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Examining Velo Holdings' KEIP

Law360, New York (August 03, 2012, 1:14 PM ET) -- On June 6, 2012, Bankruptcy Judge Martin Glenn of the U.S. Bankruptcy Court for the Southern District of New York approved a $2.875 million key employee incentive plan ("KEIP") in the Velo Holdings bankruptcy cases over the objection of the U.S. trustee finding that it was primarily incentivizing and a sound exercise of the debtors' business judgment. In re Velo Holdings Inc., Case No. 12-11384 (MG), 2012 Bankr. LEXIS 2535 (Bankr. S.D.N.Y. 2012). The decision follows well-settled law in the Southern District and Delaware regarding approval of KEIPs.

Approving Retention and Incentive Plans

Section 503(c) was added to the Bankruptcy Code in 2005 to limit the practice of debtors providing bonuses to executives simply to retain their services during the bankruptcy process — so called "pay to stay" programs. Under Section 503(c), if a program is found to be a retention plan and the employee is an insider, the plan must satisfy the strict standards of Section 503(c)(1), which effectively require that (1) the payments thereunder are essential to retention of the employee because he has a bona fide job offer from another business, (2) the services provided by the employee are essential to the survival of the business, and (3) the amount of the payments is reasonable and customary. Alternatively, if a plan is primarily incentivizing or is not applicable to insiders, Section 503 (c)(1) does not apply.

Courts have found that KEIPs are primarily incentivizing if the compensation package (1) incentivizes management to produce and increase the value of the estate or (2) motivates employees to achieve performance goals. Conversely, plans are retentive for purposes of Section 503(c)(1) where no portion of the bonus is tied to anything other than staying with the company for a certain period of time. Notably, a KEIP may have retentive purposes and avoid scrutiny under Section 503(c)(1) so long as it is primarily incentivizing. See In re Borders Group Inc., 453 B.R. 459, 471 (Bankr. S.D.N.Y. 2011) (citing In re Dana Corp., 358 B.R. 567, 571 (Bankr. S.D.N.Y. 2006)); In re Global Home Prods. LLC, 369 B.R. 778, 785 (Bankr. D. Del. 2007).

When a KEIP falls outside of the scope of Section 503(c)(1) and is not an ordinary course transaction, it can be approved under either Section 363(b) of the Bankruptcy Code, which requires a showing of a valid good faith business purpose (i.e., the business judgment test), or Section 503(c)(3), which requires that the plan be "justified by the facts and circumstances of the case." Many courts consider these two standards indistinguishable. Borders, 453 B.R.at 473-74; Dana, 358 B.R. at 576; but see In re Pilgrim's Pride Corp., 401 B.R. 229, 236-37 (Bankr. N.D. Tex. 2009) (holding that standard for approval under Section 503(c)(3) is higher than the business judgment test; if payments to employees outside the ordinary course were only subject to the business judgment test, then the language of Section 503(c)(3) would ostensibly be rendered meaningless).

Under either approach, courts generally consider whether: (1) the plan is calculated to achieve the desired performance, (2) the cost of the plan is reasonable within the context of the debtor's assets, liabilities, and earning potential, (3) the scope of the plan is fair and reasonable, (4) the plan is consistent with industry standards, (5) the debtor engaged in due diligence related to the need for the plan, the employees that needed to be incentivized, and what types of plans are generally applicable in a particular industry, and (6) the debtor received independent counsel in performing due diligence and in creating and authorizing the incentive compensation. See In re Dana Corp., 358 B.R. at 576-77.

Background

On April 2, 2012, Velo Holdings Inc., and certain of its subsidiaries commenced Chapter 11 cases in the U.S. Bankruptcy Court for the Southern District of New York. On May 8, 2012, the debtors filed a motion to approve a $2.875 million KEIP for 63 of the debtors' employees, including five insiders, who were deemed most capable of maximizing the debtors' financial performance.

The KEIP was tailored for three of the debtors' businesses: the ACU business (consisting of credit and identity theft protection and lifestyle and shopping businesses), the Coverdell & Company Inc. business, and Neverblue Communications Inc. business. Under the KEIP, $2 million was allocated to the ACU business to be paid to (1) nonexecutive employees based upon net proceeds generated for creditors and (2) executive employees provided that the debtors meet the net operating cash flow covenant in the debtors' postpetition credit agreement over the initial thirteen weeks of their cases.

The amounts allocated under the KEIP to the Coverdell and Neverblue units were to be paid depending on whether, how, and for what value, each unit was sold. If Coverdell and Neverblue were sold for less than $80 million and $20 million, respectively, then they would have to meet certain revenue and EBITDA targets for participants to receive compensation. If the sale prices were above those amounts, then a net sale proceeds calculation would apply.

The U.S. trustee objected to the KEIP arguing, among other things, that the executive payout under the ACU portion of the KEIP was not incentivizing because it only required the debtors to comply with the DIP budget rather than a providing a more ambitious target for management to reach.

The Bankruptcy Court's Decision

There was no dispute that the Velo KEIP applied to insiders, so Judge Glenn quickly turned to determining whether it was essentially a retention plan subject to Section 503(c)(1). Judge Glenn found that the KEIP properly incentivized ACU employees because the DIP budget was formulated using projected revenue and EBITDA targets and the KEIP requires the executive employees to provide additional transitional services beyond their pre-bankruptcy job responsibilities.

The court added that the debtors had previously used revenue and EBITDA targets as a basis for incentive-based pay and the targets had proven difficult to achieve. Further, the court was satisfied that the sales of the Coverdell and Neverblue units and the proposed sale prices were fair, beneficial to the debtors' estates, and incentivizing. Accordingly, the KEIP was held to be properly incentivizing and outside the scope of Section 503(c)(1).

The court then held that the proposed KEIP was a sound exercise of the debtors' business judgment. Specifically, Judge Glenn held that: (1) the KEIP did not unfairly discriminate among employees, (2) the incentives and targets comported with industry standards and were nearly identical to the debtors' prepetition incentive plan, (3) a reasonable relationship existed between the KEIP and the results to be obtained (i.e., the successful sale of the debtors’ businesses), (4) the total amount of payments under the KEIP was reasonable in light of the debtors’ financial situation, and (5) the debtors exercised proper diligence in formulating the KEIP by using a financial adviser to help determine the proper incentives. Accordingly, the court approved the proposed KEIP under both Sections 503(c)(3) and 363 of the Bankruptcy Code.

Conclusion

Judge Glenn’s decision in Velo Holdings is consistent with the approach taken by most courts when evaluating KEIPs, which have become quite commonplace in large bankruptcy cases. In sum, so long as such plans are primarily incentivizing and based upon a reasonable exercise of the debtors’ business judgment, they will be approved. However, debtors should remain careful to include incentives that are tied directly to critical restructuring related goals and that enhance the value of the debtor’s estate, rather than provide compensation for mere continued employment.

On July 17, the debtors in the Residential Capital bankruptcy cases also pending before Judge Glenn filed a motion to approve a $17.8 million bonus plan. In that case, the debtors bifurcated the plan to include a KEIP for 17 senior executives and a key employee retention plan for 174 non-insider employees, with payment primarily pegged to achievement of certain financial and operational goals and the sale of the debtors’ businesses. The Velo Holdings decision should prove very insightful regarding the outcome of the ResCap motion, which is scheduled to be heard on Aug. 8.

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