business plan. The Bankruptcy Code offers a corporate debtor with an ability to eliminate certain unnecessary expenses (e.g., rejecting above market leases) while negotiating reductions with vendors/suppliers on necessary post-confirmation supply contracts. Reducing expenses are a critical component of a successful post-confirmation business plan but more often than not various cost cutting measures are "low hanging fruit." Increasing post-confirmation revenues is a much harder challenge for most corporate debtors. The path to increasing post-confirmation revenues depends on the business and the quality of the management team—whether that path involves pursuing a new business line or focuses on improving the production and quality of the goods or services sold by that corporate debtor or implementing a completely different business model. In cases in which a Chapter 11 debtor's assets are being marketed, a top-quality management team is critical to convincing potential buyers that the assets being purchased will yield a significant return on investment if the debtor's business has sufficient working capital.

A talented management team increases the likelihood of a successful reorganization. But at what cost, and is it worth it? Ensuring that a top-quality management team is committed to the success of a financially distressed company presents a challenge to that company's board of directors. Even more challenging is convincing talented individuals to leave a financially healthy company to undertake a daunting and difficult business reorganization of a soon-to-file corporate debtor.

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[3] Available at: https://www.wsj.com/articles/toys-r-us-creditors-call-for-jury-trial-on-executive-stay-pay-11620256320.

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