Order Code RS22427
April 20, 2006

CRS Report for Congress
Received through the CRS Web

Executive Compensation in Bankruptcy: The Fairness and Accountability in Reorganizations Act

Robin Jeweler
Legislative Attorney
American Law Division

Summary

S. 2556 and its companion bill, H.R. 5113, 109th Congress, 2nd Sess. (2006), introduced by Senator Bayh and Representative Conyers, respectively, are entitled the Fairness and Accountability in Reorganizations Act of 2006. The legislation, according to its sponsors, is intended to "ensure that workers are treated more fairly during [bankruptcy] reorganizations by limiting executive compensation deals and requiring corporations to provide a more accurate picture of their holdings before attempting to modify collective bargaining agreements or promised health benefits."[1] This report surveys the bill's provisions.

Background. When a corporate debtor files for reorganization under chapter 11 of the U.S. Bankruptcy Code, 11 U.S.C. § 1101 *et seq.,* corporate management oversees the reorganization. Although a trustee is always appointed in chapter 7, chapter 11 is premised on the supposition that a reorganization is most likely to be successful and creditors and the public are most likely to benefit from continued operation of the business by existing management.[2] Under chapter 11, management may be removed "for cause, including fraud, dishonesty, incompetence, or gross mismanagement[.]"[3] Thus,

[1] *Bayh, Conyers Introduce Legislation Ensuring Greater Fairness for Workers in Corporate Bankruptcy Proceedings*, Press Release (April 6, 2006) at [http://bayh.senate.gov/releases/2006/04/06APR06pr.htm]. *See also* 152 CONG. REC. E545 (daily ed., April 6, 2006) (statement of Rep. Conyers).

[2] H.Rept. 95-595, 95th Cong., 1st sess. 233 (1977), comprising part of the legislative history of the 1978 bankruptcy law. "Moreover, the need for reorganization of a public company today often results from simple business reverses, not from any fraud, dishonesty, or gross mismanagement of the part of the debtor's management."

[3] 11 U.S.C. § 1104. Pursuant to amendment by the BAPCPA, the U.S. Trustee shall seek appointment of a trustee if "there are reasonable grounds to suspect that current members of the
(continued...)

when a company files for reorganization, all of its operations may be subject to the court's oversight. But by practice and design, the court holds hearings to review only those activities outside of the ordinary course of business or that by statute requires court authorization, such as sales of assets or the assumption or rejection of executory contracts. One treatise states that "[t]he discretion to act with regard to *ordinary* business matters without prior court approval has been said to be 'at the heart' of the powers of a trustee or debtor in possession, and courts have shown a reluctance to interfere, or to permit other parties in interest to interfere, in the making of routine, day-to-day business decisions."[4] So, when a debtor files under chapter 11, it receives permission, pursuant to 11 U.S.C. § 503, to continue its operations, including the payment of management and non-management employees. Permission to continue operations in bankruptcy is granted as part of "first-day orders."[5]

Recent high-profile bankruptcy reorganizations, such as those in the airline and auto industries, however, frequently result in significant reductions in a wide spectrum of jobs and employee benefits, including wages, retirement, and health benefits. In a climate of employee financial loss, there has been increasing scrutiny of the compensation of the executives who seek a bankruptcy court's permission to reduce employee compensation, especially through the rejection of collective bargaining agreements (CBAs).[6] Indeed, the general issue of the growth of executive compensation in relation to value provided and non-managerial employee compensation is one that receives considerable scrutiny outside of bankruptcy.[7]

Post-filing expenses incurred in the operation of the business may be considered administrative expenses. With respect to an individual executive's claim for any non-routine compensation, like all bankruptcy claims, its disposition may depend upon many factors, such as when and how it was earned and/or paid, that is, before or after the bankruptcy filing. Non-routine postpetition payments are generally subject to greater scrutiny by the court, and prepetition payments, to a more limited extent, may be subject to avoidance. Nevertheless, retention bonuses and similar compensation for executives are commonly sought and approved by the courts.[8] But they may be challenged by parties

---

[3] (...continued)
governing body of the debtor...participated in fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting." § 1104(e).

[4] 7-1108, COLLIER ON BANKRUPTCY (15th ed. rev.), ¶ 1108.07. (Footnotes omitted.)

[5] Part of the transition into bankruptcy involves court permission to ensure that the employees receive their unpaid prepetition salary and do not miss a paycheck. The priority status for prepetition wages at 11 U.S.C. § 507 enables courts to authorize continuity in payments.

[6] 11 U.S.C. § 1113.

[7] The issue of executive compensation is not necessarily linked to bankruptcy. *See* CRS Report 96-187, *A Comparison of the Pay of Top Executives and Other Workers*, by Linda Levine. *See also* Eric Dash, *Executive Pay: A Special Report, Off to the Races Again, Leaving Many Behind,* and *C.E.O. Pay Keeps Rising, and Bigger Rises Faster*, both posted April 9, 2006, at [http://www.nytimes.com/2006/04/09/business/businessspecial/09pay.html] and [http://www.nytimes.com/2006/04/09/business/businessspecial/09payside.html].

[8] For more background on executive compensation in bankruptcy, see CRS Report RL33138,
(continued...)

to the bankruptcy proceeding and denied in whole or part. In the reorganization of Delphi Corporation, the largest U.S.-based automotive parts manufacturer, which filed on October 8, 2005,[9] the bankruptcy court has, for example, authorized both an executive incentive compensation program and an early retirement incentive plan for 13,000 employees.

Amendments to Executive Compensation in the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). Enacted on April 20, 2005, and taking effect on October 17, 2005, the BAPCPA imposed new limitations on non-routine executive compensation.[10] Amendments to 11 U.S.C. § 503(c) limit both the circumstances under which severance and retention payments may be made to a debtor's officers and directors, as well as the amount of such payments. Subject to court approval based on evidence in the record, retention payments may only be made when essential to retain the individual because he or she has a bona fide job offer from another business at the same or a greater salary; the services are essential to the survival of the business; and the payment is less than 10 times the amount paid to similar non-management employees in the preceding year, or if no retention bonuses were paid in the preceding year, then no more than 25% of any similar executive benefit in the preceding year. § 503(c)(1).

Severance payments may not be made unless the payment is part of a program generally applicable to full time employees and is limited to 10 times the average amount of severance payments made. § 503(c)(2).

Other payments outside the ordinary course of business, including payments to executives, officers, managers, and consultants who are hired after the bankruptcy filing, may not be made unless they are justified by the facts and circumstances of the case. § 503(c)(3).

The statute, as amended by the BAPCPA, imposes the highest burden of proof on retention payments, i.e., the individual must be found to be essential to the business and have another job offer, which must be supported by evidentiary findings introduced into the record. Severance payments are capped and must be available to all non-management employees as well. Other payments outside the ordinary course of business must be justified.

S. 2556/H.R. 5113: Limitations on Compensation. Section 4 of the proposed bills would amend 11 U.S.C. § 503(c)(1) to broaden the requirements imposed on retention payments to include "a performance, incentive, or other bonus or any other compensation enhancement." Thus, any bonus or incentive would require an evidentiary finding that the executive had another job offer and that his or her services are essential

---

[8] (...continued)
Employment-Related Issues in Bankruptcy, by Robin Jeweler.

[9] For more background on Delphi and the automotive industry, see CRS Report RL33169, *Comparing Automotive and Steel Industry Legacy Cost Issues*, by Stephen Cooney.

[10] P.L. 109-8, § 331, 119 Stat. 23, 102-03.

to the survival of the business. These payments would also be subject to the 10-times multiplier or 25% cap in Subsection (c)(1)(C).[11]

Section 4 would replace the requirement in Subsection (c)(3) that payments outside the ordinary course of business be justified by the facts and circumstances of the case. The new standard would disallow *all* pre- and postpetition "transfers or obligations" for the benefit of officers, managers and consultants, whether within or without the ordinary course of business, unless the court makes an evidentiary finding on the record, without deference to the debtor's request, that the payments are essential to the survival of the business, or, in a liquidation, essential to maximize the value of the estate, and in either case because the services provided are essential and the payments are reasonable under the circumstances.

Under current law, the court may authorize, pursuant to § 503(b)(1), the payment of wages, salaries and commissions for services rendered after commencement of the case. Subsection (c)(3) disallows "other transfers outside of the ordinary course of business" unless justified by facts and circumstances of the case. The revised language would disallow "other transfers or obligations, whether or not outside the ordinary course of business." There is some ambiguity as to whether that language includes wages and salaries referred to in subsection (b), which are generally considered to be obligations in the ordinary course of business.

The amendments are very broad in nature and appear to repudiate the underlying theory that the debtor's management is best positioned to reorganize it. Instead of overseeing the on-going operations of the debtor, the bankruptcy judge would be charged with holding hearings to determine an appropriate level of compensation for the debtor's executives. The standard by which the judge would determine the appropriate level of executive compensation is not specified in the provision.[12]

Proponents of the bill are likely to support a new, increasingly adversarial approach to establishing, and possibly limiting, executive compensation for the reorganizing debtor. Many will view this approach as more equitable given the financial sacrifices that many non-management employees are required to make. Some may feel that bankruptcy courts' oversight of executive compensation has often been inadequate and/or ineffective, and that the growth in executive compensation in relation to the value of services provided is simply not justified, within or without of bankruptcy. These changes would be consistent with a view that corporate bankruptcy is *not* a result of business conditions beyond managerial control and that they should be required to have a greater financial stake in the

---

[11] Broadening the scope of compensation enhancements subject to § 503(c) may make sense, since one treatise predicts that "[t]he narrow scope of subsections 503(c)(1) and (c)(2) will basically result in the elimination of programs that provide compensation to officers for remaining employed with the debtor or that provide severance when such persons leave." It speculates that different methods of inducing managers to stay with the debtor will need to be found. 4-503 COLLIER ON BANKRUPTCY (15th ed. rev.), ¶ 503.17[4].

[12] For example, would the judge look to executive compensation at comparable businesses outside of bankruptcy, or mandate comparable management and non-management benefit reductions for the individual debtor?

business' success or failure. Stricter limitations on compensation may free more of the debtor's assets for other business purposes, including distribution to the debtor's creditors.

Like many vexing problems, such as pension underfunding and health insurance costs, many will question whether perceived imbalances in executive compensation are best addressed in bankruptcy. Opponents are likely to object on the ground that lengthy compensation proceedings will substantially increase the costs of bankruptcy administration. The specter of these proceedings may diminish managerial zeal for reducing non-management employee benefits in the course of reorganization. Whether that will actually benefit or hinder the likelihood of a successful reorganization is impossible to predict. Some will argue that talented managerial executives will simply opt out of troubled businesses to avoid the bankruptcy process all together. That could leave the struggling business enterprise in the hands of those who have few options. The greater philosophical and policy questions are whether, if debtors avoid reorganization, they will have a greater or lesser likelihood of maintaining solvency and staying in business, and which is a more desirable outcome.

Treatment of Foreign Affiliates. Section 5 of the bill(s) would require the bankruptcy court to specifically consider, in two situations, the ongoing impact on the debtor of the debtor's relationship with all subsidiaries and affiliates regardless of whether they are domestic or foreign, or whether they are in bankruptcy. The first would be in the determination of whether to permit a debtor to reject a collective bargaining agreement under 11 U.S.C. § 1113. The second is in connection with a debtor's application to modify retiree health benefits under 11 U.S.C. § 1114.

The law generally accepts a corporation as a free-standing legal entity. Although there is a large body of law that considers when and where it is appropriate to "pierce the corporate veil" and view separately incorporated entities as sharing assets and/or liabilities, a general discussion of this body of law is beyond the scope of this report.[13] The language of the bill does not suggest that the assets (or liabilities) of affiliates and subsidiaries be considered those of the debtor.[14] Hence, how the court is to evaluate the impact of the debtor's relationship with subsidiaries and affiliates for purposes of deciding matters before it is not explained.

The specific operation of this provision, though not immediately apparent, may be developed as the legislation wends its way through the legislative process.

---

[13] *See* Hector José Miguens, *Liability of a Parent Corporation for the Obligations of an Insolvent Subsidiary Under American Case Law and Argentine Law*, 10 AM. BANKR. INST. L. REV. 217 (2002), discussing the evolution of the theory of the corporation as an individual "entity" into a conglomerated "enterprise" and its implications in case law.

[14] *Cf.* 11 U.S.C. § 524(g), assigning liability for and third-party protection to subsidiaries and affiliates as an element of asbestos-related bankruptcy trusts.