

**IN THE UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE**

In re
Novan, Inc., *et al.*,¹

Debtors.

Chapter 11

Case No. 23-10937 (LSS)

(Jointly Administered)

Hearing Date: August 21, 2023 at 10:00 a.m.
Re Docket No. 20

**THE UNITED STATES TRUSTEE’S OBJECTION TO
DEBTORS’ MOTION FOR ENTRY OF AN ORDER
(I) APPROVING DEBTORS’ KEY EMPLOYEE INCENTIVE PROGRAM
AND (II) GRANTING CERTAIN RELATED RELIEF**

Andrew R. Vara, the United States Trustee for Regions 3 and 9 (“U.S. Trustee”), files this objection (“Objection”) to the *Debtors’ Motion for Entry of an Order (I) Approving Debtors’ Key Employee Incentive Program and (II) Granting Certain Related Relief* (the “Motion”) [D.I. 20], and in support of that Objection states:

PRELIMINARY STATEMENT

1. The Debtors seek Court approval of what they term a Key Employee Incentive Program (“KEIP”), but which is actually a retention program that seeks to pay \$175,000 each to the Debtors’ CEO and the Debtors’ CFO.² The sole “metric” that the CEO and CFO need to meet to entitle them to the KEIP payments is “the closing of the Ligand Stalking Horse APA or any other asset purchase agreement for the sale of the Debtors’ assets that contemplates a purchase price of equivalent or greater value.” Mot. ¶ 17.

¹ The Debtors in these chapter 11 cases, along with the last four digitals of the Debtors’ federal tax identification number (if applicable), are: Novan, Inc. (7682) and EPI Health, LLC (9118). The corporate headquarters and the mailing address for the Debtors is 4020 Stirrup Creek Drive, Suite 110, Durham, NC 27703.

² Capitalized terms not defined herein shall have the meanings ascribed to them in the Motion.



2. This supposed “metric” is illusory. Bonuses are to be paid simply upon the closing of a sale already in hand as of July 17, 2023 (the “Petition Date”), the date of their bankruptcy filings. Therefore, from and after the Petition Date, there is nothing the KEIP participants needed to do to earn the KEIP bonuses, other than remain employed by the Debtors and perform their jobs through the closing of the sales.

3. In addition, without providing any detail regarding severance payments, the Debtors seek the following relief: “The Debtors are authorized, but not directed, to continue payments under their usual severance policies and practices to the KEIP Participants, subject to the limitations of section 503(c) of the Bankruptcy Code.” Mot. Ex. A (Proposed Order) ¶ 5. Absent a record that such severance is permissible under section 503(c)(2) of title 11, United States Code (the “Bankruptcy Code” or “Code”), such payments cannot be approved.

4. For these reasons, set forth in more detail below, the Debtors’ Motion should be denied.

JURISDICTION & STANDING

5. Under (i) 28 U.S.C. § 1334, (ii) applicable order(s) of the United States District Court for the District of Delaware issued pursuant to 28 U.S.C. § 157(a), and (iii) 28 U.S.C. § 157(b)(2), this Court has jurisdiction to hear and determine the Motion and this Objection.

6. The U.S. Trustee is charged with overseeing the administration of Chapter 11 cases filed in this judicial district, pursuant to 28 U.S.C. § 586. This duty is part of the U.S. Trustee’s overarching responsibility to enforce the bankruptcy laws as written by Congress and interpreted by the courts to guard against abuse and over-reaching to assure fairness in the process and adherence to the provisions of the Bankruptcy Code. *See In re United Artists*

Theatre Co., 315 F.3d 217, 225 (3d Cir. 2003) (“U.S. Trustees are officers of the Department of Justice who protect the public interest by aiding bankruptcy judges in monitoring certain aspects of bankruptcy proceedings.”); *United States Trustee v. Columbia Gas Sys., Inc. (In re Columbia Gas Sys., Inc.)*, 33 F.3d 294, 298 (3d Cir. 1994) (“It is precisely because the statute gives the U.S. Trustee duties to protect the public interest . . . that the Trustee has standing to attempt to prevent circumvention of that responsibility.”); *Morgenstern v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 898 F.2d 498, 499 (6th Cir. 1990) (“As Congress has stated, the U.S. trustees are responsible for ‘protecting the public interest and ensuring that the bankruptcy cases are conducted according to [the] law’”).

7. Under section 307 of title 11 of the Bankruptcy Code, the United States Trustee has standing to be heard on the Motion and the issues raised in this Objection.

BACKGROUND

8. On the Petition Date, the Debtors filed the voluntary petitions for relief under chapter 11 of the Bankruptcy Code which initiated the above-captioned cases (the “Chapter 11 Cases”).

9. The Debtors remain in possession of their assets and continue to manage their business as debtors-in-possession pursuant to sections 1107 and 1108 of the Bankruptcy Code. As of the date hereof, no trustee, examiner or official committee of unsecured creditors has been appointed in these Chapter 11 Cases.

10. On the Petition Date, the Debtors entered into the Ligand Stalking Horse APA and filed the *Motion of Debtors for Entry of Orders (I)(A) Approving Bidding Procedures for Sale of Substantially all of Debtors’ Assets Free and Clear of Liens, Claims, Interests, and Encumbrances and Designating Ligand Pharmaceuticals as a Stalking Horse Bidder, (B)*

Scheduling an Auction and Approving the Form and Manner of Notice Thereof, (C) Approving Assumption and Assignment Procedures and (D) Scheduling a Sale Hearing and Approving the Form and Manner of Notice Thereof; (II)(A) Approving the Sale of the Debtors' Assets Free and Clear of Liens, Claims, Interests, and Encumbrances after the Auction and (B) Approving the Assumption and Assignment of Executory Contracts and Unexpired Leases; and (III) In the Alternative, Approving the Sale of the Debtors' Assets Free and Clear of Liens, Claims, Interests, and Encumbrances to Ligand Pharmaceuticals if not Approved as the Stalking Horse Bidder (the "Sale Motion") [D.I. 16].

11. Under the Ligand Stalking Horse APA, Ligand proposes to purchase substantially all of the Debtors' assets for \$15 million. While the APA is subject to higher and better offers, the Ligand Stalking Horse APA requires that such offers must include the assumption of the Royalty Agreement by any bidder other than Ligand. Sale Mot. Ex. 1 to Ex. B (APA) Art. 1 (definitions of "Conversion Trigger Event" and "Qualified Bid") and Art. 5.2(i). If the Court does not approve either the DIP Order or the Sales Procedures Order, then the APA requires the Debtors to use their reasonable best efforts to obtain an order approving the APA as a "private sale," not subject to overbids. *Id.*

12. The hearing on the bidding procedures relief sought in the Sale Motion, or the approval of the private sale to Ligand if the Conversion Trigger event occurs, is scheduled for August 16, 2023.

13. Also on the Petition Date, the Debtors filed the present Motion, seeking to approve KEIP payments to be earned simply upon the closing of a sale of substantially all of the Debtors' assets, pursuant to the Ligand Stalking Horse APA or otherwise.

14. The KEIP proposed by the Debtors covers just two employees of the Debtors, the CEO and the CFO. Mot. ¶ 16. Each will receive a payment of \$175,000 if a sale of substantially all of the Debtors' assets for an amount equal to/more than the purchase price anticipated by the Ligand Stalking Horse APA closes. *Id.* ¶ 17.

15. If the KEIP Participant voluntarily resigns before the sale closes, is terminated for cause prior to the sale closing, or accepts an offer of employment with the purchaser of the Debtors' assets, the KEIP Payment will not be made to such Participant. Furthermore, the KEIP Payment, net of payroll related taxes and insurance withholdings, will be subject to avoidance if the KEIP Participant voluntarily terminates employment or the KEIP Participant's employment is terminated for cause before either the effective date of a chapter 11 plan or the date upon which the Debtors' management team informs the KEIP Participant that their services are no longer needed. *Id.* ¶ 18.

16. The Motion also informs the Court that the KEIP Participants "will continue to be eligible for severance benefits in accordance with the Debtors' usual policies and practices and subject to the limitations of the Bankruptcy Code." *Id.* ¶ 19. The Motion provides no detail regarding the severance benefits to which KEIP Participants are eligible to receive.

ARGUMENT

Statutory Framework and Burden of Proof

17. Section 503(c)(1) of the Bankruptcy Code prohibits any "transfer made to, or an obligation incurred for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtors' business, absent a finding by the court based on evidence in the record" of the following:

- (A) the transfer or obligation is essential to retention of the person because the individual has a ***bona fide job offer*** from another business at the same or greater rate of compensation;

- (B) the services provided by the person are *essential to the survival of the business; and*
- (C) either—
 - (i) the amount of the transfer made to, or obligation incurred for the benefit of, the person is not greater than an amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made or the obligation is incurred; *or*
 - (ii) if no such similar transfers were made to, or obligations were incurred for the benefit of, such nonmanagement employees during such calendar year, the amount of the transfer or obligation *is not greater than an amount equal to 25 percent of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider for any purpose during the calendar year before the year in which such transfer is made or obligation is incurred.*

11 U.S.C. § 503(c)(1) (emphasis added).

18. Congress added section 503(c) to the Bankruptcy Code in 2005 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act to “eradicate the notion that executives were entitled to bonuses simply for staying with the Company through the bankruptcy process.” *In re Global Home Prods., LLC*, 369 B.R. 778, 784 (Bankr. D. Del. 2007) (citations omitted); *see also In re Residential Cap., LLC*, 478 B.R. 154, 169 (Bankr. S.D.N.Y. 2012) (“[I]t is widely acknowledged that the amendment was a response to perceived abuses of the bankruptcy system by ‘the executives of giant companies . . . who lined their own pockets, but left thousands of employees and retirees out in the cold.’”); *In re Nellson Nutraceutical, Inc.*, 369 B.R. 787, 800 (Bankr. D. Del. 2007) (*quoting In re Dana Corp.*, 358 B.R. 567, 575 (Bankr. S.D.N.Y. 2006) (“Dana II”) and Statement of Senator Edward Kennedy (March 1, 2005)).

19. Under Section 503(c), insider retention plans and severance plans are “severely restricted.” *Global Home Prods.*, 369 B.R. at 785. Courts should examine bonus plans “mindful of the practice that Congress sought to eradicate and . . . determine whether the

proposed targets are designed to motivate insiders to rise to a challenge or merely report to work.” *In re Hawker Beechcraft, Inc.*, 479 B.R. 308, 313 (Bankr. S.D.N.Y. 2012).

20. The Debtors, as the proponents of a bonus plan, have the burden of providing evidentiary support to establish that their bonus program is not a disguised retention plan governed by section 503(c)(1). *Hawker Beechcraft*, 479 B.R. at 314 (“[t]he proponent of the KEIP bears the burden of proving that the plan is not a retention plan governed by § 503(c)(1)”); *Residential Cap.*, 478 B.R. at 170 (“In order to show that the more permissive section 503(c)(3) applies, the Debtors must establish by a preponderance of the evidence that the [KEIP] is primarily incentivizing and not primarily retentive.”); *In re Mesa Air Group, Inc.*, No. 10-10018, 2010 WL 3810899, at *3 (Bankr. S.D.N.Y. Sept. 24, 2012); *In re Dana Corp.*, 351 B.R. 96, 102 (Bankr. S.D.N.Y. 2006) (“Dana I”); *Global Home Prods.*, 369 B.R. at 783-85.

21. The label a debtor gives to a bonus plan “must be viewed with skepticism; the circumstances under which the proposal is made and the structure of the compensation package control” whether Code section 503(c)(1) applies. *Residential Cap.*, 478 B.R. at 170.

The Debtors Have Failed to Satisfy Their Evidentiary Burden That the KEIP Is Incentivizing

22. The terms of the KEIP demonstrate that is not intended to induce a particular level of performance by the Debtors’ insiders, but instead is intended to induce them to remain employed until the closing of the sales of the Debtors’ assets.

23. For a bonus plan to be incentivizing, it should be tied to significant goals that are difficult to achieve. *See, e.g., Dana II*, 358 B.R. at 583 (court approved long-term incentive plan where benchmarks were “difficult targets to reach and [were] clearly not ‘lay-ups’”); *Hawker Beechcraft*, 479 B.R. at 313-15 (court rejected proposed bonus plan where lowest levels of proposed metrics were “well within reach”); *Residential Cap.*, 478 B.R. at 171-

72 (court rejected proposed bonus plan where participants had to remain employed by debtors to receive payment, and there was a lack of challenging performance metrics). There is no reward for maintaining the status quo.

24. *Residential Capital* is especially instructive, as it addressed a bonus that was based on sale price, as is the structure here. As set forth by the Court in that case, “triggering bonus awards solely on the basis of a *sale transaction*, confirming a reorganization plan or exiting bankruptcy are not sufficient to shift consideration of a plan providing for payment to insiders from section 503(c)(1) to section 503(c)(3).” 478 B.R. at 172 (emphasis added). The Court further found that, “absent requiring additional challenging performance metrics, the largest component of the KEIP is primarily retentive” because the only thing the KEIP participants had to do to receive their award was to remain with the debtors’ businesses until the closing of asset sales that were substantially negotiated pre-petition. *Id.*

25. In the present cases, the Debtors could have structured the KEIP so that a bonus would be earned only upon achieving a sale price in excess of the price that was locked in by the Ligand Stalking Horse APA and that would constitute a “reach,” thereby incentivizing the participants to produce a tangible result: higher bids. However, the KEIP lacks any meaningful performance thresholds, as it guarantees bonus payments to the KEIP Participants simply upon closing of a sale already in hand on the Petition Date. Similar to *Residential Capital*, the only thing the KEIP participants need to do to earn their bonuses is to remain in the employ of the Debtors until the closing of the sales of the various business units, and continue to perform their jobs. As such, the KEIP’s primarily purpose is retentive -- not incentive. *See Residential Cap.*, 478 B.R. at 172.

26. In the Motion, the Debtors also argue that the KEIP is justified because the KEIP Participants “must be sufficiently incentivized to *continue performing their crucial job functions*, given that they are tasked with not only navigating the Sale Process, but also remaining responsible for the normal day-to-day management of the Debtors’ business during these cases.” Mot. ¶ 21 (emphasis added). They further argue that the KEIP Participants will be taking on duties that are “[i]n addition to their day-to-day responsibilities and the additional tasks associated with facilitating these Chapter 11 Cases” because KEIP Participants will be “meeting with potential third-party buyers, assisting in due diligence and resolving other sale-related issues of potential buyers.” Mot. ¶ 28. Being responsible for day-to-day management, taking on tasks associated with facilitating these Chapter 11 Cases, meeting with third-party buyers and assisting with due diligence is part of the jobs of these executives. In addition, the activities to bring the sale to a closing will mostly be handled by the Debtors’ professionals. Section 503(c) of the Bankruptcy Code “requires more than increased responsibilities to justify increased pay for insiders.” *Residential Cap.*, 478 B.R. at 168.

The Debtors Have Not Provided Sufficient Information to Determine Whether the KEIP Meets the Requirements of Code Section 503(c)(1)

27. As demonstrated above, the Debtors have failed to meet their burden to establish that the KEIP is primarily incentivizing in nature. Therefore, with respect to each of the KEIP participants that are insiders, the KEIP must comply with section 503(c)(1) of the Code.

28. To comply with 503(c)(1), the Debtors must demonstrate three elements as to each “insider” who is to receive a bonus: (A) that they have a “bona fide job offer from another business at the same or greater rate of compensation;” (B) that “the services provided by the person are essential to the survival of the business;” and (C) that the amount to be paid to

each insider is either “not greater than an amount equal to 10 times the amount of the mean transfer of obligation of a similar kind given to nonmanagement employees” during that calendar year, or, if no bonus payments are made to nonmanagement employees during such calendar year, then the amount to be paid to each insider shall not be “greater than an amount equal to 25 percent of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider” during the prior calendar year. 11 U.S.C. § 503(c)(1)(A - C).

29. As to the first required element of 503(c)(1), the Debtors have yet to introduce any evidence that any of the insider KEIP participants have a “bona fide job offer from another business at the same or greater rate of compensation.”

30. As to the second element, the Debtors have asserted in the Motion that all of the services provided by the KEIP Participants are essential, but have yet to provide any evidence of the same.

31. As to the third element, no evidence has been provided regarding any bonuses provided to non-management employees during the calendar year.

The Debtors Have Not Provided Sufficient Information to Establish That the KEIP Meets the Requirements of Code Section 503(c)(3)

32. Even if the Court were to determine that some portion of the KEIP bonuses were incentivizing in nature, the Debtors would still have to establish that the requirements of section 503(c)(3) of the Bankruptcy Code are met with respect to any such portion of the KEIP. Section 503(c)(3) provides that:

Notwithstanding subsection (b), there shall neither be allowed nor paid –

.....

other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition.

11 U.S.C. § 503(c)(3).

33. In enacting Code section 503(c), Congress clarified and specifically limited what might otherwise be allowed as an administrative expense under section 503(b).

Section 503(b) of the Bankruptcy Code provides that:

(b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502 (f) of this title, including—

(1)(A) the actual, necessary costs and expenses of preserving the estate including—

(i) *wages, salaries, and commissions for services rendered after the commencement of the case;*

11 U.S.C. § 503(b) (emphasis added).

34. Administrative expenses may not be allowed unless they are actual and necessary to preserve the estate. *In re Unidigital, Inc.*, 262 B.R. 283, 288 (Bankr. D. Del. 2001). In order to hold administrative expenses to a minimum and to maximize the value of an estate, section 503(b) is narrowly construed. *See, e.g., In re N.P. Min. Co., Inc.*, 963 F.2d 1449, 1454 (11th Cir. 1992); *In re Philadelphia Mortgage Trust*, 117 B.R. 820, 828 (Bankr. E.D. Pa. 1990). To qualify for administrative priority status, an expense must arise from a transaction that accorded the estate an actual benefit. *Insilco Techs.*, 309 B.R. 111, 114 (Bankr. D. Del. 2004) (citing *Calpine Corp. v. O'Brien Envtl. Energy, Inc. (In re O'Brien Envtl. Energy, Inc.)*, 181 F.3d 527, 532-533 (3d Cir. 1999) and *In re Unidigital, Inc.*, 262 B.R. 283, 288 (Bankr. D. Del. 2001).

35. Thus, if the Court were to determine that some portion of the Debtors' KEIP was incentive-based, the Debtors would have to demonstrate that such incentive bonuses are necessary to preserve the value of the Debtors' estates under § 503(b) and are "justified by the facts and circumstances of the case" under section 503(c)(3). The Court must make an

independent determination that any bonuses to insiders that are truly incentive-based are justified by the facts and circumstances of the case, rather than deferring to the Debtors' business judgment.

36. The Debtors argue that the KEIP meets the requirements of section 503(c)(3) of the Code by citing to the factors set forth in *In re Global Home Products*, 369 B.R. 778, 786 (Bankr. D. Del. 2007). Mot. ¶ 37. However, the Debtors must introduce sufficient evidence to establish these factors, which they have failed to do. Because (a) the Court must first find that the KEIP is incentivizing (which it is not) and (b) an evidentiary predicate establishing that the KEIP is justified by the facts and circumstances of the cases must then be made, the U.S. Trustee reserves argument on this point until the record at the hearing on the Motion is closed.

Insider Severance Payments Should Neither Be Authorized Nor Approved

37. Section 503(c)(2) of the Bankruptcy Code provides that no administrative expense claim shall be allowed or paid for a severance payment to an insider unless “(A) the payment is part of a program that is generally applicable to all full-time employees; and (B) the amount of the payment is not greater than 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made.”

38. The Motion includes no information about any severance program applicable to insiders or non-insiders, the amount of severance payments made to nonmanagement employees during the present calendar year, or the proposed severance payments to the CEO and COO. As such, the order should not authorize any severance payments to any insider.

CONCLUSION

39. As the Debtors have failed to meet their burden to show that the KEIP is not a retention bonus plan, the Debtors must establish that the KEIP complies with the requirements of § 503(c)(1) of the Code. The Debtors have not done so, and therefore the Motion should be denied.

40. The U.S. Trustee reserves any and all rights, remedies and obligations to, among other things, complement, supplement, augment, alter or modify this Objection, file an appropriate motion, or conduct any and all discovery as may be deemed necessary or as may be required and to assert such other grounds as may become apparent upon further factual discovery.

WHEREFORE, the U.S. Trustee requests that this Court deny the Motion with respect to the proposed KEIP and grant such other relief as this Court deems appropriate, fair and just.

Dated: August 15, 2023
Wilmington, Delaware

Respectfully submitted,

ANDREW R. VARA
UNITED STATES TRUSTEE

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CERTIFICATE OF SERVICE

I hereby certify that on August 15, 2023, I electronically filed *The United States Trustee’s Objection to Debtors’ Motion for Entry of an Order (I) Approving Debtors’ Key Employee Incentive Program and (II) Granting Certain Related Relief* with the Clerk of this Court using the CM/ECF system which will send notification of such filing to all ECF registrants in this case.

I further certify that the foregoing was emailed to the following:

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