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Turnaround Topics

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Compensating Key Employees Following a Restructuring

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Companies emerging from a restructuring face unique challenges with compensating key employees. Prior equity incentive awards are typically wiped out, and new arrangements need to be implemented to incentivize employees to achieve challenging post-emergence goals. Management incentive plans (MIPs) are commonly used tools to provide go-forward retention and incentive opportunities, and there are key design elements that companies should consider. In addition, companies emerging from bankruptcy with clean balance sheets are often prime targets for an acquisition.

These companies must balance the need to retain and incentivize employees with the potential adverse tax ramifications of the Golden Parachute rules, which can potentially add an additional 20 percent tax on top of an executive's ordinary income tax obligations. Finally, with emergence comes a variety of other compensation and benefits issues that need to be addressed to assist with a smooth exit from a restructuring. This article explores three areas: (1) common design elements of MIPs, with insights from the authors' firm's restructuring database; (2) the interplay of bankruptcy- and emergence-related compensation programs with the Golden Parachute tax rules, including how and when the additional tax might be triggered, as well as planning opportunities to mitigate the tax impact; and (3) strategies to handle other post-emergence compensation challenges.

Post-Restructuring Equity Grants

When a company emerges from a restructuring, most pre-restructuring company stock and unvested equity awards have lost value. Lack of meaningful equity ownership in the go-forward entity, coupled with an uncertain company future, can lead to post-restructuring retention and motivation difficulties.

As compared to a steady-state company, management teams of companies completing a restructuring have no long-term alignment of interests with stockholders. A large, one-time equity grant quickly aligns incentives and locks down the management team. This large, one-time equity grant is commonly referred to as a MIP.

Absent MIP grants, it usually takes several years of annual grants to build up significant at-risk pay that the management team would forfeit if they left the company. Without sizeable, unvested long-term incentive awards, companies risk losing valuable talent during this crucial transition period. Accordingly, the size of a MIP grant is typically larger than a normal annual grant in order to immediately create meaningful incentives and aid with the long-term retention of the management team, which is especially critical during the first few years after a restructuring.

Design

There are several design features that companies and their advisors should consider when designing MIP awards, including the following questions:

- What percentage of new equity should be reserved for the MIP?
- What portion of the MIP should be granted upon emergence?
- Who should be eligible (*e.g.*, officers, middle management, all employees, etc.)?
- How will the grants be structured (*i.e.*, type of award, vesting, termination provisions, etc.)?

Most companies emerging from a restructuring will reserve a percentage of their new equity for the purpose of granting MIP awards to select key employees in connection with emergence. The typical share reserve depends on the company's size, among other factors, but a fairly common pool size is around 10 percent. A significant portion of this pool is usually granted immediately, with the majority allocated to the executive officers and the remainder left available for directors and other employees.

The portion of the pool granted immediately tends to vary between public and private companies. Private companies tend to grant a very high percentage of the MIP pool upfront, only reserving a small portion for future grants to new hires or promotions. Public companies also grant a substantial portion of the MIP pool upfront, but reserve enough shares to establish future annual grants under a steady-state long-term incentive plan.

While the size of the MIP pool and the initial grants are often the immediate focus of negotiations, less time and effort are unfortunately spent on the types of equity vehicles, their vesting terms and related termination provisions. These award details are often left to the new post-emergence board to decide. MIP awards are typically granted in the form of stock options, restricted stock, performance awards or some combination. Depending on the company's post-restructuring goals, awards can be structured as a retention vehicle (full-value equity vehicle with time-based vesting only), an incentive vehicle (vesting based on performance), or a mix of the two. Exhibit 1 shows an illustrative allocation of a post-emergence MIP. Although MIP design features vary widely based on company size, public vs. private and industry, Exhibit 2 highlights some key insights from the authors' firm's restructuring compensation database.

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Post-Restructuring Change-in-Control Considerations

Companies emerging from chapter 11 with clean balance sheets can be attractive targets for potential acquisition. Given the heightened potential for a change in control, these companies should design compensation packages that incentivize management to maximize shareholder value, including via acquisitions. Compensation packages should be designed to encourage executives to pursue attractive offers, while mitigating the risk that executives could be working themselves out of a job. Companies and their advisors should keep these principles in mind when designing the terms and provisions of executive MIP grants:

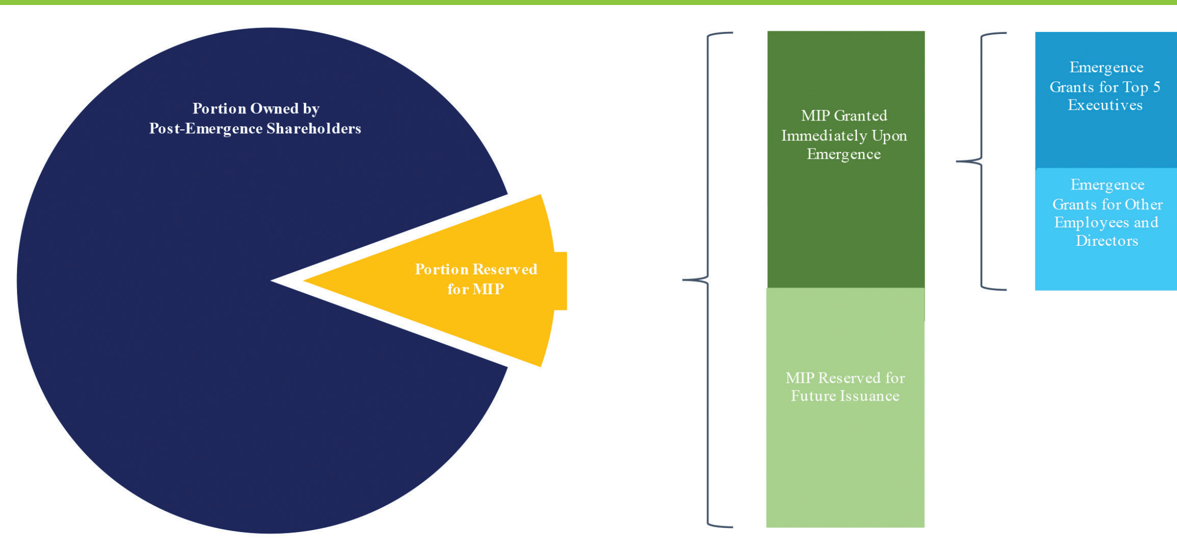
- Grants should be large enough — often two to three times the size of a typical annual grant for executive officers — to create a meaningful alignment between the interests of executives and shareholders;
- Grants should contain accelerated vesting provisions that compensate executives in the event of involuntary termination following a change in control of the company; and
- Grants should contain "good reason" definitions that allow an executive to voluntarily terminate employment without forfeiting MIP awards if their compensation, duties or responsibilities are materially diminished following a change in control.

While cash severance might naturally seem to be the main component of termination pay, the accelerated vesting of equity awards often represents the most valuable termination benefit following a change in control for executives. Exhibit 3 shows the average value of each type of benefit to which CEOs are entitled at 200 of the largest public companies.[1]

Accordingly, if the board's strategy is to immediately solicit a buyer, consideration should be given to granting full-value awards — such as restricted stock or restricted stock units — as opposed to stock options that generally require a longer time period

1 2021/2022 A&M Executive Change in Control Report.

Exhibit 1: Post-Emergence Equity Value of Company



to appreciate in value. Full-value awards would most closely align the interests of executives with shareholders.

Depending on the likelihood of a post-restructuring change in control, companies and their advisors should also consider the impact of the Golden Parachute rules under § 280G and 4999.[2] The Golden Parachute rules levy a 20 percent excise tax on executives and disallow the corresponding compensation deduction to the company. Designing post-emergence programs with § 280G in mind could substantially reduce the amount of excise tax levied on the executive and preserve the corresponding corporate tax deduction. One such design consideration would be to grant MIP awards that time-vest (rather than performance-vest), which would allow for the use of more favorable valuation rules under § 280G. In addition to MIP design considerations in the context of a change in control, boards and executives should familiarize themselves with § 280G more broadly, since it applies to many types of payments and benefits in connection with a change in control.

Overview of § 280G Golden Parachute Rules

As previously mentioned, the Golden Parachute rules impose a 20 percent excise tax on executives and disallow the corresponding compensation deduction to the company. Golden Parachute payments can include severance payments, transaction bonuses, accelerated vesting and payment of equity awards, fringe benefits and excise tax gross-up payments.

Golden Parachute payments to an executive that exceed the safe-harbor limit could trigger significant tax consequences to both the corporation and executive. Depending on the circumstances and number of executives affected, the cost to the corporation and the executives could be substantial.

The safe-harbor limit that determines whether the company or executives will be impacted by the Golden Parachute rules is equal to 300 percent of the executive's base amount. Base amount is calculated as the executive's average gross compensation over the five most recent calendar years ending before the change-in-control date. Alternatively, the excise tax and loss of deduction is imposed on any excess-parachute amount. This amount is determined based on the value of the executive's parachute payments, less 100 percent of the executive's base amount.

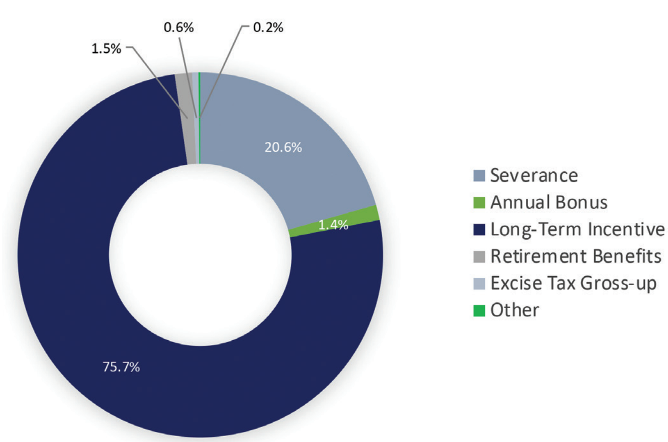
The Golden Parachute rules apply to the corporation's disqualified individuals (DIs), which is someone who is (1) an employee or independent contractor who performs personal services for a corporation; and (2) is one of the below:

- *Officers:* Any individual who is an officer of a corporation or any individual who has the duties of an officer, regardless of position, up to a maximum of 50 employees (or, if less, the greater of three employees or 10 percent of all employees);
- *1 Percent Shareholders:* Any individual who owns at least 1 percent of the corporation's stock; and
- *Highly Compensated Individuals:* Anyone making more than $150,000 per year (indexed to inflation) who is ranked in the top 1 percent of employees based on gross earnings, up to a maximum of 250 employees.

Although there are a few excise tax-mitigation alternatives that can be utilized near the time of a change in control (*e.g.*, determination of reasonable compensation amounts and base-amount planning), it is prudent to ensure that an executive's compensation package is designed for success from the outset. Many pitfalls can be avoided through compensation-plan design that considers tax implications, regulatory hurdles and shareholder concerns. With respect to the design and implementation of change-in-control arrangements, companies should consider the following:

- Benchmarking change-in-control provisions to the current market allows company boards, their compensation committees and management to validate existing change-in-control benefits or identify opportunities for change. Severance multiples, equity acceleration triggers and other change-in-control benefits should be reviewed to ensure alignment with the market.
- Accelerated vesting of equity awards on a change in control could have a significant Golden Parachute impact, depending on the normal-course vesting criteria of the awards. The Golden Parachute rules favor time-vesting awards, which are typically valued at less than their economic value when calculating their Golden Parachute impact. Performance vesting awards are not eligible for this reduced valuation and tend to have a greater Golden Parachute impact. Potential excise tax implications of

Exhibit 3: Average CEO Change-in-Control Benefit



2 *See* 26 U.S.C. §§ 280G and 4999.

Exhibit 2: MIP Data

Median Pool Size	Median Portion of Pool Granted at Emergence	Most Common Equity Vehicle	Total Number of Equity Vehicles
10% of a Company's New Equity	50% of MIP Pool Granted Immediately	Restricted Stock Units	2 Types of Equity Vehicles

the Golden Parachute rules should be considered, among various other factors, when granting equity awards. This is particularly important when making a large grant of equity awards, such as an MIP.

• The Securities and Exchange Commission requires public companies to quantify any parachute payments the CEO and other named executive officers would receive upon a hypothetical change in control at year's end and must disclose those amounts in the annual proxy statement. This provides transparency so that shareholders can weigh in on the company's pay practices through their say-on-pay votes. Management and boards of public companies should consider how shareholders and advisory firms might view the company's current Golden Parachute arrangements.

• There are various excise tax protections that companies can utilize, such as gross-ups, "best-net" provisions or cutbacks. Gross-ups have fallen out of favor and significantly declined in prevalence over the past several years, while "best-net" provisions have gained popularity. These excise tax protections help reduce the impacts of the Golden Parachute rules, but even with these provisions these rules often still prove costly to executives and corporations.

• Private corporations are also subject to the § 280G rules, but can cleanse Golden Parachute payments with a shareholder vote. It is important that management and boards of private companies understand how the shareholder vote process works so that this private-company exception can be utilized.

When designing compensation programs, the potential impact of the Golden Parachute rules should be considered. As soon as it is determined that a change in control might be on the horizon, the company should take steps to understand the impact of the Golden Parachute rules to both the company and executives.

Other Post-Restructuring Compensation Considerations

When a company emerges from bankruptcy, compensation programs are generally adjusted to reflect changes to the going-forward business. In addition to MIPs, here are a few additional compensation elements that companies should consider upon a successful emergence from a restructuring.

Employment Agreements

It is critical to evaluate common market-based provisions included in employment agreements with respect to companies emerging from a restructuring. In the broader market, there has been a decrease in the prevalence of individual employment agreements in favor of policies and plans that cover multiple employees. 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.

Severance and Change-in-Control Protections

One of the key retention tools following a restructuring is the implementation of severance and/or change-in-control protection plans. These types of protection plans can be geared toward the entire employee population (with tiered benefits) or some smaller subset. To the extent that executives do not have severance or change-in-control protections provided in employment agreements, it would be very common for executives to participate in a protection plan.

Compensation Benchmarking

Following a restructuring, companies should ensure that compensation amounts are aligned with the current market. Restructurings often impact the size and structure of the employee population and can cause compensation amounts to become misaligned as roles and responsibilities change. In addition, a company's size and market peers might be different post-restructuring than pre-restructuring. Accordingly, companies should benchmark compensation amounts to ensure alignment with the market and maintain internal pay equity.

Key Takeaways

Companies emerging from a restructuring are faced with unique compensation challenges. The proper design of new compensation arrangements can serve as powerful incentive and retention tools and help align the interests of the employees with the new owners. Boards and compensation committees need to remain attentive to changing market trends and be ready to respond when challenges arise regarding compensation and benefits provided to employees. abi

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