The “Key” to Success? KERPs in Canadian Restructuring Law

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Introduction

There are few concepts in insolvency law and restructuring that have the capacity to stir up as much controversy and attention as key employee retention plans ("**KERPs**").[1] For the public and concerned creditors, the optics of KERPs can be poor. KERPs often occur simultaneously with lower-paid workers being laid off or terminated. Junior creditors may see a dollar-to-dollar reduction in the satisfaction of their claims when KERP payments are paid. When news breaks that a high-level executive of a distressed company is receiving what essentially amounts to a bonus to incentivize the executive to remain with the company, questions are naturally raised.[2]

However, despite the potential for controversy, KERPs have emerged as a notable feature of Canadian restructurings and are not going anywhere. The recent case of *Aralez Pharmaceuticals Inc. (Re)*[3] ("***Aralez Pharmaceuticals***") summarized the general principles which have emerged from Canadian case law and practice regarding KERPs. Consistent with general principles of the *Companies' Creditors Arrangement Act*[4] (the "**CCAA**"), the case confirmed that the court has broad discretion to grant, vary or refuse to approve a KERP agreement.

Surprisingly, there has been relatively little jurisprudence or academic commentary on the prevalence of KERPs and their effectiveness in facilitating a successful restructuring or liquidation as a going-concern.[5] This paper will discuss: **i)** a summary of KERPs and the various ways in which they have been designed; **ii)** recent Canadian case law on KERPs and the principles that govern its use; **iii)** a brief review of the United States approach to KERPs and how it differs from Canada's; **iv)** the success of KERPs in accomplishing their objectives; and **v)** recommendations for the oversight and control of KERPs.

I. Overview of KERPs

In the aftermath of a company filing for CCAA protection it is to be reasonably expected that there will be heightened uncertainty regarding the future operations of the debtor company. This instability creates a situation where current employees of the debtor company might feel the need to search externally for future employment prospects. The exodus of employees integral to a

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[1] While key employee incentive plans ("**KEIPs**") differ from KERPs, for the purposes of this paper the two terms will be used interchangeably due to their similar treatment by the courts.

[2] For a good illustration of the public outcry that KERPs can generate, see news coverage regarding the Sports Authority Chapter 11 proceedings: Aimee Picchi, "A six-figure bonus for going bankrupt? Suuuure," *CBS News* August 3, 2016 available online at <https://www.cbsnews.com/news/judge-sports-authority-execs-bankruptcy-pay/> and, in Canada, the Sears CCAA proceedings: Katie Dangerfield, "Sears managers, executives get $9.2M in bonuses while thousands laid off," *Global News* July 14, 2017 available online at <https://globalnews.ca/news/3598469/sears-canada-lay-offs-management-bonuses/>.

[3] *Aralez Pharmaceuticals Inc. (Re)*, 2018 ONSC 6980 [Commercial List] [*Aralez Pharmaceuticals*].

[4] *Companies' Creditors Arrangement Act*, RSC 1985, c C-36 [CCAA].

[5] *Aralez Pharmaceuticals*, *supra* note 3 at para 29 where Justice Dunphy notes there has been "limited case law" regarding KERPs; also see Edward A Sellers, "Developments and Trends in the Governance of Distressed Enterprises in Canadian Insolvency Proceedings: Who is Making Critical Decisions?" In Janis P Sarra ed, *Annual Review of Insolvency Law 2018* (Toronto: Carswell, 2018) at footnote 30 where it is noted there has been little critical scholarly comment on KERPs.

company's daily operations would significantly weaken the ability of companies trying to maximize value in a restructuring.[6]

KERPs have been developed to stem the tide of key employees abandoning ship when the future of a debtor company is perilous. KERP payments are a secured charge over the debtor company's assets payable to key employees which motivates them to maintain their employment.[7] Although additional payments to employees is another expense to a typically expensive CCAA proceeding, they can save a debtor company money in the long run by keeping existing management intact and preventing turnover. These plans often take the form of either: **a)** bonus payments based on a percentage of the employee's annual salary; or **b)** performance-based compensation.[8] Generally, the monetary amounts payable under a KERP agreement are withheld until the conclusion of a restructuring or sale process, however, if reasonable and necessary, it is open to the parties involved to create different conditions upon which payment will be triggered.[9]

While KERPs are not codified in the CCAA, the power for courts to approve a KERP comes from the broad discretionary section 11 power that has been applied in numerous different insolvency contexts.[10] As discussed below, by extension of the Monitor's role as a court-appointed officer supervising the restructuring, the court's involvement in the negotiation, design and implementation of any KERP is a necessary aspect of the process.

II. Legal Principles Governing KERPs

The fundamental principles regulating KERPs were re-stated by Justice Dunphy in *Aralez Pharmaceuticals*. The debtor companies, Aralez Pharmaceuticals Inc. and Aralez Pharmaceuticals Canada Inc. (collectively, the "**Aralez Group**"), were operating under CCAA and Chapter 11 protection in cross-border proceedings. There were three employees of the Aralez Group identified as key employees who would play a pivotal role in the company following its sale. These employees were offered bonuses ranging from 25-50% of their salary.[11] In addition, there were nine employees who were going to be terminated following the sale but were offered performance-based incentives to maximize cash flow and sales proceeds. The unsecured creditors objected to

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[6] On the other side of the ledger, the potential for key employees to leverage their necessity in negotiating compensation plans can lead to the senior secured lender being willing to approve KERP payments at the expense of junior creditors: Roderick J. Wood, "Rescue and Liquidation in Restructuring Law" (2013) 53 CBLJ 047.

[7] A key feature of KERPs is that because they are not governed by statute, they may be flexibly designed to rank prior or subsequent to any creditors or applicable charges.

[8] The latter is usually in the form of a KEIP.

[9] E.g. death, disability or termination without cause, see *Aralez Pharmaceuticals*, *supra* note 3 at para 13. Also see the comments of Newbould J in *Grant Forest Products Inc. (Re)*, [2009] OJ No 3344, 57 CBR (5th) 128 [Commercial List] at para 22 [*Grant Forest*].

[10] *US Steel Canada Inc. (Re)*, 2014 ONSC 6145 at para 27; for more discussion on the s. 11 power see *Ted Leroy Trucking [Century Services] Ltd., Re*, 2010 SCC 60 at paras 66-70.

[11] *Aralez Pharmaceuticals*, *supra* note 3 at para 13.

the performance-based incentives for being overly generous and setting minimal thresholds for achievement.[12]

In addressing the concerns of the opposing parties, Justice Dunphy established a framework for determining the appropriateness of a KERP. The framework provided for three guidelines: **i)** Arm's length safeguards; **ii)** Necessity; and **iii)** Reasonableness of design.[13] Arm's length safeguards reflect the importance of the Monitor in the KERP negotiation phase. Due to the myriad conflicting interests presented by a KERP, without a neutral party supervising and advising the decision-makers, it is very difficult to prove the reasonableness and necessity of a KERP when the beneficiaries of a plan have been one of the actors facilitating it. Thus, the court will consider the Monitor's involvement at all stages of the negotiation.[14] The necessity criteria attempts to delineate who qualifies as a "key" employee. Employees who have similar objectives as creditors in the long-term and work in an industry that is facing a talent shortage will fall higher on the necessity spectrum, while employees who are not likely to be needed moving forward and are expendable will rarely qualify as necessary.[15] Finally, the reasonableness of the design seeks to ensure there is a rational connection between the payments and the goals of the restructuring. Courts have usually held the quantum of bonus retention payments should be between 30% and 70% of an employee's salary, but there have been instances of larger bonuses in exceptional circumstances.[16]

The *Aralez Pharmaceuticals* framework was based upon the previous jurisprudence in Ontario. In *Cinram International Inc. (Re)*[17] the court built upon the earlier decision of *Grant Forest Products Inc. (Re)*[18] and set out several factors that will influence the court's decision to approve a KERP: **i)** the opinion of the Monitor; **ii**) the possibility of employees considering alternative employment; **iii**) the importance of the employees for maximizing value and ensuring a steady transition; **iv**) the availability of replacement workers; **v)** any approval from secured creditors and/or the board of directors; and **vi**) when the KERP payments become payable.[19] These factors are effectively baked into the *Aralez Pharmaceutical* three-pronged framework which will likely be the test moving forward. In addition, the Ontario line of cases has rejected an approach

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[12] *Ibid* at paras 20-21. These creditors were represented by the Official Committee of the Unsecured Creditors appointed in the United States Chapter 11 proceedings. Due to the cross-border protocol in operation, the Ontario court had jurisdiction to consider the complaint.

[13] *Ibid* at para 30.

[14] The creditors who stand to be the ultimate beneficiaries and payees of the KERP also are expected to have significant input throughout the process.

[15] *Aralez Pharmaceuticals*, *supra* note 3 at para 30.

[16] *Walter Energy Canada Holdings Inc., Re*, 2016 BCSC 107 [*Walter Energy*]. The key employee who was the subject of the KERP had previously been given a large salary raise, and in conjunction with the retention payments made the payments on the "high end" of the KERP quantum spectrum. Notwithstanding this, the employee's multi-faceted expertise in mining operations and marketability made this an exceptional circumstance according to the court.

[17] *Cinram International Inc. (Re)*, 2012 ONSC 3767 [Commercial List] [*Cinram*].

[18] *Grant Forest*, *supra* note 8.

[19] *Cinram*, *supra* note 16 at para 91.

taken by Quebec courts to incorporate a "reasonable prospect of a successful restructuring" requirement into the analysis.[20]

III. United States' Approach to KERPs

The American approach to KERPs differs substantially from the Canadian approach. As a result of what the United States Congress perceived to be rampant abuse of KERPs during bankruptcy, the *United States Bankruptcy Code* (the "**US Code**") was amended to include § 503(c).[21] This provision imposes two onerous requirements for a KERP to be approved: **i)** the KERP must be necessary by virtue of the employee having a legitimate employment offer on similar or greater terms; and **ii)** the employee's services must be "essential to the survival of the business."[22] The need to establish both elements severely limits the availability of KERPs. While Canadian courts place great emphasis on the second requirement, there is no prerequisite offer that must be outstanding for a KERP to be implemented. The likelihood, or mere risk of, losing a key employee is sufficient.[23]

The second major difference between the American and Canadian approach is the American courts have distinguished between KERPs and KEIPs while the Canadian courts have largely treated them under the same legal principles.[24] In particular, KERPs are classified as "pay to stay" plans while KEIPs are classified as "pay for value" plans.[25] This has developed partly due to the wording of § 503(c) which results in the provision only applying to payments made "for the purpose of inducing (the employee) to remain with the debtor's business."[26] As a result, only payments classified as KERPs are burdened by the restrictive provision in the US Code while KEIPs are evaluated based on an objective business judgment standard.[27]

Not only is the availability of KERPs statutorily restricted in the United States, but the amount of the payments is as well. The quantum of the KERP to management employees cannot exceed ten times the amount of any transfer given to non-management employees in the same calendar year for any purpose. Further, if no such transfers were made in that calendar year to non-management employees, then the KERP is given a ceiling of 25% of any other transfers made to management employees in the previous calendar year.[28] This cap on the amount was enacted to tackle perceived inequities in the workplace that created instability and resentment between the

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[20] *Grant Forest, supra* note 8 at para 24. Newbould J dismissed the finding of the Quebec Superior Court in *Re MEI Computer Technology Group*, (2005) 19 CBR (5th) 257.
[21] *United States Bankruptcy Code*, 11 USC (2005), § 503(c) [US Code].
[22] *In re Global Home Products, LLC*, 369 BR 778 (2007) (Del Bankr Crt) [*Global Home*].
[23] *Canwest Global Communications Corp. (Re)*, [2009] OJ No 4286, 59 CBR (5th) 72; *Cinram, supra* note 16.
[24] *Aralez Pharmaceuticals, supra* note 3 at para 29.
[25] *Global Home, supra* note 22.
[26] US Code, *supra* note 20 at § 503(c)(1).
[27] See *In re Dana Corp.*, 351 BR 96 (Bankr SDNY 2006) [*Dana Corp.*] where the court said it would be diligent in distinguishing between authentic "pay for value" plans and those which were argued as KEIPs but in substance were KERPs. Lifland J commented if it "walks like a duck (KERP), quacks like a duck (KERP), it's a duck (KERP)."
[28] Kate Stickles & Patrick Reilley, "Identifying Insiders for Purposes of § 503(c)" (2009) 28:8 Am Bankr Inst J [Stickles & Reilley].

company hierarchy.[29] As discussed above, the quantum of KERP payments is assessed for reasonableness in Canada, however there is no statutory limit nor is there usually any balancing or comparison made with respect to employees not captured by the plan.

IV. Review of the Effectiveness of KERPs

While KERPs often result in very contentious negotiations and legal battles between various stakeholders during a CCAA proceeding, it is sometimes easy to lose sight of the forest for the trees when thinking about the appropriateness of KERPs. In essence, the fights over quantum, priority of charges and identifying key employees, *inter alia*, often obscure the most important question: do KERPs work?

Scholarly research on the empirical evidence is understandably sparse, but a recent study suggests the supposed benefits of KERPs in restructuring proceedings have a sound foundation.[30] The overall findings of the report indicate that "KERPs are an efficient contracting solution to the problem of retaining and incentivizing key employees in bankruptcy."[31] The study reviewed 553 Chapter 11 debtor companies in the United States and found that 210 of them employed KERPs.[32] Unsurprisingly, the article finds that there is a much greater propensity for KERPs to be implemented where the debtor company is located in an area and industry that is highly competitive.[33] The employees most frequently compensated by a KERP often are executives that were hired as "turnaround specialists" shortly before filing for protection, with CEOs less frequently covered.[34] In making this finding, the study suggests that it is a strong rebuttal to the oft-utilized depiction of high-powered executives getting paid for their own mistakes.[35]

With respect to the prospects of a successful restructuring, the article found that incentive bonuses which were achieved by emerging as a going concern or which were linked with revenue were highly effective.[36] In contrast, payments made based on return on asset sales were less effective.[37] This suggests KERPs are best implemented when they are tailored to the objective of

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[29] *Ibid*.

[30] Vidhan K Goyal & Wei Wang, "Provision of Management Incentives in Bankrupt Firms," (2015) Hong Kong University of Science & Technology & Queen's University Smith School of Business, available online at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2109527> [KERP Study].

[31] *Ibid* at 1.

[32] *Ibid* at 16. The KERP Study also finds that the prevalence of KERPs has been steadily increasing since the early 1990s.

[33] *Ibid* at 19.

[34] *Ibid* at 3. For the purposes of this study, a turnaround specialist is defined as someone who has "helped turnaround or restructure a company in the past or who has previously worked as consultant at advisory firms specializing in turnaround or has worked at asset management firms that focus on distress investing": *Ibid* at 10.

[35] For example, see the decision of *In re US Airways Inc.*, 329 BR 793 (Bankr EDVA 2005) where the court said "All too often [KERPs] have been widely used to lavishly reward—at the expense of the creditor body—the very executives whose bad decisions or lack of foresight were responsible for the debtor's financial plight."

[36] *Ibid* at 27.

[37] *Ibid*. The paper suggests that incentives based on asset sales are merely a way for executives to unjustly enrich themselves as there is likely no hope of emergence. However, this finding seems based on a narrow interpretation of a "successful" restructuring which requires emergence or higher earnings. There is no reason why incentive bonuses based on asset sales cannot be successful in maximizing sales proceeds.

the restructuring and would be worthwhile for insolvency professionals to consider when thinking of adopting a KERP. In fact, when a KERP is awarded based off work employees have done in the ordinary course of business and is not attached to restructuring goals, the court may be unlikely to approve it.[38]

It must be noted that the above study focused only on Chapter 11 proceedings, and thus its relevance for CCAA purposes is an open question. It could be argued that because of the restrictive American approach, KERPs have been more successful in the United States because of the narrower circumstances in which they may be utilized. In addition, many American firms have reacted to the enactment of § 503(c) by switching to "pay for value" schemes.[39] This could also suggest that incentive-based plans (or KEIPs) are more effective at achieving a successful restructuring than retention bonuses with no conditions attached. Although these concerns have some merit, in reality American firms have largely skirted the restrictions imposed in the US Code by using these incentive-based plans and suggesting their purpose is not for the retention of employees, often relying on years of similar bonus structures.[40] The KERPs in CCAA and Chapter 11 proceedings are, in substance, often quite alike. Thus, the findings of the report can reasonably be considered applicable to Canadian restructuring.

V. Recommendations for Ensuring Accountability and Effectiveness

The most common discussion in Canadian KERP literature revolves around whether Parliament should follow the Americans' footsteps and restrict the availability of KERPs.[41] For two main reasons, this would be ill-advised. The first is that this severely limits the flexibility of stakeholders and the broad discretion of the courts that are a crucial feature of CCAA proceedings.[42] Secondly, the unique role of the Monitor in CCAA proceedings shields KERPs from many of the concerns that forced the changes to the US Code. The Monitor's position as "eyes and ears of the court" creates an independent, arms-length supervisor which can check unwarranted abuses of power and account for various stakeholder interests.[43] However, as discussed below, the Monitor's role raises separate concerns.

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[38] See *Textron Financial Canada Ltd. v Beta Ltee/Beta Brands Ltd.*, [2007] OJ No 3422 where the Ontario Superior Court declined to approve a KERP because the employees subject to the plan were merely acting in their normal duties and had attempted to "jump the queue" over unsecured creditors.

[39] For an example, see *In re Blitz USA Inc.*, 475 BR 209 (2012) (Del Bankr Crt).

[40] *Dana Corp.*, *supra* note 25.

[41] Two opposite positions were taken on this issue in Magnus Verbrugge & Ryan Laity, "Let's Not Codify the Use of Kerps, Stalking Horse Bids and Third-Party Releases," (2014) 3-3 IIC Articles [Verbrugge and Laity] and Janis Sarra, "Examining the Insolvency Toolkit: Report on the Public Meetings on the Canadian Commercial Insolvency Law System" (2012) Insolvency Institute of Canada, available online at <http://www.insolvency.ca/en/iicresources/resources/Examining_the_Insolvency_Toolkit_Dr._J_Sarra_2012.pdf> [Sarra Report].

[42] Verbrugge and Laity, *ibid.*

[43] The recognition of the unique role the Monitor has in CCAA proceedings means that significant weight will be attributed to the Monitor's recommendations regarding KERPs, see *Arclin Canada Ltd., Re*, 2009 CarswellOnt 6161, [2011] WDFL 2898.

Notwithstanding the desire to maintain flexibility, the American approach of limiting the amount of the KERP payments may be worth debate. As highlighted above, any payment made to someone in management must not be greater than ten times that of a similar payment made to non-management employees and absent such payment to non-management employees, the payment must not exceed 25% of any previous transfer made to the same management employee.[44] Enacting a similar provision in Canada would greatly mitigate concerns of those employees lower in the company structure and limit the perceived inequities some KERPs create.

Arguably the most important consideration in designing and approving a KERP is determining who constitutes a "key" employee. Ultimately, some employees are going to be excluded from the KERP which can stimulate internal conflict and even exacerbate employee retention issues. Those employees not captured by the plan who may not qualify as "key" employees but are nonetheless valuable components of the company structure will be even less likely to remain during restructuring. A provision like the American statute, tailored for the Canadian experience, would prevent exuberant KERP payments that come at the expense of junior creditors and lower-ranking employees who are not privy to the negotiations. This could also prevent the unfairness that arises between management and other employees as the CCAA proceeding continues to accumulate costs.[45] In keeping with the spirit of the CCAA, however, any such provision should also include a residual discretion clause for the courts to approve a KERP as they see fit.

To ensure legitimacy, there should be increased transparency and accountability that accompanies KERP negotiations during the CCAA process. Often in practice the appointed Monitor will have already been working with the debtor company pre-filing. This may result in the KERP being developed prior to the insolvency which then requires a retroactive examination of whether the KERP is in the best interest of all stakeholders, including creditors who must then be consulted. One previous proposal to address accountability issues was to enact statutory liability for officer misconduct with relation to KERPs.[46] A counterargument is that the oppression remedy should adequately cover any officer and director liability arising from KERP abuses. Although an oppression remedy can be heard during CCAA proceedings, there is case law to suggest that any direction or remedy provided by the court must be consistent with the purpose and scheme of the CCAA.[47] This includes facilitating the debtor company's rehabilitation. These limitations on the use of the oppression remedy amidst CCAA proceedings may result in the court declining to exercise jurisdiction until restructuring is complete or dismiss the claims outright. As a result, the oppression remedy may not be the best option for dealing with officer or director impropriety with relation to KERPs.

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[44] Stickles & Reilley, *supra* note 27.
[45] Sarra Report, *supra* note 39 at 105.
[46] *Ibid* at 108.
[47] *Lightstream Resources Ltd., Re*, 2016 ABQB 665 at para 49.

Statutory liability for officers and directors would not necessarily have a deterrent effect on the admitted benefits of KERPs. The Supreme Court of Canada has found courts should generally be reluctant to find personal liability where there has been an exercise of reasonable business judgment.[48] This reflects the deference usually afforded to experienced business professionals and their judgment will ordinarily not be disturbed by the court when it was exercised in good faith.[49] Any amendment to the CCAA imposing liability should make it clear that it will only be ordered in cases of bad faith conduct.[50] There would be no reason to forego pursuing KERPs as a result of this legislative intervention if there is no misconduct involved.

Additionally, it would be prudent for the courts and/or Parliament to implement enhanced disclosure rules regarding KERPs. As previously discussed, the nature of the practice means that often the Monitor has been working with management of the debtor company prior to filing for CCAA protection and its appointment. Although this is often done in practice, it should be compulsory for full disclosure to be made regarding any pre-filing KERP discussions once the debtor company is under CCAA protection in order to provide transparency to creditors and allow for either informed consent or recommendations early in the process.[51] There is evidence to suggest that KERPs are most prevalent and successful when they are made with significant creditor input and control.[52] Encouraging communication between stakeholders, especially regarding an issue as contentious as KERPs, should always be welcomed without imposing too many additional costs.

Conclusion

The last two decades have seen KERPs become commonplace in large insolvency proceedings. This has greatly enhanced their public profile, resulting in not uncommon controversies. Alongside the increase in KERP adoption, the courts have gradually developed a workable framework that has been effective at promoting successful, transparent implementation of retention payments. While the American approach to the availability of KERPs is unduly onerous and would inhibit the prized flexibility of the CCAA regime if the same approach were implemented in Canada, there remains room to improve the treatment of KERPs in Canadian restructuring law. Based on the statistical findings of when KERPs work most efficiently, the CCAA could **(i)** be amended to reduce perceived or actual unfairness between management and other employees; **(ii)** impose statutory liability for KERP abuses; and **(iii)** enhance ex post disclosure obligations relating to KERPs developed pre-filing. These recommendations can and should be done while maintaining the flexibility and inherent supervisory powers of the courts.

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[48] *Wilson v Alharayeri*, 2017 SCC 39 at para 50.
[49] *BCE Inc. v 1976 Debentureholders*, 2008 SCC 69 at para 40.
[50] Sarra Report, *supra* note 39 at 107-108. Insolvency practitioners have voiced complaints that "benefits sought under KERP are increasingly managers seeking to blackmail creditors and the insolvency professionals, creating an imbalance in the allocation of costs and benefits during the proceeding."
[51] This is particularly the case in the instance of "pre-packs" where, due to the limited input some stakeholders have, more disclosure would be beneficial. See Alfonso Nocilla & Vern DaRe, "The Trouble with Pre-Packs" in Janis Sarra ed, *Annual Review of Insolvency 2018* (Toronto: Carswell, 2018).
[52] KERP Study, *supra* note 29 at 29.