UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF VIRGINIA
RICHMOND DIVISION

In re:	Chapter 11
TOYS "R" US, INC., et al.	Case No. 17-34665 (KLP)
Debtors.	(Jointly Administered)

OBJECTION OF THE UNITED STATES TRUSTEE TO DEBTORS' MOTION FOR ENTRY OF AN ORDER (A) APPROVING THE DEBTORS' SENIOR EXECUTIVE INCENTIVE PLAN AND (B) GRANTING RELATED RELIEF

Judy A. Robbins, the United States Trustee for Region Four, which includes the Eastern District of Virginia, Richmond Division, by and through undersigned counsel, in furtherance of the duties and responsibilities set forth in 28 U.S.C. § 586(a)(3) and (5) and pursuant to 11 U.S.C. §§ 307 and 503, the Federal Rules of Bankruptcy Procedure, and the Local Bankruptcy Rules for this District, hereby files her objection to the Debtors' Motion for Entry of an Order (A) Approving the Debtors' Senior Executive Incentive Plan (the "SEIP") and (B) Granting Related Relief (the "Bonus Motion"). *See* ECF Doc. 957. In support of her response, the United States Trustee represents and alleges as follows:

I. PRELIMINARY STATEMENT

Toys "R" Us, Inc. and certain of its affiliates (collectively, the "Debtors")[1] filed for bankruptcy approximately two months ago. With no plan of reorganization on the horizon and great uncertainty as to the projected recoveries by creditors in the cases, the Debtors filed the

[1] The Debtors in these chapter 11 cases, along with the last four digits of each Debtor's federal tax indemnification number are set forth in the Order (1) Directing Joint Administration of Chapter 11 Cases and (II) Granting Related relief [Dkt. 78]. The location of the Debtors' service address is One Geoffrey Way, Wayne, NJ 07470.

Robert B. Van Arsdale, AUST (Va. Bar No. 17483)
Shannon Pecoraro, Esq. (Va. Bar No. 46864)
Office of the United States Trustee
701 East Broad Street - Suite 4304
Richmond, VA 23219
Telephone (804) 771-2310
Facsimile (804) 771-2330

Bonus Motion requesting, *inter alia*, authority to pay up to $32 million in bonuses to 17 of its most highly compensated executives. The princely compensation proposed in the Bonus Motion is in addition to the $8.2 million in retention bonuses that five of the same executives received *immediately* before the bankruptcy filing. It defies logic and wisdom, not to mention the Bankruptcy Code, that a bankrupt company would now propose further multi-million dollar bonuses for the senior leadership of a company that began the year with employee layoffs and concludes it in the midst of the holiday season in bankruptcy. Apparently, this Christmas, Toys "R" Us intends to deliver not only "children their biggest smiles of the year" but the insiders, too. *See* Declaration of David A. Brandon, Chairman of the Board and Chief Executive Officer of Toys "R" Us, Inc., In Support of Chapter 11 Petitions and First Day Motions, ECF Doc. No. 20, ¶ 8.

Moreover, compared to historical bonuses prior to the bankruptcy that were paid annually, the Bonus Motion proposes to accelerate bonuses into quarterly payments. The fourth quarter 2017 payment would be based on certain thresholds for fiscal year 2017 Adjusted EBITDA, while the Adjusted EBITDA targets for the following quarters for 2018 are neither disclosed nor determined and left open to discussion with the Committee and the DIP Lenders.

Pursuant to section 503(c)(1) of the Bankruptcy Code, insiders cannot be paid retention bonuses absent proof that:

(1) the insider has a "bona fide job offer from another business at the same or greater rate of compensation;"
(2) the services provided by the insider are essential to the survival of the business; and
(3) the bonus cannot be more than ten times the mean retention bonus paid to non-management employees in the same calendar year.

See 11 U.S.C. § 503(c)(1). Because this exacting standard for retention bonuses is difficult to satisfy, most Debtors, including the Debtors here, instead seek authority to pay bonuses to

insiders under section 503(c)(3).

But to avoid eviscerating the rigorous restrictions on retention bonuses imposed by section 503(c)(1), bonus payments to insiders of the type sought in the SEIP Motion are subject to strict standards before the Court can approve them under section 503(c)(3). Among the hurdles that must be met to pass muster under section 503(c)(3) are that the bonuses must be justified by the facts and circumstances of the case and the thresholds must be genuinely incentivizing and not solely for the purpose of inducing those insiders to remain with the Debtors' business.

As discussed more fully below, the Debtors have failed to meet their burden under section 503(c)(3) for many reasons:

- The performance metrics for the SEIP Plan are ambiguously defined and easily subject to adjustment.
- While insiders' recoveries under the SEIP Plan are tied to target thresholds for Adjusted EBITDA, the Bonus Motion and the Declaration that accompanies it are devoid of any information regarding the historical, present, and projected Adjusted EBIDTA figures are necessary to draw comparisons to determine whether the proposed Plan is not simply a KERP with KEIP window dressing.
- The Bonus Motion fails to provide any information on how the thresholds were calculated or why they are lower by approximately 60% from the thresholds set for 2016.
- The bonuses proposed under the SEIP Plan are not tied to cash flow so that they will be paid even if the Debtors sustain significant losses.
- The Bonus Motion fails to state what extra services the executives would perform beyond their ordinary job duties if they were not additionally incentivized or to detail the nexus between the proposed bonuses under the SEIP Plan and increased responsibilities.

These metrics are easy to satisfy "lay-ups," making the bonuses impermissible "pay-to-stay" retention bonuses (absent satisfying section 503(c)(1), which Debtors do not purport to do). Simply put, the proposal to pay multi-million dollar cash awards to the highest paid executive

members of the Debtors for performing the very fiduciary duties they were hired to perform is not a basis to pay these 17 insiders even more.

Even if the Court determines that the Bonus Plan is not primarily retentive, however, approval of the Bonus Motion should still be denied. Congress's intention in promulgating Section 503(c) was to curtail payments to insiders. Even under the less exacting standards of section 503(c)(3), the SEIP Plan (1) fails to establish a reasonable relationship between bonuses and the goals to be achieved, (2) is not fair and reasonable, and (3) does not appear to be supported by appropriate industry standards. As outlined below, the Debtors have not met their burden, and the Bonus Motion should be denied.

II. FACTUAL BANKGROUND

A. General

1. On September 19, 2017 (the "Petition Date"), Toys "R" Us, Inc. and twenty-four of its affiliated companies commenced voluntary cases under Chapter 11 of the Bankruptcy Code. ECF Doc. No. 1. By order entered on September 19, 2017, the Court authorized joint administration of the cases for procedural purposes. ECF Doc. No. 78. Since the orders for relief under chapter 11 were entered, the Debtors have operated as debtors-in-possession under sections 1107(a) and 1108 of the Bankruptcy Code. To date, no trustee or examiner has been appointed in these chapter 11 cases.

3. On September 26, 2017, pursuant to section 1102(a)(1) of the Bankruptcy Code, the United States Trustee appointed the Official Committee of Unsecured Creditors ("Committee"). ECF. Doc No. 206.

The Bonus Motion

4. On November 15, 2017, the Debtors filed the Bonus Motion. ECF Doc. No. 957.

The Bonus Motion is supported by the Declaration of Brain L. Cumberland, a National Managing Director of the Compensation & Benefits practice at Alvarez & Marsal North America, LLC (the "Cumberland Declaration").

5. On the same day, the Debtors filed the Debtors' Motion for Entry of an Order (A) Approving the Debtors' Non-Insider Compensation Program and (B) Granting Related Relief. ECF Doc. No. 958 (the "Compensation Program Motion"). Contemporaneously herewith, the United States Trustee has filed a separate objection to the Compensation Program Motion.

6. The Bonus Motion seeks authority to implement a bonus plan – referred to as the SEIP – which the Debtors describe as an incentive plan for 17 key members of the Debtors' management team, including the following: (a) the Chief Executive Office ("CEO"), (b) the Chief Financial Officer ("CFO"), (c) ten Executive Vice Presidents ("EVPs"), (d) the Senior Finance Director, (e) the Senior Vice President – Controller, and (f) four Vice Presidents ("VPs"). *See* Bonus Motion at ¶ 10.

7. Under the SEIP, the participants can earn a quarterly cash incentive payment, based on a percentage of each participant's salary, but only if the Debtors achieve above certain targeted cumulative levels of EBITDA. *See id.* at ¶ 15.

8. More specifically, the SEIP payments are interpolated between "threshold," "target," and "stretch" goals – *i.e.* "Minimum Threshold," "Target Threshold," and "Maximum Threshold." *See id.* at ¶¶ 7, 16. The potential EBITDA thresholds are as follows:

SEIP FY 2017 Global EBITDA Targets	
Minimum Threshold	$484,000,000
Target Threshold	$550,000,000
Maximum Threshold	$616,000,000

9. The SEIP participants receive no payment under the SEIP if the Debtors'

EBITDA does not meet or only reaches the Minimum Threshold as set forth in Paragraph 8 above. *Id.* at ¶15. The Bonus Plan provides a threshold award opportunity of $16 million in the aggregate on an annual basis upon the achievement of the Target Threshold. *Id.* at ¶11. That amount could double if the Maximum Threshold were achieved. *Id.*

10. The Bonus Plan is based on a percentage of a participant's salary based on their role – ranging from 160% of their salaries for the EVPs or anyone with a higher title, 90% for Senior Vice Presidents, and 75% for VPs. *Id.* at ¶ 19. By way of example, and as more fully set forth in the Bonus Motion and the Exhibits attached thereto, the CEO, whose annual salary is $3,750,000.00 (in addition to the retention bonus that he was paid immediately prior to the Petition Date in the amount of approximately $2,815,000), would receive $6,000,000 – or 160% of his base annual salary – if the Target Threshold were achieved. The CEO would receive another $6,000,000 if maximum threshold is achieved.

11. The thresholds set forth in Paragraph 8 above, however, are only intended to measure performance in the fourth quarter of 2017. *Id.* at ¶ 17. Because the Debtor's fourth quarter accounts for a disproportionate amount of revenue compared to other quarters, the metrics are weighted according to quarter – the fourth quarter is weighted 40%, while the subsequent first, second, and third quarters are weighted 20% each.

12. As for the thresholds to be applied for the fiscal year 2018, the Bonus Motion states that "[t]he Debtors will consult with the DIP Lenders and Creditors' Committee to set the applicable targets for the first three quarters of 2017 as soon as reasonably practicable." *Id.* at ¶ 18. The only involvement that the Court or other parties in interest would have in establishing the applicable threshold targets for 2018 is if the Debtors, the Lenders, and the Creditors' Committee are unable to reach an agreement on the thresholds to be applied. *Id.*

Historical Figures and Projections

13. In support of the first day motions filed on the Petition Date, Toys "R" Us., Inc.'s Chief Financial Officer, Michael J. Short, filed a Declaration to support the factual allegations in the motions (the "Short Declaration"). ECF Doc. No. 30. Exhibit A to the Short Declaration includes some historical and projected financial information regarding the Debtors. Among other things, the Exhibit reflects, consistent with the information in the Debtors' 10-K filed on January 28, 2017, that the Debtors' Adjusted EBITDA for fiscal year 2016 was $792 million. *Id.* at p. 55 of 62. For the second quarter of 2017, the LTM Adjusted EBITDA totaled $709 million. *Id.* Lastly, the projected EBITDA for fiscal year 2017 was forecast as follows: (a) US Adjusted EBITDA – $396 million; (b) US Del EBITDA – $196 million; and (c) Canada EBITDA – $107 million (for a total of $$699 million). *Id.* at p. 53 of 62.

14. Upon information provided by the Debtors, the threshold targets that were applied to the bonus awards for the fiscal year 2016 were as follows: (a) Minimum Threshold – $792,000,000; (b) Target Threshold – $880,000,000; and (c) Maximum Threshold – $1,003,000,000. In 2016, as previously stated, the Debtors' 10-K reported Adjusted EBITDA of $792 million, which met – but failed to exceed – the minimum threshold level. Accordingly, the Debtors did not pay bonuses in 2016.

Bonuses Received Immediately Prior to the Petition

15. As the Debtors admit, certain of the SEIP participants received retention payments immediately prior to the Petition Date. The only information disclosed in the Bonus Motion is that, as part of the overall compensation package approved by the Debtors' Board of Directors, certain of the 17 participants – without providing any identity – received $8.2 million in the aggregate days before the commencement of the Debtors' bankruptcy cases. *Id.* at ¶ 8.

16. But the 10-Q filed in September 2017 (for the quarterly period ended July 29, 2017) disclosed that the Board of Directors approved retention bonuses for five executive officers on the eve of bankruptcy, including: (a) David A. Brandon, CEO ($2,812,500); (b) Michael J. Short, CFO ($600,000); (c) Richard Barry, Executive Vice President – Global Chief Merchandising Officer ($450,000); (d) Lance Wills, Executive Vice President – Global Chief Technology Officer ($412,500); and (e) Andre Javes, President[2] – Toys "R" Us, Asia Pacific ($325,125 based on the conversion rate on the date of payment). The retention bonuses were paid just five days before the bankruptcy filing. *See* Form 10-Q for quarterly period ended July 29, 2017, p. 41.

ARGUMENT

I. Applicable Legal Standard

The Debtors seek approval of the SEIP Plan under section 503 of the Bankruptcy Code. That section governs the allowance of administrative expenses "for actual, necessary costs and expenses of preserving a debtor's bankruptcy estate." 11 U.S.C. § 503(b)(1)(A). The two general overriding policies of section 503 are: (i) to preserve the value of the estate for the benefit of its creditors and (ii) to prevent the unjust enrichment of insiders of the estate at the expense of its creditors. *In re AMR Corp.*, 490 B.R. 158, 164-65 (Bankr. S.D.N.Y. 2013).

Section 503(c) was added to the Bankruptcy Code in 2005 to respond to "glaring abuses of the bankruptcy system by the executives of giant companies like Enron Corp. and WorldCom Inc. and Polaroid Corporation, who lined their own pockets but left thousands of employees and retirees out in the cold." (Floor Statement, quoted in *In re Dana Corp*., 358 B.R. 567, 575 (Bankr. S.D.N.Y. 2006) ("Dana II"). *See also In re Hawker Beechcraft, Inc.,* 479 B.R. 308, 312-

[2] Mr. Javes is not listed as one of the SEIP Participants in the Bonus Motion.

13 (Bankr. S.D.N.Y. 2012) (quotations omitted) ("Congress enacted § 503(c) as part of the 2005 BAPCPA amendments of the Bankruptcy Code to 'eradicate the notion that executives were entitled to bonuses simply for staying with the Company through the bankruptcy process'"); *In re Residential Capital, LLC*, 478 B.R. 154, 169 (Bankr. S.D.N.Y. 2012). The abuses at which the provision is aimed regularly manifest themselves in the guise of retention plans. *See* 3 COLLIER ON BANKRUPTCY ¶ 503.17[1] at 503-105 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2013) (section 503(c)'s "purpose was to limit the scope of . . . programs providing incentives to management of the debtor as a means of inducing management to remain employed by the debtor").

As this Court previously explained:

> All too often [insider retention plans] have been 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. But even where external circumstances rather than the executives are to blame, there is something inherently unseemly in the effort to insulate executives from the financial risks all other stakeholders face in the bankruptcy process.

In re U.S. Airways, Inc., 329 B.R. 793, 797 (Bankr. E.D. Va. 2005). Congress therefore determined that section 503(c) was necessary "to limit a debtor's ability to favor powerful insiders economically and at estate expense during a chapter 11 case." *In re Pilgrim's Pride Corp*., 401 B.R. 229, 234 (Bankr. N.D. Tex. 2009).

Through section 503(c), Congress prohibits debtors from paying bonuses to executives and insiders "simply for staying with the Company through the bankruptcy process." *In re Global Home Prods., LLC.,* 369 B.R. 778, 783-84 (Bankr. D. Del. 2007). Rather, under section 503(c)(1), a Debtor may only provide a bonus designed to cause an insider to remain in the Debtor's employ if:

(1) the bonus payment is essential to the retention of the employee because the employee has a "bona fide job offer from another business at the same or greater rate of compensation;"
(2) the services provided by the employee are essential to the survival of the business; and
(3) the amount of the payment is within the parameters set by the statute.

See 11 U.S.C. § 503(c)(1). In light of section 503(c), a retention plan payable to insiders can no longer be "justified solely on the debtor's business judgment." *In re Velo Holdings, Inc.*, 472 B.R. 201, 209 (Bankr. S.D.N.Y. 2012); *In re Borders Grp. Inc.,* 453 B.R. 459, 470-471 (Bankr. S.D.N.Y. 2011). If a proposed transfer falls within section 503(c)(1), then the business judgment rule does not apply, irrespective of whether a sound business purpose may actually exist. *See In re Dana Corp*., 351 B.R. 96, 102 (Bankr. S.D.N.Y. 2006) ("Dana I"). Rather, a transfer to an insider to induce the insider to remain with the debtor's business must satisfy the requirements under subdivisions (A), (B), and (C) of section 503(c)(1). *See e.g. In re Residential Capital, LLC*, 478 B.R. at 169 ("[I]f a debtor proposes to (i) make a transfer or incur an obligation; (ii) to or for the benefit of an insider of a debtor; (iii) for the purpose of retaining that insider, it must meet the strict requirements of section 503(c)(1)."); *Dana II*, 358 B.R. at 575 (summarizing the requirements under Section 503(c)(1) of the Bankruptcy Code).

After the addition of section 503(c) to the Bankruptcy Code in 2005, debtors began to craft performance-based insider incentive plans with some retentive elements to avoid the stringent requirements imposed by section 503(c)(1) on insider retention bonuses. In determining whether section 503(c)(1) applies to such plans, courts have framed the issue as whether the plans are "pay to stay" retention plans or "pay for value" compensation plans offering incentives based on performance. *See In re Global Home Prods, LLC*, 369 B.R. at 783.

The proponent of a purported "incentive" plan bears the burden of proving that the proposed plan is not a pay-to-stay retention plan governed by section 503(c)(1). *In re*

Residential Capital, LLC, 478 B.R. at 170 (sustaining U.S. Trustee objection to insider bonuses proposed by affiliated debtors). A debtor's label of a plan as incentivizing to avoid the strictures of section 503(c)(1) must be viewed with skepticism; the circumstances under which the proposal is made and the structure of the compensation package control. *Id*. (*citing In re Velo Holdings, Inc*., 472 B.R. at 209-210). A plan that does not require additional work or effort beyond that contemplated prepetition is not an incentive plan but is retentive and cannot be approved under the more lenient standards for incentive plans. *In re Patriot Coal Corp*., 492 B.R. 518, 531 (Bankr. E.D. Mo. 2013) (citations omitted).

B. The Bonus Motion Must Be Denied Because The Debtors Have Failed to Meet Their Burden to Prove that the SEIP Plan Meets the Requirements of Section 503(c)(1)

As a threshold matter, the participants are all officers or "officers in control" of the Debtors, and thus qualify as "insiders" within the meaning of 11 U.S.C. § 101(31). The Debtors do not appear to dispute that. Whether the SEIP Plan is subject to the standards of section 503(c)(1) or 503(c)(3), therefore, hinges upon whether it is primarily retentive. *In re Residential Capital*, 478 B.R. at 170 ("In order to show that the more permissive section 503(c)(3) applies, the Debtors must establish by a preponderance of the evidence that the KEIP is primarily incentivizing and not primarily retentive."). Said differently, the Debtors must demonstrate that the SEIP Plan presents challenging standards and significant hurdles that are difficult to achieve. *In re Hawker Beechcraft*, 479 B.R. at 313.

Here, the Debtors have failed to satisfy their evidentiary burden that this is not simply a KERP with KEIP window dressing. As discussed further below, there is no information provided in the Bonus Motion to support the fact that that SEIP Plan is incentivizing and not primarily retentive in nature. The SEIP Plan should only be approved if the Debtors satisfy the standards of section 503(c)(1) – which they have not.

The initial concern in evaluating any proposed "incentive" plan – such as the SEIP Plan proposed in the Bonus Motion – is that it is merely a disguised KERP. *Hawker Beechcraft*, 479 B.R. at 312-13; *Velo Holdings*, 472 B.R. at 209 (reasoning that courts must be wary of attempts to characterize what is essentially an insider retention plan as an "incentive" plan "to bypass the requirements of section 503(c)(1)" and should "consider the circumstances under which particular proposals are made, along with the structure of the compensation packages, when determining whether the compensation programs are subject to section 503(c)(1)"). S*ee also Dana I,* 351 B.R. at 102 n. 3 ("If it walks like a duck (KERP), and quacks like a duck (KERP), it's a duck (KERP)").

The Court must examine any proposed KEIP to determine whether the milestones resulting in payment are "designed to motivate insiders to rise to a challenge or merely report to work." *Hawker Beechcraft*, 479 B.R. at 313. While stating that the purpose of the SEIP Plan is to "incentivize" the participants, the Debtors have not advanced any evidence or information to demonstrate that the retentive effect of the SEIP Plan is not its primary purpose.

First, the performance metrics for the SEIP Plan are ambiguously defined and easily subject to adjustments. The Bonus Plan states that the insiders can earn quarterly cash payments "if the Debtors achieve above certain targeted cumulative levels of EBITDA," which is defined to mean earnings before interest, depreciation, and amortization. *See* Bonus Motion at ¶¶ 7, 15. The metric used in the SEIP Plan is defined as "Global EBITDA," which is not specifically defined in the Bonus Motion. From information that the United States Trustee received from the Debtors' representatives, however, the "Global EBITDA" metric is the same as "Adjusted EBIDTA," which is defined in the Debtors' 10-K for the fiscal year ended January 28, 2017 as "EBITDA . . . as further adjusted to exclude the effects of certain income and expense items that

management believes make it more difficult to assess the Company's actual operating performance including certain items which are generally non-recurring. . . ." *See* Toys "R" Us, Inc., Form 10-K for fiscal year ended January 28, 2017, at p. 24. As such, "Adjusted EBITDA," as opposed to EBITDA, is subject to adjustments and manipulation. Nowhere in the Bonus Motion, however, do the Debtors address the adjustments that they intend to make to EBITDA or how "Global EBITDA" will be calculated, and even more importantly any factual information regarding the likelihood that any of the thresholds will be met.

Second, there is nothing in the proposed SEIP Plan that ties the recoveries of the participants to the recoveries of creditors or other stakeholders. Rather, the participants will be paid quarterly bonuses if certain thresholds of Adjusted EBITDA are met. What is glaringly missing from the Bonus Motion, the Cumberland Declaration, or any exhibit filed to date in support of the Bonus Motion, however, is any information that provides a comparison of historical, present, or projected Adjusted EBIDTA figures. Aside from general and broad statements that the thresholds proposed in the Bonus Motion are challenging to achieve, there has been no information advanced or analysis presented regarding the likelihood that it will be achieved. *See, e.g, In re Hawker Beechcraft, Inc.*, 479 B.R. at 313 (S.D.N.Y. 2012) (court must determine whether proposed targets "are designed to motivate insiders to rise to a challenge or merely report to work").[3] The information available as of the Petition Date, through the Short Declaration, indicates that for the second quarter of 2017 the LTM (last twelve months) Adjusted EBITDA[4] totaled $709 million. Moreover, while it is not entirely clear whether the forecast

[3] It is the United States Trustee's understanding, upon information and belief, that an official analysis was not prepared to determine the likelihood of Toys R Us achieving the target and maximum thresholds metrics; however, it is her understanding that they are based on actual data for the first eight months of 2017, preliminary results for the ninth month, and forecasts for the remaining three months – none of which is provided in the Bonus Motion.

[4] This figure may also include the Adjusted EBIDTA for two quarters of 2016.

information on Exhibit 1 of the Short Declaration is equivalent to the Adjusted EBITDA used for the SEIP Plan, it appears that for fiscal year 2017, EBITDA was forecast as such: (a) US Adjusted EBITDA – $396 million; (b) US Del EBITDA – $196 million; and (c) Canada EBITDA – $107 million; for a total of $699 million – a figure significantly higher than even the Maximum Threshold.

Third, there is no evidence presented to date that the threshold levels for the SEIP Plan are actually incentivizing. According to the Bonus Motion, the SEIP payments are interpolated between "threshold," "target," and "stretch" goals. *See* Bonus Motion at ¶ 7. In Paragraph 16 of the Bonus Motion, the Debtors change the names of their goals to "Minimum Threshold," Target Threshold," and "Maximum Threshold." *Id.* at ¶16. No matter what the name, there is no information to support the bald faced statements that the thresholds were set at challenging levels. As set forth above, the SEIP's thresholds for fiscal year 2017[5] are as follows:

- Minimum Threshold: $484,000,000
- Target Threshold: $550,000,000
- Maximum Threshold: $616,000,000

There is very little information, however, regarding how the thresholds were calculated. The Bonus Motion provides that the SEIP "adjusts the EBITDA targets to take into account the current circumstances and operating environment following the filing of this chapter 11 cases." *See* Bonus Motion at ¶ 14. The Debtors' only attempt at explaining what the "current circumstances and operating environment following the filing of this chapter 11 cases" that were taken into account to establish the threshold targets is contained in the Cumberland Declaration,

[5] The KEIP Motion states that the Debtors will consult with the DIP Lenders and Creditors' Committee to set the applicable targets for the first three quarters of 2018 as soon as reasonably practicable. The United States Trustee objects to this provision and requests that, if the KEIP Motion is approved, the Debtors file a motion for the Court to approve any change in thresholds.

but even that information sheds only a dim light on the meaning of the statement. More specifically, the Cumberland Declaration explains that the threshold levels were determined based on the DIP budget and adjusted for

> (1) supply chain disruption due to news of the Debtor's bankruptcy filing; (b) difficulty of securing allowances from vendors at levels consistent with prior allowances; (c) continued disruption of the retail industry; and (d) increased gift card redemptions and decrease gift card purchases.

See Cumberland Declaration at ¶ 16. The Debtors do not provide any further detail regarding how the thresholds were calculated, nor do they offer any insight as to the value of their starting threshold or the value placed on any of the adjustments. For example, by what amount did the Debtors reduce the thresholds because of supply chain disruption due to news of the Debtors' bankruptcy filing?

Fourth, although not contained in the Bonus Motion, the Debtors provided the United States Trustee information regarding the thresholds for the bonus plan for 2016, which were as follows:

- Minimum Threshold: $792,000,000
- Target Threshold: $880,000,000
- Maximum Threshold: $1,003,000,000

The thresholds included in the Bonus Motion are approximately 60% of the thresholds for 2016. Accordingly, it appears that the Debtors may not have individually weighted any of the above described adjustments as stated in the Cumberland Declaration; instead, they simply reduced the thresholds by 40%. The Debtors, however, need to explain why they believe that a 40% reduction is appropriate given the current circumstances.

Fifth, the SEIP faces a different problem in that the bonuses are not tied to cash flow. EBITDA has no relation to cash flow because it does not include interest and taxes, which

must be paid. In addition, as previously noted, the Debtors intend to use Adjusted EBITDA as the metric, which excludes other payments that the Debtors actually make. Given that the Debtors have lowered their thresholds while increasing the bonuses, it is possible that the Debtor will pay $32 million in bonuses if the maximum threshold is met (or $16 million in bonuses of the target threshold is met) when it is operating at a loss or has negative cash flow. The Debtors should only be permitted to pay incentive bonuses if cash flow warrants it after the payment of all expenses.

Lastly, in addition to the questionable and ambiguous metrics proposed in the SEIP Plan, the Debtors fail to identify any new duties that each of the participants will undertake. Rather, the Bonus Motion states that the participants "have little clarity regarding their post-restructuring employment status or even who the future owners of the business will be. These employees have already experienced dramatically increased workloads as a result of operating in Chapter 11 and the Debtors' related restructuring efforts." *See* Cumberland Declaration at ¶ 8. The Debtors' suggestion that the proposed KEIP bonuses pass statutory scrutiny because they somehow induce superior performance wrongly implies that without the bonuses, the executives would not staunchly exercise their pre-existing fiduciary and contractual duties to maximize value for creditors. *See Dana I*, 351 B.R. at 102.

The Bonus Motion fails to state what extra services the executives would perform beyond their ordinary job duties if they were not additionally incentivized or to detail the nexus between the proposed bonuses and increased hours and responsibilities, if any. *See Hawker Beechcraft*, 479 B.R. at 313 (finding that the debtors failed to sustain their burden of proof when they did not identify the roles of each plan participant or why, individually or as part of a team, they will contribute services that are necessary to achieve the targets). *See also In re Residential Capital,*

LLC , 478 B.R. at 171 ("Yes the KEIP Participants may well have increased responsibilities to make the auction a success, but the KEIP Awards are not primarily measured by those efforts or the auction results."). The key insider employees that are part of the SEIP Plan are already under an obligation to work their hardest for the Debtors for which they are already paid handsomely. Some of them have also received an aggregate $8.2 million in retention bonuses right before the Petition Date – only five days before the bankruptcy filing to be exact. If the Court does not approve the KEIP Motion, the CEO will still receive annual compensation in 2017 of $6,563,000. According to the Market Compensation Analysis, which is attached as Exhibit 1 to the Cumberland Declaration, the Debtors' CEO's base compensation, without incentives, is greater than 90% of the companies reviewed. If the KEIP Motion is not approved, other key insiders will also continue to be highly compensated, as set forth below:

Position	Salary (without incentives)
CEO	$6,563,000
EVP, Chief Merchandising Officer	$1,050,000
CFO	$1,400,000
EVP, President TRU International	$919,000
EVP, Global Chief Technology Officer	$963,000

In fact, it would be a waste of estate assets for the Debtors to pay these large salaries for anything less than maximum effort. The SEIP Plan, therefore, is not an incentive for these employees to work harder. Here, at best, incentivizing the insiders is merely a secondary purpose of the SEIP Plan, whose primary purpose appears to remain retentive. Said differently, the SEIP is a simply a carrot to keep these insiders from leaving for greener pastures.

1. The Bonus Motion Must Be Denied Because It Seeks Blanket Authority to Pay Quarterly Bonuses in 2018 Based on Thresholds That Are Yet to Be Determined

The Bonus Motion makes clear that the thresholds that are set forth in the pleading, *see supra* at ¶ 9, will only be used to measure performance in the fourth quarter of 2017. As to the

thresholds applicable for the first three quarters of 2018, however, the Debtors plan to consult with the DIP Lenders and Creditors' Committee to set the applicable targets for the first three quarters of 2018 at a later date. *See* Bonus Motion at ¶ 17. If the parties are unable to reach an agreement on subsequent thresholds, the Debtors will seek Court approval for them. *Id.*

In essence, the Debtors are asking the Court to bless the SEIP Plan and pay millions in quarterly bonuses while the Debtors are still in bankruptcy – all with the sole consent of the two main constituencies – without knowing whether the proposed metrics for 2018 pass muster under the strict standards of section 503(c)(1). Such request should not be approved because it would clearly provide the Debtors authority – with some limited supervision – to pay insiders without any reassurance that the payments meet the requirements imposed in the Bankruptcy Code.

B. Even if the Bonus Plan Were Governed by Section 503(c)(3), It is Still Deficient

If the Court finds that section 503(c)(1) does not apply, the Court may also consider whether the payments are permissible under section 503(c)(3). *Dana II,* 358 B.R. at 575. The text of section 503(c)(3) places a fact-finding duty upon the bankruptcy court to determine whether a payment outside the ordinary course of business was justified.

In adopting section 503(c), Congress expressly moved away from the general permissive standard of section 363(b) towards a more specific statutory prohibition of bonus payments absent factual findings of justification by the bankruptcy court. 11 U.S.C. §503(c)(3). *See GT Advanced Techs. Inc. v. Harrington*, No. 15-CV-069-LM, 2015 WL 4459502, at *7 (D.N.H. July 21, 2015) ("§ 503(c)(3) directs courts to give plans such as the SEIP in this case more scrutiny than is required by the § 363(b)(1) business judgment test"); *In re Pilgrim's Pride Corp.*, 401 B.R. 229, 236-237 (Bankr. N.D. Tex. 2009) (Section 503(c)(3) sets a higher standard of review

and should not be equated to the business judgment rule as applied under Section 363; to do so would render 503(c)(3) redundant).

Thus, it is clear that section 503(c) is "intended to give the judge a greater role: 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." *Pilgrims' Pride*, 401 B.R. at 237. To evaluate whether a proposed bonus plan passes muster under section 503(c)(3), courts generally consider the following factors outlined in *Dana II*:

1. Is there a reasonable relationship between the plan proposed and the results to be obtained, i.e., will the key employee stay for as long as it takes for the debtor to reorganize or market its assets, or, in the case of a performance incentive, is the plan calculated to achieve the desired performance?

2. Is the cost of the plan reasonable in the context of the debtor's assets, liabilities and earning potential?

3. Is the scope of the plan fair and reasonable; does it apply to all employees; does it discriminate unfairly?

4. Is the plan or proposal consistent with industry standards?

5. What were the due diligence efforts of the debtor in investigating the need for a plan; analyzing which key employees need to be incentivized; what is available; what is generally applicable in a particular industry?

6. Did the debtor receive independent counsel in performing due diligence and in creating and authorizing the incentive compensation?

See Dana II, 358 B.R. at 576-77.

Here, the Debtors have failed to satisfy several of the factors. First, the SEIP Plan does not establish a relationship between effort and outcome. As stated previously, it is not evident that any of the thresholds are challenging to meet. Even under the less rigorous standards of section 503(c)(3) and 363, and the benchmarks for the payments of bonuses must be "difficult targets to reach." *Dana II*, 358 B.R. at 583. As set forth above, the Debtors have not provided

the Court with the facts and analysis necessary to determine whether a reasonable relationship exists between the proposed bonuses and the results to be obtained. The Bonus Motion is void of any historical, present, or projected information regarding the Debtors' Adjusted EBITDA or any information or data used in developing the present thresholds under which the insiders will receive payments for the fourth quarter of 2017. As for the metrics to be applied to 2018, the Debtors in essence are requesting *carte blanche* to pay insiders if they meet thresholds which are unknown at this time, but which will be established at a later date with the Committee's and DIP Lenders consent, but no transparency to the Court, the United States Trustee, or other parties in interest.

Moreover, prior to the Petition Date, the Debtors had an incentive program that paid bonuses annually. The Debtors have changed the payment structure of the incentive bonuses to quarterly payments within 20% of the bonus being paid for each of the first, second, and third quarter and 40% of the bonus being paid for the fourth quarter. The sole reason to change the frequency of paying the bonuses is to push more money to the key insider employees earlier in the cases and quicker. Thus, within a few months of the Petition Date and with no plan on the horizon, the insiders could receive millions in bonuses in addition to the $8.2 million that was received less than a week prior to the Petition Date and the millions they already receive in base salary.

Second, the Debtors have failed to establish that the SEIP Plan is fair and reasonable and does not discriminate against non-insider employees. Five days prior to the Petition Date, some of the same insiders who are now eligible to earn anywhere between $16 million to $32 million in annual bonuses were awarded $8.2 million of retention bonuses. The CEO alone received a bonus of approximately $2,815,000 just to stay with the company – bringing his total annual

compensation to over $6.5 million.

Lastly, while the Debtors argue that the SEIP Plan is consistent with industry standards, the information provided does not fully support that statement. The SEIP Plan covers a total of 17 participants; however, information provided by the Cumberland Declaration only provides information as to the salary, retention bonuses, and proposed SEIP payments of only the CEO; the CFO; the EVP – Chief Merchandising Officer; the EVP – Global Chief Technology Officer; and the EVP – President TRU International. Accordingly, there is no specific and complete support for the statement that "[t]he estimated total direct compensation of each of the SEIP Participants fell within a range of competitive practice for comparable positions when [sic] including the SEIP amounts at the target level." *See* Cumberland Declaration at ¶ 21. Moreover, the statement in the Cumberland Declaration that "without the SEIP, the total direct compensation of each SEIP Participant, inclusive of the retention payments made prepetition, will be well below the competitive medians" is certainly not supported by the figures attached to the Declaration at Exhibit 1. To the contrary, as previously stated, the Debtors' CEO's base salary alone – which is $3,750,000 per year is even above the 90th percentile of the industry standards analyzed, and the total direct compensation, including the projected SEIP payment valued at 160% base salary, is close to the 75% percentile of the industry standards analyzed.

CONCLUSION

The Debtors have failed to show that the Bonus Plan does not contemplate impermissible retention payments to the Debtors' insiders. The Debtors have also failed to show that the Bonus Plan sets sufficiently stringent goals for insiders to meet to obtain the proposed bonuses. The Bonus Motion, therefore, should be denied.

WHEREFORE, the United States Trustee respectfully requests that the Court sustain the foregoing Objection, deny the Bonus Motion, and grant such other and further relief as the Court may deem just and proper.

Respectfully Submitted,

Dated: November 28, 2017

Judy A. Robbins
United States Trustee, Region Four

By: /s/ *Robert B. Van Arsdale*

Robert B. Van Arsdale (Va. Bar No. 17483)
Shannon Pecoraro (Va. Bar No. 46864)
Office of the United States Trustee
701 East Broad Street, Suite 4304
Richmond, Virginia 23219
(804) 771-2310
robert.b.van.arsdale@usdoj.gov
shannon.pecoraro@usdoj.gov

By: /s/ *Lynn A. Kohen*

Lynn A. Kohen (Md. Fed. Bar No. 10025)
Office of the United States Trustee
6305 Ivy Lane, Suite 600
Greenbelt, MD 20770
301-344-6221
lynn.a.kohen@usdoj.gov

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on November 28, 2017 a copy of the foregoing document was sent via the Court's CM/ECF system to all other parties entitled to notice pursuant to the Court's May 16, 2016 Order (I) Establishing Certain Notice, Case Management, and Administrative Procedures and (II) Granting Related Relief [Docket No. 129].

/s/ Lynn A. Kohen
Lynn A. Kohen