Management Stock Option Programs In Bankruptcy Cases: Let The Market Be Your Guide

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One of the myriad issues facing a company undergoing Chapter 11 reorganization is how to encourage essential managers to remain with the business and to reward them for the additional tasks they must undertake to guide the company through the process. Many companies use cash incentive programs that provide cash payments when certain benchmarks are achieved, such as confirmation of the plan or sales of assets for the benefit of creditors. However, the usefulness of such plans can be limited by the company's need for cash, and they do not provide an ongoing incentive based on the business's post-reorganization prospects. Stock option incentives, in contrast, do not require large cash outlays and enable officers to reap unlimited rewards by increasing the value of the reorganized entity.

Stock option incentives may have another, more controversial purpose, however. They may be a vehicle for substantial shareholder-managers of the debtor to retain an equity position in the reorganized business without contributing new value in money or money's worth to the reorganization for the benefit of creditors. When incumbent management includes holders of substantial equity, stock option plans can therefore run afoul of the Absolute Priority Rule, 11 U.S.C. §1129(b)(2), which forbids the holder of an interest junior to an objecting class of impaired creditors from receiving any property "on account of" its junior interest. If an impaired creditor class objects to a stock option plan that benefits shareholder-managers, the reorganizing debtor bears the burden of proving that the stock options are not issued "on account" of the managers' prior shareholdings. As a practical matter, this means demonstrating that the option programs are being issued solely as an incentive to provide future services.

This issue recently arose in the bankruptcy cases of *Washington Group International, Inc. et. al.* ("WGI"), which are currently pending in the United States Bankruptcy Court for the District of Nevada (the "Nevada Bankruptcy Court").[1] WGI's proposed reorganization plan wiped out all pre-petition equity. However, it included an agreement (the "Washington Agreement") negotiated between and among Dennis Washington, WGI's pre-petition Chairman and 38% shareholder, WGI and the Steering Committee for the prepetition secured lenders. The Washington Agreement would have allowed Mr. Washington to buy options for 14.5% of the shares in the reorganized debtor, on a fully diluted basis, at three different strike prices, and would have permitted him to acquire up to 40% of the total equity in reorganized WGI by post-confirmation purchases at market. The Plan would have given WGI's secured lenders 93% of the pre-dilution equity in the reorganized company, while giving the general unsecured creditors 7%.

The impaired general unsecured creditors

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objected to the plan provision which contained the Washington Agreement on the ground that it was granted "on account of" Mr. Washington's pre-petition 38% equity interest. After a two day evidentiary hearing, the Bankruptcy Court held that the WGI had not met its burden of proving that the Washington Agreement did not violate the Absolute Priority Rule, and it rejected the Washington Agreement.[2]

The principal modern decision interpreting the Absolute Priority Rule is *Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 441 (1999). In *203 North LaSalle*, the Supreme Court held that property is received "on account of" a former equity interest if there is "a causal relationship between holding the prior claim or interest and receiving or retaining property."[3] Under *203 North LaSalle*, a former equity holder receives property in the reorganized corporation "on account of" his former interest if the holder does not pay full value, in money or realizable money's worth, for the property received. The former shareholder's exclusive right to bid for a new equity interest is itself property, and a former equity holder who receives that right has necessarily received it "on account of" his position when that right has not been tested by market forces. It is "the exclusiveness of the opportunity, with its protection against the market's scrutiny of the purchase price by means of competing bids or even competing plan proposals, that renders the former owners' right a property interest extended 'on account of' the old equity position and therefore subject to an unpaid senior creditor class's objection."[4]

The Debtors in *Washington Group International* argued that the Washington Agreement did not violate the Absolute Priority Rule because the consideration for the Washington Agreement was not his prior equity position, but future services to be rendered by Mr. Washington. They introduced testimony from WGI's secured lenders that the secured lenders were indifferent to Mr. Washington's prior equity ownership and concerned only with assuring his continued services to the reorganized business. These witnesses testified that Mr. Washington was important to the reorganized companies to foster business relationships and garner new business. Neither Mr. Washington nor WGI's President, who signed the Washington Agreement on WGI's behalf, testified. The Debtors also argued that because the stock options would not vest until a year post-petition, that Mr. Washington would not "receive" property under the Plan.

On the other side, the objecting general unsecured creditors argued that the Washington Agreement fell squarely within the ambit of the Absolute Priority Rule because Mr. Washington received the option package as a result of his prior ownership of 38% of the equity in WGI. They presented Mr. Washington's deposition testimony that he had refused to continue serving as Chairman without an equity interest in the new company, and that he had selected the Washington Agreement's 40% aggregate equity figure because it would restore him to his pre-petition interest. More importantly, they presented the deposition testimony of WGI officers and the secured lenders that no one made a search for an alternative manager or attempted to place a value of the services rendered by a chairman in the open market. The Debtors' failure to consider alternatives or to market test the Washington Agreement in any way proved fatal.

After a two-day trial, the Bankruptcy Court held that the Washington Agreement violated the Absolute Priority Rule. The Bankruptcy Court found that the options and stock purchase rights were property, that Mr. Washington's exclusive opportunity to obtain them in return for service as Chairman was property, and that he received the stock purchase rights and the exclusive dealing opportunity on account of his prior equity ownership. It held that the Debtors had the burden of proof to demonstrate that the Washington Agreement was not on account of his previous equity position and that there was not sufficient evidence introduced by WGI to carry the burden. The Bankruptcy Court focused on the fact that neither WGI nor the secured lenders conducted any analysis to value the chairman's compensation in the market or test the consideration for Mr. Washington's future services by market forces. While WGI and the secured lenders were not required to utilize an executive search firm to assess a value for management options, they had to present some evidence of the market value of his future services to demonstrate that this exclusive opportunity was granted to Mr. Washington entirely in exchange for his future services and not in any part on account of his prior ownership interest.

The Debtors had tried to defend the Washington Agreement as similar to the management incentive program approved in *In re Leslie Fay Companies, Inc.*, 207 B.R 764 (Bankr. S.D.N.Y. 1997) *aff'd*, 222 B.R. 718 (S.D.N.Y. 1998) *aff'd sub nom., Falbaum v. Leslie Fay Companies, Inc.*, 182 F.3d 899 (2d Cir. 1999), *cert. denied* 528 U.S. 1075 (2000). This pre-*203 North LaSalle* decision had held that the Absolute Priority Rule was not implicated when former shareholder-managers holders received stock options that would vest only after the individuals performed services important to the reorganization and which options were tied to the future performance of the reorganized entity. The Nevada Bankruptcy Court found that the Washington Agreement contained similarities to the *Leslie Fay* case, but also significant differences. Most notably, non-shareholder managers in *Leslie Fay* received equal or greater incentive stock options in the reorganized business, and the options received by the former shareholder-managers were for significantly less than their pre-petition equity stake.

Several lessons can be learned from the WGI case. First, the exclusive opportunity to obtain a post-petition equity interest in the reorganized debtor is itself a valuable right. To the extent that it is offered only to shareholder-managers, as opposed to being offered to officers generally, the offer is presumptively on account of the shareholders' prior equity position. It is easier for a debtor to demonstrate that a stock option plan is solely on account of future services to be rendered if it gives equivalent opportunities to non-shareholder managers on the basis of their positions and efforts in the reorganized business. Second, a debtor will have to come forward with evidence that any option incentives provided to former shareholders are no more favorable than the going market rate for similar executive services performed by a non-shareholder. The credibility of such evidence is enhanced by either a search for alternative management or the non-discriminatory provision of incentives to non-shareholder managers.

Finally, because the burden rests on the debtor to prove that no part of an equity interest granted to former shareholder-managers is on account of their pre-petition interest, the Absolute Priority Rule gives impaired creditor classes leverage to oppose a continued equity interest in the business by former shareholder managers. If the business is the reflection of a dominant former owner, its best interests may require that principal's continued participation with the incentive of an equity stake. If the business is a family business or otherwise closely held, such continued participation may be a primary goal of the debtor's management. In any of these cases, the blocking power of the impaired objecting creditor class makes it convenient for existing shareholder-management to obtain the consent of impaired creditor classes on this issue where feasible. To obtain the consent, a debtor must either convince the involuntary holders of new equity that their interests are better served if certain members of the former ownership take an active, enthusiastic role in management, or provide objecting creditors with present consideration. The Absolute Priority Rule as interpreted in *203 North LaSalle* and applied in *Washington Group International* increases a bankruptcy court's scrutiny of management option plans, thereby providing ammunition to junior creditors in the chapter 11 negotiation process.

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[1] *Case No. BK-N-01-31627 (Jointly Administered)*

[2] *The debtor or other proponent of a plan has the burden both to come forward with evidence that the proposed plan does not violate the Absolute Priority Rule and to prove it. 7 COLLIER ON BANKRUPTCY ¶1120.02[4](15th ed. 2001) at 1129-21 through 22,* citing Acequia, Inc. v. Clintoin, *732 F.2d 1352, 1358 (9th Cir. 1986);* United States ex rel Farmers Hom Admin. v. Arnold & Baker Farms, *177 B.R. 648, 654 (9th Cir. BAP 1995),* aff'd *85 F. 3d 1415 (9th Cir. 1996).*

[3] Id. *at 451.*

[4] Id. *at 456.*

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