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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	**Chapter 11**
FAIRWAY GROUP HOLDINGS CORP., ***et al.*****,**	:	**Case No. 20-10161 (JLG)**
Debtors.[1]	:	**(Jointly Administered)**

DEBTORS' OMNIBUS REPLY
TO OBJECTIONS TO MOTION OF DEBTORS FOR
ENTRY OF AN ORDER APPROVING DEBTORS' (I) KEY EMPLOYEE
INCENTIVE PROGRAM AND (II) KEY EMPLOYEE RETENTION PROGRAM

[1] The Debtors in these chapter 11 cases, along with the last four digits of each Debtor's federal tax identification number, are as follows: Fairway Group Holdings Corp. (2788); Fairway Group Acquisition Company (2860); Fairway Bakery LLC (4129); Fairway Broadway LLC (8591); Fairway Chelsea LLC (0288); Fairway Construction Group, LLC (2741); Fairway Douglaston LLC (2650); Fairway East 86th Street LLC (3822); Fairway eCommerce LLC (3081); Fairway Georgetowne LLC (9609); Fairway Greenwich Street LLC (6422); Fairway Group Central Services LLC (7843); Fairway Group Plainview LLC (8643); Fairway Hudson Yards LLC (9331); Fairway Kips Bay LLC (0791); FN Store LLC (9240); Fairway Paramus LLC (3338); Fairway Pelham LLC (3119); Fairway Pelham Wines & Spirits LLC (3141); Fairway Red Hook LLC (8813); Fairway Stamford LLC (0738); Fairway Stamford Wines & Spirits LLC (3021); Fairway Staten Island LLC (1732); Fairway Uptown LLC (8719); Fairway Westbury LLC (6240); and Fairway Woodland Park LLC (9544). The location of the Debtors' corporate headquarters is 2284 12th Avenue, New York, New York 10027. Fairway Community Foundation Inc., a charitable organization, owned by Fairway Group Holdings Corp., is not a debtor in these proceedings.

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TO THE HONORABLE JAMES L. GARRITY, JR.,
UNITED STATES BANKRUPTCY JUDGE:

Fairway Group Holdings Corp. and its debtor affiliates, as debtors and debtors in possession in the above-captioned chapter 11 cases (collectively, the "**Debtors**"), submit this omnibus reply (the "**Reply**") to the objections (the "**Objections**")[1] interposed to the *Motion of Debtors for Entry of an Order Approving Debtors' (I) Key Employee Incentive Program and (II) Key Employee Retention Program* (ECF No. 200) (the "**Motion**").[2] The Debtors respectfully submit as follows:

Preliminary Statement

1. The Debtors are in the advanced stages of their chapter 11 cases and their strategic asset sales strategy (the "**Sale Strategy**"). From the outset, the Sale Strategy has been the foundation of these chapter 11 cases and essential to maximizing recoveries for all creditors and preserving as many jobs as possible. Much already has been accomplished towards successfully executing the Sale Strategy. Following the Commencement Date, the Debtors' successful execution of the Sale Strategy—led by their Key Employees—facilitated a robust auction (the "**Auction**"), which commenced on March 16, 2020, for the sale of substantially all of the Debtors' assets, including the Stalking Horse Package and the Other Assets. In addition, as

[1] On March 4, 2020, the United States Trustee (the "**U.S. Trustee**") filed the *Objection of The United States Trustee to Motion of Debtors for Entry of Order (I) Approving Debtors' Incentive and Retention Programs for Certain Key Employees and (II) Granting Related Relief* (ECF No. 263) (the "**U.S. Trustee Objection**") and on March 5, 2020, the United Food and Commercial Workers Union Local 1500 (the "**Union**," and together with the U.S. Trustee, the "**Objecting Parties**") filed the *Objection and Response of the United Food and Commercial Workers Union Local 1500, to Debtors' Motion for Entry of an Order Approving Debtors' (I) Key Employee Incentive Program and (2) Key Employee Retention Program (Docket Nos. 200, 223)* (ECF No. 268) (the "**Union Objection**," and together with the U.S. Trustee Objection, the "**Objections**").

[2] Capitalized terms used but not otherwise defined herein shall have the respective meanings ascribed to such terms in the Motion or the *Order (I) Approving (A) Bidding Procedures for Sales Of Debtors' Assets, (B) Stalking Horse Bid Protections, (C) Form and Manner of Notice of Sales, Auctions, and Sale Hearings, and (D) Assumption and Assignment Procedures and Form and Manner of Notice of Assumption and Assignment; (Ii) Authorizing Designation of Additional Stalking Horse Bidders; (Iii) Scheduling Auctions and Sale Hearings; and (IV) Granting Related Relief* (ECF No. 202), as applicable.

described below, the Debtors have achieved a global settlement with their unions and a plan settlement with the Creditors' Committee (the "**Plan Settlement**").

2. On March 25, 2020, as set forth in the *Notice of Successful Bidders at Global Auction* (ECF No. 378), the Debtors announced the sale of five stores, the Harlem parking lot and the production and distribution center (the "**PDC**") to Village Super Markets, Inc. ("**Village**") for approximately $76 million—which was almost $8 million higher than the initial Stalking Horse Bid—(the "**Stalking Horse Sale Transaction**"), the sale of the Georgetowne store to Seven Seas Georgetowne, LLC for approximately $5 million (the "**Key Foods Sale Transaction**"), and the sale of the Paramus and Woodland Park stores leases to Amazon Retail LLC for $1.5 million (the "**Amazon Sale Transaction**," and together with the Stalking Horse Sale Transaction and the Key Foods Sale Transaction, the "**Sale Transactions**"), for total sale proceeds of approximately $82.5 million. The Debtors are seeking approval of the Sale Transactions at the hearing on April 14, 2020 at 11:00 a.m. (Eastern Time).

3. As described in further detail in the Motion, despite the Debtors' significant accomplishments to date, much work remains to be done to effectuate the Sale Strategy and ensure maximized recoveries for stakeholders. The remaining steps in the Sale Strategy and these chapter 11 cases include (i) consummating the Sale Transactions (including compliance with certain agreed performance covenants and the transition of stores and related assets to the winning bidders), (ii) maintaining operations at all of the Debtors' stores to serve their communities during the global pandemic caused by COVID-19; (iii) continuing to pursue buyers for the Debtors' stores and assets that were not sold at the Auction, (iv) ultimately winding down stores that cannot be sold; (v) implementing the UFCW Settlement (as defined below); and (vi) preparing and securing confirmation of a chapter 11 plan consistent with the Plan Settlement and distributing

proceeds to creditors in accordance therewith. The success of these chapter 11 cases, including completion of the Sale Strategy, attaining recoveries for creditors, and preserving as many jobs as possible, has never been a guarantee. The achievements thus far have turned in large part on the performance and productivity of the Key Employees. Likewise, the success of the remaining stages of these chapter 11 cases also will depend on the continued performance of the Key Employees. The Key Employees have in-depth knowledge of the Debtors' prepetition businesses, assets, liabilities, counterparties and operations, and are absolutely essential to the Debtors' ability to carry out critical tasks and objectives in a quick, efficient and accurate fashion.

4. Needless to say, operating a company in chapter 11 is not an easy task in and of itself. Adding a global sale process on top of ordinary chapter 11 operations and obligations is even more challenging and difficult. These Debtors—through the heroic efforts of all of their employees and led by their Key Employees—have been asked to go even further and operate in chapter 11 and manage a global sale process during an unprecedented global pandemic caused by COVID-19. Not only must the Key Employees address operational issues caused by the Debtors' chapter 11 filings and focus on implementing the Debtors' Sale Strategy, but they also must address all of the additional operational issues caused by the global pandemic, such as ensuring that all of their employees and customers are working and shopping in a safe environment; managing increased employee apprehension about working under these circumstances; addressing delayed or short deliveries from their vendors caused by their own challenges arising from the crisis; operating with a smaller number of Key Employees due to recent resignations and remote working arrangements of some support staff members; being required to change merchandising mix and display on a continuous basis due to supply shortages and supply chain problems; adapting food production and delivery to unpredictable employee schedules due to issues with public transit

and quarantining of employees due to possible exposure to COVID-19; and operating under the requirement that KERP Participants and other members of the Debtors' management must physically visit stores to ensure merchandising and operational standards are in compliance with the Debtors' established internal protocols.

5. Under these circumstances, there can be no doubt that promoting morale and providing appropriate incentives have been and continue to be critical to the Debtors' business and the Sale Strategy. In addition, as noted in the *Notice of Modification to Key Employee Retention Program Relating to the Motion of Debtors for Entry of an Order Approving Debtors' (I) Key Employee Incentive Program and (II) Key Employee Retention Program* (ECF No. 408) (the "**Employee Programs Disclosure**"), the Debtors have lost five (5) KERP Participants since the filing of the Motion. As the global pandemic caused by COVID-19 continues to progress, news reports of the danger of non-remote work has made finding replacements an unprecedented struggle—more so than for any Chapter 11 debtor—while, at the same time, the importance of keeping grocery stores accessible and in operation has only grown. At this point there can be little doubt about the need for the Employee Programs or that they are in the best interests of all parties at stake in these chapter 11 cases.

6. It should also be noted that, if achieved, the KEIP Incentive Award will be paid ***entirely*** out of proceeds otherwise distributable to the Senior First Out Term Lenders. Accordingly, such payments should not in any way affect—or move the goal post for—junior creditors. Nowlan Decl. ¶ 12. The Employee Programs were approved by the independent Special Committee and are supported by the party most affected by the Employee Programs, the Ad Hoc Group. In addition, following an independent evaluation of the Employee Programs, the Official Committee of Unsecured Creditors (the "**Creditors' Committee**") now also supports the Motion.

Nowlan Decl. ¶ 12. Moreover, the structure and circumstances of the KEIP Program are substantially similar to the key employee incentive program approved by this Court just last year in the chapter 11 cases of *In re Ditech Holding Corp.*, Case No. 19-10412 (JLG) (Bankr. S.D.N.Y. 2018).

7. The only objections to the approval of the Motion are the U.S. Trustee Objection and the Union Objection. The Objections both seek additional disclosures with regard to the KEIP Participants and KERP Participants, including their job descriptions and responsibilities. To address the Objecting Parties' disclosure issues, in support of this Reply and in further support of the Motion, the Debtors submit the supplemental declaration of Michael Nowlan, Chief Restructuring Officer of the Debtors, annexed hereto as **Exhibit A** (the "**Supplemental Nowlan Declaration,**" and together with the Nowlan Declaration,[3] the "**Declarations**"). In the Supplemental Nowlan Declaration, the Debtors address the concerns in the Objections and offer additional information regarding, among other things, the KERP Participants, certain modifications to the KERP, and the KEIP Participants.

8. In addition, following the filing of the Union Objection and in light of the unique position of the union employees with respect to these chapter 11 cases, the Debtors engaged in a separate negotiation on a wide host of issues with their unions (the "**UFCW Locals**") and the funds administered by certain of the UFCW Locals to provide pensions, legal services, health and welfare coverage, and scholarships to the union employees (together with the UFCW Locals, the "**UFCW Parties**"). As discussed further herein, these negotiations ultimately culminated in the

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[3] "**Nowlan Declaration**" refers to the declaration of Michael Nowlan, Chief Restructuring Officer of the Debtors, annexed to the Motion as Exhibit B, and all later amendments thereto, including the *Amended Declaration of Michael Nowlan in Support of Motion of Debtors for Entry of an Order Approving Debtors' (I) Key Employee Incentive Program and (II) Key Employee Retention Program* (ECF No. 228) filed by the Debtors on February 27, 2020.

Debtors' Motion for (I) Authorization and Approval of Global Settlement Among Debtors, United Food and Commercial Workers Local 1500, Local 1262, and Local 371, United Food and Commercial Workers Local 1500 Pension Fund, and the UFCW Local 1500 Benefit Funds And (II) Related Relief (ECF No. 382) (the "**UFCW Settlement**"), currently set for hearing on April 14, 2020 at 11:00 a.m (Eastern Time). In accordance with the UFCW Settlement, the UFCW Parties have agreed to rest on the Union Objection with regard to the Motion and will not participate in or request an evidentiary hearing or offer oral argument.

9. For the reasons set forth herein, in the Motion, and in the Declarations, the Employee Programs should be approved and the Objections should be overruled.

I. The Objections to the KEIP Should be Overruled and the KEIP Should be Approved

10. The Objections to the KEIP can be summarized as follows: (a) the Debtors provide insufficient evidence to evaluate whether the KEIP is sufficiently incentivizing in nature, *see* U.S. Trustee Obj. at 2; Union Obj. ¶ 19; (b) the Performance Metrics are not sufficiently difficult to achieve, *see* U.S. Trustee Obj. at 10-11; Union Obj. ¶¶ 25-29; (c) the KEIP is essentially, in whole or in part, a disguised retention plan, *see* U.S. Trustee Obj. at 9; (d) even if the KEIP is rendered an incentive plan, it is not justified by the facts and circumstances of these chapter 11 cases, *see* U.S. Trustee Obj. at 13-14; Union Obj. ¶¶ 21-24; and (e) the KEIP does not comply with section 503(c) of the Bankruptcy Code, *see* Union Obj. ¶¶ 15-17. Each of these objections is addressed below, further demonstrating that the KEIP should be approved.

A. The Debtors Provide Sufficient Evidence Pertaining to the KEIP

11. The Objections assert that the Motion lacks certain information regarding the KEIP Participants, including their job titles and duties. *See* U.S. Trustee Obj. at 2; Union Obj. ¶ 19. In the interest of full disclosure and transparency, the Employee Programs Disclosure set forth each KEIP Participant's job title and respective individual allocation of the aggregate KEIP

Incentive Award. The Supplemental Nowlan Declaration includes a schedule outlining each KEIP Participant's duties as well. *See* Suppl. Nowlan Decl. Sched. 1. Accordingly, any objections regarding the identity of KEIP Participants or their duties are now moot.

B. The Performance Metrics are Challenging to Meet

12. Contrary to the Objections, the Debtors have in fact demonstrated that the Performance Metrics are difficult to achieve and are, therefore, incentivizing. *See* U.S. Trustee Obj. at 10-11; Union Obj. ¶¶ 25-29.

13. As set forth in the Nowlan Declaration, there is no guarantee that the Performance Metrics will be achieved. Nowlan Decl. ¶ 17. A recovery of any amount by the Senior First Out Term Lenders[4] is predicated on the Debtors successfully confirming a Plan, which is not guaranteed. Suppl. Nowlan Decl. ¶ 9. And, as of the Commencement Date, there was no certainty as to whether the transaction contemplated by the bid submitted by Village (the "**Stalking Horse Bid**") would even be approved by the Bankruptcy Court and, if consummated, what the value of that bid ultimately would be. Among other uncertainties, pursuant to the *Asset Purchase Agreement by and Among Fairway Group Holdings Corp. and Village Super Markets, Inc.* (the "**Stalking Horse Agreement**"), Village had the right to remove "non-core" stores from the list of assumed leases at any time prior to the later of the date that is (i) forty-five (45) days from the date of the Stalking Horse Agreement and (ii) two (2) days prior to the date of the auction for the assets contemplated by the Stalking Horse Agreement (the "**Auction**"), *see* Stalking Horse Agreement,

[4] The Performance Metrics tie the payout of the KEIP Incentive Award to recoveries of the Senior First Out Term Lenders. Annexed to the Motion as Schedule 1 is a chart summarizing the Performance Metrics, with individual payments of the KEIP Incentive Award increasing based on the aggregate recoveries of the Senior First Out Term Lenders. The maximum KEIP Incentive Award is tied to a $30 million recovery by the Senior First Out Term Lenders.

§ 1.1(c) (ECF No. 19 at Ex. C), thereby potentially decreasing the Stalking Horse Bid by as much as $7.29 million.

14. There also was no assurance that the Debtors would be able to sell any of their other assets which, as of the Commencement Date, had received no bids. Recognizing these uncertainties, the KEIP was designed to incentivize the KEIP Participants to work at a high level to ensure not only that the Stalking Horse did not exercise its right to drop any stores or assets from the proposed transaction, but also to continue making the Debtors' assets enticing in order to attract potential bidders for the Debtors' other assets as well as to potentially attract better or higher bids on the assets included in the Stalking Horse Agreement. Suppl. Nowlan Decl. ¶ 9. In short, the Performance Metrics were designed to incentivize the KEIP Participants to achieve value maximizing objectives that will inure to the benefit of all stakeholders.

15. Not only is the achievement of the Performance Metrics uncertain, but they also present a true challenge for the KEIP Participants. The Union asserts that the original $70 million Stalking Horse Bid almost certainly would result in payout under the Performance Metrics, as the Senior First Out Term Lenders will recover "any additional funds received above the $70 million payment." Union Obj. ¶¶ 26-29. Similarly, the U.S. Trustee asserts that the Motion does not make clear whether the Stalking Horse Bid alone could result in payment of all or part of the KEIP Incentive Award. *See* U.S. Trustee Obj. at 10-11. These Objections radically underestimate the fundamental risks the Debtors have faced throughout these chapter 11 cases and diminish the herculean efforts the KEIP Participants are putting forward to concurrently maintain stable operations, maximize value throughout the sales process, and work towards the finish line of these chapter 11 cases (as noted, the recent novel Coronavirus pandemic has only added further unforeseen and unprecedented challenges). Even with the successful bids in hand, the Objecting

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Parties ignore the fact that the Debtors, through the efforts of their Key Employees, must still satisfy the operating covenants and other obligations under the asset purchase agreements and successfully close the Sale Transactions, all in the context of a global pandemic.

16. Moreover, the Union's assertion that to meet the threshold for payment under the Performance Metrics the Debtors would need to achieve only a 14% increase in revenue beyond the Stalking Horse Transaction, is simply inaccurate. Union Obj. ¶ 29. If only it were that simple. This statement ignores that administrative and priority expense claims must be paid to confirm a chapter 11 plan, and such payments will effectively come ahead of the Senior First Out Term Loans. In addition, (i) pursuant to the Plan Settlement, the Ad Hoc Group has agreed to contribute $1.5 million plus $150,000 in expenses for the benefit of general unsecured creditors, and (ii) pursuant to the UFCW Settlement, approximately $4 million in payments are projected to be made to the UFCW Parties or their represented members. All of these payments must be satisfied before the Senior First Out Term Loans will realize any recovery. Even then, the Senior First Out Term Lenders must recover $10 million before the KEIP Incentive Plan is triggered.

17. The Debtors' postpetition capital structure is set forth in the following table, with the Debtors outstanding loans organized by descending priority.

Table 1: The Debtors' Postpetition Capital Structure

Classes of Loans in Descending Priority	**Loan Amount**
New Money DIP Facility	$25 mm
Super Senior Secured L/C Facility	$26.8 mm
New Term Loan Facility	$16 mm
Aggregate Total	*$67.8 mm*
Senior First Out Term Loans	$76.5 mm
Senior Last Out Term Loans	$56.8 mm
Holdco Loans	$51.0 mm
Debtors' Total Funded Indebtedness	$252.1 mm

As the table demonstrates, at Plan Confirmation, ***before*** the Debtors can pay out any amounts to the Senior First Out Term Lenders, the Debtors must first pay off, ***in full***, (i) the $67.8 million owed in debt senior to the Senior First Out Term Loans (as set forth in Table 1), including (a) the new money DIP Facility, (b) the Super Senior Secured L/C Facility, and (c) the New Term Loan Facility; (ii) all operational and ordinary course claims, in the estimated amount of $35 million to $45 million; (iii) all administrative claims, in the estimated amount of between $11 million and $17 million, including payments to be made under the UFCW Settlement; (iv) all priority claims, in the estimated amount of between $1 million and $3 million; and (v) pursuant to the Plan Settlement, general unsecured claims will receive a gift of $1.5 million plus $150,000 for expenses of the general unsecured creditor trust. Suppl. Nowlan Decl. ¶ 11. In other words, the Debtors must receive sale proceeds of approximately $120 million before any proceeds are available to the Senior First Out Term Lenders.[5]

18. Further, in order for the KEIP Participants to meet even the lowest threshold Performance Metric to achieve a KEIP Incentive Award, not only will approximately $120 million first have to be paid out on these claims, but the Senior First Out Term Lenders also must receive at least $10 million in recoveries. Accordingly, the recovery required in order for the KEIP Participants to meet even the lowest of the Performance Metrics is well in excess of a 14% increase in revenue beyond the Stalking Horse Transaction.

19. The notion that KEIP Participants could achieve the objectives outlined in the KEIP simply by "showing up," *see* U.S. Trustee Obj. at 10-11; Union Obj. ¶¶ 25-29, could not be further from reality. Nowlan Decl. ¶ 17. To meet the Performance Metrics, the KEIP Participants have been required to work long hours implementing the Sale Strategy within a

[5] The estimated amounts set forth in this paragraph are preliminary and subject to change, which could be material.

compressed timeline while simultaneously dealing with the added pressures and workload brought on by the chapter 11 cases and the Coronavirus pandemic. In addition to performing their preexisting job duties—but now under significantly more difficult circumstances—the KEIP Participants have been tasked with numerous additional duties due to employee attrition as well as the separate demands of implementing the Sale Strategy.

20. With regard to the diligence process alone, the KEIP Participants have assisted the Debtors in responding to and facilitating approximately (i) two hundred and fifty (250) due diligence requests, (ii) thirty (30) calls with potential bidders (including but not limited to diligence discussions, introductory management calls, and calls regarding clarification on the Debtors' financial information, (iii) one hundred and thirty (130) internal calls (including bi-weekly updates, sales process discussions, diligence issues, and scheduling), and (iv) thirty (30) store tours and/or meetings. Suppl. Nowlan Decl. ¶ 10.

21. The KEIP Participants also have been actively engaged in managing other aspects of the implementation of the Sale Strategy and administration of the chapter 11 cases including, among other things, (i) maintaining operations, including engaging with key vendors, meeting customer needs and satisfying other requirements to maintain operations at a high level to incentivize potential purchasers to make attractive bids; (ii) managing issues and communication with the Debtors' landlords; (iii) preparing for and coordinating the transition of stores and related assets to purchasers; (iv) implementing "first day" and other relief to stabilize the Debtors' businesses and operations; (v) satisfying reporting and other requirements under the Bankruptcy Code and of the United States Trustees' office; and (vi) facilitating the sale or closure of the remaining stores. *See* Suppl. Nowlan Decl. ¶ 10.

22. In the face of these challenges, and while handling a workload normally handled by multiple employees, the KEIP Participants have worked tirelessly to maximize value since the beginning of the Debtors' sale process and continue working to ensure the Debtors are positioned to achieve the best possible outcome for all stakeholders. These efforts led to the robust and competitive bidding at the Auction for the sale of the Debtors' assets, which culminated in Village's winning $76 million bid, as well as the bids for the Key Foods Sale Transaction and the Amazon Sale Transaction. The Sale Transactions, if approved, will bring additional value to the Debtors' estates—above the amount contemplated at the Commencement Date from the initial Stalking Horse Bid—in an aggregate amount of approximately $14.5 million.

C. The KEIP is Not a Retention Plan

23. Contrary to the U.S. Trustee's assertion that the Debtors fail to satisfy their burden to demonstrate that the KEIP constitutes an incentive plan and is not merely retentive, *see* U.S. Trustee Obj. at 9, the KEIP Incentive Award is tied to achievement of the Performance Metrics that has incentivized the KEIP Participants to continue adding value to the Debtors in the midst of an ongoing sale process, and which will continue to incentivize the KEIP Participants to work towards finalizing recoveries to Senior First Out Term Lenders throughout the Sales Strategy Wind-Down. The Performance Metrics also are designed to provide a higher KEIP Incentive Award to the KEIP Participants depending on the return to the Senior First Out Term Lenders. Accordingly, the KEIP Participants are incentivized to minimize costs to the Debtors' estates and to maximize asset sale proceeds. Courts consistently have held that compensation plans such as the KEIP that set out specified challenging performance goals are primarily incentivizing. *See, e.g.*, *In re Residential Capital, LLC*, 478 B.R. 154, 171 (Bankr. S.D.N.Y. 2012) ("When a plan is designed to motivate employees to achieve specified performance goals, it is primarily incentivizing, and thus not subject to section 503(c)(1).") (internal citations omitted); *In re Dana*

Corp., 358 B.R. 567, 584 (Bankr. S.D.N.Y. 2006) (finding that "[b]y presenting an executive compensation package that properly incentivizes [management] to produce and increase the value of the estate, the Debtors have established that section 503(c)(1) does not apply").

D. The KEIP is Justified by the Facts and Circumstances of these Chapter 11 Cases

24. Section 503(c)(3) of the Bankruptcy Code permits payments to a debtor's employees outside the ordinary course of business if such payments are justified by "the facts and circumstances of the case." 11 U.S.C. § 503(c)(3). Here, the KEIP Incentive Award is justified by the facts and circumstances of these cases.

25. In this and other districts, courts have concluded that whether payments to employees are justified by the "facts and circumstances" of a case is to be determined by application of the business judgment rule. *See In re Velo Holdings Inc.*, 472 B.R. 201, 209 (Bankr. S.D.N.Y. 2016) ("[The] facts and circumstances language of 503(c)(3) creates a standard no different than the business judgment standard under section 363(b)."). Accordingly, the determination of whether an incentive plan is justified by the facts and circumstances of the case and the analysis of whether the approval of such plan is a sound exercise of the debtor's business judgment are the same. In *Dana II,* Judge Lifland listed six factors that courts consider when determining if the structure of a compensation proposal and the process for its development meet "sound business judgment test" in accordance with section 503(c)(3) of the Bankruptcy Code. *See In re Dana Corp.*, 358 B.R. at 576-77 ("*Dana II*"). For the reasons set forth in paragraphs 44 through 47 of the Motion, the KEIP plainly satisfies the *Dana II* text. The arguments of the Objecting Parties that the Debtors do not satisfy the *Dana II* factors have no merit.

26. The U.S. Trustee argues that the Debtors fail to explain, pursuant to *Dana II,* how the benchmarks for payment under the KEIP are difficult to meet, and asks that the Debtors

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provide a chart demonstrating expected bonuses "if the stalking horse is the only source of payment." *See* U.S. Trustee Obj. at 14. As discussed above, the Debtors must satisfy approximately $120 million in obligations and postpetition claims as well as make a distribution of at least $10 million to the Senior First Out Term Loans before any KEIP Incentive Award is distributed to the KEIP Participants. *See* U.S. Trustee Obj. at 14. Even after the winning bids at the Auction are closed, which is no simple task especially in this environment, that will generate approximately $82.5 million and still require another almost $50 million in proceeds before the KEIP Incentive Awards are triggered.

27. The Union argued that the Debtors do not meet the *Dana II* factors because the cost of the KEIP as a percent of the Debtors' liquidity at the Commencement Date is unreasonable. *See* Union Obj. ¶ 22. This is a red-herring. The relevant consideration is not what the Debtors' liquidity was as of the Commencement Date, but rather what the Debtors' liquidity will be following the conclusion of the Sale Strategy, which process has been driven by the KEIP Participants. Suppl. Nowlan Decl. ¶ 12. At bottom, the cost of the KEIP is reasonable because it is designed to pay out KEIP Incentive Awards commensurate with value to the estate the KEIP Participants will have achieved.

E. The KEIP Does Not Run Afoul of Section 503(c)(1) of the Bankruptcy Code

28. The Union Objection also claims that the prepetition payment made to KEIP Participants, amounting to approximately 50% of the total available KEIP Incentive Award, renders the KEIP unlawful under 503(c)(1). Union Obj. ¶¶ 15-17. Specifically, the Union objects on the basis that the prepetition payment was improperly retentive rather than incentivizing. Union Obj. ¶¶ 17, 19. This Objection is meritless on multiple fronts.

29. As an initial matter, the Debtors are not seeking approval of the prepetition payment made to the KEIP Participants. *See* Mot. n.3. Section 503(c) is inapplicable to prepetition payments.

30. Moreover, even if the Court were to evaluate the prepetition payment—which it need not do—courts routinely find that a "pay for value" plan must be primarily, but not exclusively, incentivizing. *See, e.g.*, *In re Nellson Nutraceutical*, 369 B.R. 787, 802 (Bankr. D. Del. 2007). As the Delaware Bankruptcy Court explained:

> Any payment to an employee, including regular wages, has at least a partial purpose of retaining the employee. Therefore, if the Court did not apply a materiality standard, all payments to insiders would be subject to 503(c)(1), which would be an absurd result. At the same time, applying a "sole purpose" standard goes too far. Thus, the Court reads section 503(c)(1) to mean a transfer to an insider of the debtor for the *primary* purpose of inducing such person to remain with the debtor's business

Id. (citation omitted and emphasis in original); *see also In re Velo Holdings*, 472 B.R. at 209–10 ("Although a purported KEIP may contain some retentive effect, that does not mean that the plan, overall, is retentive rather than incentivizing in nature.").

31. Additionally, the prepetition KEIP payment was necessary to ensure that the KEIP Participants were incentivized from the outset of the Debtors' Sale Strategy, which began approximately six (6) months prior to the Commencement Date. From the commencement of the Sale Strategy, and as doubts about the Company's stability first began to surface, the KEIP Participants were increasingly asked to take on additional duties outside the scope of their normal job descriptions. During the prepetition period the burden on KEIP Participants continued to increase. Indeed, due to mounting attrition in the run-up to the Commencement Date, the KEIP Participants not only had to take on additional duties necessary for the Debtors to continue operating in the ordinary course, but also were relied upon to assist with tasks related to chapter

11 and the Sale Strategy. These additional responsibilities went well beyond the duties that the KEIP Participants had been hired to do and upon which their compensation was based. *See* Nowlan Decl. ¶ 10; Suppl. Nowlan Decl. ¶ 7.

32. Because the KEIP Participants have highly marketable skills, the Debtors also deemed it imperative to provide a reasonable payment to the KEIP Participants prior to the Commencement Date, to induce them to stay and see through the Sale Strategy and as compensation for the additional efforts that they had been and would be expected to continue to put forth. Accordingly, the Special Committee, in consultation with the Debtors' advisors, determined that it was critical to the continued success of the Sale Strategy to devise an incentive plan that included a retentive element. Mot. ¶¶ 19, 46; Nowlan Decl. ¶¶ 15-16; Suppl. Nowlan Decl. ¶ 6. This prepetition payment is subject to clawback should any KEIP Participant voluntarily terminate employment within nine (9) months of January 21, 2020. *See* Mot. ¶¶ 22, 28(f).

33. Notably, the structure of the KEIP is consistent with the structure of the key employee incentive plan recently approved by this Court in *In re Ditech Holding Corp.*, Case No. 19-10412 (JLG) (Bankr. S.D.N.Y. 2018) (ECF No. 450) ("**Ditech**").[6] In *Ditech*, the debtors implemented a key employee incentive plan that consisted of a prepetition installment payment in the aggregate amount of approximately $2.4 million (approximately 50% of the total award) and a postpetition "Base KEIP" payment of up to $2.5 million, contingent upon the completion of certain milestones.[7] *Ditech* at ECF No. 228 ¶ 27. The Debtors' KEIP mirrors both the structure

[6] The transcript of the hearing on the debtors' motion for approval of the *Ditech* key employee incentive plan is annexed hereto as **Exhibit B**.

[7] The debtors in *Ditech* additionally provided for a "Sale KEIP," entitling a subset of Base KEIP participants to incremental awards in the event of a sale of certain of the debtors' assets. As is the case here, the total potential award under the Sale KEIP ranged from $2.0-$30.1 million, tied to recoveries to the Term Loan lenders. *Ditech* at ECF No. 228 ¶ 3.

and circumstances of *Ditech*. And, consistent with the plan in *Ditech*, the Debtors' prepetition payment to KEIP Participants represents approximately 50% of the maximum available payout under the KEIP.

34. In sum, although the prepetition payment undoubtedly had a retentive effect, the KEIP is primarily incentivizing overall.

II. The Objections to the KERP Should be Overruled and the KERP Should be Approved

35. The Objections to the KERP are premised on the following five (5) issues: (a) the KERP includes insufficient information to deduce whether the KERP Participants are "insiders" or to ascertain their role with the Debtors, *see* U.S. Trustee Obj. at 2; Union Obj. ¶ 13; (b) certain of the KERP Participants appear to be insiders based on job title, *see* U.S. Trustee Obj. at 12-13; (c) the KERP is too rich, *see* Union Obj. ¶¶ 7-14; (d) the Debtors have not satisfied the relevant legal standard under section 503(c)(3) of the Bankruptcy Code—i.e., that the KERP is justified by the facts and circumstances of these cases, *see* U.S. Trustee Obj. at 13-15; Union Obj. ¶ 22; and (e) the KERP discriminates unfairly against the employees not included in the KERP, including union employees, *see* Union Obj. ¶ 10-12, 24**.** As detailed below, the Objections are without merit and the KERP should be approved.

A. The Debtors Have Provided Sufficient Information Regarding the KERP Participants

36. The Objections asserted that the Motion lacks basic information regarding the KERP Participants, including their job responsibilities, whether they were appointed by the Board, and to whom they report. *See* U.S. Trustee Obj. at 12-13; Union Obj. ¶ 13. To address these Objections, the Debtors already have provided the U.S. Trustee and the Union additional information with respect to the KERP Participants, and additional information addressing the Objections also is annexed to the Supplemental Nowlan Declaration to be filed under seal. *See*

Schedule 2. In addition, the Debtors have advised the U.S. Trustee and the Union that since filing the Motion, five (5) KERP participants have resigned or tendered notices of resignation, and the Debtors have added seven (7) new KERP Participants. *See* Employee Programs Disclosure. As a result of these changes, the total overall payout under the KERP has decreased by $148,835. A schedule of the modifications made to the KERP is annexed to the Supplemental Nowlan Declaration as **Schedule 3**.

B. None of the KERP Participants is an "Insider"

37. Contrary to the U.S. Trustee's assertion, the Nowlan Declaration clearly detailed the reasons why the KERP Participants are not insiders. *See* Mot. ¶¶ 35-37; Nowlan Decl. ¶ 7.

38. The U.S. Trustee focuses on the titles of the Key Employees—e.g., "vice president" or "manager"—without more, to suggest that such employees may be insiders. *See* U.S. Trustee Obj. at 12-13. But, as set forth in the Motion, it is well-settled that an employee's job title, alone is not dispositive as to whether an employee is an "insider" for purposes of sections 503(c)(1) and 503(c)(2) of the Bankruptcy Code. *See* Mot. ¶ 35.[8] The U.S. Trustee Objection

[8] Although section 101(31) of the Bankruptcy Code defines an "insider" to include, among other things, an "officer of the debtor" and a "person in control of the debtor," the job titles alone are not determinative. *See In re Borders Grp. Inc.*, 453 B.R. 459, 469 (Bankr. S.D.N.Y. 2011) (noting that "[c]ompanies often give employees the title 'director' or 'director-level,' but do not give them decision-making authority akin to an executive" and concluding that certain "director level" employees in that case were not insiders); *In re Glob. Aviation Holdings Inc.*, 478 B.R. 142, 148 (Bankr. E.D.N.Y. 2012) ("The label an employer chooses to attach to a position is not dispositive for purposes of insider analysis because companies often give employees the title 'director' or 'director-level' but do not give them decision-making authority akin to an executive."). Even the cases cited by the U.S. Trustee acknowledge that job titles in and of themselves are *not* controlling. *See Borders Grp. Inc.*, 453 B.R. at 468 (holding that "[a]n individual's title, by itself, is insufficient to establish that an individual is a director or officer" and concluding that, notwithstanding their job title, certain "director-level" employees were not insiders); *In re Foothills Texas, Inc.*, 408 B.R. 573, 579 (Bankr. D. Del. 2009) (reaffirming that the "mere title of a person does not end the inquiry" and "[j]ust as there may be non-statutory insiders that fall within the definition of an insider but are outside of the enumerated categories, there may be persons that fall within the enumerated categories but do not meet the definition of the category"); *In re Kunz*, 489 F. 3d 1072 (10th Cir. 2007) (it is not simply the title "director" or "officer" that renders an individual an insider; rather it is the set of legal rights that a typical corporate director or officer holds).

ignores the uncontroverted facts and applicable law, and instead improperly invites this Court to judge a book by its cover.

39. Under well-settled law, in order for a KERP Participant to be considered an insider, the employee must have "at least a controlling interest in the debtor or . . . exercise sufficient authority over the debtor so as to unqualifiably dictate corporate policy and the disposition of corporate assets." *In re Velo Holdings, Inc.*, 472 B.R. 201, 208 (Bankr. S.D.N.Y. 2012) (citations omitted). Based on this standard, and notwithstanding any assumptions one might make based off of the employees' job titles, none of the Key Employees qualifies as an "insider" of the Debtors.

40. First, none of the KERP Participants has discretionary control over any substantial budgetary amounts or the ability to dictate company policy. *See* Nowlan Decl. ¶ 7. The KERP Participants are subordinate to and required to report to an executive management team member or a KERP Participant that, in turn, reports to an executive management team member. Suppl. Nowlan Decl. ¶ 14. Second, all KERP Participants must obtain approval from senior management before taking any action with respect to the disposition of significant assets. *See* Nowlan Decl. ¶ 7. Third, none of the KERP Participants is a member of the Special Committee or the Debtors' board of directors, was appointed by the board of directors, or participates in the Debtors' corporate governance. *See* Nowlan Decl. ¶ 7. Finally, none of the KERP Participants had any say or input whatsoever on any aspect of the development of the KERP or its ultimate formulation. *See* Nowlan Decl. ¶ 7.

41. Accordingly, there are no "insiders" eligible for KERP Payments and, therefore, section 503(c)(1) of the Bankruptcy Code does not apply.

C. The Cost of the KERP Is Reasonable

42. The cost of the KERP is reasonable in light of the Debtors' assets, liabilities, and revenues and is consistent with, and within the range of reasonableness of, similar programs implemented in chapter 11 cases with debtors of similar size. *See* Nowlan Decl. ¶¶ 20-21. Contrary to the Union's assertion that the KERP is "too rich," the cost per KERP Participant as a percentage of base salary on average is 28% and ranges from only 12.5% to 50%. This is comparable to both the average (21.3%) and median (19.1%) of comparable cases, and between the 50th percentile (19%) and the 75th percentile (30%) of comparable cases. Suppl. Nowlan Decl. ¶ 18.

43. Decisions concerning the percentage of base salary for each individual KERP Award were made based on a variety of factors including the KERP Participant's industry and institutional experience, current compensation, and the Debtors' operational needs in light of the Sale Strategy. Suppl. Nowlan Decl. ¶ 17. The amounts were then approved by the Special Committee after it independently considered these same factors. Nowlan Decl. ¶ 3; Suppl. Nowlan Decl. ¶ 17. In addition, since the filing of the Motion, the number of KERP Participants has increased from twenty-five (25) to twenty-seven (27) employees, lowering the average per-employee payout from $52,000 to $42,696. Suppl. Nowlan Decl. ¶ 14.

44. In their criticism of the KERP, the Objecting Parties fail to take into account the aggregate savings the Debtors will achieve through the requirement that KERP Participants forfeit their severance payment in exchange for the KERP Award.[9] The aggregate savings to the

[9] Contrary to the Union's assertion, severance payments may not simply be rejected and treated as prepetition unsecured claims in the Second Circuit. With respect to the priority of severance claims, the Second Circuit has long held that severance claims triggered by postpetition termination are entitled to administrative expense status under sections 503 and 507 of the Bankruptcy Code. *Straus-Duparquet, Inc. v. Local Union No. 3*, 386 F.2d 649 (2d Cir. 1967).

Debtors from being relieved of these severance obligations could be as much as ***$1.8 million***, which would more than offset the KERP payment amounts. *See* Nowlan Decl., n.5; Suppl. Nowlan Decl. ¶ 19. Analyses conducted by Mackinac of thirty-seven (37) comparable key employee retention plans identified only one (1) comparable chapter 11 company that required a waiver of an employee's severance claim and only two (2) that required a reduction in the available retention bonus for such key employee by the amount of the employee's severance claim. Suppl. Nowlan Decl. ¶ 20.

45. Compared to key employee incentive programs approved in other cases, as well as the fact that implementation of the KERP will result in a net benefit to the Debtors' estates, the KERP is appropriate and should be approved.

D. The Requirements of Section 503(c)(3) Have been Satisfied

46. Because none of the KERP Participants are "insiders," *see supra* paras. 35-37, section 503(c)(3) sets forth the applicable standard for evaluating the KERP—that it is "justified by the facts and circumstances of the case." 11 U.S.C. § 503(c)(3). The Objecting Parties' assertion that the KERP is not justified by the facts and circumstances of these cases is meritless. U.S. Trustee Obj. at 13-14; Union Obj. ¶¶ 21-24. In fact, when investigating the need for and designing the KERP, the Debtors received input from the Special Committee, their advisors, and the Ad Hoc Group, all to ensure that the terms of the KERP were justified by the facts and circumstances of this case and consistent with industry standards. *See* Nowlan Decl. ¶ 24. In addition, after an independent evaluation, the Creditors' Committee also now supports the Employee Programs.

47. For the reasons set forth in paragraphs 48 through 51 of the Motion—which now are further supported by the Supplemental Nowlan Declaration—the KERP satisfies the controlling *Dana II* factors.

48. The Debtors, with the assistance of their advisors, determined that the scope of the KERP—which was made available only to those employees that are essential to the Debtors' sale and wind down efforts—is both fair and reasonable (as measured by the *Dana II* factors). Although the circumstances of each debtor are unique, Mackinac determined that the KERP generally is in line with the terms of key employee retention plans approved in other recent chapter 11 cases. *See* Nowlan Decl., ¶ 21.

49. As an initial matter, the Debtors and their advisors designed the KERP to motivate and reward the KERP Participants for their significant efforts, given the increased demands placed upon them in connection with the chapter 11 process, and to avoid the loss of key personnel critical to maintaining ongoing operations. Failure to retain the KERP Participants likely would have caused the Debtors' financial performance during the chapter 11 cases to suffer, as the KERP Participants work across a variety of disciplines and are responsible for facilitating a range of the Debtors' tasks critical to the Sale Strategy and the Debtors' operations. *See* Nowlan Decl., ¶ 8. Retaining these employees also has avoided the need for the Debtors to incur significant time and expense to hire and train replacement employees, which would, in turn, divert their attention and efforts from effectuating the Sale Strategy (and which would have been almost impossible over the last several weeks due to the global pandemic caused by COVID-19). *See* Mot. ¶ 48.

50. As set forth above, the overall cost of the KERP is reasonable. The same is true with respect to the scope of the KERP. The Debtors, with the assistance of their advisors, undertook a careful selection process to determine the specific employees eligible for the KERP. Out of the Debtors' total employee base, the Debtors identified a select group of twenty-seven (27) Key Employees to participate in the KERP. *See* Suppl. Nowlan Decl. ¶ 16. The total number of

KERP Participants as a percentage of the Debtors' total employee base as of the Commencement Date is just 0.90%, which is lower than the average 1.05% among the thirty-seven (37) comparable key employee retention plans surveyed by the Debtors and their advisors (ranging from approximately 0.14% to 35% of the employee base). Suppl. Nowlan Decl. ¶ 13. In designing the KERP, the Debtors received input from the Special Committee and their advisors, and consulted with the Ad Hoc Group, all to ensure that the terms of the KERP were impartial, fair and consistent with industry standards. *See* Nowlan Decl. ¶ 24.

51. Moreover, the current need to retain the KERP Participants is especially pressing given the recent exodus of other employees, including KERP Participants. During the three (3) months immediately preceding the filing of the Motion, the Debtors lost twenty-four (24) valuable employees due to voluntary resignations and are at serious risk of losing more key employees. *See* Mot. ¶ 4. In addition, since the filing of the Motion, five (5) of the KERP Participants resigned or tendered notices of resignation. *See* Suppl. Nowlan Decl. ¶ 14. There can be little doubt that additional resignations would follow in the event that the KERP is not approved.

52. As a result of the Debtors' already lean workforce, the loss of any additional KERP Participants will cause further disruption in operations and risk degradation in value of the Debtors estates. The Debtors have expended significant time and energy in order to mitigate the effects of the recent departures of five (5) of the KERP Participants through adding an additional seven (7) KERP Participants, but as there is little or no redundancy in the roles and responsibilities of the KERP Participants (most of whom are handlings tasks previously covered by multiple employees), it is critical that the remaining KERP Participants remain with the Debtors. Suppl. Nowlan Decl. ¶ 5.

53. The fact that even more KERP Participants have not actually resigned or threatened to resign as of the date hereof does not negate the risk the Debtors are seeking to address.[10] Simply put, because of the pending Motion, there is some expectation among the remaining KERP Participants that the program will be approved.

E. The KERP Does Not Discriminate Unfairly, Including Against Union Employees

54. The Union argued that the KERP is inequitable and discriminates unfairly against non-KERP Participants. Union Obj. ¶¶ 12-14. As an initial matter, the Debtors are not required to explain why an excluded employee was not selected to participate in the KERP. Rather, the Debtors only must show, as they have, that the KERP does not discriminate unfairly. Further, as discussed herein, the Debtors have reached agreement with the unions on the UFCW Settlement, which will provide appropriate relief designed to best address the circumstances of the union employees.

55. To be sure, the decision to not include additional employees, not just union employees, was not based on any malicious intent towards non-KERP employees or favoritism toward KERP Participants. Rather, it was based on, and supported by, business justifications and the circumstances under which the Debtors are operating. Suppl. Nowlan Decl. ¶ 21.

56. Moreover, as set forth earlier herein, in light of the unique position of the union employees with respect to these chapter 11 cases, the Debtors engaged in a separate negotiation on a wide host of issues with the UFCW Parties, which negotiations ultimately culminated in the UFCW Settlement.

[10] To the extent any of the KERP Participants currently are looking for alternative employment, it would be unlikely that they would advise the Debtors of this effort prior to accepting another position.

57. The UFCW Settlement provides relief and benefits tailored to specifically address the needs of the union employees. By separately addressing the needs of the union employees through the UFCW Settlement rather than the KERP, the Debtors were able to structure the KERP to best incentivize the KERP Participants based on their specific circumstances and address the unique needs and concerns of their union employees through the UFCW Settlement. For example, as noted above, the KERP Participants are required to forego entitlement to severance in order to receive the KERP Award, resulting in substantial savings for the Debtors' estates on administrative severance claims equal to approximately $1.8 million. This data point was an important factor in how Mackinac analyzed the reasonableness of the KERP. Suppl. Nowlan Decl. ¶ 22. On the contrary, union employees are not entitled to severance under the collective bargaining agreements, so no such set-off was available. However, under the UFCW Settlement, union employees who are terminated and execute a release agreement will now receive (a) between one (1) to four (4) weeks of severance pay, depending on their tenure with the Debtors, and (b) two (2) months of health care coverage. *See* UFCW Settlement, ¶ 2(vi). The UFCW Settlement was intensively negotiated by the UFCW Parties, the Ad Hoc Group, and the Debtors, and allows the Debtors to provide meaningful relief to terminated union employees in a way that would not be possible through the KERP. Suppl. Nowlan Decl. ¶ 22.

58. In view of the above, and all of the considerations cited in the Motion and the Nowlan Declaration, the Debtors have demonstrated that there are valid justifications for the employees eligible to participate in the KERP and that the KERP does not discriminate unfairly.

Conclusion

59. In sum, the Employee Programs are reasonable, the Motion should be approved, and any remaining Objections overruled. The Employee Programs are appropriately designed and narrowly tailored to incentivize the KEIP Participants to create and maximize value

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for the benefit of the Debtors' economic stakeholders and to motivate and retain the KERP Participants while the Debtors implement the Sale Strategy and administer the chapter 11 cases. The Debtors and their advisors, in consultation with the Ad Hoc Group, undertook a careful selection process to determine the specific employees that should be eligible for the Employee Programs and designed the Performance Metrics to achieve desired objectives that will benefit all shareholders. Accordingly, for the reasons stated herein and in the Motion, the Debtors respectfully submit that this Court should overrule the Objections and grant the Motion.

WHEREFORE the Debtors respectfully request entry of the Proposed Order and such other and further relief as the Court may deem just and appropriate.

Dated: April 8, 2020
New York, New York

/s/ Draft
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Exhibit A
Supplemental Nowlan Declaration

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**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

In re	:	**Chapter 11**
FAIRWAY GROUP HOLDINGS CORP., *et al.*,	:	**Case No. 20-10161 (JLG)**
Debtors.[1]	:	**(Jointly Administered)**

**SUPPLEMENTAL DECLARATION
OF MICHAEL NOWLAN IN SUPPORT
OF MOTION OF DEBTORS FOR ENTRY OF
AN ORDER APPROVING DEBTORS' (I) KEY EMPLOYEE
INCENTIVE PROGRAM AND (II) KEY EMPLOYEE RETENTION PROGRAM**

I, Michael Nowlan, pursuant to section 1746 of title 28 of the United States Code, hereby declare that the following is true to the best of my knowledge, information and belief:

[1] The Debtors in these chapter 11 cases, along with the last four digits of each Debtor's federal tax identification number, are as follows: Fairway Group Holdings Corp. (2788); Fairway Group Acquisition Company (2860); Fairway Bakery LLC (4129); Fairway Broadway LLC (8591); Fairway Chelsea LLC (0288); Fairway Construction Group, LLC (2741); Fairway Douglaston LLC (2650); Fairway East 86th Street LLC (3822); Fairway eCommerce LLC (3081); Fairway Georgetowne LLC (9609); Fairway Greenwich Street LLC (6422); Fairway Group Central Services LLC (7843); Fairway Group Plainview LLC (8643); Fairway Hudson Yards LLC (9331); Fairway Kips Bay LLC (0791); FN Store LLC (9240); Fairway Paramus LLC (3338); Fairway Pelham LLC (3119); Fairway Pelham Wines & Spirits LLC (3141); Fairway Red Hook LLC (8813); Fairway Stamford LLC (0738); Fairway Stamford Wines & Spirits LLC (3021); Fairway Staten Island LLC (1732); Fairway Uptown LLC (8719); Fairway Westbury LLC (6240); and Fairway Woodland Park LLC (9544). The location of the Debtors' corporate headquarters is 2284 12th Avenue, New York, New York 10027. Fairway Community Foundation Inc., a charitable organization, owned by Fairway Group Holdings Corp., is not a debtor in these proceedings.

1. I submit this supplemental declaration (this "**Supplemental Declaration**") in further support of the *Motion of Debtors for Entry of an Order Approving Debtors' (I) Key Employee Incentive Program and (II) Key Employee Retention Program* (the "**Motion**") and in support of the *Debtors' Omnibus Reply to Objections to Motion of Debtors for Entry of an Order Approving Debtors' (I) Key Employee Incentive Program and (II) Key Employee Retention Program* (the "**Reply**"). I previously submitted a declaration attached to the Motion (the "**Declaration**"),[2] which I incorporate into this Supplemental Declaration by reference.

2. Except as otherwise indicated, all facts set forth in this Supplemental Declaration are based upon (a) my personal knowledge of the Debtors' industry, management team, and current situation, (b) information received from members of the Debtors' management, their employees, or their advisors, and (c) my review of the relevant documents or matters within the personal knowledge of other professionals at Mackinac working under my supervision, or (d) my financial restructuring, interim management, turnaround, and management consulting experience of more than twenty (20) years. I am familiar with the structure of the Debtors' prepetition compensation program, the structure of the Debtors' proposed key employee incentive program (the "**KEIP**"), and the structure of the Debtors' proposed key employee retention program (the "**KERP**" and together with the KEIP, the "**Employee Programs**"). I have reviewed the Motion, Reply, and documents identified therein and believe that they accurately reflect the circumstances leading to the development of the Employee Programs and the justification and need for relief. I am authorized to submit this declaration. If called to testify, I could and would testify to each of the facts and opinions set forth herein.

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[2] Capitalized terms not otherwise defined herein shall have the meanings ascribed to them in the Motion, Declaration, or Reply as applicable.

The KEIP and KERP

3. As discussed in my Declaration, the Debtors' Key Employees are critical to the Debtors' ability to maximize value through the sale process and remain essential to ensuring the success of the wind-down of the estates. Employees are not immune to the pressures of chapter 11—the KEIP and KERP Participants find themselves uncertain of future employment and compensation while remaining responsible for additional chapter 11 related duties.

4. Many of the Debtors' employees have sought alternative employment opportunities. Indeed, in the short time since the Debtors filed the Motion, the Debtors have experienced employee attrition, including five (5) KERP Participants who have resigned or tendered notices of resignation. In order to maintain a stable employee base and maximize value for all stakeholders, the Debtors determined that incentivizing performance of Key Employees was (and remains) both appropriate and necessary. As a result of the Debtors' already lean staff, the loss of any additional Key Employees at this juncture would cause a disruption in operations and potential degradation in value of the Debtors' estates. Furthermore, as the global pandemic caused by COVID-19 continues to progress, news reports of the danger of non-remote work has made finding replacements an unprecedented struggle.

5. There is very little or no redundancy in the roles and responsibilities of the Key Employees. Furthermore, because the Key Employees possess valuable skills and are highly marketable, it was and is essential to provide them with sufficient incentive to remain with the Company postpetition, particularly in light of the fact that numerous Key Employees have assumed additional responsibilities beyond their normal duties not only to maintain operations in chapter 11, but also during the unprecedented global pandemic caused by COVID-19.

Reasonableness of the KEIP

6. The KEIP was developed in consultation with members of the Debtors' management team and the Debtors' advisors, along with the Special Committee and the Ad Hoc Group. The KEIP was reviewed and approved by the Special Committee of the Board of Directors, comprised of two independent directors, neither of whom is a participant in either of the Employee Programs. The Debtors and Special Committee determined that the KEIP was in the best interest of the Debtors and its stakeholders and appropriately addresses the Debtors' objectives.

7. There are a total of nine (9) KEIP Participants, whose job titles and responsibilities are annexed hereto in **Schedule 1**. The terms of the KEIP are summarized in paragraph 28 of the Motion. As further outlined in the Motion, the KEIP contemplates two payments—one prepetition and one postpetition—to be made to the KEIP Participants. The prepetition payment amounted to approximately $935,000 in the aggregate. The KEIP Participants will be eligible to receive a maximum postpetition KEIP Incentive Award of $937,806, in the aggregate, if all target Performance Metrics are met.

8. The prepetition KEIP payment was critical to ensuring that the KEIP Participants remained incentivized from the outset of the Sale Strategy, which began approximately six months prior to the Commencement Date. During that prepetition period, KEIP Participants were increasingly asked to take on extra duties beyond the scope of their normal responsibilities, both to ensure that the Debtors could continue operating in the ordinary course and guarantee completion of all chapter 11 and Sales Strategy-related tasks. Because the KEIP Participants were asked to assume responsibilities beyond those that they originally agreed to in exchange for their normal base pay, and because the KEIP Participants possess valuable skills and

are highly marketable, it was essential to provide the KEIP Participants with sufficient incentive to remain with the Company prior to the Commencement date.

9. The Debtors' goal in constructing the KEIP was to incentivize the KEIP Participants to meet Performance Metrics throughout the Debtors' chapter 11 cases that would have a direct impact on the Debtors' financial performance and serve to preserve and maximize the value of the Debtors' estates throughout the chapter 11 cases. The value-driving Performance Metrics have and continue to encourage employees to maintain focus on and dedication to the success of the Debtors' business operations while driving towards the consummation of the Sale Transaction and confirmation of a plan. Given the circumstances of these chapter 11 cases, achieving each of the Performance Metrics continues to require extraordinary efforts by the KEIP Participants.

10. There is no guarantee that the Performance Metrics will be achieved. As of the Commencement Date, it was uncertain whether the Stalking Horse Transaction would be consummated and, if consummated, whether the Stalking Horse Transaction would be finalized with a specific value, especially given the ability of the Stalking Horse Bidder to drop certain stores and the PDC from the bid. Recognizing this uncertainty, the KEIP was designed to incentivize the KEIP Participants to work at a high level in order to, among other things, reduce the risk that the Stalking Horse Bidder would exercise its rights under the terms of the Stalking Horse Bid to drop any stores or assets from the proposed transaction. Moreover, the KEIP was designed to incentivize the KEIP Participants to continue making the Debtors' assets enticing in order to attract potential bidders for the Debtors' other assets (as there was no guarantee that the Debtors would have been able to sell their other assets) and to attract better or higher bids on the assets included in the Stalking Horse Agreement. The KEIP Participants could not achieve the

goals of the KEIP simply by "showing up." Instead, the KEIP Participants have had to work to maximize value for the Debtors' estates, negotiate and drive a successful process with regard to the sales process, and continue to shepherd the Debtors towards an expeditious exit from bankruptcy through the Sale Transactions and a chapter 11 plan.

11. Beyond striving to achieve the Performance Metrics, the KEIP Participants also have been keenly involved in implementing the Sale Strategy by, among other things:

a) maintaining Company operations by engaging with key vendors, meeting customer needs, and satisfying other requirements to continue operations at a high level to incentivize potential purchasers to make attractive bids;

b) managing issues and maintaining communication with the Debtors' landlords;

c) preparing for and coordinating the transition of stores and related assets to purchasers;

d) implementing "first day" and other relief to stabilize the Debtors' businesses and operations;

e) leading negotiations with unions, landlords, buyers, and other key constituents in connection with the sales and otherwise;

f) reviewing and responding to diligence and other information requests; and

g) satisfying reporting and other requirements under the Bankruptcy Code and the United States Trustee's office.

With regard to the diligence process, the KEIP Participants have also assisted the Debtors in responding to and facilitating approximately (i) two hundred and fifty (250) due diligence requests; (ii) thirty (30) calls with potential bidders (including but not limited to diligence discussions, introductory management calls, and calls regarding clarification on the Debtors' financial information); (iii) one hundred and thirty (130) internal calls (including bi-weekly updates, sales

process discussions, diligence issues, and scheduling); and (iv) thirty (30) store tours and/or meetings.

12. As stated in my Declaration, all postpetition KEIP Incentive Awards will be distributed from proceeds arising out of recoveries otherwise distributable to the Senior First Out Term Lenders. A recovery of any amount to the Senior First Out Term Lenders is predicated on the Debtors confirming a Plan and (i) paying all operational and ordinary course claims in full, amounting to an estimated aggregate cost of between $35 million and $45 million; (ii) paying all administrative claims in full, amounting to an estimated aggregate cost of between $11 million and $17 million, including payments to be made under the UFCW Settlement; (iii) satisfying the New Money DIP Facility, New Term Loan Facility, and the Super Senior Secured L/C Facility in full, amounting to an aggregate cost of $67.8 million; (iv) paying all priority claims, in the estimated amount of between $1 million and $3 million; and (v) pursuant to the Plan Settlement, general unsecured claims will receive a gift of $1.5 million plus $150,000 for expenses of the general unsecured creditor trust.[3]

13. The facts and circumstances of these chapter 11 cases justify the KEIP Incentive Award. When evaluating the cost of the KEIP as a percent of the Debtors' liquidity, the key consideration is not the cost of the KEIP as a percent of the Debtors' liquidity as of the Commencement Date, but rather what the Debtors' liquidity will be following the conclusion of the Sale Strategy—a process that will be driven by the KEIP Participants.

Reasonableness of the KERP

14. The terms of the KERP are summarized in paragraph 31 of the Motion. The Debtors, in conjunction with their advisors, undertook a careful selection process to determine the

[3] The estimated amounts set forth in this paragraph are preliminary and subject to change, which could be material.

specific employees eligible for the KERP. Out of the Debtors' total employee base, the Debtors selected a narrowly-defined group of Key Employees to participate in the KERP. The total number of participants as a percentage of total employee base is 0.90%. This percentage is lower than the average (1.05%) among thirty-seven (37) comparable chapter 11 companies reviewed by Mackinac. The total number of participants included in those comparable key employee retention programs, as a percentage of total employee base, ranges from approximately 0.14% to 35%.

15. Since the filing of the Motion, five (5) KERP Participants have resigned or tendered notices of resignation. Since the filing of the Motion, the Debtors have added seven (7) new KERP Participants, increasing the KERP Participants from twenty-five (25) to twenty-seven (27). The average per-employee payout under the KERP has decreased, from $52,000 to $42,696, and the total overall payout under the KERP has decreased by $148,835. Annexed hereto in **Schedule 2**, to be filed under seal, is a chart setting forth the following information for each of the KERP Participants: (a) title; (b) job description; (c) to whom they report; (d) whether they were appointed by the board of directors; (e) salary; (f) the severance each KERP Participant chose to forego in order to be eligible for the KERP; and (g) their proposed KERP Awards. As set forth in Schedule 2, each of the KERP Participants is subordinate to and required to report to an executive management team member or a KERP Participant that, in turn, reports to an executive management team member. Annexed hereto in **Schedule 3** is a schedule of the modifications made to the KERP.

16. Compared to the retention programs in comparable chapter 11 cases, the modifications to the aggregate total cost and terms of the KERP remain in line with the terms of the key employee retention plans approved in other recent chapter 11 cases. As provided in Table I below, although the payout per employee is near the high end of the range in comparison to other

key employee retention plans, both the total number of KERP Participants and the total program size is near the median. As a whole, the cost and size of the KERP remains reasonable in comparison with these other key employee retention plans.

Table I: Peer Comparison of the Modified KERP[4]

($ in 000s)

Retail	1	2	3	4	5	6	7	8	9	10
	Am. Apparel ('16)	Marsh	Draw Another Circle	Fresh & Easy	Brookstone	Fairway	FTD Companies	PacSun	Am. Apparel ('15)	Golfsmith
# of Participants	7	15	17	21	25	**27**	68	69	82	127
	Marsh	Fresh & Easy	Brookstone	Draw Another Circle	Am. Apparel ('16)	Golfsmith	Fairway	PacSun	FTD Companies	Am. Apparel ('15)
Total Payout	$160.8	$325.0	$392.0	$547.8	$867.5	$955.0	**$1,152.8**	$1,505.0	$2,000.0	$2,181.6
	Golfsmith	Marsh	Fresh & Easy	Brookstone	PacSun	Am. Apparel ('15)	FTD Companies	Draw Another Circle	Fairway	Am. Apparel ('16)
Payout Per Employee	$7.5	$10.7	$15.5	$15.7	$21.8	$26.6	$29.4	$32.2	**$42.7**	$123.9

Note: payout information in the preceding table does not reflect impact of mitigating severance for certain KERP Participants

17. Only the twenty-seven (27) KERP Participants will be eligible to receive the KERP Payments. Receipt of a KERP Award is dependent on the KERP Participants having performed and continuing to perform a variety of critical functions, which are directly linked to the Sale Strategy and the preservation of value. The KERP Participants are essential non-insider employees that would be difficult, if not impossible at this juncture, to replace and require financial incentives to remain employed during the Sale Strategy due to the highly competitive employment market.

18. The Debtors designed the KERP with careful thought. Decisions concerning the percentage of base salary for each individual KERP Award were made based on a variety of factors including each KERP Participant's industry and institutional experience, current

[4] Table I in my Declaration sets forth the same analysis using the Debtors' pre-modification KERP terms.

compensation, and the Debtors' operational needs in light of the Sale Strategy. The amounts were then approved by the Special Committee after it independently considered these same factors.

19. Mackinac reviewed over sixty-five (65) bankruptcy filings for criteria similar to the circumstances of the Debtors, including: (i) chapter 11 filings within the last five (5) years; (ii) a key employee retention plan proposed and approved by the bankruptcy court; (iii) the debtor company was within the retail or grocery industry; (iv) the debtor company had assets between $95 million and $465 million; and (v) the debtor company had revenue between $264 million and $887 million. This review resulted in Mackinac identifying nine (9) comparable chapter 11 cases, as reflected in Table I herein. The aggregate total cost and terms of the KERP are generally in line with the terms of the key employee retention plans approved in these comparable chapter 11 cases. Moreover, the cost per KERP Participant as a percentage of base salary on average is 28% and ranges from 12.5% to 50% which is comparable to both the average and median of comparable cases—21.3% and 19.1%, respectively—and between the 50th percentile (19%) and the 75th percentile (30%) of comparable cases.

20. The cost of the KERP does not take into account the aggregate savings to the Debtors through the requirement that KERP Participants give up their entitlement to receive severance in order to be eligible to receive the KERP Award. The forfeiture of the KERP Participants' potential severance claims could result in a maximum aggregate savings to the Debtors of up to $1.8 million, which would offset any of the KERP implementation costs incurred by the Debtors. This was a significant factor considered by Mackinac when analyzing the reasonableness of the KERP.

21. Based on my analysis of the comparable chapter 11 companies, few companies required either waiver of an employee's severance claim in order for such employee to

be eligible to participate in the company's key employee retention program, or a reduction in the retention bonus due to such key employee by the amount of the employee's severance claim. Analysis conducted by Mackinac of thirty-seven (37) comparable key employee retention plans identified only one (1) comparable chapter 11 company that required a waiver of an employee's severance claim, and only two (2) comparable chapter 11 companies that required a reduction in the available retention bonus for such key employee by the amount of the employee's severance claim.

22. The decision to not include additional employees in the KERP, including union employees, was not based on any malicious intent towards non-KERP employees or favoritism toward KERP Participants. Rather, it was based on, and supported by, business justifications and the circumstances under which the Debtors are operating.

23. In light of the unique position of the union employees with respect to these chapter 11 cases, the Debtors engaged in a separate negotiation on a wide host of issues with the UFCW Parties, which negotiations ultimately culminated in the UFCW Settlement. The UFCW Settlement provides relief and benefits tailored to specifically address the needs of the union employees. By separately addressing the needs of the union employees through the UFCW Settlement rather than the KERP, the Debtors were able to structure the KERP to best incentivize the KERP Participants based on their specific circumstances and address the unique needs and concerns of their union employees through the UFCW Settlement. For example, as noted above, the KERP Participants are required to forego entitlement to severance in order to receive the KERP Award, resulting in substantial savings for the Debtors' estates on administrative severance claims equal to approximately $1.8 million. This data point was an important factor in how Mackinac analyzed the reasonableness of the KERP. On the contrary, union employees are not

entitled to severance under the collective bargaining agreements, so no such set-off was available. However, under the UFCW Settlement, union employees who are terminated and execute a release agreement will now receive (a) between one (1) to four (4) weeks of severance pay, depending on their tenure with the Debtors, and (b) two (2) months of health care coverage. The UFCW Settlement was intensively negotiated by the UFCW Parties, the Ad Hoc Group, and the Debtors, and allows the Debtors to provide meaningful relief to terminated union employees in a way that would not be possible through the KERP.

24. The UFCW Settlement was intensively negotiated by the unions, the Ad Hoc Group, and the Debtors, and allows the Debtors to provide meaningful relief to terminated union employees in a way that would not be feasible through the KERP.

Conclusion

25. Based on the foregoing, my experience, the studies and analyses performed by Mackinac with regard to the Employee Programs, and the terms and provisions of the Employee Programs, I believe that the Employee Programs are reasonable, appropriately designed, and narrowly-tailored to incentivize the KEIP Participants and to retain the KERP Participants for the benefit of the Debtors, their economic stakeholders, and the successful administration of these Chapter 11 Cases.

I, the undersigned, declare under penalty of perjury that the foregoing is true and correct.

Date: April 8, 2020

/s/ Michael Nowlan
Name: Michael Nowlan
Title: Senior Managing Partner,
Mackinac Partners, LLC

SCHEDULE 1

Table I: KEIP Participant Information

KEIP Participant Information

KEIP Participant	Job Title	Duties/Responsibilities
1.	Chief Executive Officer	Responsible for the overall success of the organization and the ultimate decision-maker for the Company; responsible for leading, guiding, directing, and evaluating the work of other executives and managers; oversees the complete operation of the organization and evaluates the success of the organization in reaching its goals; ensures that the organization's leaders experience the consequences of their actions whether through reward and recognition or performance coaching and disciplinary actions; leads a variety of tasks supporting the sale process, due diligence for prospective buyers, strategic insight for negotiations with buyers, and operational considerations related to selling the company in pieces.
2.	Chief Financial Officer	Responsible for managing the Company's finances, including financial planning, management of financial risks, record-keeping, and financial reporting; ensures the integrity of fiscal data and modeling transparency and accountability; leads financial and information technology diligence efforts in support of the sale process and the chapter 11 filing.
3.	Senior Vice President, Human Resources	Responsible for labor relations, negotiating and administering the labor agreements, benefits purchasing, employee relations, investigations, recruiting, compensation and incentive plans, orientation, and training; works with the Director of Security on employee safety and safety training; works with the Operations Management teams in the stores and PDC on all employment related matters; one of the two Trustees on the 401(k) plan; leads employee management efforts related to union negotiations, implementing activities to remain in compliance with federal, state and local WARN act provisions, severance and benefit programs, assistance with developing the KEIP/KERP, and assistance with restructuring the corporate operations as the Debtor sells off assets.

KEIP Participant	Job Title	Duties/Responsibilities
4.	Vice President, Finance	Supervises the Accounting Department and personally handles cash management and taxation; has overall responsibility for finance, payroll, and risk management; oversees financial reporting, treasury, inventory, payables and receivables, and the user side of financial systems; one of the two Trustees on the 401(k) plan; leads bankruptcy reporting efforts and the finance and accounting teams involved with cash management, vendor payments, and compliance with various bankruptcy orders involving cash disbursements; supports buyer diligence for the sale process.
5.	Senior Vice President, General Counsel	Responsible for the legal affairs of the company; handles or supervises the handling of transactional matters, contract writing and review, responses to lawsuits and claims against the company, compliance matters, alleged violations, and claims against the Company; supervises the Director of Security and Loss Control and the Manager of Food Safety; coordinates with outside counsel to support various bankruptcy related motions and leads legal side diligence for prospective buyers.
6.	Executive VP, Center Store	Responsible for the merchandising of all center store products, sales planning, and promotions, as well as all perishable areas; supervises pricing, the POS Department, and wine store merchandising; supports operational diligence efforts and leads efforts to ensure supply chain post-filing and amidst the COVID-19 pandemic.
7.	Vice President, Fresh Foods & Product Development	Manages all development and merchandising aspects of the fresh food programs including those produced at the PDC; stays on top of trends in fresh foods and develops products to stay ahead of the market; specifies ingredients and raw materials for the manufacturing processes and ensures that products meet the Debtors' sensory and quality requirements and standards; led the development of the Sur La Route brand and has introduced internally-developed and joint venture to-go concepts in the stores; supervises the Cafes, Sur La Route, and the Wholesale Program; supports operational diligence efforts and efforts to ensure supply chain post-filing and amidst the COVID-19 pandemic.

KEIP Participant	Job Title	Duties/Responsibilities
8.	District Manager	Acts as District Manager for most of the Manhattan stores, one Brooklyn store, and the New Jersey stores; has sales, expense, scheduling, store merchandising, and P&L responsibility for the stores; supervises the store managers and provides leadership training and development of the store teams; supports operations diligence and transition issues related to the sale process; provides front-line leadership to stores amidst the COVID-19 pandemic.
9.	Associate Counsel	Handles all types of legal matters, *e.g.*, transactional, contract writing and review, responses to lawsuits and claims against the company, compliance matters, alleged violations, etc.; versed in various areas of the law including, but not limited to, real estate, employment discrimination, accident claims, insurance, contracts, and torts; supports buyer diligence, Asset Purchase Agreement negotiations, and various bankruptcy related filings and motions.

SCHEDULE 2

Table II: KERP Participant Information

[Schedule 2 Proposed To Be Filed Under Seal]

SCHEDULE 3

Table III: Modifications Made to the KERP

Schedule of KERP Award Modifications

KERP Participant	**Job Title**	**Modified KERP Award** (rounded to nearest dollar)
KERP Participants Who Have Resigned or Given Notice of Resignation		
(1)	Director of Specialty	($39,398)
(2)	Director of Security and Safety	($39,525)
(3)	Director of Cheese	($36,771)
(4)	Merchandising Planogram Manager	($29,942)
(5)	VP Private Label	($118,473)
KERP Participants Added in the KERP		
1	Payroll Clerk	$5,485
2	Payroll Clerk	$10,873
3	HR Manager	$14,145
4	HR Generalist / Trainer / Recruiter	$11,158
5	Category Manager Meat	$22,763
6	Director Coffee and Cheese	$17,075
7	Director Pricing and POS	$28,891
KERP Participants Since the February 20, 2020 KERP		
8	EVP Sales and Marketing	$125,000
9	Executive VP of IT	$125,000
10	Director of Accounting and Financial Reporting	$67,741
11	HRIS/Payroll Manager	$39,783
12	Accounting Manager	$29,958
13	Director of Construction	$52,015
14	Director of Applications	$47,970
15	Sr. Director Of Meat and Seafood	$46,818
16	VP Center Store	$92,500
17	Director of Human Resources	$70,383
18	Director of Retail App. Tech.	$39,784
19	E Commerce Operations	$31,518
20	Director of Dairy (add Frozen)	$20,555
21	Director of Marketing	20,046
22	Organics Category Manager	$13,736
23	VP, PDC	$112,615
24	OPS Manager PDC	$23,860
25	Executive Chef	$22,613
26	Bakery Operations Manager	$16,308
27	District Manager	$44,188
	Modified KERP Total:	**$1,152,781**
	February 20, 2020 KERP Total:	$1,301,616
	Net Change in KERP Cost:	**($148,835)**

Exhibit B

***Ditech* Transcript**

1 UNITED STATES BANKRUPTCY COURT
2 SOUTHERN DISTRICT OF NEW YORK
3 - x
4 In the Matter of:
5
6 DITECH HOLDING CORPORATION, Case No. 19-10412-jlg
7
8 Debtors.
9
10 - x
11
12 U.S. Bankruptcy Court
13 One Bowling Green
14 New York, NY 10004
15
16 April 18, 2019
17 3:20 PM
18
19 B E F O R E :
20 HON. JAMES L. GARRITY, JR.
21 U.S. BANKRUPTCY JUDGE
22
23
24
25 ECRO: Shea

1 Motion to Approve/Motion of Debtors for Entry of an Order
2 Approving Key Employee Incentive Program (Doc #228)
3
4 Objection of the United States Trustee to the Motion of
5 Debtors for Entry of an Order Approving Key Employee
6 Incentive Program (Doc #347) continued from 4/11/2019 adj
7 from 4/16/2019
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25 Transcribed by: Sherri L. Breach, CERT*D-397

1 A P P E A R A N C E S :
2 WEIL, GOTSHAL & MANGES
3 Attorneys for Debtor
4
5 BY: RAY C. SCHROCK, ESQ.
6
7 OFFICE OF THE UNITED STATES TRUSTEE
8 Attorneys for U.S. Trustee
9
10 BY: BENJAMIN HIGGINS, ESQ.
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1 P R O C E E D I N G S
2 THE COURT: Be seated, please.
3 All right. This is in Ditech Holding Corp. Case
4 Number 19-10412. This is the adjourned hearing on the
5 motion to approve a motion of the debtors for the entry of
6 an order approving a key employee incentive program.
7 The Court heard argument on this matter and then
8 adjourned it to today, and the Court will issue its ruling
9 as follows.
10 Ditech Holding Corporation, formally known as
11 Walter Investment Management Corp., and 13 of its affiliates
12 which I will collectively refer to as the debtors are
13 debtors and debtors-in-possession in these Chapter 11
14 cases./ The matter before the Court is their motion
15 pursuant to Sections 363(b)(1) and 503(c) of the Bankruptcy
16 Code seeking authority to implement a key employee incentive
17 plan which I'll refer to as the KEIP. See the debtors'
18 motion for entry of an order approving the implementation of
19 debtors' key employee incentive plan, ECF Number 228. I'll
20 refer to that as the motion.
21 In support of the motion the debtors submitted
22 declarations of Gerald A. Lombardo (ph), the debtors' chief
23 financial officer. I'll refer to that as the Lombardo
24 declaration. It's Exhibit B to the motion; and Bentum
25 Stradley (ph) of Pay Governance, LLC, or Pay Governance, the

1 debtors' compensation consultant. And I'll refer to that as
2 the Stradley declaration. And that's attached to the motion
3 at Exhibit C.
4 The Office of the United States Trustee and the
5 Geery (ph) class action object to the motion. See ECF
6 Numbers 347, which is the U.S. Trustee objection, and 335
7 which is the GCA objection.
8 Creditors Richard Laygens (ph) and Gail Laygens,
9 Matthew Bennett, Jasmine Bennett, Dawn Davis, Grace Carlton,
10 Robert T. Hall and Sally W. Hall joined in each of those
11 objections. See ECF Numbers 350 and 353.
12 The debtors filed a reply to the objections which
13 is supported by a supplemental declaration of Mr. Lombardo.
14 I'll refer to that as the supplemental Lombardo declaration.
15 That's at ECF Number 358.
16 The debtors supplemented those submissions with a
17 letter dated April 16th, 2019. I'll refer to that as the
18 April 16 letter, and that's at ECF Number 417.
19 As of the petition date the debtors have
20 outstanding debt obligations relating to certain term loans
21 which are secured by a first -- on a first lien basis by
22 substantially all the debtors assets in the principal amount
23 of approximately $961 million. I'll refer to those as the
24 term loans.
25 The debtors also have outstanding note obligations

1 in the principal amount of approximately $253 million as of
2 the petition date relating to certain notes which are
3 secured on a second lien basis on substantially all of the
4 debtors' assets and, as such, are subordinate to the term
5 loans. I'll refer to those loans as the second lien notes.
6 The ad hoc committee -- excuse me -- the ad hoc
7 group of term loan holders filed a statement in support of
8 the KEIP in the motion, essentially joining the motion and
9 the debtors' reply to the objections to the motion. See ECF
10 Number 360.
11 The Court held a hearing on the motion on April
12 11th, 2019. For the reasons set forth below the Court
13 grants the motion and respectfully overrules the objections.
14 The debtor -- debtors filed these voluntary
15 Chapter -- these voluntary cases under Chapter 11 of the
16 Bankruptcy Code on February 11th, 2019. That's the petition
17 date. The debtors, together with their non-debtor
18 subsidiaries, collectively the company, operate as an
19 independent servicer and originator of mortgage loans and
20 servicer of reverse mortgage loans. See the declaration of
21 Gerald A. Lombardo pursuant to Rule 1007-2 of Local
22 Bankruptcy Rule for the Southern District of New York.
23 That's ECF Number 2. I'll refer to that as the first day
24 declaration at paragraph 6.
25 The petition date is approximately one year after

1 Walter Investment Management Corp. or WIMC, the debtor --
2 the company's parent company merged from its pre-packaged
3 Chapter 11 case as Ditech Holding. See first day
4 declaration at paragraph 54.
5 The final decree was entered in the WIMC Chapter
6 11 case on August 14, 2018. That's the first day
7 declaration at paragraph 53.
8 WIMC's goal in its Chapter 11 case was to
9 deleverage its overleveraged capital structure sufficiently
10 to enable Ditech Holding, the reorganized debtor, to
11 implement its business plan. See the first day declaration
12 at paragraph 54.
13 Through its confirmed Chapter 11 plan, WIMC
14 eliminated more than $800 million in funded debt. That's
15 also at 54. Upon WIMC's emergence from Chapter 11 the
16 company's business plan called for it to streamline its
17 business through, among other things, operational
18 enhancements and cost reductions. First day declaration at
19 55.
20 However, even as it sought to implement that plan
21 the company faced unanticipated, persistent and wide spread
22 liquidity and performance challenges. First day declaration
23 at 55.
24 In response to those challenges and prior to the
25 commencement of these cases the debtors took a number of

1 steps to address, among other things, the impact of
2 forecasted reductions in liquidity on its compliance with
3 various loan facilities. Those steps included the
4 initiation of a process to evaluate strategic alternatives
5 to enhance value in the company. That's the Lombardo
6 declaration at paragraph 10.
7 Ditech's Holding -- Ditech Holding's board of
8 directors, which I'll refer to as the board, and a board
9 sub-committee consisting of four independent board members
10 -- I'll refer to that collectively as the special committee
11 -- directed that effort. That's Lombardo declaration at 10.
12 With the assistance of the debtors' advisors, the
13 special committee oversaw a process pursuant to which it
14 evaluated a range of potential strategic alternatives
15 including: One, the sale of the entire company; two, the
16 sale of certain assets and business platforms; three, a
17 merger; or, four, continuing as a stand-alone entity. I'll
18 refer to those as the prepetition marketing and sale
19 process. That's at Lombard declaration at 10.
20 That process spanned multiple months and involved
21 soliciting interest from 33 potentially interested parties,
22 including strategic and financial buyers with the financial
23 and operational wherewithal to complete a transaction.
24 Lombardo declaration at 10.
25 As that process was unfolding the board and

1 special committee determined that ensuring enhanced employee
2 performance would be critical for the debtors to achieve
3 their objectives of preserving and maximizing value of the
4 company for the company's stakeholders.
5 As such they took steps to abate employee
6 attrition and incentivize key employees in connection with
7 the pre-petition new sale and marketing process. See
8 Lombardo declaration at 11.
9 In or about June 2018 the board began discussing
10 an incentive program for key employees that would
11 incentivize performance during an out of court strategic --
12 out of court -- the out of court strategic review
13 negotiations with potential buyers. Lombardo declaration at
14 11.
15 As part of the strategic review and marketing
16 process the debtors, with the assistance of their advisors,
17 undertook what they describe as a deliberative and
18 innovative process to design an effective and appropriate
19 compensation program. Lombardo declaration at 11.
20 Those efforts culminated in the compensation
21 committee of the board and board's approval of a transaction
22 incentive bonus pool of $5 million in July 2018. I'll refer
23 to that as the pre-petition KEIP, and that's at Lombardo
24 declaration at 11.
25 The pre-petition KEIP was payable in two

1 installments. The first 50 percent was payable upon the
2 execution of definitive documents for a changing control
3 transaction, and the second 50 percent was payable upon the
4 compensation of a transaction subject to meeting certain
5 performance targets. See the motion for authority to (a)
6 pay employee obligations and (b) continue employee benefit
7 programs and related relief at ECF Number 13 which I'll
8 refer to as the wages motion at paragraph 41.
9 In addition to the pre-petition KEIP, in September
10 2018 the company approved $11 million in retention payments
11 to approximately 60 critical employees which required the
12 employees to remain employed by the company until October 2,
13 2019 subject to some limited exceptions. I'll refer to that
14 as the pre-petition KERP program, and that's at the wages
15 motion at paragraph 40.
16 By October 2018 it became clear to the debtors
17 that the highest bid for their business -- business would
18 not exceed the outstanding amount on the debtors' second
19 lien notes. See the first day declaration at paragraph 66.
20 From October to December 2018 the debtors
21 conducted discussions with the term lenders and second lien
22 notes regarding possible re-capitalization structures.
23 First day declaration at paragraph 66 to 68.
24 In the fall of 2018 it also became clear to the
25 debtors that it was likely that to implement a transaction

1 they would have to do so through a Chapter 11 case. See
2 Lombardo declaration at 12.
3 Accordingly, the board and compensation committee
4 reformulated the pre-petition KEIP to focus on the
5 implementation of a change of control transaction through an
6 in-court Chapter 11 process. See Lombardo declaration at
7 12. They approved the reformulated pre-petition KEIP in
8 December 2018.
9 The debtors pre-petition efforts culminated in the
10 execution of the restructuring support agreement with 80
11 percent of the term lenders who we'll refer to as the
12 consenting term lenders on February 8, 2019. See the first
13 day declaration at paragraph 9. See also the RSA which is
14 attached as Exhibit A to the first day declaration.
15 Among other things the RSA provides for a toggle
16 Chapter 11 plan, specifically the debtors agree to propose a
17 plan that in the first instance calls for the sale of all or
18 substantially all of their assets -- we'll refer to that as
19 the sale transaction -- with the sale proceeds being
20 distributed to creditors, but provides in substance that if
21 the debtors are not able to effectuate such a sale
22 transaction, the plan will call for the re-capitalization of
23 the debtors. We'll refer to that as the reorganization
24 transaction.
25 The reorganization transaction will extinguish

1 over $800 million of funded debt including the entirety of
2 the second lien notes and leave the company wholly owned by
3 the term loan -- term loan holders or the term lenders with
4 $400 million of debtors in an appropriately sixed exit
5 working capital facility. See the first day declaration at
6 paragraph 9.
7 The RSA also allows for smaller asset sale
8 transactions to boost liquidity in either toggle scenario.
9 We'll refer to that as an asset sale transaction. See first
10 day declaration at 9.
11 Upon the entry into the RSA on or about February
12 8, 2019 in accordance with the pre-petition KEIP certain
13 employees, including statutory insiders, received a first
14 installment payment in the aggregate amount of approximately
15 $2.4 million. See the Lombardo declaration at paragraph 12,
16 the wages motion at paragraph 41.
17 The debtors are not seeking approval of that $2.4
18 million payment.
19 After the petition date in consultation with the
20 consenting term lenders the debtors developed an additional
21 incentive component to the existing KEIP structure, and that
22 is the sale KEIP. See the Lombardo declaration at paragraph
23 13.
24 The motion is modified by the terms of this 6 --
25 April 16 letter requests approval of a KEIP that the debtors

1 contend is designed to incentivize key employees in the
2 event of a reorganization transaction with a toggle for a
3 sale of some or all of the debtors' assets pursuant to an
4 asset sale transaction or a sale transaction.
5 Under the KEIP 31 employees, including eight
6 employees which the debtors concede are statutory insiders
7 -- I'll refer to them as the base KEIP participants -- are
8 eligible to receive up to $2.5 million. I'll refer to that
9 as the base KEIP.
10 In addition the subset of the base KEIP
11 participants, who we'll refer to as the sale incentive
12 participants, and with the base KEIP participants, the KEIP
13 participants will be entitled to incremental awards in the
14 event of a sale and that's the sale KEIP.
15 The base KEIP is comprised of three separate
16 performance based metrics. Those targets are, first, a
17 change in control milestone which is 20 percent of the base
18 KEIP. If the debtors close a change of control transaction
19 which includes a recapitalization pursuant to the plan or
20 other strategic transaction approved by the board, which
21 we'll refer to as a change of control transaction, each base
22 KEIP participant will earn 20 percent of his or her base
23 KEIP award.
24 There's a financial performance metric in the base
25 KEIP which is worth -- which is allocated 45 percent of the

1 base KEIP award. If the debtors maintain their expenses at
2 or under forecast based on their 2019 business plan through
3 the consummation of a plan, each base -- each KEIP, base
4 KEIP participant will earn 45 percent of his or her base
5 KEIP award.
6 And finally there is the GSC adherence aspect of
7 the award which is 35 -- which is allocated 35 percent of
8 the base KEIP.
9 Would you -- for those -- for those of you who are
10 dialing in, mute your phone.
11 (Pause)
12 THE COURT: Thank you.
13 If the debtors maintain their Fannie Mae star
14 rating through the closing of the reorganization
15 transaction, each base KEIP participant will earn 15 percent
16 -- excuse me -- 35 percent of the base KEIP award.
17 The sale KEIP was formulated post-petition by the
18 debtors with the assistance of the consenting term lenders
19 and other advisors. The sale KEIP awards are tied to term
20 lender recoveries in a sale if such recoveries exceed 65
21 percent of term loan par value in such a transaction. We'll
22 refer to that as the sale KEIP threshold.
23 If the sale KEIP threshold is reached, the sale
24 KEIP will pay $2 million to the sale incentive participants.
25 Payouts incrementally increase up to the sale -- up to a

1 sale -- up to a sale price that pays the term lenders a
2 recovery of par plus accrued interest. At that point $30.1
3 million would be paid out under the sale KEIP. Each sale
4 KEIP participant will be deemed to waive his or her
5 entitlement to post-petition severance on a dollar for
6 dollar basis to the extent the sale KEIP award is actually
7 paid. See the motion at paragraph 21.
8 The sale KEIP awards are payable on top of any
9 base KEIP awards. Accordingly, upon any sale which
10 effectuates a change in control transaction the sale
11 incentive participants would be awarded with 50 -- awarded
12 with $500,000 under the base KEIP regardless of whether the
13 sale KEIP threshold is met. The base KEIP and the sale KEIP
14 share the following terms.
15 First, each KEIP participants' award is subject to
16 continued employment through the earlier of 90 days
17 following the consummation of a change of control
18 transaction or the effective date of the plan and, two,
19 October 2nd, 2019 unless a participant is terminated without
20 cause, quits for good reason or similar standard or becomes
21 disabled or dies. See the motion at paragraph 17 and 21.
22 Second, the KEIP awards will be allocated among
23 the KEIP participants according to certain allocation
24 schedules. The sale KEIP provides that the CEO -- provides
25 the CEO with 19.5 percent allocation, the CFO with a 10.5

1 percent allocation, the general counsel, chief legal
2 officer, and secretary with a 6.75 allocation, and the
3 remaining nine sale incentive participants with a 6.25
4 allocation of the sale KEIP awards.
5 That accounts for 93 percent of the award. The
6 sale KEIP provides that on five days' notice to the U.S.
7 Trustee the creditors' committee and consenting term
8 lenders, the CEO may allocate the remaining seven percent of
9 the sale KEIP awards to non-insider employees that are not
10 sale incentive participants.
11 The CEO will also have the authority to allocate
12 up to $150,000 of his sale KEIP award to sale incentive
13 participants that are employees of debtor, Reverse Mortgage
14 Solutions or RMS, to facilitate the sale of RMS to a third
15 party.
16 Finally, the term lenders will bear the cost of
17 the KEIP awards, specifically the sale KEIP awards will be
18 payable solely out of the term lenders' recovery under the
19 plan. Similarly, any base KEIP awards will be treated as a
20 distribution on account of the term loans, thus reducing the
21 term loan claims.
22 The Court notes that in assessing the merits of
23 the motion it has attached no significance to the fact that
24 the term loan lenders are bearing the cost of the awards.
25 Although the motion seeks only approval of the

1 KEIP, the debtors have additional compensation plans in
2 place and contemplate further plans as well.
3 In substance, in opposing the motion the U.S.
4 Trustee makes the following four arguments.
5 First, that the debtors have failed to prove that
6 the base KEIP is an incentive plan as opposed to a retention
7 plan.
8 Second, that to the extent the base KEIP is an
9 incentive plan the debtors have failed to meet their burden
10 of establishing that the base KEIP payments are justified by
11 the facts and circumstances of this case, primarily because
12 the debtors have already paid large prepetition bonuses.
13 Third, that the debtors have failed to prove that
14 the sale KEIP threshold is hard to reach and, therefore,
15 sufficiently incentivizing.
16 And, lastly, that the sale KEIP incentivizes the
17 sale incentive participants to put the interest of the term
18 lenders first, arguably creating a conflict of interest.
19 The GCA acknowledges that its objections are
20 substantially the same as the U.S. Trustee's and, therefore,
21 it sufficiently -- it suffices to -- solely to explain and
22 review the U.S. Trustee's objections.
23 The debtors' response bolstered by the
24 supplemental Lombardo declaration primarily argues that both
25 the base keep and sale keep are sufficiently incentivizing

1 and that both satisfy the standards of approval under the
2 requisite sections of the Bankruptcy Code.
3 Section 503(c)(1) prohibits the allowance and/or
4 payment of administrative expense claims to retain an
5 insider; that is, made to an insider with the purpose to
6 incentivize the insider to remain with the company unless:
7 "(A) The transfer obligation is essential to the
8 retention of a person because the individual has a bona fide
9 job offer from another business at the same or greater rate
10 of compensation;
11 "(B) the services provided by the person are
12 essential to the survival of the business; and
13 "(C) either:
14 "(1) the amount of the transfer made to or
15 obligation incurred for the benefit of the person is not
16 greater than an amount equal to ten times the amount of the
17 mean transfer or obligation of a similar kind given to non-
18 management employees for any purpose during the calendar
19 year in which the transfer is made or the obligation is
20 incurred; or
21 "(2) if no such similar transfers were made to or
22 obligations were incurred for the benefit of such non-
23 management employees during such calendar year, the amount
24 of the transfer or obligation is not greater than the amount
25 equal to 25 percent of the amount of any similar transfer or

1 obligation made to or incurred for the benefit of such
2 insider for any purpose during the calendar year before the
3 year in which such transfer is made or obligation is
4 incurred."
5 11 U.S.C. Section 503(c)(1). See also In re:
6 Residential Capital, LLC, 491 B.R. 73 at 82 (Bankruptcy
7 Court, SDNY 2019). I'll refer to that case as Res Cap 2.
8 Section 503(c)(1) was added as one of the PAP CPA
9 amendments in 2005. Among other things in enacting that
10 legislation Congress sought to limit the scope of key
11 employee retention plans. See Res Cap 2, 491 B.R. at 82.,
12 In re: Dana Corp. at 358 B.R. 567 at 575. It's the
13 Bankruptcy Court for the Southern District of New York 2006.
14 I'll refer to that case going forward as Dana 2.
15 Section 503(c)(1) is not applicable to payments
16 made to insiders or obligations incurred on their behalves
17 that are intended to motivate them to achieve specified
18 performance goals. See, for example, In re Res Cap 2, 491
19 B.R. at 83 to 84, In re: Aralias Fund Pharmaceuticals U.S.
20 Inc., Case Number 18-12425, 2018 Westlaw 6060356 at 3,
21 Bankruptcy Court, SDNY, November 19, 2018.
22 The debtors contend that the plans at issue here
23 are so called pay for value plans because they offer
24 incentives to the participants based on performance. Courts
25 analyze incentive plans under Sections 503(c)(3) or 363(b)

1 of the Bankruptcy Court, not Section 503(c)(1). See In re
2 Aralias Pharmaceuticals U.S. Inc., 2018 Westlaw 6060356 at
3 3.
4 Pursuant to Section 363(b)(1), "The trustee, after
5 notice and a hearing, may use, sell or lease, other than in
6 the ordinary course of business property of the estate."
7 See 11 U.S.C. Section 363(b)(1). It's well settled that
8 under this section the business judgment rule is the
9 standard for reviewing business transactions outside the
10 ordinary course of business. See In re Global Home Products
11 LLC, 369 B.R. 778 at 783 to 84 and at 787 Bankruptcy for the
12 District of Delaware 2007.
13 Section 503(c)(3) states that "transfers or
14 obligations that are outside the ordinary course of
15 business" will not be allowed unless they are "justified by
16 the facts and circumstances of the case." 11 U.S.C. Section
17 503(c)(3). See also In re Aralias Pharmaceuticals U.S.
18 Inc., 2018 Westlaw 6060356 at 3.
19 "Courts have held that the facts and circumstances
20 language in Section -- in Section 503(c)(3) creates a
21 standard that is no different than the business judgment
22 standard under Section 363(b)." In re Borders Group Inc.,
23 453 B.R. 459 at 474 (Bankruptcy Court SDNY 2011). Citations
24 omitted.
25 As noted by Judge Glenn in Borders in Dana 2 Judge

1 Lifland listed the following factors that courts consider
2 when determining if the structure of a compensation proposal
3 and the process of its development meet the business
4 judgment test.
5 One, is there a reasonable relationship between
6 the plan proposed and the results to be obtained, i.e. will
7 the key employees stay for as long as it takes for the
8 debtor to reorganize or market its assets, or in the case of
9 a performance incentive is the plan calculated to achieve
10 the desired performance;
11 Two, is the cost of the plan reasonable in the
12 context of the debtors' assets, liabilities, and earnings
13 potential;
14 Three, is the scope of the plan fair and
15 reasonable, does it apply to all employees, does it
16 discriminate unfairly;
17 Four, is the plan or proposal consistent with
18 market industry standards;
19 Five, what were the due diligence efforts of the
20 debtor in investigating the need for a plan, analyzing which
21 key employees need to be incentivized, what is available,
22 what is generally applicable in a particular industry; and
23 Six, did the debtor receive independent counsel in
24 performing due diligence and in creating and authorizing the
25 incentive compensation.

1 That's Dana 2, 358 B.R. at 576.
2 When analyzing a proposed plan for compensating
3 insiders courts conduct a two-part analysis. First, unless
4 the debtors are seeking approval of a plan under Section
5 503(c)(1) the Court must consider "Whether the KEIP is a
6 true incentive plan or instead a disguised retention plan."
7 See In re: Hawker Beechcraft Inc., 479 B.R. 308 at 312
8 (Bankruptcy Court, SDNY, 2012).
9 Second, if the proposal embodies a true incentive
10 plan the Court will apply the Dana factors to determine --
11 the Dana 2 factors to determine whether the plan represents
12 a sound exercise of the debtors' business judgment. See
13 ResCap 2, 491 B.R. at 88.
14 Debtors seeking to establish that a proposed plan
15 is an incentive plan must show by a preponderance of the
16 evidence that the proposed insider plan is not primarily for
17 retentive purposes. See In re Residential Capital LLC, 478
18 B.R. 154 at 170 (Bankruptcy Court, SDNY, 2012). I'll refer
19 to that as ResCap 1.
20 This is fundamentally a factual question. See In
21 re Velo Holdings Inc., 472 B.R. 201 at 207 (Bankruptcy,
22 SDNY, 2012).
23 In evaluating whether a plan is an incentive plan
24 courts look past the labels that debtors attach to their
25 plan. See ResCap 1, 478 B.R. at 170 to 171. See also In re

1 Dana Corp., 351 B.R. 96 at page 102, note 3 (Bankruptcy
2 Court, SDNY). We'll refer to this as Dana 1, where Judge
3 Lifland observed that "if it walks like a duck or KERP and
4 quacks like a duck or KERP, it's a duck or KERP."
5 A plan is primarily incentivizing if it presents
6 targets that are difficult to achieve, forcing the executive
7 to -- executives to work hard to achieve their bonuses. See
8 In re Aralias Pharmaceuticals Inc., 2018 Westlaw 6060356 at
9 3, internal quotations and citations omitted.
10 The plan must offer incentive -- incentives based
11 on performance, a paid for value plan rather than offering
12 pay just for remaining with the debtor, a pay for stay plan.
13 See ResCap 1, 478 B.R. at 170. See also In re: Hawker
14 Beechcraft Inc., 479 B.R. at 314 to 15. The Court denied a
15 proposed plan where the debtors failed to show "why
16 individually or as part of a team the plan participants will
17 contribute to services that are necessary to achieve the
18 targets" and where the plan proposed a payout with respect
19 to a transaction that was "bound to occur."
20 Further, a purported KEIP will not be deemed
21 retentive simply because it contains some retentive effects.
22 See In re: Aralias Pharmaceuticals U.S. 2018 Westlaw 6060356
23 at 3 quoting In re Velo Holdings Inc., 472 B.R. at 210.
24 Rather, courts take a holistic view of
25 compensation packet -- of the compensation package to

1 determine whether it is -- it's truly an incentive plan.
2 See Dana 1, 358 B.R. at 571. See also Aralias
3 Pharmaceuticals, 2018 Westlaw 6060356 at 5.
4 The Court now will turn its attention to the KEIP
5 plans before the Court.
6 As a preliminary matter in evaluating the KEIP the
7 Court must determine whether the KEIP participants are
8 statutory insiders under the Bankruptcy Code. The Court --
9 the debtors concede that eight of the base KEIP participants
10 are statutory -- are -- eight of the -- excuse me.
11 The debtors concede that eight of the base KEIP
12 participants are statutory insiders. Six of them are also
13 sale incentive participants. The insiders are the CEO, the
14 CFO, the general counsel, chief legal counsel and secretary,
15 the chief accounting officer, the senior vice-president,
16 chief human resources officer, the president of RMS, the
17 chief risk compliance officer, and the treasurer. The chief
18 risk compliance officer and the treasurer are base KEIP
19 participants, but are not sale KEIP participants. See the
20 motion at 11 and note 11.
21 Accordingly, to avoid the application of Section
22 503(c)(1) to the payments called for under the KEIP, the
23 debtors must prove that the base and sale KEIPS provide
24 incentive, incentives to the participants based upon their
25 performance and are not calculated simply to retain the KEIP

1 participants' services. If the debtors fail to meet that
2 burden, the motion must be denied because debtors have not
3 attempted to prove that the proposed payments under the KEIP
4 meet the strict standards of Section 503(c)(1). See Aralias
5 Pharmaceuticals, 2018 Westlaw 6060356 at 3.
6 We'll first focus on the base KEIP.
7 The debtors selected the base KEIP participants
8 because they "have played and will continue to play
9 significant roles in optimizing the debtors' business
10 performance, including with respect to the debtors'
11 servicing functions and meeting the ambitious financial
12 performance metrics that these Chapter 11 -- during these
13 Chapter 11 cases to allow the debtors to maximize value and
14 facilitate the successful consummation of a transaction."
15 See the motion at paragraph 17(a). See also the Lombardo
16 declaration at paragraphs 15 to 16.
17 The base KEIP provides for payments of $2.5
18 million that will be treated as payments to the term lenders
19 and call for the base KEIP participants to meet three
20 performance based metrics. With respect to the change in
21 control target, which if satisfied accounts for 20 percent
22 or half -- or $500,000 of the base KEIP award. The CFO
23 highlights the challenges associated with operating the
24 company in bankruptcy. He notes that the debtors' business
25 is "highly technical and heavily regulated. The day to day

1 responsibilities are demanding and require constant
2 communication and coordination by the debtors' employees
3 with various stakeholders, including the GSEs and Ginny Mae,
4 the debtors' warehouse lenders, special purpose entities and
5 vendors to manage customer expectation and comply with
6 industry regulations." See the supplemental Lombardo
7 declaration at paragraph 8.
8 He further stresses that the Chapter 11 cases are
9 "ongoing market -- and ongoing -- "ongoing marketing
10 processes resulted in exponential demands on the debtors'
11 employees," and that "The pressures are further challenged
12 by the reality that the debtors' employees, and in
13 particular the debtors' key employees, are being recruited
14 by headhunters." That's the supplemental Lombardo
15 declaration at 8.
16 Moreover, at the hearing the debtors' counsel
17 contended that it is a challenge for the debtors to maintain
18 and improve operations while simultaneously working towards
19 a change in control transaction. Counsel noted that it's
20 not a foregone conclusion that the debtors will meet their
21 post-petition financing covenants and that to consummate a
22 reorganization transaction the debtors must obtain exit
23 financing which still needs to be documented.
24 Counsel further noted that the challenges of
25 operating the debtors' highly regulated company in Chapter

1 11 and the added pressures of simultaneous -- of
2 simultaneously conducting the post-petition marketing
3 process have put a significant strain on the work -- on the
4 key employees.
5 The U.S. Trustee did not dispute any of those
6 contentions and did not refute, let alone challenge Mr.
7 Lombardo's testimony. Still, the U.S. Trustee argues that
8 the change of control target is not sufficiently
9 incentivizing. It is primarily retentive. See the U.S.
10 Trustee objection at 16.
11 The U.S. Trustee notes that the RSA has already
12 been negotiated and executed and $2.4 million have already
13 been paid to certain employees including insiders with
14 respect to that effort.
15 Further, the U.S. Trustee argues that the
16 confirmation of the plan will trigger the award and that the
17 met -- that metric requires the base KEIP participation --
18 base KEIP participants to remain employed with the debtors
19 and perform their basic duties as the debtors seek
20 confirmation of the plan. That's the U.S. Trustee objection
21 at 16.
22 To the U.S. Trustee's point, Courts find that
23 where an insider needs to do no more than the basic tasks of
24 operating a debtor-in-possession to receive the predominant
25 portion of a KEIP award, the KEIP is primarily retentive in

1 nature and cannot be approved under a business judgment
2 standard. That's what happened in ResCap 1 where the Court
3 rejected a purported KEIP that would vest 63 percent of the
4 KEIP awards upon the closing of two stalking horse sales
5 where the work was "largely done" pre-petition. The Court
6 reasoned:
7 "In addition to running their business, the KEIP
8 participants must engage in daily diligence and marketing
9 meetings with both the existing stalking horse bidders as
10 well as third parties who are being solicited by or who have
11 reached out to the debtors' investment bankers to
12 participate in the sale process. In addition, in order to
13 deliver a stand-alone operation the employees must ensure
14 the complete segregation of the debtors' operations and
15 eliminate any lingering independent aspects of the debtors'
16 operations with those of AFI.
17 "According to the debtors each of these
18 responsibilities requires a significant amount of time and
19 effort from the KEIP participants. They must also address a
20 myriad of significant regulatory issues and they have
21 increased day to day responsibilities meeting the
22 information and operational demands associated with the
23 simultaneous sale and bankruptcy process. The debtors
24 submitted evidence to show how the KEIP participants'
25 responsibilities and demands have increased as a result of

1 the proposed asset sales.

2 "While it is no doubt true that the requirement of

3 these Chapter 11 cases and the proposed asset sales have

4 altered or increased the work required of insiders, such

5 would also be true in virtually all Chapter 11 cases.

6 Section 503(c) requires more than increased responsibility

7 to justify increased pay for insiders."

8 See ResCap 1 at 168, internal citations and

9 footnotes omitted. See also Dana 1, 351 B.R. 96 at 99,

10 concluding that the plan -- that it was a KERP where among

11 other things it provided awards upon the effective date of a

12 plan of reorganization regardless of the outcome. And In re

13 Hawker Beechcraft Inc. 479 B.R. at 313 where in rejecting --

14 the Court rejected a KEIP where it found that "in essence,

15 the KEIP pays a bonus for consummating a plan that is likely

16 to occur."

17 That is not to say that it's never appropriate to

18 approve insider compensation plans where a portion of the

19 award vests upon the closing of a pre-negotiated

20 transaction. Indeed, the ResCap court ultimately approved

21 the revised version of the KEIP which awarded 20 percent of

22 the KEIP for the closing of the stalking horse sales tied to

23 the remainder of the KEIP to improvements to the purchase

24 price and achieving other financial and operational metrics.

25 See In re Residential Capital LLC, Case Number 12-12020, ECF

1 Number 1762 which is the revised KEIP Motion, and ECF Number
2 1854 which is the order approving the revised KEIP.
3 Similarly, in Aralias Pharmaceuticals the Court
4 approved the KEIP which provided for a portion of the KEIP
5 award to rest upon the closing of the stalking horse sales
6 and incremental awards for any increase in price. See 2018
7 Westlaw 6060356 at 3.
8 In that case the debtors and their advisors
9 started working on the KEIP prior to the petition date. On
10 the petition date the debtors signed non-binding letters of
11 intent to enter into purchase agreements to sell their
12 principal assets.
13 Those letters were later converted into proposed
14 asset purchase agreements with an aggregate price of $240
15 million. The KEIP provided that the participants would
16 receive awards equal to 18.75 percent of their annual
17 salaries if the asset sales realized between 230 and $249.99
18 million and increased awards for higher sales. The KEIP
19 also provided that the participants would receive awards
20 equal to 25 percent of their annual salaries for meeting a
21 net operating cash flow target which represented 100 percent
22 of the DIP budget and higher awards if the debtors' net
23 operating cash flow exceeded 100 percent.
24 The Aralias creditors' committee objected to the
25 KEIP arguing, among other things, that the plan was

1 primarily retentive in nature because the targets were not
2 hard to reach.
3 In over reeling the objection the Aralias Court
4 reasoned that the net operating cash flow target was hard to
5 achieve and that the KEIP incentivized the participants to
6 achieve it. The Court noted "It was not certain that the
7 debtors would be able to achieve the DIP budget projections"
8 because the KEIP participants needed to handle the
9 uncertainty created when two new generic pharmaceutical
10 companies entered the market for the debtors' most
11 profitable assets.
12 The Court further reasoned that the debtors'
13 bankruptcy effected their relationship with clients and the
14 debtors needed to work hard to maintain those relationships.
15 Similarly, the Court reasoned that the sale
16 threshold was hard to reach, notwithstanding that it would
17 be paid simply if the stalking horse sales closed.
18 The Court also found that the debtors needed to
19 work hard to convert the letters of intent into stalking
20 horse bids, which required the debtors to handle
21 intellectual property issues, obtain foreign consents, and
22 participate in diligence processes. The Court reasoned that
23 the participants would need to do similar work to prepare
24 for the auction of the assets and therefore found that the
25 asset sale targets would reward participants for that work.

1 The Court found that taken as a whole the KEIP, as
2 originally developed, is primarily incentivizing.
3 This Court is satisfied that the base KEIP is more
4 closely resembles the revised KEIP in ResCap and the KEIP in
5 Aralias. While the change in control target does tie 20
6 percent of the awards to a change in control transaction,
7 and in the RSA the debtors and term lenders agreed to a
8 reorganization transaction, the debtors still must work hard
9 to ensure that the transaction occurs. They will -- that
10 will involve navigating the challenges associated with
11 operating heavily regulated mortgage servicer in bankruptcy
12 while dual tracking a sale process. See the Lombardo
13 declaration at paragraph 23 listing the challenges and
14 concluding there's no guarantee the debtor -- that the
15 debtors will meet the performance metrics in their current
16 business environment.
17 The supplemental Lombardo declaration at
18 paragraphs 8 to 9 noting that the debtors -- that if the
19 debtors fail to satisfy assurances and cover -- and
20 covenants with the GSAs, Ginny Mae and the warehouse lenders
21 among others, the debtors' ability to timely consummate a
22 plan would be jeopardized and the results would be
23 disastrous.
24 Moreover, the debtors will need to obtain exit
25 financing to facilitate its stand-alone transaction. The

1 Court is satisfied that the base KEIP participants cannot
2 simply show up to work to earn the award. See In re Dana 2,
3 358 B.R. at 583 where the Court approved a KEIP where the
4 achievement was not a layup. Compare In re Hawker
5 Beechcraft Inc., 479 B.R. at 313 where the Court rejected a
6 KEIP which paid bonuses if the debtors consummated a stand-
7 alone plan or third party transaction where the plan was
8 bound to occur and the sale price target did not seem to be
9 much of a challenge.
10 The balance of the base KEIP of $2 million is tied
11 to the financial performance and GSC adherence targets. The
12 uncontested evidence demonstrates that those targets are
13 hard to reach. The financial performance target is achieved
14 if the debtors maintain their expenses at or under their
15 2019 business plan. The 2019 business plan provides that
16 the debtors' 2018 expenses not exceed $595.5 million. See
17 the supplemental -- Lombardo supplemental declaration at
18 paragraph 10.
19 The debtors' prior projected expenses for 2017
20 through 2019 were 927 million, 826 million, 820 million
21 respectively. To meet the financial performance target the
22 base KEIP participants must cut expenses by approximately
23 $225 million. The Court is satisfied that this is
24 sufficient -- that this is a sufficiently challenging task.
25 See the supplemental Lombardo declaration at paragraphs 10

1 to 11 with the CFO describing the target as an
2 unquestionably challenging task and listing the initiatives
3 being undertaken to achieve cost reduction including, among
4 other things, outsourcing servicing of loans, redesigning
5 customer support process, and analyzing certain leases and
6 contracts that might be rejected.
7 Compare Hawker Beechcraft Inc., 479 B.R. at 315
8 finding that a portion of the KEIP which paid bonuses based
9 on a business plan projections not incentivizing where the
10 debtors' CEO testified that the company would hit the target
11 if they didn't incur any "whoopsies" and the debtors "failed
12 to compare their pre-petition plans to the KEIP."
13 The debtors state the following with respect to
14 the Fanny Mae star rating. "S&P and Moody rate the debtors
15 as residential loan servicers. The servicing guide, Fanny
16 Mae single family published February 15, 2017 and the
17 selling guide, Fanny Mae single family published January 21,
18 2017, contain certain requirements with respect to an
19 approved Fanny Mae servicer's maintenance of minimum
20 servicer ratings. The debtors' failure to maintain
21 favorable or specified ratings could result in the debtors
22 termination as servicer and impair the debtors' ability to
23 consummate future servicing transactions.
24 "In addition, in connection with the assurances of
25 future performance negotiated between the debtors and Fanny

1 Mae, the debtors are committed to maintaining a monthly star
2 score card metric as good as or better than such metrics for
3 each separate portfolio of Fanny Mae loans serviced or
4 subserviced by Ditech as of the month ending November 30,
5 2018.
6 "A downgrade in the debtors' service -- servicer
7 rating could adversely affect the debtors' business,
8 financial condition or results of operations and the ability
9 to finance servicing advances and maintain their status as
10 an improved servicer by Fanny Mae, Freddie Mac and Ginny
11 Mae." See the motion at 8, Footnote 9.
12 The base KEIP participants will meet the GSC
13 adherence target only if the debtors maintain their Fanny
14 Mae star rating through the closing of the reorganization
15 transaction. The evidence shows that the debtors and Fanny
16 Mae are in constant communication with respect to the
17 delinquency and other recovery characteristics of the Fanny
18 Mae loan portfolio and where Fanny Mae notes performance is
19 deteriorating it requires immediate improvement. See the
20 supplemental Lombardo declaration at 14.
21 Thus, the debtors are implementing specific
22 initiatives to maintain their Fanny Mae star rating which
23 include right sizing staffing to improve collection
24 performance, developing programs to maximize loss
25 mitigation, and developing enhancement to better provide

1 reporting with respect to foreclosure activities. See the
2 supplemental Lombardo declaration at 15.
3 The maintenance of the Fanny Mae star rating is
4 not guaranteed and the base KEIP incentive -- base KEIP
5 incentivizes the base KEIP participants to successfully
6 implement initiatives to maintain that rating. See Lombardo
7 declaration at paragraph 23, the supplemental Lombardo
8 declaration at paragraphs 9 and 13.
9 Accordingly, based upon that foregoing the Court
10 finds that the base KEIP is primarily incentivizing.
11 Thus, the Court finds that the debtors have met
12 their burden of establishing that the base KEIP is a pay for
13 value incentive plan for purposes of Sections 503(c)(1) and
14 (c)(3) of the Bankruptcy Code. The Court is also satisfied
15 that by application of the Dana 2 factors the debtor has
16 demonstrated that the base KEIP is a sound exercise of the
17 debtors' business judgment.
18 First, the debtors have shown a reasonable
19 relationship exists between the base KEIP and the results to
20 be obtained. The base KEIP awards correspond to hard to
21 reach targets that are designed to preserve and maximize
22 value of the debtors' estates through the Chapter 11 cases.
23 See the supplemental Lombardo declaration at paragraph 7.
24 Second, the cost of the plan is reasonable in the
25 context of the debtors' assets, liabilities and earnings

1 potential. The 2.5 million in potential base KEIP awards
2 was set pre-petition by the compensation committee and
3 income consultation with pay governance. See the Stradley
4 declaration at paragraph 6.
5 Pay governance estimates that if the KEIP
6 participants receive the full value of their base KEIP
7 awards their total cash compensation will be comparable to
8 the -- to the 62 percent of the market when factoring in the
9 $2.4 million paid to the KEIP participants pre-petition.
10 See the Stradley declaration at 5 and at note 4.
11 Courts consider pre-petition compensation relevant
12 in approving compensation plans. See ResCap 1, 478 B.R. at
13 169, note 22, noting the concern that the KEIP participant
14 might receive more in total compensation post-petition than
15 they receive before bankruptcy.
16 At the hearing the Court noted that in its
17 analysis pay governance did not account for the payments to
18 the KEIP participants under the pre-petition KERP plans.
19 The U.S. Trustee states that based on information provided
20 to it approximately $10.8 million of the pre-petition KERP
21 program payments were paid to KEIP participants. Moreover,
22 that more than $7.3 million of the pre-petition KERP
23 payments were paid to the eight admittedly statutory
24 insiders who were KEIP participants.
25 It stands to reason that if the payments that the

1 KEIP participants have or will receive under the pre-
2 petition KERP program are accounted for, the KEIP programs
3 may well be viewed as generous relative to industry
4 standards. However, the Court finds it's significant that
5 the debtors' independent compensation committee approved the
6 KEIP awards and that the creditors' committee does not
7 object to the size of such awards, which leads the Court to
8 conclude that the potential compensation is reasonable.
9 At this point it appears that the unsecured
10 creditors may be out of the money and, as such, every
11 additional dollar of expense puts them further away from
12 obtaining a distribution through the plan. Thus, for that
13 reason and others the Court finds that the committee's
14 support of this program lends itself to the debtors'
15 contention that it is a reasonable program.
16 Third the Court is satisfied that the undisputed
17 evidence shows that the base KEIP covers the appropriate
18 number of employees, does not unfairly discriminate and was
19 the product of sufficient due diligence in consultation with
20 independent counsel and advisors. See the Lombardo
21 declaration at paragraphs 6 to 8 which discusses the
22 formulation of the KEIP with the assistance of advisors.
23 Lastly, the Court finds that the base KEIP is
24 consistent with industry standards. Accordingly, the Court
25 -- the debtors have satisfied all the Dana 2 factors and

1 thus the Court finds that the implementation of the -- of
2 base KEIP is a proper exercise of the debtors' business
3 judgment.
4 The Court then now considers the sale KEIP. The
5 sale incentive part -- the sale incentive participants were
6 selected because they were identified to have the most
7 measurable impact on the success of the sale by, among other
8 things, leveraging relationships to foster strong bids,
9 reducing expenses, developing balance sheet item analyses
10 and historical trained information to support future
11 reserves, developing a transition plan and budgets to assist
12 bidders, analyzing holdbacks from bidders to reduce or
13 eliminate them through information sharing, educating
14 bidders about the upside potentials and evaluating bids.
15 See Lombardo declaration at paragraphs 16 to 17.
16 The U.S. Trustee argues that the debtors provide
17 no information that would allow parties to determine whether
18 the sale KEIP's threshold target is hard to reach so as to
19 prove that it is not a KERP. See the U.S. Trustee objection
20 at 20. Indeed, the debtors offer nothing beyond the
21 following statement made in the Lombardo declaration with
22 respect to -- with respect to the sale KEIP:
23 "Both the performance metrics under the base KEIP
24 and the payment scale under the sale incentive were vetted
25 through an iterative process by the debtors' professionals,

1 including pay governance, members of the debtors'
2 management, reflect -- reflect input by the consenting term
3 lenders and were reviewed and recommended by the
4 compensation committee and were approved by the board to
5 ensure that the receipt of the KEIP awards demands an
6 appropriate reach from KEIP participants to drive out
7 performance, but not require unrealistic or unattainable
8 goals that would thwart the motivational purpose of the
9 KEIP. There's no guarantee that the debtors will meet the
10 performance metrics in their current business environment
11 and reach the payment scales under the sale incentives."
12 See the Lombardo declaration at paragraphs 22 to 23.
13 The debtors' burden is to demonstrate that the
14 sale KEIP is an incentive performance plan. To some extent,
15 Mr. Lombardo's uncontested testimony supports such a
16 finding. However, again, what's most significant to the
17 Court is the fact that the creditors' committee supports the
18 plan. The credit -- the committee and its members are
19 court-appointed fiduciaries. They've been actively involved
20 in the case. Based upon that involvement it's clear to the
21 Court that if the committee was not persuaded that the
22 threshold targets were reasonable; that is, difficult to
23 obtain, it would not support the program.
24 Accordingly, the Court finds that the sale KEIP is
25 primarily incentivizing and not retentive in nature. The

1 Court also finds that the sale KEIP is a proper exercise of
2 the debtors' business judgment in considering the Dana
3 factors. The sale KEIP awards are only awarded if the
4 debtor reaches the threshold which for the reasons stated
5 above the Court believe are challenging.
6 Moreover, incremental recoveries above the
7 threshold will correspond to higher rewards -- higher awards
8 and therefore the debtors are incentivized to work hard to
9 seek a value maximizing sale. See the supplemental Lombardo
10 declaration at paragraph 7.
11 The core cost of the sale KEIP is reasonable in
12 the context of the debtors' assets, liabilities and earning
13 potential. Again, while the Court expressed concern at the
14 hearing that the pay governance did not consider the effect
15 of the KERP programs that may have on the insiders' total
16 compensation, the fact that the debtors' independent
17 compensation committee approved the amount of the potential
18 KEIP awards and the creditors' committee support with that
19 award leads the Court to conclude that the potential
20 compensation is reasonable.
21 Additionally, the Court is satisfied that the
22 undisputed evidence shows that the sale KEIP covers the
23 appoint -- the appropriate number of employees and does not
24 unfairly discriminate and was the product of sufficient due
25 diligence and consultation with independent counsel and

1 advisors. See the Lombardo declarations at paragraphs 6, 8,
2 13 and 15 through 17.
3 The sale KEIP's discretionary allocation
4 provisions do not alter this finding. No party has raised
5 an objection to the sale KEIP's discretionary allocation
6 provisions. Moreover, those provisions were formulated with
7 the assistance of the debtors' advisors, were approved by
8 the compensation committee and will be payable from already
9 vested sale KEIP awards and are being made available to
10 incentivize non-insiders, non-insider employees, all RMS
11 sale incentive participants to increase sale values.
12 For the -- all of the foregoing reasons the Court
13 finds that the sale KEIP is consistent with industry
14 standards.
15 As a final point U.S. Trustee raises an objection
16 concerning a potential conflict of interest that would be
17 created if the term lenders are permitted to fund the KEIP
18 awards which it submits is entirely for the lenders'
19 benefit. The Court notes, however, that the term lenders
20 appear to be the fulcom (sic) creditors in this case. It's
21 only incidental that they will be primarily -- they will
22 primarily benefit from the KEIP's -- the KEIP participants'
23 efforts. There's nothing inherently wrong with that.
24 Further, the conflict of interest appears to be
25 overstated as the debtors can put independent directors in

1 place which will approve any sale or change in control
2 transaction to the extent that there are not already
3 independent directors in place.
4 So based upon the foregoing the Court finds that
5 the motion as modified by the April letter is granted. The
6 Court directs the debtors to please settle an order.
7 Thank you very much.
8 (Proceedings concluded at 4:19 p.m.)
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1 I N D E X

2 RULINGS

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4 DESCRIPTION PAGE

5 Motion to Approve/Motion of Debtors for Entry

6 of an Order Approving Key Employee Incentive

7 Program (Doc #228) 6

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1 C E R T I F I C A T I O N

2

3 I, Sherri L. Breach, CERT*D-397, certified that the

4 foregoing transcript is a true and accurate record of the

5 proceedings.

6

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8 ____________________________________

9 Sherri L. Breach

10 AAERT Certified Electronic Reporter & Transcriber CERT*D-397

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13 Date: April 22, 2019

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