IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	:	Chapter 11
	:	
A123 SYSTEMS, INC., *et al.*,	:	Case No. 12-12859 (KJC)
	:	
Debtors.[1]	:	**Hearing Date: 11/8/12 at 10:00 a .m.**
	:	**Objection Deadline: 11/2/12 at 4:00 p.m.**
	:	**Extended by Agreement to 11/6/12 at 11:00 a.m.**

UNITED STATES TRUSTEE'S OBJECTION TO DEBTORS' MOTION FOR ORDER APPROVING (I) KEY EMPLOYEE INCENTIVE PLAN, (II) KEY EMPLOYEE RETENTION PLAN AND (III) POSTPETITION SEVERANCE PLAN (D.I. 108)

In support of her Objection to the Debtors' Motion for an Order Approving (I) a Key Employee Incentive Plan, (II) a Key Employee Retention Plan and (III) a Postpetition Severance Plan (the "Motion"), Roberta A. DeAngelis, United States Trustee for Region 3 ("U.S. Trustee"), by undersigned counsel, avers as follows:

1. This Court has jurisdiction to hear this Objection.

2. Pursuant to 28 U.S.C. § 586, the U.S. Trustee is charged with overseeing the administration of Chapter 11 cases filed in this judicial district. 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. *See United States Trustee v. Columbia Gas Sys., Inc. (In re Columbia Gas Sys., Inc.)*, 33 F.3d 294, 295-96 (3d Cir. 1994) (noting that U.S. Trustee has "public interest standing" under 11 U.S.C. § 307, which goes beyond mere pecuniary interest); *Morgenstern v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 898 F.2d 498, 500 (6th Cir. 1990) (describing the UST as a "watchdog").

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[1] The Debtors in these Chapter 11 Cases, along with the last four digits of each Debtor's federal tax identification number, are: A123 Systems, Inc. (3876); A123 Securities Corporation (5388); and Grid Storage Holdings, LLC (N/A). The above-captioned Debtors' mailing address is c/o A123 Systems, Inc., 200 West Street, Waltham, Massachusetts 02451.

3. In furtherance of her case supervisory responsibilities, as well as pursuant to 11 U.S.C. § 307, the U.S. Trustee has standing to raise and be heard on this Objection.

4. The Debtors filed these jointly administered cases on October 16, 2012 (the "Petition Date").

5. The U.S. Trustee appointed an official committee of unsecured creditors ("Creditors' Committee") on November 2, 2012.

6. On October 19, 2012, the Debtors filed the instant Motion, seeking approval of (a) a Key Employee Incentive Plan ("KEIP") for 10 named employees, most or all of whom are insiders, (b) a Key Employee Retention Plan ("KERP") for 66 named employees whom the Debtors allege are not insiders,[2] and (c) a postpetition severance plan for all full-time employees that mirrors the Debtors' prepetition, ordinary course of business severance plan, subject to certain additional restrictions, including those under 11 U.S.C. § 503(c)(2).

7. The Motion states that it is critically important to the sale process that their key employees remain with the Debtors (Motion, ¶13), and further states that the "KEIP, the KERP and the Severance Plan have been designed to achieve the objective of continuing employment within the parameters of Bankruptcy Code Section 503(c)…" Motion, ¶ 14.

8. The U.S. Trustee does not assert a position with respect to the proposed postpetition severance plan, provided that any severance payments to insiders comply with 11 U.S.C. § 503(c)(2).

9. The Motion does not set forth adequate information regarding the 66 employees named as KERP participants for the U.S. Trustee to determine that none of the participants is an

[2] The Debtors also seek authority to establish a $300,000 discretionary KERP pool to cover additional key employees who are neither insiders nor KERP participants.

insider. As the Debtors acknowledge in the Motion, certain of the participants hold job titles which suggest insider status. The U.S. Trustee leaves the Debtors to their burden of proof at the hearing on the Motion, reserving the rights to seek additional information regarding such participants before the hearing and to cross-examine representatives of the Debtors at the hearing.

10. The proposed KEIP raises several concerns regarding whether it is designed primarily to induce key employees to remain in the Debtors' employ or instead to induce higher performance by those employees.

(a) The statements in paragraphs 13 and 14 of the Motion indicate that the KEIP is intended in large part to induce key employees to remain in the Debtors' employ through the completion of the sale of 85% of their assets.

(b) Moreover, key employees can earn payments under the KEIP only if (i) they remain employed by the Debtors on the date the 85% asset sales threshold is met, or (ii) have been terminated without cause prior to that date.

(c) The primarily retentive intent of the KEIP is further supported by the Debtors' discussion regarding the KERP, which they expressly acknowledge to be a retention plan. In footnote 6 of the Motion, the Debtors "reserve the right to move any KERP Participant who is found to be an insider out of the KERP and into the KEIP."

11. According to the Motion, the Debtors propose to pay approximately nine key employees,[3] all or most of whom appear to be insiders, incentive payments based on two equally weighted bonuses that are collectively "targeted" at 100% of each participant's annual salary.

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[3] The Debtors have advised counsel for the U.S. Trustee that they now anticipate ten KEIP participants.

12. The first bonus, designated as an Asset Sale Bonus, provides for bonus payments based on the gross proceeds received by the Debtors upon sale of 85% or more of their assets.

(a) For gross proceeds under $150 million, no bonus would be paid.

(b) For gross proceeds of $150 million, the Asset Percentage would be 50% of the weighted target bonus (*i.e.*, 25% of annual salary).

(c) For gross proceeds between $150 million and $200 million, each $1 million increase in proceeds would yield a 1% increase in the Asset Percentage, so gross proceeds of $200 million would yield 100% of the weighted target bonus (50% of annual salary).

(d) For gross proceeds between $200 million and $250 million, each $1 million increase in proceeds would yield a 1.5% increase in the Asset Percentage, so gross proceeds of $250 million would yield 175% of the weighted target bonus (87.5% of annual salary).

(e) For gross proceeds over $250 million, each $1 million increase in proceeds would yield a further 1% increase in the Asset Percentage, or an additional 0.5% of annual salary.

(f) There is no upper limit on the Asset Percentage. Thus, while the Motion suggest that the maximum Asset Percentage would be 175% (87.5% of annual salary) based on gross proceeds of $250 million, a sale of the Debtors' assets for $500 million would yield an Asset Percentage of 425% (212.5% of annual salary).

13. The second bonus is designated as a DIP Budget Bonus, and provides for bonus payments based on the Debtors' Cash Liquidity on the earlier of December 30, 2012 or the date on which the Debtors complete the sale of 85% of their assets. "Cash Liquidity" is defined as

total liquidity on a book cash basis (cash in bank less outstanding checks) plus any unused availability under the DIP credit agreement. The DIP Budget Target is $12,000,994.[4]

(a) If Cash Liquidity as a percentage of the DIP Budget Target (the "Cash Liquidity Percentage") is below 80% on the determination date, no bonus would be paid.

(i) For a Cash Liquidity Percentage of 80%, the DIP Budget Percentage would be 50% of the weighted target bonus (*i.e.*, 25% of annual salary).

(ii) For a Cash Liquidity Percentage between 80% and 90%, each 1% increase would yield a 3% increase in the DIP Budget Percentage, so that a Cash Liquidity Percentage of 90% would yield 80% of the weighted target bonus (40% of annual salary).

(iii) For a Cash Liquidity Percentage between 90% and 100%, each 1% increase would yield a 2% increase in the DIP Budget Percentage, so that a Cash Liquidity Percentage of 100% would yield 100% of the weighted target bonus (50% of annual salary).

(iv) For a Cash Liquidity Percentage between 100% and 130%, each 1% increase would yield a 0.8333% increase in the DIP Budget Percentage, so that a Cash Liquidity Percentage of 130% would yield 125% of the weighted target bonus (62.5% of annual salary).

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[4] Section 6.12 of the DIP Credit Agreement between the Debtors and Wanxiang Group (which replaced the original DIP lender, Johnson controls, Inc.), requires that the Debtors "maintain on deposit in the United States cash in an aggregate amount equal to not less than $10,000,000." Because the Motion was filed before the change of DIP lenders from Johnson Controls, Inc. to Wanxiang Group, it is not clear whether the DIP Budget Target remains at $12,000,994.

(v) For a Cash Liquidity Percentage between 130% and 150%, each 1% increase would yield a 2.5% increase in the DIP Budget Percentage, so that Cash Liquidity Percentages of 140% and 150% would yield 150% and 175%, respectively, of the weighted target bonus (75% and 87.5%, respectively, of annual salary).

14. Bonuses payable under the KEIP are subject to reduction by any other performance bonus, retention bonus or severance pay otherwise payable to a KEIP participant.

15. The Motion does not provide sufficient information regarding the degree of difficulty of achieving the Asset Sale Bonus. While the Motion asserts that the KEIP has "challenging performance targets that will not be easily met," the facts suggest otherwise.

(a) On the Petition Date, the Debtors had already received a $125 million stalking horse bid from Johnson Controls, Inc. for only their automotive assets, and the Debtors have received strong indications of interest and intention to bid on those assets from Wanxiang Group.

(b) The sale of the Debtors' automotive assets will not strip the "crown jewels" from the estate and leave only scraps; to the contrary, even after the sale of the Debtors' automotive assets, the Debtors estate will hold substantial assets in their electrical grid and commercial battery business lines.

16. When a KEIP sets the performance bar so low that the lowest targets are well within reach, it is a not a true incentive plan; it is a disguised retention plan. *In re Hawker Beechcraft, Inc.*, ___B.R. ___, 2012 WL 3637251, *5 & n.7 (Bankr. S.D.N.Y. August 24, 2012) (noting that while targets were not "lay-ups", "they are more like free throws than half court flings at the buzzer").

17. Here, setting a minimum gross proceeds target of only $150 million to qualify for an Asset Sale Bonus sets the performance bar too low; the target is within easy reach and participants will not be required to "stretch" to reach it. Whether one describes the minimum target as a "lay-up" (*see In re Dana Corp.*, 358 B.R. 567, 583 (Bankr. S.D.N.Y. 2006)) or as a "free throw" (*see Hawker Beechcraft, supra*), the Asset Sale Bonus is virtually-risk free to KEIP participants.

18. Similarly, the Motion does not provide sufficient information regarding the degree of difficulty of achieving the DIP Budget Bonus.

(a) Debtor in Possession financing agreements virtually always impose budget requirements and constraints on a debtor, including liquidity covenants. In this case, the DIP Credit Agreement with Wanxiang Group provides contains a cash liquidity covenant in Section 6.12.

(b) Where a DIP financing agreement already imposes financial covenant obligations, failure to comply with those covenants is an event of default, and the milestone of "not defaulting" is an illusory goal; it amounts to a virtually guaranteed bonus payment for doing what the Debtor are already contractually obligated to do.

(c) A DIP Budget Bonus that becomes payable only upon significantly exceeding the DIP Budget Target might impose a degree of difficulty sufficient to justify a bonus payment. Here, however, the bar is set too low, as a DIP Budget Bonus would be payable even if the Debtors only achieved 80% of the DIP Budget Target.

19. In addition to advocating for performance target levels that are insufficient to justify payment of incentive bonuses, the Motion articulates an incorrect legal standard for evaluation of the KEIP. Although the Debtors acknowledge that the KEIP is subject to Section

503(c)(3), they argue that the applicable standard is the business judgment rule. In this regard, the Motion ignores and fails to accord proper meaning to the restrictions imposed by Bankruptcy Code Section 503(c)(3). The Debtors are seeking authority to incur an administrative expense for the KEIP. Section 503(c) represents a legislative effort to rein in unbridled severance, retention and other payments that deplete estates. The introduction to Section 503(c) is telling. It states in relevant part:

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

The provision was specifically enacted as an amendment to Section 503 by Section 331 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). In enacting Section 503(c), Congress clarified and specifically limited what might otherwise be allowed as an administrative expense under Section 503(b).

20. Section 503(b)(1)(A)(i) provides in relevant part that after notice and a hearing, the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case shall be allowed as an administrative expense.

21. Administrative expenses are given priority status and paid ahead of other unsecured claims. See 11 U.S.C. § 507. *In re Insilco Technologies, Inc.*, 309 B.R. 111,114 (Bankr. D. Del. 2004). 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 (11^{th} 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 Technologies, supra, 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). The Debtors' assertion that the KEIP is governed by the business judgment rule ignores the pivotal holding of *O'Brien Envtl. Energy, Inc., supra*, that the allowability of administrative expenses "depends upon the requesting party's ability to show that [were] actually necessary to preserve the value of the estate. Therefore, we conclude that *the business judgment rule should not be applied as such in the bankruptcy context*. Nonetheless, the considerations that underlie the debtor's judgment may be relevant to the Bankruptcy Court's determination …." 181 F.3d at 535 (emphasis added). The proposed KEIP payments, like the break-up fees under consideration in *O'Brien Envtl. Energy, Inc.*, are administrative expenses. Their allowability must be determined under administrative expense jurisprudence rather than the more lenient business judgment rule.

22. The Debtors must demonstrate that the proposed KEIP payments are necessary to preserve the value of the estate and are permissible under the statutory test. The Debtors have not met, and cannot meet this burden with respect to the KEIP as it is currently proposed.

23. Before the KEIP is considered, the Debtors should be required to establish that it imposes goals that require participants to perform at an objectively measurable higher level than in the past. Additionally, the Debtors should be required to establish or disclose the following:

(a) The methodology used to determine the initial goals, incremental goals, and bonus amounts proposed in the KEIP;

(b) all other compensation paid to each KEIP participant in the twelve months preceding the Petition Date;

(c) the existence of any other bonus or incentive payment plans and amounts paid thereunder; and

(d) the identify any compensation professional who assisted them in preparing the KEIP.

24. The Debtors should also be required to produce copies of any report or other materials prepared by any compensation professional in connection with preparing the KEIP.

25. The Motion fails to set forth adequate justification for the administrative expense of the proposed Key Employee Incentive Program. The information set forth in the Motion suggests that the KEIP is structured more for the purpose of ensuring that senior management personnel remain in the Debtors' employ than to preserve or enhance the value of the estate through higher performance. Moreover, the Motion fails to justify the absence of any cap or limit on the Asset Sale Bonus.

26. Because it fails to demonstrate that the proposed KEIP bonuses are justified by the facts and circumstances of the case, the Motion should be denied.

WHEREFORE, the United States Trustee respectfully requests that the Court deny the Motion with respect to the proposed Key Employee Incentive Plan, condition approval of the Key Employee Retention Plan on satisfactory evidence that no participant therein is an insider, and grant such other relief as is appropriate.

Respectfully submitted,

ROBERTA A. DeANGELIS
UNITED STATES TRUSTEE

Dated: November 6, 2012

BY: /s/ Mark S. Kenney

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