AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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On the Edge

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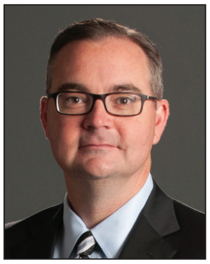
So They Stay and Do Not Go: Navigating Recent Trends in Restructuring Compensation



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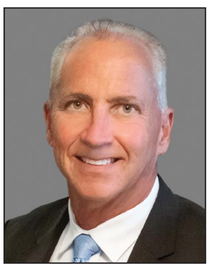

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As the world begins to emerge from the COVID-19 pandemic, businesses have been facing new headwinds from supply-chain disruptions, inflation and recessionary fears. These factors could result in an uptick in bankruptcy filings in 2023. Over the last several years, there has been a rise in the use of upfront retention programs in place of, or in combination with, traditional Key Employee Incentive Programs (KEIPs). More recently, the U.S. Government Accountability Office (GAO) has openly called for Congress to step in to curtail this growing trend. These potential restrictions could make it even more difficult for distressed companies to retain top talent in one of the tightest labor markets in recent history. This article evaluates the current state of restructuring compensation using data from a comprehensive database of court-approved programs,[1] and discusses growing trends and potential developments in light of increased scrutiny from regulators and stakeholders.

KEIPs

For more than 15 years, it was standard practice for companies in bankruptcy to implement a performance-based incentive plan, known as a KEIP, to ensure that it motivates, rewards and retains critical talent during a restructuring. The popularity of KEIPs is a direct result of the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) and the limitations it placed on retention bonuses to insiders. Due to the strict rules under § 503(c)(1) of the Bankruptcy Code (added by BAPCPA), retention bonuses to insiders were effectively eliminated. Accordingly, companies began adding performance metrics to these programs so that they would fall under the more liberal business-judgment standard (under which the incentive plan may be approved based on business judgment and an analysis of the facts and circumstances of the case).

However, these performance goals must be challenging and not considered "lay-ups" in order to escape the more restrictive treatment under § 503(c)(1). Common performance metrics used by companies include: (1) financial metrics (EBITDA, cash flow, operating income, and liquidity); (2) sale of assets; (3) confirmation of a reorganization plan/emergence from bankruptcy (usually by a specified time); and (4) cost reduction/expense control (see Exhibit 1).

One of the greatest challenges when structuring a compensation program in a distressed situation is developing performance metrics that are both challenging and achievable. This is compounded by current uncertainty around inflation, labor-market and supply-chain shortages, and interest rates that make forecasting traditional financial and operational performance measures difficult. Metrics are typically designed so that executives have "line of sight" between organizational actions and performance measures, allowing the organization to create a plan of action to achieve stated goals. This becomes increasingly difficult when macroeconomic conditions make once-reasonable performance targets unachievable. The inherent difficulty in setting performance metrics in the current environment has led many companies to pursue alternative avenues to retain key talent without the restrictions of § 503(c)(1), including the use of upfront retention payments.

1 This database is provided by the authors' firm.

Popularity of Upfront Retention Payments

In recent years, upfront retention awards have become more popular and are seen as an effective way to retain key employees. These awards are paid in advance of the desired retention period (and prior to any bankruptcy filing, if applicable) and include a clawback provision in which the recipient must pay back the amounts if they do not provide services for the required time period and/or achieve certain performance metrics. Even though these programs are not subject to the court-approval process, they could still be challenged as a preferential or fraudulent transfer under the Bankruptcy Code and applicable state law. Successful challenges are extremely rare and very fact-specific.

Two drawbacks of these programs are potential liquidity issues and the enforceability of the clawback provision. Most distressed companies are already strapped for cash, and a large upfront cash outflow may be unfeasible. Furthermore, to the extent that an employee receives an upfront retention payment but does not stay employed through the retention period, it may be difficult or impractical for the company to claw back the payments. Therefore, these upfront awards are typically reserved for a small group of senior management to lessen the potential administrative burden of clawing back payments from a large population.

Increased Scrutiny for Upfront Retention Payments

Since these programs are implemented and paid prior to bankruptcy, they generally fall outside of the constraints on insider retention under the Bankruptcy Code, but they still have been the subject of scrutiny. Several companies have received backlash from the media after making large retention payments on the eve of a bankruptcy filing. The optics are less than ideal when such payments are coupled with mass layoffs. The media has latched on to this concept, and "bonus" has become a dirty word during and leading up to bankruptcy.

However, it is important to remember that an executive's base salary typically only comprises 10-20 percent of their compensation package (versus the vast majority for nonexecutives), with the remainder being comprised of retention and incentive elements. Few high-caliber executives are willing to work for only 10-20 percent of their normal annual compensation, which is especially true when the decrease in compensation is coupled with the added workload, uncertainty and stress that come along with restructuring. Therefore, companies must carefully consider the benefits of retaining key talent, even if the program will inevitably face scrutiny. While combating media spin can be an impossible task, companies that want to mitigate negative exposure should consider the following suggestions.

Don't Delay Making Upfront Payments

If possible, companies should try to avoid making payments on the eve of bankruptcy. The cases receiving the most criticism have been those in which payments were made shortly before a chapter 11 filing. Still, this is not always possible when a company's financial situation quickly deteriorates, and this should not stop companies from taking appropriate action to retain key talent.

Ensure that the Program Is Reasonable

Just because the upfront retention program is not subject to court approval does not mean that the company should not undertake a robust program-design process. If the program is reasonable in design and amount and consistent with programs at similar companies, the company can defend its decision and process to stakeholders and the public.

Address the Entire Organization

When implementing an upfront retention program for senior management, do not forget to also address compensation issues at lower levels of the organization. Although payments to rank-and-file employees are not subject to the same restrictions as insiders under the Bankruptcy Code, re-evaluating performance metrics, payout frequency and award values for this population is no less critical. Putting in place programs for the entire workforce can combat claims that the organization has focused all its attention on highly compensated executives.

Response from the GAO

Last year, the GAO took aim at upfront retention awards, recommending that Congress amend the Bankruptcy Code to bring prebankruptcy bonuses under court oversight and provide factors that the court should consider before approving them. The GAO's review of court dockets for the approximately 7,300 companies that filed for chapter 11 in fiscal year 2020 revealed that none of the debtors requested court approval for executive retention bonuses during bankruptcy, while 42 debtors awarded prebankruptcy

Exhibit 1: Insights from Alvarez & Marsal's Restructuring Compensation Database

Although market levels differ widely based on company size and industry, below are some key findings on KEIPs approved by bankruptcy courts since 2020.

Median Number of Participants

7 Executives

Median Target Cost of Plan

$1.0 Million

Range of Target Plan Costs

- Over $18 Million
- Less than $100,000

retention bonuses — totaling approximately $165 million — from five months to two days before filing.

The GAO viewed upfront retention as an attempt to undermine § 503(c)'s restrictions and decrease the ability of creditors, U.S. Trustees and the courts to prevent bonuses that are inconsistent with the section's requirements. They noted some academics and practitioners that supported amending § 548 of the Bankruptcy Code to allow executive bonuses granted within a certain time frame to be recovered or avoided if the bonuses would not have been allowed under § 503(c). Other commentators believed that legislative responses are unnecessary and could lead to unintended consequences.

While much of the criticism of upfront retention payments has focused on the direct costs of the program, little attention is given to the potential savings to the estate through the avoidance of administrative and legal expenses incurred through the court-approval process. Court approval often requires substantial legal and professional fees; putting in place upfront retention programs is often far more cost-effective.

Currently, there are no proposals in Congress to amend § 503(c) that are likely to pass. However, companies facing financial distress should still stay updated on the most recent judicial and legislative developments to avoid being caught off-guard.

Post-Emergence Incentive and Retention

When emerging from bankruptcy, a company's stock and any unvested equity awards are usually cancelled or become virtually worthless. Lack of meaningful equity ownership in the go-forward entity, coupled with an uncertain company future, leads to difficulties in retaining and motivating key executives following emergence. Emergence equity grants under a management incentive plan (MIP) can relieve some of these challenges.

In prior years, MIPs were commonly negotiated during the bankruptcy proceeding as part of the restructuring-support agreement. Recently, there has been an increase in deferring these decisions until the new post-emergence board is in place. Prominent practices around MIPs also vary significantly depending on whether the entity emerges as a public or private entity (see Exhibit 2).

Throughout the COVID-19 pandemic, due to heightened instability in certain sectors, there have been increasingly complex capital structures being utilized post-restructuring. This can create unique issues when it comes to providing market levels of compensation through a MIP. In these situations, the common stock may have little to no value, so companies shift to more creative long-term incentive structures such as hybrid equity and cash awards or phantom awards that mirror the return on preferred stock. In recent years, the use of performance-based awards in combination with traditional restricted stock or restricted stock units has become increasingly popular. These alternative awards require significant work to ensure that they are properly structured and communicated to employees in an understandable way as to not lose their incentivizing effect.

Companies should also revisit and revise employment agreements and severance/change in control protections after emerging from bankruptcy. General policies and plans that cover multiple employees have become more prevalent than individualized employment agreements. However, given the uncertainty for executives when a company is emerging from bankruptcy with a new ownership structure, it is not uncommon for new employment agreements to be entered into with executives.

Impact of the Type of Restructuring

Whether it is an unplanned freefall, a tightly constructed pre-packaged filing or something in between, what is appropriate and practical from a compensation perspective will differ depending on the type of filing. Although every case is different, Exhibit 3 summarizes what is commonly seen based on where a company falls on the spectrum of bankruptcy filings.

The trend toward utilizing pre-packaged filings and upfront retention awards has continued due to the lengthy process to get a KEIP approved in bankruptcy court. Absent a new retention or incentive program, a large compensation gap may exist, resulting in increased attrition at the worst possible time. The compensation path is impacted not only by the type of filing, but also based on whether an entire industry is in distress versus a single company struggling in an otherwise thriving industry. In the latter circumstances, healthy competitors can swiftly poach key talent and high-performers. In addition, the Great Resignation has impacted the talent market significantly, especially for those key employees with easily transferrable skills (*e.g.*, financial, legal and human-resource professionals) who can more eas-

Exhibit 2: Insights from Alvarez & Marsal's Restructuring Compensation Database

Although market levels differ widely based on company size, public vs. private, and industry, below are some key findings on MIPs awarded since 2020.

Median Pool Size	Median Amount Granted at Emergence	Most Common Vehicle
10%	**38%**	**RS/Us**
of a company's equity	of MIP Pool	Time-based Restricted Stock/Units

ily switch to a different company or industry. Therefore, it is important to always ensure that the appropriate compensation programs are in place to prevent unwanted departures within the management ranks.

Conclusion

As we appear to have turned a corner in the COVID-19 pandemic, new economic and regulatory uncertainties have been emerging for distressed companies. Retaining and motivating key talent remains critical for companies entering or emerging from bankruptcy. Upfront retention payments have grown in popularity due to their flexibility and cost-effectiveness, but they have also garnered the attention of regulators and commentators who view them as an attempt to circumvent the Bankruptcy Code. While it is unclear what the long-term outcome might be, companies facing a restructuring today should be aware of and consider all options when determining the best route to retain and incentivize key employees.

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Exhibit 3: Bankruptcy Filings

SPECTRUM OF BANKRUPTCY FILINGS

Type of Bankruptcy Filing	Freefall	Pre-Arranged	Pre-Packaged
	Duration: 6+ Months	Duration: 3 – 6 Months	Duration < 3 months
	Need for bankruptcy filing occurred quickly	Bankruptcy was anticipated	Bankruptcy is planned
	Little to no planning prior to filing, so generally tend to be longer & more complex cases	Some negotiations have occurred with creditors, but no major plans in place	The plan of reorganization is filed at the same time as the chapter 11 petition
	More likely to implement KEIPs and KERPs since cases are longer and more uncertain	Less likely to implement KEIPs and KERPs than freefall filings	More likely to just try to get normal bonus approved and/or focus on emergence grants under the management incentive plan (MIP)
	In lieu of or in addition to KEIPs, may implement retention or incentive bonuses with clawback provisions if certain criteria are not satisfied	Instead, may implement retention or incentive bonuses with clawback provisions if certain criteria are not satisfied	May consider retention bonuses as well that are commensurate with a short bankruptcy