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APPROVING EMPLOYEE RETENTION AND SEVERANCE PROGRAMS: JUDICIAL DISCRETION RUN AMUCK?

A. MECHELE DICKERSON

INTRODUCTION

Because of recent chapter 11 mega-filings, Congress recently considered when (if ever) bankruptcy courts should be allowed to approve employee retention or severance programs. These programs are increasingly controversial because approving them creates the perception that bankruptcy courts condone a debtor's desire to give highly paid executives bonuses, while simultaneously laying off lower-level workers. Since lower-paid employees frequently are not covered by these bonus programs and often are terminated during the corporate restructuring, Congress seemed poised to eliminate this perception of inequitable treatment.

This Essay considers when (or whether) it is appropriate for courts to approve a debtor's request to adopt an employee retention or severance program. Specifically, the Essay considers whether courts are given too much discretion when deciding to approve these programs and whether the appearance that highly paid employees are allowed to profit from a chapter 11 reorganization justifies preventing courts from approving payments that might help facilitate a successful chapter 11 proceeding. While the enormous amount of payments involved in some recent highly publicized mega-cases mandates that courts approve plans in a way that is both rational and transparent, this Essay argues that courts' discretion generally should not be constrained. Instead, courts asked to approve these programs should continue to be guided by one factor: whether making the payments is necessary to help the debtor...

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1 See Nancy Rivera Brooks, Enron Execs Were Paid to Remain, L.A. TIMES, Dec. 7, 2001, § 3 (Business), at 3 (contrasting average $110,000 retention bonus given to Enron executives to average $4,500 severance pay for lower-level workers).

2 See Bethlehem Asks to Give $9 Million in Bonuses: Bankruptcy Judge Gets Plan, PLAIN DEALER (Cleveland), Dec. 29, 2001, at C1 [hereinafter Bethlehem Asks to Give] (reporting Bethlehem Steel Corp. submitted plan to allocate $8 million to 87 employees, and another $1 million to CEO Robert S. Miller, Jr.); Ann Davis, Want Some Extra Cash? File for Chapter 11: 'Pay-to-Stay' Bonuses are Common at Busted Tech Firms, WALL ST. J., Oct. 31, 2001, at C1 (reporting trend of retention bonuses paid to executives has increased due to wave of telecom bankruptcies); Enron Asks Court for Another Round of Retention Bonuses, WALL ST. J., Apr. 1, 2002, at C6 (reporting Enron petitioned court to approve third round of bonuses worth $125 million to key employees); Nelson D. Schwartz et al., Greed-Mart: Attention, Kmart Investors. The Company May Be Bankrupt, but Its Top Brass Have been Raking It In, FORTUNE, Oct. 14, 2002, at 139 (reporting Kmart's use of over $3 million in "inducement payments" and incentives to top executives); Jeff St. Onge, Bankruptcy Judge Oks WorldCom Bonuses: $25 Million Intended to Help Retain Key Staff, THE RECORD (Bergen County, NJ), Oct. 30, 2002, at B1 (reporting bankruptcy judge approved $25 million in retention bonuses for WorldCom key executives over objections of creditors).
achieve a successful reorganization or efficient liquidation. If that answer is yes, then courts largely should be allowed to ignore the "appearance" that the program favors certain employees.

Part I of the Essay discusses employee retention and severance programs in general. This Part suggests that, given the prevalence and general acceptance of these benefit plans outside of bankruptcy, there is nothing per se inappropriate about a chapter 11 debtor's request to provide retention or severance payments to its employees. Part II then describes the authority bankruptcy courts have when deciding whether to approve a debtor's request to implement a post-petition retention or severance program. In general, courts will approve a debtor's request to implement these bonus programs as long as the court concludes that the overall program is reasonable and that the debtor exercised proper business judgment in formulating the program. This Part then presents arguments typically advanced in support of, and in opposition to, the implementation of these programs and concludes by demonstrating that courts appear to have reached a general consensus when deciding which factors warrant the approval of these programs.

Congress recently proposed legislation designed to curtail the discretion of courts to approve post-petition retention and severance programs. Part III briefly discusses this legislation and other recent legislative attempts to curb judicial discretion. I suggest that judicial discretion arguably should be curbed when courts either have reached inconsistent, unpredictable results or when they rely on murky, undefined standards. I ultimately conclude, however, that the legislation designed to curb a court's ability to approve retention or severance programs is ill-advised largely because courts already apply rational factors that focus solely on whether the program is needed to help facilitate an efficient reorganization or liquidation. Indeed, the legislation would do little more than codify the factors courts already consider when approving these programs. Part III concludes that the legislation's proposed curbs on judicial discretion is problematic because these curbs likely will have negative unintended consequences.

Part IV of the Essay suggests that one possible benefit of the increased legislative scrutiny of bankruptcy court's discretionary authority is the potential that the test proposed in the retention and severance program legislation could (with a few modifications) be usefully applied in a different bankruptcy context. Specifically, while courts reach rational, transparent results when approving retention or severance programs, it is harder to say that about court orders or opinions that have approved debtors' motions for authorization to pay the prepetition claims of "critical vendors" under the Doctrine of Necessity. Part IV briefly discusses criticisms of the Doctrine of Necessity and acknowledges the validity of some of those criticisms due to the inconsistent, unpredictable results reached by courts that have approved payments under the Doctrine of Necessity and because the "doctrine" itself is murky and largely undefined. Given this, I suggest that the curbs contained in this recent legislation, as slightly modified, could
help curtail what many critics suggest is unbridled judicial discretion to approve the arguably unwarranted payment of pre-petition claims.

I. SEVERANCE AND RETENTION PROGRAMS

A. In General

Severance payments are generally a form of compensation offered after an employee is terminated and serves as replacement income for the employee while he or she searches for new employment. Employers offer retention bonuses to their employees as a reward or incentive for remaining with a company during a period of downsizing, merger, or reorganization and to compensate them for any related opportunity costs and risks associated with remaining with the company. It is a common practice for employers to provide severance or retention payments to their employees. According to a recent survey, almost 80% of employers offer their employees some type of severance package. Likewise, recent research indicates that more than three-fourths of companies in the ten major industry sectors surveyed nationwide report the existence of some type of employee severance policy. Since severance pay is not mandated by federal law, it most frequently is provided voluntarily by employers. As a result, benefits provided by programs may vary dramatically from employer to employer.

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3 See generally BLACK'S LAW DICTIONARY 1379 (7th ed. 1999).
8 Although the federal Fair Labor Standards Act does not mandate that employers provide severance pay, some state employment laws have such a mandate. In addition, certain regulated industries may have standards regarding severance payments. Similarly, private collective bargaining agreements may also outline standards that the employer must apply when deciding whether to provide severance benefits to covered employees. See U.S. DEPT OF LABOR, Benefits Topics - Severance Pay, at http://www.dol.gov/dol/topic/benefits-other/severancepay.htm; see also, ALEXANDER HAMILTON INSTITUTE, INC., Benefits Alert Newsletter, at http://www.benefitsalert.com/newsletter/banl082202.shtml (explaining severance pay not mandated by federal law).
9 See ALEXANDER HAMILTON INSTITUTE, INC., supra note 8 (stating there is no "one-size-fits all" program).
While the type of severance and retention benefits program that businesses offer their employees varies significantly, the programs contain certain common aspects. Most employers appear to base some or all of their severance payments on the length of service the employee has with the company. The most common employee service requirements range from six months to one year, and the typical formula used to calculate the severance amounts is a week of pay for each year of employee service. Typical severance packages can range anywhere from $2,000 to $100,000, with "key" or highly compensated employees typically receiving larger packages with increased benefits.

Employee retention bonuses vary more dramatically from company to company than do severance programs. Almost a third of all companies award employee bonuses that simply consist of an extended period of typical severance benefits. However, 28% use a more complicated formula based on a certain percentage of the employee salary, while the remaining 40% use an individualized formula based on factors such as length of service and position within the company.

B. Retention Plans In Chapter 11 Cases

It has become common for debtors to seek court permission to give bonuses to key or "mission critical" employees to encourage them to remain with the company after the business files for bankruptcy. Indeed, recent research suggests that almost half of all employers who file a petition for relief under chapter 11 of the Bankruptcy Code offer retention (also called "pay-to-stay") bonuses to ensure the continued service of their employees. In addition, it is increasingly common for a company to offer selective retention bonuses to certain individuals if the company anticipates that it will file for bankruptcy. Companies provide this benefit both to retain the employee and to help ensure the employee's loyalty during the company's

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10 See Rogers, supra note 6 (noting study findings).
11 Id. (finding median severance pay for officers, executives, and senior executives is two weeks' salary per year of service with company); see also Harrison, supra note 5 (observing higher-level executives more likely to negotiate severance pay individually in employment contracts).
12 See Rogers, supra note 6 (quoting client services consultant).
13 See Harrison, supra note 5.
14 See Bethlehem Asks to Give, supra note 2 (discussing retention bonuses for Bethlehem Steel Corp. and LTV Corp. executives); Davis, supra note 2 (discussing argument debtor companies use to support retention bonuses); Speedo Maker Asks Bankruptcy Judge to Approve Bonuses, N.Y. TIMES, Sept. 7, 2001, at C6 (discussing retention bonuses for key employees of Warnaco Group); Chris Woodward & Martin Kasindorf, Enron Execs Pocket Big Bonuses, USA TODAY, Feb. 1, 2002, at 1B (showing debtor's motivation for giving retention bonuses).
15 See Harrion, supra note 5.
16 See Brooks, supra, note 1 (reporting Enron paid 500 of its employees $55 million in retention bonuses, while other employees who lost jobs in the wake of filing were told they would receive no more than $4,500 in severance pay); Richard Korman & Tony Illia, Pay-to-Stay Plan Miffs Employees, ENGINEERING NEWS-REC., Jun. 18, 2001, available at http://www.construction.com/NewsCenter/Headlines/ENR/20010618b.jsp (stating selective retention bonuses are common in bankruptcy); Richard A. Oppel, Jr. & Kurt Eichenwald, Enron Paid $55 Million for Bonuses, N.Y. TIMES, Dec. 6, 2001, at C1 (observing Enron selectively paid about 500 employees retention bonuses while terminating 4000 other employees).
reorganization efforts. However, the advent of high-profile mega-filings within the last two years has brought into question the propriety of this practice. While critics object to both severance and retention programs, the most scrutiny, by far, has been on the judicial approval of key employee retention programs. As a result, companies who offer selective retention bonuses only to management (i.e. key employees) during their reorganizations increasingly have been criticized by the media, legislators, and the general public.

II. JUDICIAL APPROVAL OF EMPLOYEE RETENTION AND SEVERANCE PROGRAMS

Bankruptcy courts derive their authority to approve a debtor’s request to maintain or implement a retention or severance program from section 363(b) of the Bankruptcy Code. Section 363(b) gives a trustee or debtor-in-possession the authority to use, sell or lease, "other than in the ordinary course of business," property of the estate only upon court approval. Bankruptcy judges traditionally employ a two-part test when asked to approve a proposed retention or severance program. First, the court looks at whether the debtor exercised proper business judgment in formulating the program, i.e., whether a sound business practice justifies the request. Second, the court considers whether the proposed program is fair and reasonable.

Given the discretionary nature of this test, the decision to approve these plans necessarily will vary according to the circumstances of each individual case. Courts typically interpret section 363(b) liberally in order to give bankruptcy judges "substantial freedom to tailor" orders to "meet differing circumstances," and to avoid shackling the judge "with unnecessary rigid rules."

A. Rationale for Approving Retention or Severance Programs

While the court is given wide flexibility under section 363(b) to determine when to approve requests to use, sell, or lease a debtor’s property outside the

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17 See Harrison, supra note 5.
22 Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063, 1069 (2d Cir. 1983) (maintaining bankruptcy judge needs freedom to respond to particular facts of each case).
ordinary course of business, the debtor is required to articulate a business justification other than the "mere appeasement of major creditors" and must do more than just "follow the hue and cry of the most vocal special interest groups." Debtors often argue that they need to implement a retention program to appease key or mission-critical employees who might otherwise abandon the firm during the "thankless phase of rebuilding or dismantling an ailing enterprise." In addition, debtors maintain that they need to implement the plan to assuage employees' fears that remaining with the company would either force them to work in a materially adverse work environment or would impose severe limitations on their career opportunities, or that the employees need a "cushion" to fall back on if they are terminated because of a failed reorganization.

Debtors also argue that implementing a retention program saves them the cost of having to replace key employees. They argue that the cost to the business if critical employees leave includes: the intangible loss of expertise or experience that employees take with them; the direct costs of paying headhunter fees to find and hire replacement workers; the need to pay hiring bonuses or relocation fees for new employees if old employees leave the company; and, the time-cost involved with bringing new employees up to speed within the business. These costs, debtors contend, can be avoided by offering retention or severance payments to entice key management to stay.

Debtors also seek to implement or maintain severance or retention programs for equitable reasons. That is, debtors seek approval of these programs to reward employees for their hard work and dedication to the business. Likewise, debtors

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24 See In re Lionel Corp., 722 F. 2d at 1071 ("In fashioning its findings, a bankruptcy judge must not blindly follow the hue and cry of the most vocal special interest groups; rather, he should consider all salient factors pertaining to the proceeding.").
25 See Brooks, supra, note 1 (explaining why Enron paid bonuses); see also In re Geneva Steel Co., 236 B.R. 770, 772 (Bankr. D. Utah 1999) (noting uncontested evidence offered by debtor that talented job candidates often avoid working for chapter 11 debtors); In re Interco, Inc., 128 B.R. at 232 ("Participation in the Retention Plan will include only certain employees critical to the Debtors' ongoing operations . . . [and] is expected to encourage the Critical Executives to remain with the Debtors.").
26 See In re Montgomery Ward Holding Corp., 242 B.R. at 150 ("[A]s a result of the large amount of publicity surrounding the Debtors' bankruptcy, employees are very insecure and morale is at a low."); In re Geneva Steel Co., 236 B.R. at 773 (arguing key employees needed "a cushion to fall back on in the event they were terminated").
27 See In re Aerovox, Inc., 269 B.R. 74, 79 (Bankr. D. Mass. 2001) (stating cost of headhunting fees and additional expenses incurred in bringing new employees up to speed can equal upwards of entire year's salary for that employee); In re Montgomery Ward Holding Corp., 242 B.R. at 150 (explaining in testimony "[d]ebtors would incur significant expenses associated with replacing employees including searching fees, hiring bonuses, relocation expenses and disruption at the store and corporate levels"); In re Geneva Steel Corp., 236 B.R. at 772 (offering debtor's uncontested evidence where executive search firms charge fees that may equal 30% of key employee's base salary and that business likely would be required to pay above market salaries to induce qualified candidates to accept employment offer with chapter 11 debtor).
28 See In re Am. West Airlines, Inc., 171 B.R. 674, 678 (Bankr. D. Ariz. 1994) (seeking to reward "dedication of all of the employees of the debtor"); see also Jeffrey Krasner, Request for Bonuses Draws Fire from Former Arthur D. Little Workers, BOSTON GLOBE, June 5, 2002, at C1 (debtor's counsel argued to
have asked judges to approve plans to institute a cash-based retention program where (as often is the case) the chapter 11 filing eliminated or rendered worthless the value of any long-term, stock-based compensation employees had been promised pre-petition. Thus, debtors claim a judge should approve programs in order to compensate employees whose pre-petition compensation packages were effectively rendered valueless by the bankruptcy filing.

Finally, debtors ask courts to approve retention or severance programs in order to maintain a continuity of management, which may be the only way to preserve the value of the business. Especially during a chapter 11 reorganization, maintaining management stability is crucial to allay the concerns of existing creditors and to attract potential post-petition lenders. Moreover, even if the debtor likely would be sold as a going concern, it is in the best interest of the estate to retain a stable management team to preserve "buyer confidence." Given this concern, when debtors know (or believe) that the fear of employee flight will erode a potential buyer's confidence in the business, they argue that sound business practices merit the approval of a retention or severance program to prevent the possible decrease in the sale price of the business.

B. Factors Courts Consider When Approving Plans

Courts will generally approve key employee retention programs under section 363(b) "if the Debtor has used proper business judgment in formulating the program and the court finds the program to be fair and reasonable." Courts will rarely overturn a debtor's business decision "unless it is shown to be so manifestly unreasonable that it could not be based upon a sound business judgment, but only on bad faith, or whim or caprice." The business judgment test that courts apply when deciding whether to approve a retention plan is derived largely from the court "[i]t is now timely and fair to reward the key employees who remained with the debtors [and] tirelessly played an indispensable role" in the successful sale process; WORLDCOM INC.: OK Sought for $25 Million in Staff Retention Bonuses, CHI. TRIB., Oct. 19, 2002, Business, at 2 (quoting spokesman for debtor who said, "[t]he retention plan is an important element of our overall strategy to retain and reward employees for their efforts during our reorganization").

See In re Interco, Inc., 128 B.R. at 231 ("[S]tock-based, long-term incentive plans are widely used in the Debtors' industries as part of executive compensation packages . . . however, no value currently exists in these plans.").

32 In re Aerovox, Inc., 269 B.R. at 82 (finding particular employee was vital to successful reorganization); In re Montgomery Ward Holding Corp., 242 B.R. at 150 (showing debtors thought keeping certain employees was necessary for reorganization).

33 In re Aerovox, Inc., 269 B.R. at 81-82 (finding particular employee was vital to realizing best possible sale price); see also John Dempsey & Michael Siebenhaar, Bankruptcy Blues: Retaining Key Employees During a Financial Crisis, WORKSPAN, Feb. 1, 2002, available at 2002 WL 12188219 (discussing most bankrupt companies structure and implement retention plans for employees with eye towards goal of bankruptcy proceeding, whether it be obtaining highest liquidation value for remaining assets, or restructuring and obtaining highest resale value of all or portion of business).

34 In re Aerovox, Inc., 269 B.R. at 80 (citing In re Interco Inc., 128 B.R. 229, 234 (Bankr. E.D. Mo. 1991) (internal citation omitted)).

business judgment rule that courts apply when deciding whether members of a corporate board of directors should be held liable for breaching their fiduciary duty of care.

The corporate business judgment rule is designed to encourage directors to freely exercise their managerial discretion and to remove uncertainty from corporate transactions by avoiding an ex post appraisal of the their decisions. In general, unless it can be shown that the directors acted with the primary goal of accomplishing an impermissible purpose, decisions made by disinterested directors who used a rational, deliberately considered process to be informed or who made a good faith effort to advance the firm's interests typically will be shielded from liability. One question courts often ask when considering the rationality of the directors' deliberations is whether they sought external advice. Because of this, directors who are asked to consider whether a merger or takeover is financially "fair" to shareholders routinely seek the advice of investment bankers. Indeed, they rely on the advice they receive both to justify any merger decision the board approves and also to defend against potential liability if shareholders sue them for breaching their fiduciary duty of care. Similarly, it is not uncommon for the directors of companies who are seeking additional capital or are in merger discussions to obtain "solvency opinions" before committing to these potentially harmful transactions.

Determining the reasonableness of the debtor's request to adopt a retention or severance program requires courts to analyze certain specific factors in addition to just simply looking at the parties' justifications for approval or rejection. While courts take into consideration the debtor's alleged need for the approval of bonus programs, they also consider the objections of the United States Trustee, individual creditors, the unsecured creditors' committee or bondholders' committee, and other interested parties (including unions). Though creditors' committees sometimes support a debtor's motion to implement a retention program, when they (or others) object they typically argue that the programs are unnecessary given the additional administrative expenses which necessarily will be incurred. Objectors specifically

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34 See Ajay Sports, Inc. v. Casazza, 1 P.3d 267, 275 (Colo. Ct. App. 2000); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) ("The rule operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation.").
36 See William J. Carney, Fairness Opinions: How Fair are They and Why We Should Do Nothing About It, 70 WASH. U. L.Q. 523, 525 (1992) ("It is more useful to think of fairness opinions as assuring the continued application of the business judgment rule during an era when it has been under severe attack.").
38 See In re Geneva Steel Co., 236 B.R. 770, 772 (Bankr. D. Utah 1999) (indicating unsecured creditors' committee and bondholders' committee both supported debtor's motion to approve retention program; however, objections were filed by United States Trustee and Steelworkers Union).
argue that debtors should be forced to provide concrete evidence that key employees either have actually threatened to leave or are planning to leave before the court finds that the additional expense imposed by a retention or severance program are justified.\(^40\)

In determining the reasonableness of the debtor's request, courts consider how long the program requires employees to stay with the company. This likely stems from the fact that many retention plans offered by non-debtor businesses calculate the amount of retention bonuses based on the length of service the employee has with the company and also because requiring the employees to stay with the debtor for a longer period should help ensure the success of the reorganization. Thus, when considering whether an individual employee should receive a retention bonus from a debtor, courts justifiably consider how long the plan requires employees to remain with the company. There is no fixed time period courts have demanded, however, and courts have approved plans that require employees to stay for a fixed period of time ranging from six months through plan confirmation.\(^41\)

Judges often consider intangible factors, including employee sacrifice, when deciding whether the debtor exercised sound business judgment in adopting the plan. For example, courts consider whether employees were forced to take pay cuts or whether their benefits were decreased before the company filed for bankruptcy.\(^42\) Courts also have considered whether employees have agreed (or will agree) to waive any potential claims they may have had against the debtor under a prepetition employment contract.\(^43\) Thus, one court evaluated whether employees...
would waive claims based on a breach of a "change in control" agreement, under which they would have the right to be paid a multiple of their respective salaries if the debtor was sold.\textsuperscript{44} If the program proposes to make severance payments to compensate employees who are terminated before a chapter 11 plan is substantially consummated, courts are likely to require the program to mitigate those payments if the terminated employee obtains employment before the fixed period ends.\textsuperscript{45}

Courts also consider factors directly related to the employees themselves. For example, they consider whether there is an immediate danger of losing key employees because those employees have already been approached by competitors, or because the debtor has reason to believe that it is likely those employees are exploring other employment options.\textsuperscript{46} In addition, courts will likely explore the post-petition turnover rate of executives or wage employees.\textsuperscript{47} Courts also are likely to consider whether the proposed compensation program is sufficiently in line with wages paid to similarly situated employees\textsuperscript{48} and whether the plan takes a broad or narrow approach to employee compensation, i.e., whether the plan covers highly paid executives, or all employees and, if the plan covers only key or essential employees, how the plan defines "essential."\textsuperscript{49} Finally, courts consider the overall cost of the program that is submitted for approval, and are more likely to approve plans that appear reasonable and that contain costs that are transparent and fairly predictable.\textsuperscript{50}

Since the business judgment test that courts apply when deciding whether debtors can use estate property is substantially similar to the corporate business judgment rule, bankruptcy courts also scrutinize the process that the board of directors used when they approved the retention or severance program. Thus, when deciding whether to approve a program, courts will consider how many times the board met to discuss the proposed program, the nature of those discussions, and

\textsuperscript{44} See, e.g., In re Interco Inc., 128 B.R. at 232 (considering two executives' waiver of "change in control" claims under their current employment agreements in exchange for payments under court-approved retention plan).

\textsuperscript{45} See In re Geneva Steel Co., 236 B.R. 770, 773-74 (Bankr. D. Utah 1999) (refusing to approve severance plan that would pay either six or nine months salary as severance payments unless plan reduced amount of payment payable if employees obtained other employment during relevant time period).

\textsuperscript{46} See, e.g., In re Montgomery Ward Holding Corp., 242 B.R. at 150 (citing debtor's employees were being targeted at unusually high rate by other organizations and competitors); In re Geneva Steel Co., 236 B.R. at 772 (noting debtor "contends that there is a real danger that key employees will be enticed away by other companies if a retention plan is not implemented").

\textsuperscript{47} See In re Montgomery Ward Holding Corp., 242 B.R. at 150 (asserting employee attrition rate of 20%); cf. In re Geneva Steel Co., 236 B.R. at 772 (considering anecdotal evidence of employee attrition based on debtors statement that "the loss of key employees often leads to the resignation of other key employees").

\textsuperscript{48} See In re Montgomery Ward Holding Corp., 242 B.R. at 150 (relying on evaluation of third-party consultant in determining that compensation package was in line with others in industry); see also In re Geneva Steel, 236 B.R. 773-74.


\textsuperscript{50} See, e.g., In re Interco Inc., 128 B.R. 229, 232 (Bankr. E.D. Mo. 1991) (evaluating the threshold, target, and maximum amounts of the proposed plan).
whether the board hired an outside consultant to advise it on the need to implement
the program.51

III. LEGISLATIVE RESPONSE TO RETENTION AND SEVERANCE PROGRAMS

A. Analysis of Legislation

The recent highly publicized mega-filings and the perception that highly paid
executives have been allowed to benefit at the expense of shareholders and
employees have caused Congress to question the continued validity of allowing
courts to exercise broad discretion when deciding whether to approve retention or
severance bonuses. Congress recently considered legislation, the "Employee Abuse
Protection Act of 2002" ("Act"),52 that would place restrictions on a court's ability to
approve retention or severance programs under section 363(b). The last version of
the Act that Congress considered53 focused on the payments of retention and
severance bonuses to key employees and on the protection of lower-level rank and
file employees and sought to limit the courts' discretion to approve key employee
retention plans.54

Section 10455 of the Act would prohibit a court from approving retention
programs that propose to transfer estate property to employees unless three specific
factors are met.56 First, the court must find that "the transfer or obligation is

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51 See In re Montgomery Ward Holding Corp., 242 B.R. at 150–51 (relying heavily on significant
discussions among directors, and lengthy consultations with Ernst & Young in determining need for, and
fashioning, a retention plan); see also In re Aerovox, Inc., 269 B.R. 74, 78–81 (Bankr. D. Mass. 2001)
(reporting testimony by member of Aerovox board of directors that Board met five times before submitting
retention plan proposal to court and had many serious discussions about cost-benefit analysis and indicating
that this "established that the Board utilized sound business judgment."); In re Am. West Airlines, Inc., 171
B.R. at 677 (finding significance in Board's use of outside professional services consultant in crafting
employee bonus plan).
of proposed bill is "[t]o protect employees and retirees from corporate practices that deprive them of their
earnings and retirement savings when a business files for bankruptcy").
Original Act]. The original version of the bill was submitted to the Senate in July 2002 and contained a
number of provisions that were not directly related to the issue of management compensation. For example,
§§ 102 & 103 of the original proposed legislation addressed the "transparent characterization of transactions"
and the "trustee as [a] good faith reliance purchaser for value," respectively. More specifically, § 102 was
proposed as a reaffirmation of the court's ability to decide whether a sale of assets was in fact a disguised
loan against corporate assets, and its subsequent ability to re-characterize the sale as an avoidable secured
transaction. In addition, § 103 extended to trustees the power to set aside certain liens or security interests.
Id.
Amended Act].
55 See Amended Act, supra note 54, § 3, stating:

[T]here shall neither be allowed, nor paid . . . a transfer made to . . . an insider of the
debtor for the purpose of inducing such a person to remain with the debtor's business,
essential to the retention of the person." Absent a finding by the court based on evidence in the record [supporting the factors set forth in this Act].

Next, the court must not only determine that the employee would have left but for the retention bonus, but must also determine that "the services provided by [that] person are essential to the survival of the business." If no bonuses were paid to non-management employees during that year, then the court could approve payments only if the payments did not exceed twenty-five percent of the amount of payments given to that person during the preceding calendar year.

Section 104 also regulates a debtor's ability to implement a post-petition severance program. This section prohibits courts from approving severance payments unless two conditions are met. First, the payment must be made as part of a program that is applicable to all full-time employees. Second, the amount of the payment to any key employee must not exceed ten times the mean severance pay given to non-management employees during the same calendar year.

B. Justifications for Curtailing Judicial Discretion

Legislators, and some academic commentators, seem highly distrustful of bankruptcy judges' ability to properly exercise judicial discretion. Indeed, the means-testing bankruptcy legislation that has been considered by Congress for the
last 5 years is specifically designed to restrict judges' ability to determine whether a consumer debtor should be allowed relief under chapter 7 of the Code. This and other legislation is essentially a "contest over the institutional choice between markets, and judges, fought out over crystalline versus muddy rules." Congress and other bankruptcy critics seem to prefer clear, inflexible "crystalline" rules that severely limit a court's ability to make fact-based decisions over flexible "muddy" rules that give courts considerably more discretion. Because section 363 of the Code does not list specific factors courts must consider when deciding whether to approve a retention or severance program, Congress not surprisingly is now attempting to prevent judges from relying on that Code provision when they are asked to approve such programs.

Though legislators and commentators are rarely this blunt, their desire to curb judicial discretion seems to stem from a belief that bankruptcy judges either are biased in favor of debtors, are stupid, or are incapable of exercising discretion in a principled or transparent fashion. It is, of course, virtually impossible to refute (or support) an allegation that judges are biased or stupid absent a large-scale empirical study of bankruptcy judges and their decisions. It is reasonable to assume, however, that most trial-level judges (bankruptcy judges included) are probably more interested in moving their dockets and trying to reach the "right" decision than they are in trying to advance some political agenda. While the fact that courts are

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63 The means-testing legislation that has been introduced in Congress for the last several years seeks to replace the current § 707(b) substantial abuse standard with a more rigid formula to determine when and how individual debtors must repay creditors. See Jean Braucher, Means Testing Consumer Bankruptcy: The Problem of Means, 7 FORDHAM J. CORP. & FIN. L. 407, 411 (2002) (arguing in part that proposed means tests hurts not only true abusers but extends to hurt legitimate and honest debtors as well). The "means-test" formula proposes a complex two-step test that arguably has the effect of restricting access to bankruptcy relief through the imposition of this strict rule. See id. at 411, 425–26. One of the more controversial aspects of the rigid "means test" is that it requires no threshold median income test. Thus, because this test is applied to debtors across the board without considering the debtor's income, the test applies even to those debtors who have no realistic possibility of repaying their creditors. See id. at 434–45.


65 Id.


68 See Bainbridge, supra note 66, at 96 (arguing most trial court judges are overworked and concerned with getting through caseloads and avoiding criticisms of decisions). Since bankruptcy judges in some districts face severe time constraints because of their over-crowded dockets, see Richard B. Schmitt &
allowed to exercise wide discretion in resolving some bankruptcy disputes may cause some bankruptcy decisions to appear unpredictable or irrational\(^69\) this is not true with decisions that approve retention or severance programs since, as discussed earlier, bankruptcy courts typically consider the same factors when deciding to approve these programs.

Even if judges occasionally reach the wrong conclusion when they exercise their discretion based on the relatively flexible business judgment test, there nonetheless is a very good reason to give judges discretion and flexibility when they evaluate retention or severance programs. If the debtor and the employees covered by the retention program understand that a bankruptcy court has the authority to examine the transaction, if a party in interest objects to the program, they will be forced to avert to that possibility during negotiation.\(^70\) Forcing the parties ex ante to consider the possibility that a court will refuse to implement the program should help to avoid overreaching by the employees who are negotiating the terms of the program and should cause the debtor's board of directors to critically examine the

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\(^70\) See Janger, * supra* note 64, at 585.
program before recommending its approval. Likewise, allowing judges to exercise discretion when reviewing a retention or severance program should deter creditors from objecting to a program that will lead to a more efficient reorganization because of their knowledge that the court can examine both the reasonableness of the program and the reasonableness of the creditors' objections to the program.\(^{71}\)

C. Critique of Legislation

When courts are asked to approve an employee retention or severance program, they necessarily must make highly fact and industry-specific analyses. The Act, like the means-testing bankruptcy legislation, is designed to create a "one-size-fits-all" test that restricts a bankruptcy court's ability to exercise discretion when deciding whether to approve a retention or severance program. In theory, this could be viewed as beneficial since the Act could provide clear statutory guidance for judges who analyze these types of bonus programs. However, this particular Act simply is not necessary.

Unlike criticisms made when bankruptcy judges rely on section 105 of the Code to permit the debtor to engage in acts not otherwise permitted by a specific provision of the Code,\(^{72}\) courts approve retention or severance plans pursuant to section 363(b) and this section explicitly permits courts to allow debtors to use estate property. Moreover, the "one-size-fits-all" test suggested by the Act is unwarranted since, pursuant to section 363(b), judges already apply consistent (and essentially transparent) factors when they evaluate the business judgment the debtor exercised in proposing the plan. Bankruptcy courts who are asked to make decisions based on section 363(b) of the Code not only can rely on bankruptcy court precedent, but can also rely on tests developed by state and federal judges who have been asked to determine whether the business judgment rule shields directors from liability based on an alleged breach of fiduciary duty. Thus, while in theory allowing courts to exercise unfettered discretion leads to unpredictable results, this has generally not occurred when courts have approved retention or severance programs under section 363 because courts who have evaluated these programs apply factors that appear to be accepted by bankruptcy judges across the country.

The only factors the Act adds to those that courts already consider are the numerical caps. Bankruptcy courts have not placed rigid caps on the amount of payments that employees can receive under retention or severance programs. Instead, they attempt to ensure that the benefits the programs pay are tied to the

\(^{71}\) Moreover, it simply is unreasonable to expect judges will get it right each time. Though most bankruptcy judges were experienced bankruptcy or corporate law practitioners before they joined the bench, it is mere folly to suggest they have time to dissect a debtor's proposed retention or severance program or that they have time to independently determine affected employees' likely employment possibilities in the market. See Bainbridge, supra note 66, at 91 (suggesting academic criticisms of judicial opinions unfairly hold judges to "Herculean model" expecting judge to get it right each time and assuming judge has full information and full knowledge).

\(^{72}\) See supra note 69.
"success" of the organization and that those payments are consistent with wages paid in the market by evaluating the wages that similarly-situated employees receive from peer companies. Although the Act's reliance on numerical caps may help to assuage the symbolic concern that management employees are not receiving a disproportionate amount of the bonuses proposed to be paid by the program, the caps could prevent a court from approving a plan that is necessary to the debtor's reorganization. For example, if a management employee agreed to take a pay cut in the calendar year that preceded the bankruptcy filing in order to help keep the business afloat, capping the employee's bonus at 25% of the payments the person received during that period would not be fair, would not be justified, and most likely would force the employee to accept wages that are lower than the employee could receive in the market. Likewise, though it is a good sound bite to say that management employees can receive no more than 10 times the mean payments given to non-management employees, if a particular key employee demands wages which are consistent with those paid to like employees in similar industries (but which exceed the proposed cap), it would potentially harm the company's reorganization or liquidation efforts to prevent a court from approving the payment. In short, if the debtor can prove that the employee is key, that the wages demanded are consistent with those paid in the market, and that the debtor needs the employee to effectively reorganize (or be sold as a going concern), the court should have the discretion to approve the payments notwithstanding the appearance that a highly-paid employee is being allowed to profit at the expense of lower wage employees and creditors.

IV. POTENTIAL BENEFIT OF LEGISLATION

One potential benefit of the legislation is that it could, with a few modifications, be used to give bankruptcy courts a clear standard and list of factors to apply when they are asked to approve a debtor's request to pay an unsecured creditor's pre-petition claims before plan confirmation under the Doctrine of Necessity. Courts rely on section 105 of the Code to approve the payment of pre-petition obligations outside of the priority scheme provided in section 507 of the Code. Section 105 empowers the court to issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title. Courts have relied on this provision to authorize numerous kinds of creditor payments the most common (and least controversial) being the payment of pre-petition unsecured employee wage claims.

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73 See supra note 41 and accompanying text.
74 See supra note 48 and accompanying text.
77 Courts typically hold pre-petition employee wage and benefit claims, which are entitled to priority of payment under 11 U.S.C. § 507(a)(3), are payable before other creditor claims under authority of section...
In principle, payments should be made only if the debtor shows that paying a creditor's pre-petition claim is in the best interest of all creditors and the health of the debtor in general. \(^{78}\) To overcome the Bankruptcy Code's requirement that the claims of similarly situated creditors receive equal treatment, the debtor must show the court that paying specific pre-petition claims is somehow "necessary" to an effective reorganization. \(^{79}\) Frequently, courts are asked to allow debtors to make post-petition payments in "first-day orders.\(^{80}\) Indeed, these motions have been filed in each of the most recent mega-corporate filings and courts have approved payments in each of these cases. \(^{81}\)

A court in the Northern District of Texas recently set forth a three-part test to determine whether post-petition payments made pursuant to the doctrine of necessity are acceptable. In *In re CoServ*, \(^{82}\) the court suggested that debtors must show that, for one reason or another, the creditor is virtually indispensable to the profitable operation or preservation of the estate. \(^{83}\) A showing that the vendor is the sole source for an item, or the only one who could deliver the item by the debtor's deadline, would seem to satisfy this first requirement. \(^{84}\) The debtor must also demonstrate that failing to pay the claim will cause a harm, or eliminate an


83 *Id.* at 498.

84 See *id.*
economic advantage, that is disproportionate to the amount of the claim. 85 Finally, the debtor must establish that there is no practical or legal alternative to paying the claim. 86 Thus, if the debtor cannot obtain the goods and services by giving a creditor a deposit or by paying COD, this last requirement also should be satisfied. If the debtor can prove all three of these conditions (typically by either expert testimony from witnesses in the industry, or by the debtor or vendor) by a preponderance of evidence, the CoServ court concluded that the claim presumably should be deemed "necessary" and, thus, allowed. 87

Despite the apparent clarity of the CoServ opinion, there is wide discrepancy among the Circuits as to whether courts have the authority to approve the payment of any pre-petition unsecured claim prior to confirmation of a chapter 11 plan and those who have approved such payments have struggled when deciding how to define the standard lower courts should apply when deciding whether to approve these payments. 88 This, not surprisingly, has caused bankruptcy and district courts to reach wildly divergent results when deciding whether to authorize these payments. 89 Though courts suggest that they narrowly apply the rule, 90 commentators have bitterly criticized courts' reliance on the "doctrine of necessity." 91 Specifically, critics argue that approving a request to pay a pre-petition claim (1) is not specifically authorized by the Bankruptcy Code, 92 (2) is inconsistent

85 Id.
86 Id. at 499.
87 Id. at 498.
88 For example, the Third Circuit has determined "the sine qua non for the application of the 'necessity of payment' doctrine is the possibility that the creditor will employ an immediate economic sanction, failing such payment." Matter of Lehigh & N.E. Ry. Co., 657 F.2d. 570, 581 (3d Cir. 1981). However, the First Circuit has defined the standard simply as "indispensably necessary." In re Boston and Maine Corp., 634 F.2d. 1539 (1st Cir. 1980). The Fifth Circuit has declined to authorize the payment of pre-petition claims with post-petition funds under § 105. See In re Oxford Mgmt., Inc., 4 F.3d. 1329, 1333-34 (5th Cir. 1993).
89 Compare In re Just for Feet, Inc. 242 B.R. 821, 826 (D. Del. 1999) (authorizing payment of pre-petition claims to footwear and athletic apparel vendors as "critical" to Just for Feet's reorganization because officers of corporation testified it would not survive), and In re NVR, L.P., 147 B.R. 126, 128 (Bankr. E.D. Va. 1992) (determining court may in fact authorize payment pre-petition of claims upon showing of "substantial necessity" by proponent of payment), and In re Eagle-Pitcher Indus., Inc., 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991) (holding payment must be "necessary to avert serious threats to [c]hapter 11 process."), with In re FCX, Inc., 60 B.R. 405, 410 (E.D.N.C. 1986) (holding bankruptcy court improperly subordinated claims by approving payment of pre-petition payroll claims).
90 See In re CoServ, L.L.C., 273 B.R. at 491 ("The court does not disagree that it can allow Debtors to pay prepetition debt [under Doctrine of Necessity and] other than pursuant to plan--but holds it may do so only under extraordinary circumstances.").
91 See, e.g., Patricia L. Barsalou & Zack Mosner, Preferential First-Day Orders: Same Question, Different Look, AM. BANKR. INST. J., Feb. 2003, at 8 (determining best way to bring Congress' attention to need for some type of specific and codified doctrine of necessity is for courts to follow section 105 -- and not apply common law doctrine of necessity -- and allow terribly drastic results. Also, authors state "routine entry of preferential orders [such as those entered by court according to doctrine of necessity] . . . allows debtors, courts, and certain well-positioned creditors . . . to act as though the Code has already been amended, while other parties, including tax priority creditors [and those creditors without sufficient notice] . . . are relegated to the existing Code."); Charles Jordan Tabb, Emergency Preferential Orders in Bankruptcy Reorganizations, 65 AM. BANKR. L.J. 75, 115 (1991) (urging "judges to adopt a uniform rule refusing to approve the preferential treatment of any prepetition claims.").
with the priority scheme established in section 507 of the Code, and (3) allows courts to approve payments without first providing a clear and transparent definition for when a creditor is "critical" or when a payment is "necessary." Most academic commentators suggest that courts should not have the authority to approve the pre-confirmation payment of an unsecured creditor's pre-petition claim. Other commentators have argued that, rather than revising the Code to eliminate the ability of courts to approve critical vendor motions, Congress should instead codify the doctrine of necessity.

The Act, though not applicable to the pre-confirmation payment of pre-petition claims, could help respond to the criticisms of the continued applicability of the doctrine of necessity by clarifying when (if ever) it is appropriate to pay creditors outside the statutorily established priority scheme. That is, applying the standards contained in the Act would force courts to condition the approval of the payment of a pre-petition unsecured claim on a finding that paying the claim before other similarly ranked claims is crucial to the creditor's willingness to continue to do business with the debtor. Assuming the court makes that finding, it should then ask whether the creditor's services are essential to the survival of the business. Finally, because of the risk that paying pre-petition unsecured claims outside of the normal priority scheme may cause other creditors to receive less than their pro rata share in the bankruptcy distribution, courts should compare the amount of the proposed payment to the likely amount of funds available to pay other similarly ranked claims and should, if necessary, place a cap on the amount of payments pre-petition creditors can receive. In formulating such a cap, the court should consider the amount of payments the creditor received pre-petition and the amount of pre-petition payments debtors made to creditors who are not being viewed as "critical vendors."

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93 See Brighton, supra note 92, at 116 ("Congress had a very specific scheme concerning the priority of payments under the Code when it was adopted . . . [to preserve integrity of the Code and its uniform application, Courts should tread very lightly in using any power which overrides the intent of Congress.").


95 See White, supra note 94, at 37.

96 A numerical cap would be appropriate when deciding whether to pay pre-petition claims ahead of other similarly-situated claims because such payments are inconsistent with the Code's priority scheme. In contrast, imposing caps on the amounts of retention or severance payments debtor could pay would not be appropriate because those payments would be based on service the employee provided to the debtor post-petition, and thus, theoretically would be administrative expenses which would be entitled to first priority payment assuming the estate is administratively solvent. See 11 U.S.C. § 503(b) ("After notice and hearing, there shall be allowed administrative expenses, other than claims allowed under § 502(b) of this title").
CONCLUSION

Though arguing for less judicial discretion is now in vogue, and Congress has spent several years attempting to curtail the discretion of bankruptcy judges, there simply is no reason to legislatively dictate when bankruptcy courts can approve employee retention or severance programs. There is nothing unusual about employer retention or severance programs, as they are widely offered by U.S. businesses. Though creditors (and especially unions) understandably object when debtors seek to implement a key-employee retention or severance program, judicial decisions approving these programs have adopted generally consistent factors that focus on whether the programs provide a benefit to the estate. If bankruptcy courts had exercised their discretion in a haphazard, unpredictable fashion or had not required debtors to demonstrate that the payments provide a valuable benefit to the estate, Congress would be justified in legislatively dictating when such payments should be allowed.

Rather than viewing payments to highly paid employees in terms of justice or injustice to lower paid workers, courts should ask whether the payment benefits the estate overall. If the answer is yes, then the court should be allowed to exercise its judgment to determine whether to approve the request to implement the retention or severance program. Certainly, highly paid executives should not be allowed to plunder a bankruptcy estate by demanding that they receive a large retention or severance bonus with no requirement that they provide services to the estate in an amount roughly commensurate with the payments. However, if the debtor company needs the services of the executives to have an effective reorganization (or orderly liquidation), and the executives demand market-based retention or severance payments as a condition of remaining with the company, courts should be allowed to approve these payments without being handcuffed by a rigid, inflexible rule.