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Navigating Compensation Considerations and Payroll Obligations During a Restructuring

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One of the biggest challenges that companies face during a restructuring is the ability to competitively pay key talent. Prior equity incentive awards are typically wiped out, and existing bonus-plan metrics might no longer be feasible. Realigning compensation programs in a distressed situation is critical, especially if the restructuring is effectuated through a chapter 11 filing. Key employee incentive plans (KEIPs) and pre-paid incentive/retention awards are common tools to retain and motivate key talent during a restructuring. There are principal design elements of these award types that companies should carefully consider.

In addition to compensation program design considerations, companies undergoing a restructuring must navigate a complex web of related payroll and information-reporting obligations. Key areas of focus should include compensation clawback management, maintenance of ongoing payroll compliance, successor-employer determinations and compliance with state experience-transfer regulations, and information-reporting compliance. Effectively addressing these payroll and information-reporting matters is crucial for maintaining compliance and controlling costs throughout the restructuring process and beyond. This article discusses market trends and design considerations for restructuring compensation programs and the best practices for navigating payroll tax and information-reporting obligations, and minimizing related costs throughout a restructuring.

Compensation Considerations

KEIPs

Section 503(c)(1) of the Bankruptcy Code practically disallows meaningful retention bonuses to insiders. To the extent that companies have to seek court approval for their compensation programs, companies must pivot to entirely incentive-based compensation packages for insiders. Incentive plans must be justified by the "facts and circumstances of the case," which a number of courts have held to constitute a "business judgment" standard.

Performance Considerations

To meet the business-judgment standard, performance goals must contain meaningful performance measures that are not easily achievable. While there is no bright-line test to measure how challenging a particular performance measure should be, companies should consider the probability of achievement based on the specific performance measures selected. Common performance metrics vary by industry but commonly include (1) financial metrics (earnings before interest, taxes, depreciation and amortization; 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.

Evaluating a KEIP

When sizing a KEIP package for insiders, it is important to remember that the KEIP is essentially replacing both the short- and long-term incentive programs (STIP and LTIP, respectively). Accordingly, it is common for targeted amounts under the STIP and LTIP to be consolidated into a comprehensive KEIP award (sometimes at a discount). In order to ensure that targeted payout opportunities under a KEIP are reasonable, the following analyses are commonly performed:

1. comparison to market compensation levels: ensure that competitors cannot easily poach talent;
2. historical compensation amounts: generally try to avoid large pay cuts/increases, unless warranted by changes in roles or responsibilities; and
3. comparison to other programs approved in bankruptcy: understand the size and scope of other court-approved programs that have been successfully approved and implemented.

Payment Timing

Although KEIP payments generally occur at the end of a designated performance period (*e.g.*, a specific date or event), certain performance metrics can be measured and paid out on a quarterly or semi-annual basis. Factors to consider when determining payout timing include the type of performance metrics, length of the case and the type of restructuring (*e.g.*, emergence vs. liquidation).

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Negotiating a KEIP

Compensation issues in a restructuring are often subject to scrutiny, particularly by creditors and the U.S. Trustee. When designing a KEIP, it is prudent to anticipate challenges and negotiations — to both the design and the amount of compensation. The negotiation and approval process typically plays out over the course of several weeks or months. Since it is imperative to stabilize the workforce with competitive compensation as quickly as possible, it is often helpful to begin the negotiation process early and preview the potential KEIP with key stakeholders prior to a filing (if the facts/circumstances of the case allow).

The inherent difficulty and cost of getting a KEIP approved in a timely manner has led many companies to pursue alternative avenues to retain key talent without the restrictions of § 503(c)(1), including the use of pre-paid/upfront retention payments (see Exhibit 1).

Pre-Paid Retention Awards

Pre-paid retention awards have become increasingly 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), but are subject to a clawback whereby the recipient must repay the amount if certain retention or incentive requirements are not satisfied.

Since these programs are implemented and paid prior to bankruptcy, they generally fall outside of the constraints on insider retention under § 503(c)(1) of the Bankruptcy Code. However, they could still be challenged as preferential or fraudulent transfers under the Code and applicable state law.

Challenges

Although successful challenges to pre-paid retention awards have been extremely rare and very fact-specific, the optics of such awards are less than ideal. Employees, unions, governments and particularly the media tend to take issue with a perceived "windfall" of cash bonuses being paid to top executives leading up to a bankruptcy filing.

Most distressed companies are already tight on cash, and large upfront cash payments are simply not feasible from a liquidity perspective. However, pre-paid programs are typically a viable option for companies that have good cash flow but are facing chapter 11 for other reasons (*e.g.*, legal issues, debt restructuring, etc.). It might be difficult or impractical for the company to claw back payments from employees that leave the company prior to fulfilling their retention obligations. Accordingly, pre-payments are typically reserved for a small group of senior management to lessen the burden of potential clawbacks from a large population of employees.

Payment Timing

If possible, companies should seek to avoid making payments on the eve of bankruptcy. The

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

While market levels vary significantly based on company size and industry, below are some key findings on KEIPs approved by bankruptcy courts since 2020 for companies with assets exceeding $1 billion.

Median Number of Participants

8 Executives

Median Target Cost of the Plan

$6 Million

Range of Target Plan Costs

More than $18 Million

Less than $500,000

most heavily criticized cases have been those in which payments were made shortly before a chapter 11 filing. However, there can also be negative consequences of making the payments too early.

When a company discloses that it has pre-paid cash bonuses to executives, employees and markets will read into why that pre-payment is being made and set off the bankruptcy alarm. It is important to consider all payment timing ramifications and make the best decision when all facts and circumstances are considered.

Evaluating Reasonableness

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. Although it is a minority practice, a few companies have implemented pre-filing programs with performance-based clawbacks to combat the notion that the executives simply had to stay in their seats.

Ultimately, companies must take appropriate action to retain key talent. There has been a continued trend of companies steering away from the uncertain KEIP approval process and opting to pre-pay retention and incentive awards in order to immediately lock down executives (see Exhibit 2).

Payroll Obligations

In addition to addressing compensation-design considerations, companies undergoing restructuring face a multifaceted array of payroll and information-reporting obligations.

Clawback Considerations

As previously noted, clawbacks of compensation present unique payroll tax challenges. The tax treatment of compensation clawbacks varies significantly based on the timing of the repayment by the employee.

Clawback occurs in current year: If the compensation subject to clawback was paid in the *current year*, and the employee repays such compensation in the current year, the employee's current-year wages are reduced for federal income tax, withholding, Social Security, Medicare and unemployment insurance purposes. These adjustments typically occur on a pre-tax basis within payroll, simplifying the reconciliation of tax obligations.

Clawback occurs in earlier year: In contrast, if the compensation subject to clawback was paid in a *prior year*, and the employee repays such compensation in the current year, the claim-of-right doctrine applies, adding complexity to the correction process. The claim-of-right doctrine states that adjustments apply to the year in which the compensation was originally paid, not the repayment year. In such cases, employees repay the gross repayment amount (includes income taxes previously withheld), and current-year wages are not adjusted. Reporting requirements differ based on the type of wages involved:

- For Social Security and Medicare wage purposes, corrected Forms W-2 (Forms W-2c) must be filed for the year in which the compensation subject to clawback was originally paid. The corrections must reflect reductions in both wages and associated taxes. Employees receive refunds for the reduced Social Security and Medicare taxes from the company, and the company must collect written documentation from each impacted employee certifying that they both received the refund and will not claim it again in the future.
- For federal income tax wage purposes, the repayment is not reflected on corrected Forms W-2, and federal income tax withheld is not refunded to the employees. Instead, employees may be able to claim deductions or credits on their personal tax returns related to the repayment, subject to limitations.

Adjusted quarterly federal tax returns (Forms 941-X) must also be filed to reconcile the changes in Social Security and Medicare wages for the prior year. These adjustments ensure that corrections are properly reflected for the tax year and quarter in which the original payment occurred, and that aggregate Forms W-2 totals on file with the Social Security Administration tie out to the Internal Revenue Service-reported totals on the Forms 941.

These complex rules underscore the importance of careful payroll tax management and clear communication with employees about the tax implications of wage repay-

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

While market levels vary significantly based on company size and industry, below are some key findings on pre-paid retention awards made since 2020 by companies with assets exceeding $1 billion.

Median Retention Period	Individual Retention Payment Range	Individual Percentage of Base Salary Range
1 Year	**More than $11.5 Million**	**More than 1,000%**
	Less than $150,000	**Less than 50%**

ments, particularly those that span over multiple tax years. Companies undergoing a restructuring should pay special attention to these considerations when implementing clawback policies or addressing overpayments.

Continuation of Payroll Tax Withholding and Reporting Obligations

During restructuring proceedings, companies must maintain strict and ongoing oversight of payroll tax obligations across all jurisdictions to ensure timely withholding and remittance of federal, state and local taxes. Key responsibilities include the following:

- Implementing robust processes to review and evaluate employment tax filings for all time frames (distinguishing between pre- and post-petition payroll tax liabilities);
- Establishing a comprehensive tax calendar for deposit schedules to prevent the imposition of penalties for failure to timely deposit payroll taxes;
- Addressing historical tax notices and issues (including potential exposures and prior year corrections); and
- Reconciling federal, state and local tax accounts.

Diligent management of these often-complex obligations throughout a restructuring, either through in-house teams or co-sourced support from employment tax specialists, can minimize compliance risks, control costs and facilitate a smooth post-bankruptcy transition.

Successor Employer Considerations and Unemployment Experience-Rating Transfers

Following a chapter 11 restructuring, the emerged company might not retain its prior federal employer-identification number, or a new entity may otherwise be established. Alternatively, if the restructuring results in a § 363 sale, the purchaser may acquire the assets and employees of the debtor entity. In these cases, an analysis should be done to confirm whether the entity ultimately acquiring the employees and assets constitutes a "successor"-in-interest, and to confirm the extent to which state unemployment experience-rating transfers are mandated under federal and state law. Companies should ensure that any required state unemployment experience transfer applications are timely filed to avoid noncompliance notices.

In certain cases, successorship status might yield cost-savings opportunities. For example, under certain circumstances, successor entities might have the option to inherit or decline a predecessor's state unemployment experience-tax rating, and that choice can substantially affect current and future year payroll costs.

A successor may also be entitled to a state unemployment rate reduction and/or wage-based duplication refunds for current and/or prior years, depending on the type of restructuring involved and state law provisions. These cost-optimization opportunities might be available to debtors-in-possession, § 363 purchasers and post-emergence employing entities alike.

Federal and State Backup Withholding and Information-Reporting Obligations

Increased Form 1099 reporting and backup withholding obligations may arise during a restructuring in light of claimant payouts. It is crucial to obtain correct taxpayer-identification numbers for claimants and other payees to mitigate the need to impose federal backup withholding on reportable distributions pursuant to § 3406 of the Internal Revenue Code. State backup withholding also applies in several states; for those states that impose backup withholding, payors might need to register for tax accounts to enable remittance of withheld state taxes, if such accounts are not already in existence.

Also, do not forget about state information-reporting requirements. With respect to Form 1099 information reporting, while the combined federal/state filing program (CFSF) for information returns can simplify reporting, it might not satisfy the compliance requirements for all states. Direct filing of Forms 1099 is required by several states when there has been state withholding on the payment, or when the payment exceeds a state-prescribed threshold, regardless of the state's CFSF participation. Noncompliance with respect to direct state filing of Forms 1099 can result in significant information-reporting penalties, which can quickly accumulate for payors dealing with large volumes of Form 1099 reportable payments during restructuring.

Key Takeaways

When properly structured, retention and incentive programs can be one of the most powerful tools to facilitate a successful restructuring. By understanding the puts and takes of restructuring compensation alternatives, organizations can ensure that their compensation programs support both employee alignment and the company's long-term success. Accordingly, it is prudent to perform careful and thoughtful analyses when designing restructuring compensation programs.

Effectively managing employment tax and information-reporting obligations is also crucial for companies undergoing restructuring. This includes navigating such complex issues as clawbacks, ensuring ongoing payroll tax withholding and reporting, determining successor employer status and complying with state experience transfer regulations, and adhering to federal and state information-reporting requirements. By proactively addressing these challenges, companies can minimize compliance risks, control costs, and facilitate a smooth post-bankruptcy transition. **abi**

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