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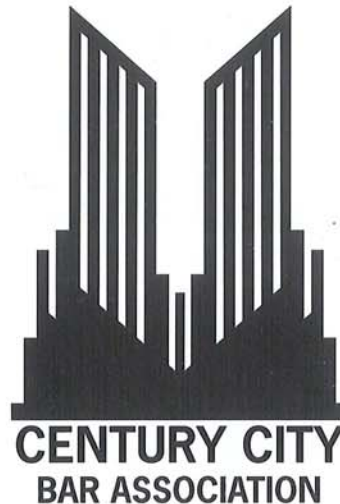
EXECUTIVE COMPENSATION ISSUES IN FINANCIALLY-TROUBLED COMPANIES

By Brian L. Davidoff and Jeanne C. Wanlass

In the wake of the bankruptcies recently filed by such companies as Lehman Bros., Mervyn's and Circuit City, as well as the forecast spread of the financial troubles suffered by the real estate and automotive industries, a prudent executive should be aware of compensation and liability issues arising both before and after a company files a bankruptcy case.

COMPENSATION IN BANKRUPTCY

Probably the first question that crosses most people's minds upon learning that their company has financial troubles or has filed a bankruptcy case is: "Will I continue to get paid?" The answer to this natural concern depends on many factors, but certain types of payments to high-level executives face a higher standard of scrutiny after a bankruptcy is filed.



Post-Petition Services

Before a bankruptcy case is filed, the amount of compensation is determined by the executive and the company and is generally based on the value of his or her services in the marketplace. After a bankruptcy filing, however, insiders of a debtor corporation must have

their compensation approved by the Bankruptcy Court. For corporations, insiders include the directors, officers, or persons in control of a corporation and their relatives and in the case of partnerships, the general partners. 11 U.S.C. Section 101(31)(B). To obtain approval, a Notice of Setting/Increasing Insider Compensation detailing the amount of compensation and other perquisites is filed with the Court and served on the company's major creditors and the Office of the U.S. Trustee (which has responsibility for reviewing the activities of chapter 11 debtors). If no objection is filed, then the payments may be made, including those post-petition payments not paid while waiting for approval. If an objection is filed, the parties may either resolve the amount and nature of the compensation among themselves or have the Court determine what compensation is appropriate.

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Post-petition payments to employees, including executives, are considered “administrative” expenses of the estate and are therefore entitled to be paid before most of the corporation’s unsecured pre-petition debts. 11 U.S.C. Sections 503(b)(1)(A)(i) and 507(a)(2).

After watching executives from bankrupt companies such as Enron and WorldCom receive large retention bonuses and severance payments while regular employees and retirees suffered, however, Congress amended the Bankruptcy Code in 2005 to address some of those abuses. Under the Bankruptcy Abuse Prevention And Consumer Protection Act of 2005 (“BAPCA”), certain payments to insiders are especially scrutinized. An insider cannot receive payments from a debtor which are designed to induce him or her to remain with a debtor after a bankruptcy filing unless the Bankruptcy Court specifically finds that: (1) the payments are essential to retaining that insider because he or she has a bona fide job offer from another business at the same or a greater rate of compensation; (2) his or her services are essential to the survival of the business; and (3) either (i) the amount of the payment is not greater than 10 times the mean payment of a similar kind made to non-management employees during that year or (ii) the amount of the payment is not more than 25% made to the insider for any purpose during the prior year. 11 U.S.C. Section 503(c)(1). Likewise,

severance payments to the debtor’s insiders are also prohibited unless they are part of a program generally available to all full-time employees and the amount of the severance is not greater than 10 times the amount of severance given to non-management employees during the same calendar year. 11 U.S.C. Section 503(c)(2).

Outstanding Payment For Pre-Petition Services

If the company has, prior to the bankruptcy filing, failed to pay wages, salaries or commissions, including vacation, several and sick leave pay, earned by an employee in the 180 days before the bankruptcy is filed, up to \$10,000 of his or her claims for these amounts are entitled to “priority” status. 11 U.S.C. Section 507(a)(4). Priority status allows those creditors to be paid before the company’s general unsecured creditors, but after administrative creditors.

Preferential Payments

A preferential payment is any transfer from the debtor to a creditor in satisfaction of a prior debt made within certain deadlines before the bankruptcy case was filed. 11 U.S.C. Section 547(b). Executives should be aware that payments made to insiders (including officers and directors) which were made by the debtor corporation during the year before the bankruptcy is filed must be reported on the debtor’s bankruptcy filing. This reporting allows a chapter 7 or 11 trustee, or in some situations a committee of the company’s largest unsecured

creditors, to file a lawsuit to have the funds returned to the corporation if appropriate. 11 U.S.C. Section 547(b). While in most situations salaries are defensible, loan repayments and executive bonuses are at risk and require more careful consideration. For example, if an insider causes his or her loan to a debtor corporation to be repaid before its agreed terms, that payment may have to be returned to the debtor’s bankruptcy estate.

In this era in which the actions of officers and directors appear to be subject to greater scrutiny, executives are well-served by paying close attention to these issues.

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