The Examiners: Insider Pay Disclosures Can Spark Troubling Unintended Consequences

Wall Street Journal
By Jack Butler
November 18, 2015

When it comes to pre-bankruptcy insider pay, how much disclosure is enough?

Payments made to officers, directors and other "insiders" in control of a distressed corporate debtor are closely scrutinized by other stakeholders as well as the media in larger chapter 11 cases. Bankruptcy rules require companies to disclose insider payments during the 12-month period leading up to a bankruptcy filing. The official bankruptcy forms include placeholders for naming insider recipients (along with their addresses and relationship to the company), the date and amount of each payment, and the amounts still owed to the insider. The Wall Street Journal's review of major corporate chapter 11 cases between 2008 and 2013 found that while most companies followed the disclosure requirements, about one in 13 companies (including some with court permission) modified their disclosures by reporting lump sums without names, redacting amounts paid, recording employee identification numbers in lieu of name or using a combination of these and other approaches.

Read literally, bankruptcy disclosure forms arguably require much more extensive financial information and cover many more individuals than would otherwise be required by public company regulators such as the Securities and Exchange Commission. However, even ground rules for customary public reporting are evolving. Earlier this year, the SEC adopted a rule requiring public companies to disclose the ratio of the annual compensation of their chief executive officer to the median of the annual compensation of their employees. A month earlier, the SEC proposed new rules that would require listed companies to adopt policies obligating executive officers to, in some circumstances, pay back incentive-based compensation.

Unfortunately, broad-based public bankruptcy disclosures about executive compensation have led to troubling unintended collateral consequences including harassment of executives at their homes and in their communities, internal disruption at companies already in extremis when different pay levels (beyond those customarily disclosed by public companies) become public, and disruptions and delays in sales and reorganization processes.

Public disclosure advocates counter that bankruptcy rules require detailed information about each bankruptcy insider and payments made to him or her so that there should be full compliance without debate. They also point out that these insiders were in control of

the distressed business and are responsible for the events leading up to the chapter 11 filing, including the attendant loss of value suffered by creditors, employees, shareholders and other stakeholders who are entitled to know exactly what each and every insider has been paid. It is important to highlight that this debate is solely about the level of public disclosure since bankruptcy fiduciaries (and often other principal participants in a chapter 11 case) are able to obtain and evaluate this information on a confidential basis.

Whatever the merits of the disclosure debate may be, the debate is swept up in the larger controversy surrounding executive pay faced by healthy and distressed businesses alike. For example, in their controversial treatise on the unfulfilled promise of executive compensation, Lucian Bebchuk and Jesse Fried weave a detailed account of how structural flaws in corporate governance have enabled managers to influence their own pay and have produced widespread distortions in pay arrangements. They believe that directors must focus on shareholder interests and operate independently from the executives whose compensation they set by making directors more directly accountable to shareholders. In rebuttal, critics point to executive compensation practices of distressed businesses to demonstrate that reducing "agency costs"—the problem created by the separation of ownership and control in larger public companies which is mitigated in distressed situations through the consolidation of ownership interests and assertion of control by sophisticated investors—doesn't lead to material changes in executive compensation arrangements.

Those in control of, or seeking control of, distressed businesses believe in the importance of providing reasonable market-based executive compensation incentives to bankruptcy insiders of distressed businesses. This fundamental economic reality has led special interest groups to lobby Congress for increasingly punitive limitations on executive compensation during chapter 11 reorganization cases. This hostile environment— which is unacceptable to the economic owners of distressed businesses, let alone insiders who control these companies—is another contributing factor to the tsunami of prepackaged chapter 11 reorganizations and expedited asset sales in lieu of taking time to rehabilitate companies and confirm plans of reorganization.

As long as bankruptcy fiduciaries have unfettered access to information about bankruptcy insider payments, public disclosures about bankruptcy insider pay should be balanced against all-too-real privacy and disruption concerns. But the real action in bankruptcy insider pay is how to recalibrate the system in a manner that continues appropriate judicial oversight of reasonable market-based compensation practices while reducing the hostility of the current chapter 11 environment in order to rehabilitate distressed businesses and preserve jobs.