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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	Chapter 11
Hawker Beechcraft, Inc., *et al.*,	Case No. 12-11873 (SMB)
Debtors.	(Jointly Administered)

PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW OF THE INTERNATIONAL ASSOCIATION OF MACHINISTS AND AEROSPACE WORKERS, AFL-CIO RELATING TO DEBTORS' MOTION FOR THE ENTRY OF AN ORDER APPROVING THE DEBTORS' KEY EMPLOYEE INCENTIVE PLAN AND KEY EMPLOYEE RETENTION PLAN AND GRANTING RELATED RELIEF

The International Associations of Machinists and Aerospace Workers, AFL-CIO (the "**IAM**") submits these proposed findings of fact and conclusions of law in connection with the Debtors' *Motion for Entry of an Order Approving the Debtors' Key Employee Incentive Plan and Key Employee Retention Plan and Granting Related Relief* [Docket No. 349] (the "**Motion**").

FINDINGS OF FACT

General Background

1. On May 3, 2012 (the "Petition Date") each of the Debtors filed a voluntary petition for relief under chapter 11 of title 11 of the United States Code (the "**Bankruptcy Code**") in the United States Bankruptcy Court for the Southern District of New York (the "**Court**"). Motion, ¶ 4.

2. On May 4, 2012, the Court entered an order directing that the Debtors' chapter 11 cases be jointly administered for procedural purposes only pursuant to Rule 1015(b) of the Federal Rules of Bankruptcy Procedure (the "**Bankruptcy Rules**"). *Id*.

3. The Debtors continue to manage and operate their businesses and properties as debtors-in-possession pursuant to sections 1107 and 1108 of the Bankruptcy Code. *Id*.

4. The Debtors manufacture business jets, trainer/attack aircraft as well as propeller and piston aircraft under the Hawker and Beechcraft brands. In addition, the Debtors operate 100 service centers to support their fleet of Debtor-manufactured aircraft. *See* Declaration of Robert S. Miller (I) In Support of the Debtors' Chapter 11 Petitions and First Day Declarations and (II) Pursuant to Local Bankruptcy Rule 1007-2, ¶6 [Docket No. 22] (hereinafter the "**First Day Decl.**").[1]

5. As of the Petition Date the Debtors had approximately 5,420 employees. As of the Petition Date the IAM represented approximately 2,430 of the

[1] Both the Debtors' Motion and the Miller Declaration (as defined herein) refer to the First Day Decl. *See* Motion, Fn. 2 and Miller Declaration, Fn. 2.

Debtors' employees, or approximately 45% of the Debtors' workforce. First Day Decl., ¶¶ 6 and 21.

6. GS Capital Partners VI, L.P. and other private equity funds affiliated with Goldman, Sachs & Co. ("**GS Capital**") and Onex Partners II LP and related funds ("**Onex**") (collectively, the "**Equity Sponsors**") each own approximately 49% of the common stock of Debtor Hawker Beechcaft, Inc. First Day Decl. ¶¶ 29 & 46. The Equity Sponsors acquired their interests (the "**Acquisition**") in March 2007 from Raytheon Company for total consideration of approximately $3.2 billion. *Id*. ¶¶ 28 & 46.

7. The Equity Sponsors financed the Acquisition using the proceeds from the borrowings under a Senior Secured Credit Facility, the offering of Senior Fixed Rate Notes, Senior PIK-Election Notes, and Senior Subordinated Notes (each as defined in the First Day Decl.), and equity contributions by GS Capital, Onex, and certain members of management. First Day Decl., ¶ 28.

8. As of April 30, 2012, the Debtors' outstanding funded debt obligations were in the aggregate principal amount of $2.38 billion and were comprised of: (a) $1.827 billion of obligations under the Senior Secured Credit Facility, (b) $409 million outstanding under the Senior Fixed Rate Notes; (c) $415.7 million outstanding under the Senior PIK-Election Notes; (d) $308.3 million outstanding under the Senior Subordinated Notes; and (e) $59.6 million outstanding under the EDC Facility. First Day Decl., ¶ 29.

9. Since the Acquisition, the Debtors' net sales have steadily and significantly declined from approximately $3.546 billion in 2008 to approximately $2.435 billion in 2011. First Day Decl., ¶ 7. Similarly, the Debtors' EBITDA has

plummeted from approximately $338.6 million in 2008 to $53.8 million in 2011. *Id.* ¶ 9. Generally, the Debtors' blame their deteriorating financial performance on "depressed demand primarily as a result of uncertainty in the global economy." *Id.* ¶ 47.

The Commencement of the Restructuring

10. In the months leading up to the Petition Date, the Debtors' terminated approximately 800 IAM-represented factory and shop workers (nearly 1/3 of the existing IAM-represented workforce), closed several facilities in Wichita, Kansas and outsourced certain operations. First Day Decl., ¶ 55. In addition, the Debtors negotiated favorable concessions with respect to the collective bargaining agreement with the IAM. *Id.* ¶ 56.

11. In the first quarter of 2012, after terminating 800 IAM-represented employees in 2011 (as well as 8% of salaried employees in 2010), the Debtors increased compensation for certain members of the senior leadership team (the "**SLT**") for whom the purported KEIP is now being proposed by approximately 4% of base salary. First Day Decl., Fn. 12; Motion, Fn. 4. In addition, the Debtors restored the salaries of certain SLT members who had previously consented to voluntary pay reductions. *Id.*

12. Furthermore, in February 2012, the Debtors hired Robert S. Miller, as Chief Executive Officer to lead their restructuring efforts. First Day Decl., ¶ 56. Notwithstanding the proclaimed importance and skills of the SLT, the Debtors paid Mr. Miller a $5 million signing bonus and agreed to pay him an annual salary of $1.5 million as well as an opportunity to earn a bonus equal to 200% (or $3 million) of his annual salary. Tr. p. 22, lines 19-20; p. 51, lines 10-25. Although the Debtors are not seeking to approve a bonus for Mr. Miller at this time, Mr. Miller did not rule out the possibility that

a motion to approve a bonus would be filed in the future. Tr. p. 22, lines 22-25 and p. 53 line 1.[2]

13. In addition to hiring Mr. Miller, the Debtors retained Perella Weinberg Partners ("**PWP**") in late December 2011 to provide investment banking and financial advisory services. First Day Decl., ¶ 56. Pursuant to an order entered by the bankruptcy court on May 30, 2011, PWP will be paid a $10,000,000 restructuring fee upon consummation of a restructuring and perhaps even more in the event of a sale transaction. [Docket No. 174].

14. Moreover, in March 2012, the SLT received additional support when the Debtors' retained Alvarez and Marsal North America, LLC ("**A&M**") to provide additional restructuring and financial advisory services, including assisting in developing the Debtors' business plan, assisting with raising DIP financing and negotiating the Debtors' prepetition restructuring support agreement. First Day Decl., ¶ 56; Tr. p. 65 lines 6-11.

15. The Debtors filed their chapter 11 petitions on May 4, 2012, with a comprehensive and extensive debt for equity restructuring plan already in place that was agreed to by a majority of the Debtors' prepetition secured creditors and prepetition senior bondholders. *See* Motion at ¶ 6 and First Day Decl. at ¶ 2.

16. After extensive prepetition negotiations, the Debtors, together with 68.14% of their prepetition secured lenders and 72.55% of their prepetition senior bondholders (collectively, the "**Consenting Creditors**") entered into a Restructuring Support Agreement (the "**RSA**"). A copy of the RSA is attached as exhibit A to the First

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2 References to "Tr. _____" refer to the transcript of the hearing held on July 26, 2012 in connection with the Motion.

Day Decl. *See Declaration of Robert S. Miller In Support of the Debtors' Motion For Entry Of An Order Approving The Debtors' Key Employee Incentive Plan And The Key Employee Retention Plan And Granting Related Relief,* ¶ 4 and Fn. 2. (hereinafter, the "Miller Declaration").

17. Pursuant to the RSA, the Debtors' would convert 100% of their prepetition secured bank debt and their prepetition unsecured bond debt into equity (the "**Standalone Transaction**"), with the holders of secured claims receiving 81.1% of the equity in the reorganized debtor and general unsecured creditors share in 18.9% of the equity in the reorganized debtor. First Day Decl., ¶¶ 59-60; Miller Declaration, ¶ 4 and Fn. 2. The Consenting Creditors would be required to support the Debtors restructuring process in which their debt would be converted into equity of the reorganized company. *Id*. at ¶ 60.

18. Thus, as of the Petition Date, in consultation with a large team of experienced and highly paid financial and legal advisors, the Debtors had already developed a "a clear timeline for the Debtors' chapter 11 process" and established a "clear path for a successful chapter 11 restructuring." First Day Decl. ¶¶ 60-61.

19. With respect to the timeline, as of the Petition Date, the Debtors' had agreed to (a) file a plan of reorganization and disclosure statement by June 30, 2012, (b) obtain an order approving the disclosure statement by August 31, 2012 (c) confirm the plan by November 15, 2012 and (d) consummate the plan by December 15, 2012. First Day Decl., *¶ 60.* Presumably, given the experienced restructuring team that the Debtors had assembled, the proposed timeline was well-vetted and the Debtors believed that it was achievable.

20. In addition to providing for the Standalone Transaction, the RSA, provides that the Debtors and their advisors would engage in a marketing process in an effort to sell the Debtors' assets pursuant to a transaction (the "**Third-Party Transaction**") that was more attractive than the Standalone Transaction. Miller Declaration, ¶ 5. Indeed, for months prior to the Petition Date the Debtors and their advisors engaged in an extensive marketing effort to attract a stalking horse bidder for their assets. *Id.* ¶ 8.

21. On July 10, 2012, as a result of the marketing efforts, the Debtors filed a motion to enter into an exclusive negotiation agreement with Superior Aviation Beijing, Co., Ltd. ("**Superior**"). Miller Declaration, ¶ 5 and Debtors' Motion for the Entry of an Order Authorizing the Debtors to Enter Into an Exclusive Negotiations Agreement and a Refund Agreement [Docket No. 324] (the "**Superior Motion**"). On July 17, 2012, the Court granted the Superior Motion. *See* Docket No. 361. Pursuant to the Superior Motion, the Debtors have agreed to negotiate exclusively with Superior for a period of 45 days (or until August 31, 2012) to become the stalking horse bidder to acquire certain of the Debtors' assets (but excluding the defense business) for a purchase price of $1.79 billion. *See* Superior Motion, ¶ 4.

22. Although there is little information provided regarding Superior, it is an entity primarily backed and financed by the Chinese government. As part of the Superior Proposal, Superior would not assume any obligations relating to the Debtors' three defined benefit pension plans, including the pension plan covering IAM-represented employees, nor would it assume any obligations for post-employment benefits (other than COBRA benefits which are paid for by employees). *See* Superior Proposal, ¶ 1; Tr.

p. 120, lines 9–11. Similarly, a condition of the Standalone Transaction is that the pension plans will be terminated. Tr. p. 120, lines 1-3

23. On June 30, 2012, consistent with the PSA, the Debtors filed their plan of reorganization (the "**Plan**") and disclosure statement (the "**DS**"). *See* Docket Nos. 304 and 305 and Miller Declaration, ¶ 4. The Plan and DS essentially incorporate the restructuring that is outlined in the RSA. *Id*.

24. On July 27, 2012, the day after the Court conducted the hearing on the Motion, consistent with the PSA timeline developed by the Debtors prior to the Petition Date, the Debtors filed a motion, and scheduled a hearing for August 30, 2012, to consider approval of the disclosure statement and related relief. [Docket No. 425].

The Motion

25. On July 13, 2012, the Debtors filed the Motion seeking approval of a purported key employee incentive plan (the "**KEIP**") and a key employee retention plan (the "**KERP**") [Docket No. 349]. A hearing in connection with the Motion was held on July 26, 2012. At the conclusion of the hearing the Court approved the KERP and reserved decision with respect to the KEIP. Tr. p. 120, line 24, p. 121 lines 12-13.

26. The KEIP would apply only to the eight (8) member SLT (the "**KEIP Executives**") whom the Debtors concede are "insiders" under section 101(31) of the Bankruptcy Code. Motion, ¶ 18; Miller Decl., ¶ 16. The SLT consists of the Chairman, the Executive Vice President of Operations, the Vice President of Human Resources, the Vice President of Engineering, the Executive Vice President and General

Counsel, the Senior Vice President and Global Customer Support, the Chief Financial Officer,[3] and the Executive Vice President of Customers. *Id.*

27. The total annual base salaries of the KEIP Executives is $2,664,000. Motion, ¶ 25.

28. Historically, to supplement base salary, the Debtors implemented incentive bonus programs for both the SLT and other non-insider employees. Miller Declaration, ¶ 11. However, no evidence was presented concerning the design of the prepetition bonus plans applicable to the SLT in terms of the amount of the potential incentive awards as a percentage of base salary. *Id*. Although the prepetition incentive plan was described generally as providing bonuses for management (not just the SLT members) equal to "a percentage of participants' respective base salaries," no testimony was provided as to the potential bonus awards for any of the SLT members. Miller Declaration, ¶11. Therefore, it is impossible to compare the reasonableness or consistency of the proposed KEIP bonus opportunities (which, as noted below, could equal 200% of base salary) to those offered prior to the Petition Date.

29. Under the KEIP, the Debtors are seeking authority to pay aggregate bonuses of up to $5,328,000, or an astonishing 200% of base salary. Miller Decl., ¶26. The Debtors allege, without providing specific evidence, that the KEIP Executives are critical to a successful restructuring process and to obtain maximum value for the Debtors' estate. Motion, ¶ 19.

30. Under the KEIP, the Debtors are proposing two potential (but exclusive) methods for providing bonuses to the KEIP Executives: either

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[3] It should be noted that the CFO was hired in September 2011, and has only been working for the Debtors for a mere 10 months. *See* First Day Decl. at ¶ 56.

(i) consummation of the Standalone Transaction, which is the consensual restructuring plan that was agreed to by a majority of the prepetition lenders and bondholders prior to the Petition Date, or (ii) approval and consummation of a Third-Party Transaction. Miller Declaration, ¶ 17.

31. Significantly, under either a Standalone Transaction or a Third-Party Transaction, KEIP Executives must be employed and retained by the Debtors through the date of consummation of either transaction (unless they are terminated without cause or resign for good reason). Tr. p. 75, lines 2-10; Motion, ¶ 27. If they leave prior to consummation, they would not be entitled to any of the purported incentive compensation. *Id*.

32. Furthermore, undermining the assertion that the KEIP is primarily incentive driven as opposed to retentive driven, Mr. Miller, the Debtors' chief executive officer, admits that the proposed bonus program is being implemented because there is a significant concern that the SLT members "could seek alternative employment opportunities and, as a result, immediately undermine the Debtors' restructuring efforts at a critical juncture of the Debtors' chapter 11 cases and in the Debtors' business cycle. Miller Declaration, ¶ 30.

The Standalone Transaction Award

33. Under the Standalone Transaction, the KEIP Executives would be entitled to the Standalone Transaction Award if certain conditions were satisfied. In particular, the Standalone Transaction Award includes both a Consummation Award and a Financial Performance Award. Miller Declaration, ¶¶19-22. Both the Consummation Award and Financial Performance Award provide the SLT with cash award opportunities

measured against a percentage of each KEIP Executive's base salary. *Id* ¶19. The Consummation Award portion of the Standalone Transaction Award is tied solely to the timing of the consummation of the Standalone Transaction. *Id.* ¶ 20. The amount of the Consummation Award ranges from 50% of base salary if the consummation date is between December 8, 2012 and December 15, 2012, to 100% of base salary if the Standalone Transaction is consummated on or before November 17, 2012. Id. ¶ 20; Motion, ¶ 21. These dates, however, are not firm. They can be extended without notice or court oversight at the discretion of the Debtors and with the agreement of the Consenting Creditors and the Committee. Motion, ¶21. In addition, the target consummation dates will be automatically extended by the number of days (but not to exceed 30 days) beyond August 31, 2012, in which the Debtors have not resolved the treatment of their three defined benefit pension plans. *Id.*

34. No evidence was presented by the Debtors as to why the SLT deserve any bonus, let alone a bonus equal to between 50% and 100% of base salary, for consummating the Standalone Transaction between November 17, 2012 and December 15, 2012. Nor is there any evidence as to what actions any of the particular SLT members can be expected to take that will promote consummation of the Standalone Plan by the target dates. As noted above, the Standalone Transaction has been fully negotiated, has the support of the key constituent groups, and a hearing to approve the DS is already scheduled for August 30, 2012. Based on this timeline, the Debtors will have approximately 75 days from the expected DS approval to confirm and consummate the Standalone Plan by the purported "stretch" target of November 17, 2012, and more than 100 days to meet the projected target date of December 15, 2012. These timeframes are

well within the norm of any chapter 11 case, and clearly within the norm of a prenegotiated case such as this one. It should also be noted that the Standalone Transaction does not involve the execution risks (i.e. approvals of both United States and Chinese governmental authorities) associated with the Third-Party Transaction with Superior.

35. As for the Financial Performance Award component of the Standalone Transaction, it would be triggered upon achieving certain levels of Cumulative Net Cash Flow and is also tied to the date of consummation of the Standalone Transaction. Miller Declaration, ¶22; Motion ¶ 23. Similar to the Consummation Award, the Financial Performance Award would equal a percentage of the executives' base salary up to 100% of base salary. *Id.* Based upon the consummation date, the Debtors have proposed various ranges for their Cumulative Net Cash Flow which would provide the KEIP Executives with a bonus ranging between 50% of base salary if the Debtors meet the "target" Cumulative Net Cash Flow and 100% of their annual base salary if the maximum target is achieved. *Id.* The "target" Cumulative Net Cash Flow, which would trigger a bonus equal to 50% of base salary, is admittedly not a "stretch" goal and is, in fact, simply consistent with the Debtors' expected projections. Tr. pp. 61-62 and p. 66, lines 17-24

36. The Debtors presented testimony of John Stuart, a senior director of A&M, one of the Debtors' financial advisors, in an effort to demonstrate that the Cumulative Net Cash Flow targets were difficult to achieve. Mr. Stuart, however, did not testify that any of those targets were "stretch" targets in the context of a Standalone Transaction. Tr. pp. 65-73. Although he agreed with Debtors' counsel that they were not

"lay-ups" [Tr. p. 67, line 3], Mr. Stuart did not testify that they were stretch targets [Tr. pp.65-73] nor did he or any other witness provide evidence as to how a particular SLT member could influence achievement of the targets. *Id*. Furthermore, although Mr. Stuart testified that the revenue side of the Cumulative Net Cash Flow target was not certain to be achieved because not all future revenues sources have been specifically identified [Tr. pp. 66-67], he did not explain why that supports a finding that the revenue projections were a stretch. The fact is that all revenue projections are based on assumptions regarding future sales and receipts and that by their nature projections do not guaranty future results.

37. In addition, with respect to the expense side of the Cumulative Net Cash Flow calculation, Mr. Stuart focused on the "unquantifiable costs" of carving out the defense business and stated that those costs are not included in the disbursements line and "make the net cash flow targets more difficult to achieve." Tr. p. 69, lines 11-22. While this may or may not be true, it is totally irrelevant to the issue of whether the Financial Performance Award targets are a stretch because costs associated with carving out the defense business would only be incurred in the event of a Third-Party Transaction with Superior or some other prospective purchaser who would not purchase the defense business. As noted below, however, in the event of a Third-Party Transaction, financial performance targets have absolutely no bearing upon whether the SLT receives a bonus or the amount of the bonus. Thus, in the context of the Standalone Transaction, the costs of carving out the defense business will not be incurred and the testimony regarding those potential costs and their impact on achieving the Financial Performance Award is irrelevant.

<u>The Third-Party Transaction Award</u>

38. In the event the Debtors proceed with and consummate a Third-Party Transaction, the KEIP Executives would receive bonuses equal to 200% of their base salary (the "**Third-Party Transaction Award**"), provided the transaction is approved by the Court on or before December 15, 2012, closes prior to January 15, 2013 and results in a purchase price of at least $1.79 billion. Miller Declaration, ¶ 29; Motion, ¶ 29. Similar to the design of the Consummation Award, the target dates for the Third-Party Transaction can be extended without notice, good reason or Court oversight, provided that the Consenting Creditors and the Committee agree to the extension. Motion, Fn. 10. Payment of the Third-Party Transaction Award would be distributed on the effective date of the transaction, provided that SLT members remain with the Debtors through the payment date unless a member is terminated without good cause or resigns for good reason. *Id*. 30.

<u>Alternative Bonus</u>

39. In the event the Debtors determine to pursue the Third-Party Transaction, but through no fault of management, the Third-Party Transaction does not close, the Debtors will award the Standalone Bonus. Motion ¶ 31. The level of Cumulative Net Cash Flow that needs to be reached for 50% of the bonus to be awarded, however, will be adjusted to reflect the costs expected to be incurred while the Debtors pursue the third-Party Transaction. *Id*.

40. In an effort to support the reasonableness of the proposed KEIP generally, the Debtors submitted the declaration and testimony of Nick Bubnovich, an independent consultant for the Towers Watson compensation consulting firm. Mr. Bubnovich testified that he compared the compensation levels of the SLT members with

other executives using three separate surveys each consisting of approximately 550 companies and concluded that the compensation levels of the SLT are below industry mean primarily because the SLT do not have incentive opportunities in 2012. *See* Declaration of Nick Bubnovich In Support Of The Debtors' Motion For Entry Of An Order Approving The Debtors' Key Employee Incentive Plan And Key Employee Retention Plan, ¶¶ 14-15 (hereinafter, "**Bubnovich Decl**."); Tr. pp. 78-79. However, Mr. Bubnovich did not provide any details regarding the comparability of any of the 550 companies to the Debtors in terms of either annual sales, profits, industry, number of employees or any other relevant factors. *Id.*

41. Mr. Bubnovich also did not provide any evidence as to whether the specific performance timelines, targets, or metrics were reasonable or challenging or whether there is any reasonable nexus between the work performed by any of the SLT members and the achievement of any of the performance goals. For example only, Mr. Bubnovich did not provide any evidence (nor did any other witness) as to how the efforts of the Debtors' Vice President for Human Resources would influence the outcome of either the Standalone Transaction or the Third-Party Transaction.

42. Mr. Bubnovich also attempted to justify the proposed KEIP by comparing it to KEIP programs in 25 other bankruptcy cases involving companies with median revenues and employees comparable to the Debtors. Bubnovich Decl., ¶ 17; Tr. p. 81, lines 9-21. Mr. Bubnovich did not identify any of the 25 companies nor did he compare any of the 25 other debtors in terms of industry, profitability or case outcomes. *Id*.

43. Moreover, Mr. Bubnovich acknowledged that only "approximately" 10 of his 25 comparables included awards that were at, near or above the Standalone Transaction Award payouts at the target performance levels (i.e. 50% of base pay). Bubnovich Decl. ¶ 17; Tr. p. 81, lines 18-21.

44. In addition, Mr. Bubnovich acknowledged that only 2 (or less than 10%) of his 25 comparables offered bonus opportunities equal to or greater than the 200% offered to the SLT. Tr. p. 87, lines 17-19.

45. Lastly, a review of the entire record demonstrates that neither Mr. Bubnovich nor any other witness provided evidence that the KEIP is consistent with industry standard.

CONCLUSIONS OF LAW

46. Fundamentally, and contrary to the Debtors' assertions, the KEIP is not an incentive program designed to reward the Debtors' senior executives for achieving material, value-enhancing targets and challenging targets either during or after the chapter 11 cases. Rather, through the KEIP the Debtors propose to make lump sum awards totaling up to approximately $5.3 million (or up to 200% of the base salary) to eight insiders to remain with the Debtors while they complete the restructuring process that is already in place and close to consummation. The Motion, in substance, seeks to approve a postpetition retention program whose primary purpose is to encourage the SLT insiders to remain with the Debtors for a short period of time and to pay them millions of dollars for doing so.

47. In short, the KEIP is a disguised retention plan that fails to satisfy the strict criteria found in section 503(c)(1) of the Bankruptcy Code that apply to postpetition retention programs for insiders.

48. Alternatively, in the event the that the Court determines the bonus program is primarily incentive motivated, the KEIP it is not justified by the facts and circumstances of the chapter 11 case as required by section 503(c)(3) of the Bankruptcy Code and is not a sound exercise of the Debtors' business judgment because it seeks to provide bonuses that are unnecessary, unreasonable, excessive, discriminatory and not consistent with industry standards. Accordingly, the Court should deny the Debtors' Motion to approve the KEIP.

A. The KEIP is a Disguised Retention Plan that Violates Section 503(c)(1) of the Bankruptcy Code

49. Congress enacted section 503(c) in 2005 to end abusive compensation practices in bankruptcy cases by placing limits on the payment of retention and incentive bonuses and severance to insiders and others *See In re Dana Corp.*, 358 B.R. 567, 575 (Bankr. S.D.N.Y. 2006); *In re Brooklyn Hospital Center*, 341 B.R. 405, 413 (Bankr. E.D.N.Y. 2006).

50. Bankruptcy Code section 503(c) provides:

> (c) Notwithstanding subsection (b), there shall neither be allowed, nor paid--
>
> (1) a transfer made to, or an obligation incurred for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtor's business, absent a finding by the court based on evidence in the record that--
>
> (A) the transfer or obligation is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation;

> (B) the services provided by the person are essential to the survival of the business; and
>
> (C) either--
>
> (i) the amount of the transfer made to, or obligation incurred for the benefit of, the person is not greater than an amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made or the obligation is incurred; or
>
> (ii) if no such similar transfers were made to, or obligations were incurred for the benefit of, such nonmanagement employees during such calendar year, the amount of the transfer or obligation is not greater than an amount equal to 25 percent of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider for any purpose during the calendar year before the year in which such transfer is made or obligation is incurred;
>
> (2) a severance payment to an insider of the debtor, unless--
>
> (A) the payment is part of a program that is generally applicable to all full-time employees; and
>
> (B) the amount of the payment is not greater than 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made; or
>
> (3) other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition.

11 U.S.C. § 503(c).

51. Section 503(c)(1) severely limits any payments to insiders "for the purpose of inducing such person to remain with the debtor's business...." 11 U.S.C. § 503(c)(1); *see In re Velo Holdings,* 2012 WL 2015870 at *5 (Bankr. S.D.N.Y. June 6, 2012) (stating "the effect of section 503(c) was to put in place 'a set of challenging standards' and 'high hurdles' for debtors to overcome before retention bonuses could be paid"); *In re Mesa Air Group, Inc.*, 2010 WL 3810899 at *1 (Bankr. S.D.N.Y. 2010); *In re Nellson Nutraceutical*, Inc., 369 B.R. 787, 800 (Bankr. D. Del. 2007); *In re Global Home Products LLC*, 369 B.R. 778, 783-84 (Bankr. D. Del. 2007); *In re Dana Corp.*, 358

B.R. 567 (Bankr. S.D.N.Y. 2006) (*Dana II*); *In re Dana Corp.*, 351 B.R. 96, 100 (Bankr. S.D.N.Y. 2006) (*Dana I*); *In re U.S. Airways, Inc.*, 329 B.R. 793, 797-98 (Bankr. E.D. Va. 2005) (stating that "changes will severely limit both the circumstances under which severance and retention payments may be made to insiders as well as the amount of such payments….").

52. The purpose of section 503(c)(1) is "to limit a debtor's ability to favor powerful insiders economically at estate expense during a chapter 11 case." *In re Pilgrim's Pride Corp.*, 401 B.R. 229, 234 (Bankr. N.D. Tex. 2009). In enacting the provision, Congress sought "to eradicate the notion that executives were entitled to bonuses simply for staying with the Company through the bankruptcy process." *In re Global Home Prods., LLC*, 369 B.R. at 784 (internal quotation omitted). To achieve that goal, Congress established specific and rigorous evidentiary standards that must be satisfied by a proponent before a bankruptcy court may authorize payments to an insider for the purpose of inducing the insider to remain with the debtor's business. *See Dana I*, 351 B.R. at 100.

53. In an effort to avoid the rigorous criteria embodied in section 503(c)(1), the Debtors have chosen to characterize their KEIP as a performance based incentive program for insiders and attempt to justify the enormous awards as an exercise of reasonable business judgment.

54. Courts, however, do not determine whether section 503(c)(1) applies to a postpetition compensation plan based upon the label the debtor places on the plan. Rather, when determining whether a compensation program is subject to section 503(c)(1) of the Bankruptcy Code, courts consider the circumstances under which

particular proposals are made, along with the structure of the compensation package. *See In re Mesa Air Group*, 2010 WL 3810899 at *2; s*ee Dana I*, 351 B.R. at 102 n. 3 (stating that if a proposed KEIP "walks like a duck (KERP) and quacks like a duck (KERP), it's a duck (KERP)."). Any attempt by a debtor to mischaracterize a retention plan in order to bypass the requirements of section 503(c)(1) should be looked upon with disfavor. *See e.g. In re Velo Holdings,* 2012 WL 2015870 at *6 (Bankr. S.D.N.Y. 2012); *In re Borders Group, Inc*., 453 B.R. 459, 470 (Bankr. S.D.N.Y. 2011).

55. The Debtors argue generally that the KEIP is incentive driven because it is designed to incentivize KEIP participants and to "motivate the members of the Debtors' management and align their incentives with those of the Debtors' stakeholders." *See* Motion, ¶ 16. Mr. Bubnovich, the Debtors' compensation consultant, asserts that the KEIP is primarily incentive based because it has "variable performance associated with it" and contains "performance metrics." Tr. pp. 82-83. Mr. Bubnovich, however, does not provide any view as to whether those performance goals require outperforming or merely performing to meet existing projections that are presumably based on reasonable assumptions and achievable goals.

56. An analysis of the terms of the bonus plan and the circumstances under which it was proposed demonstrate that the KEIP is a retention plan because its primary purpose is to encourage the KEIP Participants to remain with the Debtors through a transitional period during which the risk of defections is greatest. *See In re Brooklyn Hospital Center*, 341 B.R. at 413; *In re Georgetown Steel Co*., 306 B.R. 549, 556 (Bankr. D.S.C. 2004).

57. In particular, the Debtors filed their chapter 11 cases with a comprehensive and extensive restructuring plan already in place that set ouit a "clear path" for a "successful reorganization." First Day Decl., ¶¶ 2, 6 and 61; Miller Decl., ¶¶ 4 and 5. . The Debtors, together with 68.14% of their prepetition secured lenders and 72.55% of their prepetition senior bondholders entered into the RSA pursuant to which the Debtors are under a strict timeline to complete these chapter 11 cases. *See* First Day Decl., ¶ 60; Miller Declaration, ¶ 4. Thus, the Debtors already have an obligation and commitment to a majority of their prepetition creditors to obtain approval of a disclosure statement by August 31, 2012 and to consummate a plan of reorganization by December 15, 2012. Thus, there is no additional incentive necessary, nor any justification, to provide additional compensation to the KEIP Executives in the form of the KEIP bonuses. The KEIP appears to be little more than the Debtors "encouraging" certain insiders with substantial additional compensation to continue to work in their current positions for a few more months – something clearly restricted under section 503 (c) (1) of the Bankruptcy Code.

58. Furthermore, the target date of consummation of the Standalone Transaction in the KEIP is December 15, 2012, the same target date of consummation contained in the RSA. *See* Motion, ¶ 21. Thus, the Debtors are not attempting to incentivize the KEIP Executives to achieve a new target date of consummation; rather, the KEIP is primarily retentive in nature for the KEIP Executives to remain with the Debtors as the process completes its natural course of action with targets that have not changed since the Petition Date.

59. As noted above, the Standalone Transaction has been fully negotiated and has the support of the key constituent groups and a hearing to approve the DS is already scheduled for August 30, 2012. Based on the existing timeline, the Debtors will have approximately 75 days from the expected DS approval to confirm and consummate the Standalone Plan by the purported "stretch" target of November 17, 2012 and more than 100 days to meet the projected target date of December 15, 2012. These timeframes are well within the norm of any chapter 11 case, and clearly within the norm of a prenegotiated case such as this one. Moreover, as a practical matter, there is no evidence as to what actions, beyond those normally expected of senior management, the SLT members can take to achieve the targeted consummation dates.

60. In the absence of establishing any meaningful and challenging timeline targets for consummation of the Standalone Transaction, the KEIP cannot be properly characterized as primarily incentive in nature. Rather, despite its label, the KEIP is truly a retention plan to provide excessive compensation for several key insiders to remain with the Debtors until they complete the restructuring process that is already in place with targets that are easily reachable.

61. The KEIP also provides for a Financial Performance Award upon achieving certain Cumulative Net Cash Flow levels in the short term. There is no evidence, however, that these targeted levels are at all challenging, let alone a stretch, for the KEIP Executives to achieve. In fact, the Debtors' acknowledge that the "target" Cumulative Net Cash Flow which would trigger a bonus equal to 50% of salary is simply consistent with existing projections and does not require outperformance. Tr. pp. 61-62

and p. 66, lines 17-24. Thus, the Financial Performance Bonus is likewise an improper basis for the KEIP because it is not tied to meaningful and challenging targets.

62. Further undermining the Debtors' contention that the bonus program is primarily incentive driven is the fact that the SLT members must remain employed by the Debtors until the time the Standalone Transaction or Third-Party Transaction are completed. Tr. p. 75, lines 2-10; Motion ¶ 27.

63. Finally, the predominantly retentive nature of the program is evidenced by Mr. Millers' candid acknowledgement that given the status of the case, the bonus program is critical because "the SLT could seek alternative employment opportunities" which could "immediately undermine the Debtors' restructuring efforts at a critical juncture of the Debtors' chapter 11 cases and in the Debtors' business cycle." Miller Declaration, ¶P 30. While the retention of the SLT may be important, it cannot not justify the award of bonuses unless the bonus program meets the mandate of section 503 (c) (1) of the Bankruptcy Code.

64. Having determined that the KEIP is a retention based plan for insiders, the next step is to determine whether the Debtors have satisfied the statutory requirements of Bankruptcy Code section 503(c)(1).[4] Indeed, the Debtors have not even attempted to establish that any elements of the statute have been met and, clearly, the proposed KEIP does not satisfy section 503(c)(1). Among other things, there is no evidence that the proposed awards are essential to the retention of each KEIP Participant, that any participant has a bona fide job offer at the same or greater rate of compensation, or that the services of each participant are essential to the survival of the business.

[4] It is clear, and the Debtors do not deny, that all of the KEIP Executives, each of whom are either an officer, director, or a person in control of the debtor, are insiders within the meaning of section 101(31) of the Bankruptcy Code. *See* 11 U.S.C. § 101(31). *See* Motion at ¶ 18.

Moreover, there is no evidence that the proposed award amounts fall within the compensation parameters set forth in section 503(c)(1)(C)(i) or (ii).

65. For the foregoing reasons, the KEIP is a disguised retention plan that is prohibited by section 503(c)(1). Accordingly, the KEIP should be denied.

B. Implementation of the KEIP is Not Justified by the Facts and Circumstances of the Chapter 11 Case Nor a Sound Exercise of the Debtors' Business Judgment

66. In the event the Court determines that the KEIP is, in fact, an incentive plan not governed by the specific requirements of section 503(c)(1), the KEIP Motion should nevertheless be denied because the proposed payments are "not justified by the facts and circumstances of the case" as required by § 503(c)(3) nor is the decision to make the bonus payments an exercise of sound business judgment.

67. True incentive based bonuses to insiders that are "ordinary course transactions" are subject to the "valid business purpose" test under section 363 of the Bankruptcy Code and must have a good faith and reasonable basis. *See In re Mesa Air Group, Inc.*, 2010 WL 3810899 at *3 (Bankr. S.D.N.Y. 2010). However, incentive based bonuses to insiders that are outside the ordinary course are subject to a heightened degree of scrutiny under section 503(c)(3) and must be justified by "the facts and circumstances of the case." *Id.* at 2; *Pilgrim's Pride*, 401 B.R. at 236. Under section 503(c)(3), "even if a good business reason can be articulated for a transaction, the court must still determine that the proposed transfer or obligation is justified in the case before it." *Id.* at 237; s*ee also Dana I*, 351 B.R. at 100-101 (stating section 503(c) "makes abundantly clear that, to the extent a proposed transfer falls within sections 503(c)(1) or (c)(2), then

the business judgment rule does not apply, irrespective of whether a sound business purpose may actually exist."); *but see Velo Holdings*, 2012 WL 2015870 at *9.

68. The Debtors do not argue that the KEIP is an ordinary course transaction. Instead, they seek approval of the KEIP as a transaction outside the ordinary course of business but incorrectly rely on the business judgment analysis applicable to transactions governed by § 363 to support the relief requested. *See* Motion ¶ 42. Alternatively, the Debtors argue the KEIP is authorized under section 503(c)(3) because the payments are "justified by the facts and circumstances." *Id.* at ¶ 60. Both of these arguments fail.

69. Courts considering proposed bonus plans under section 503 (c) (3) have balanced a number of factors, including the following, to determine whether incentive plans should be approved: (i) whether the plan is calculated to achieve the desired performance; (ii) whether the plan's cost is reasonable in the context of the debtor's assets, liabilities and earning potential; (iii) whether the plan is fair; does it apply to all employees' does it discriminate unfairly; (iv) whether the plan is consistent with industry standards, (v) whether the debtor performed due diligence in investigating the need for a plan and determining which key employees needed to be incentivized, and (vi) whether the debtor received independent counsel in developing the plan. *See Dana II*, 358 B.R. at 576-77; *see also, Borders*, 453 B.R. at 474 (applying the Dana II test).

70. Here, the Debtors' Motion should be denied because the proposed KEIP bonuses are unnecessary, unreasonable, excessive, and discriminatory. Moreover, there is no evidence that the KEIP is consistent with industry standards. Furthermore, although the Debtors presented generalized assertions that the SLT members as a whole

"will play an indispensible role in the performance of the business over the next few months, which will drive the overall outcome of the Standalone Transaction or the Third-Party Transaction" [Miller Declaration ¶ 6], no evidence has been presented that the Debtors' performed due diligence in investigating which key employees need to be incentivized. The fact that the Debtors retained a consulting firm to assist in the development of the KEIP does not overcome the serious flaws in the KEIP. This is especially the case here, where the consultants' testimony was unpersuasive.

71. Simply stated, establishing reachable, projected and extremely short term targets that trigger the payment of up to $5.3 million in "incentive" pay to eight executives cannot be justified under any circumstances.

72. Assisting the Debtors in closing either the Standalone Transaction or Third-Party Transaction, both of which are well on their way towards completion, does not constitute a legitimate and meaningful performance target because the KEIP Executives are not required to "stretch" above and beyond in order to reach those goals. As noted earlier, the evidence is clear the Standalone Transaction and Third-Party Transaction are far along in the process and that the SLT can earn significant bonuses merely by reaching various targets that are consistent with expected projections that were prepared with the assistance of a large team of experienced professionals. Perhaps, if the Standalone Transaction or the Third-Party Transaction were in their formative stages, the implementation of a bonus program to analyze, develop and consummate a transaction could be justified. However, that is not the case here.

73. In addition, the unreasonableness and excessive nature of the bonuses is evidenced by the fact that Mr. Bubnovich stated that only "approximately" 10

of the 25 bankruptcy KEIPs that he analyzed were at, near or above the Standalone Transaction Award payouts at the target levels (i.e. 50% of base pay). Bubnovich Decl., ¶ 17; Tr. p. 81, lines 18-21. Even more compelling, is the fact that Mr. Bubnovich acknowledged that only 2 (or less than 10%) of his 25 comparables offered bonus opportunities equal to or greater than the 200% offered to the SLT. Tr. p. 17-19.

74. Moreover, it is important to consider that PWP, the Debtors' investment banker who has been deeply involved in the Standalone Transaction and Third-Party Transaction since prior to the Petition Date, stands to receive a $10,000,000 restructuring fee upon consummation of a restructuring and perhaps even more in the event of a sale transaction. Given PWP's lead role in both the restructuring and sales efforts and the substantial fees they will earn upon consummation of either type of transaction, it is difficult to understand why the KEIP Executives should be awarded up to 200% of their base salaries (or approximately $5.3 million) upon consummation of a Standalone Transaction or Third-Party Transaction.

75. The fact that the Debtors needed to retain Mr. Miller to supervise the SLT and to orchestrate the restructuring for a minimum compensation of $6.5 million and to retain A&M for additional financial advisory services also undercuts the argument that paying SLT members up to 200% of their salary is reasonable under the facts and circumstances of this case.

76. As part of their argument, the Debtors attempt to justify the payment of exorbitant bonuses by relying on the fact that the KEIP Executives did not receive bonuses in 2011 because they failed to meet the applicable 2011 performance metrics. *See* Motion, ¶¶ 11, 34; Miller Declaration, ¶ 11; Bubnovich Declaration, ¶ 13.

The failure to meet the prepetition incentive targets in 2011, however, does not provide any justification for the implementation of unreasonable and excessive awards in 2012.

77. Additionally, the Debtors are attempting to provide excessive bonuses for the eight KEIP Executives while at the same time rank and file jobs are being lost and the Debtors are attempting to terminate pension plans. Pursuant to the tentative agreement with Superior, Superior would not assume any obligations relating to the Debtors' defined benefit pension plans, including the pension plan covering IAM employees, nor would it assume any obligations for post-employment benefits for their employees. Tr. p. 120, lines 9-11 and Superior Proposal, ¶ 1. This is in addition to the fact that shortly before the Petition Date the Debtors eliminated 800 rank and filed jobs, negotiated favorable amendments to the collective bargaining agreement with the IAM and outsourced certain operations. *See* First Day Decl. at ¶ 55. Furthermore, the Debtors and the IAM have been, and are currently, in the process of collective bargaining negotiations in an effort to avoid litigation under section 1113 of the Bankruptcy Code. Tr. p. 119, lines 14-19. The negotiations revolve exclusively around the Debtors' proposed termination of the hourly employees' single employer defined benefit plan and its replacement with a defined contribution plan. *Id*. Given the conditions faced by the overwhelming majority of the Debtors' workforce, it is unreasonable, unfair and inequitable to offer the SLT such generous bonus opportunities for such little achievement. Thus, the KEIP clearly discriminates against the Debtors' other employees in favor of eight the SLT insiders.

78. Finally, no evidence was presented with respect to the question of whether the KEIP is consistent with industry standards. While Mr. Bubnovich testified

that he reviewed 3 surveys each containing approximately 550 companies and a group of 25 debtors that developed KEIPs during chapter 11 cases, he did not testify that any of his comparator companies were in the same industry as the Debtors. And, as noted above, his testimony regarding the companies that he did review demonstrates that less than 10% of those companies offered bonus awards equal to 200% of annual salary and that only approximately 40% offered bonuses near, equal to, or greater than 50% of base salary for meeting "target" projections. Bubnovich Decl., ¶ 17; Tr. p. 81, lines 17-19, 21.

79. In sum, to the extent that sections 503(c)(3) or 363 apply, consideration and balancing of the factors outlined in *Dana II* and other cases demonstrate that the Debtors have not made a sufficient showing that implementation of the KEIP is justified by the facts and circumstances of the chapter 11 case or that it is an exercise of sound business judgment.

80. In light of the Debtors' failure to meet their evidentiary burden, the KEIP should not be approved.

CONCLUSION

81. For the reasons stated herein the IAM respectfully requests that the Court deny the Motion to the extent it seeks approval of the KEIP.

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