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WHAT'S INSIDE

NAVIGATING BOARD OF DIRECTOR COMPENSATION IN BANKRUPTCY AND POST-EMERGENCE MANAGEMENT INCENTIVE PLANS

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Introduction

A company experiencing financial distress and subsequent bankruptcy or out-of-court restructuring presents unique challenges for its board of directors. These challenges are not only operational in nature but also extend to the compensation structures that need to be re-evaluated and adjusted to ensure the continued engagement and motivation of both board members and key executives. This article discusses the intricacies of board of director compensation during bankruptcy and explores the critical considerations boards need to consider for establishing effective Management Incentive Plans (MIPs) for the company post-emergence, to help ensure a successful go-forward company.

The Role of the Board During Bankruptcy

Leading into and during a bankruptcy, the role of the board of directors becomes even more critical and demanding of the directors' time. Directors are tasked with making pivotal decisions that can determine the company's future. This period often involves increased workloads, as directors must navigate complex legal, financial, and operational challenges, working closely with attorneys, financial advisors, and bankruptcy courts. They are tasked with balancing the interests of various stakeholders, including creditors, shareholders, employees, and customers, while also ensuring legal obligations. According to the Spencer Stuart Director Pulse survey (conducted in March of 2023), the average public company director's time commitment is 321 hours per year, and the average private company's time commitment is 150 hours per year. This includes preparing for, traveling to, and attending meetings. However, in preparation for and during a bankruptcy, this commitment can increase significantly, particularly in the early stages leading into a bankruptcy when critical decisions are required.

Common Changes to Board Compensation

Conversion to Cash Compensation

Typically, compensation for board directors at public companies includes a mix of cash and equity retainers when a company is financially stable and not facing a restructuring. Equity compensation, which commonly includes restricted stock that vests immediately or over time, often loses value during periods of financial distress. The depreciation in value of equity during this time can be a challenge to retaining experienced directors critical in assisting the company to navigate periods of uncertainty. As a result, boards frequently conduct market analyses to ensure that compensation remains competitive with the broader market and attractive enough to retain talent. One of the most common adjustments to board compensation during bankruptcy is the conversion of equity retainers to cash retainers. For example, a company that provides a $50,000 cash retainer and a $100,000 equity retainer might convert payment to an all-cash retainer of $150,000. This adjustment can provide stability to compensation for board members and further align their interests with the immediate financial needs of the company. The board can retain talent and ensure directors remain focused on guiding the company through bankruptcy proceedings.

Adjustments to Payout Timing

To maintain directors' focus throughout the restructuring process, adjustments to payout timing are also considered. Boards overseeing companies with annual payout programs often switch to quarterly payouts, payable in advance of the beginning of each quarter. This approach ensures that directors remain engaged and motivated during the critical restructuring period. More frequent payouts to directors can reinforce the ongoing importance of their role and help navigate the financial challenges leading into and during a restructuring. Also, implementing quarterly payouts can serve as a retention tool, mitigating the risk of directors stepping down when their guidance and expertise is valued.

Remuneration for Special Service

In certain cases, the board may form a separate restructuring committee to handle specialized tasks associated with a restructuring. This committee is typically comprised of directors with a proven track record and relevant expertise in restructuring, legal matters, and industry-related challenges. Additionally, a board member might be appointed as the Chief Restructuring Officer (CRO). In exchange for these additional duties, directors are often provided with additional compensation commensurate with their increased responsibilities. The amount and form of this compensation can vary widely based on the company's needs and the individual director's contributions. The goal is to align the interests of the directors with the successful emergence from bankruptcy and increase the likelihood of a successful outcome for the company and stakeholders.

Return to Meeting Fees

While many companies have moved away from paying per-meeting fees in favor of fixed retainers, the restructuring context may warrant a return to meeting fees. This approach reflects the additional workload and greater board engagement required during the restructuring process. However, some boards may prefer to stick with fixed retainers to simplify the administrative process and avoid the challenge of defining what constitutes a board meeting. Fixed retainers can be easier to manage and to account for during periods of financial uncertainty.

Benchmarking and Market Analysis

Before making any changes to board compensation, it is essential for boards to evaluate market levels of pay by benchmarking compensation at similar companies. This benchmarking process involves evaluating compensation data from a designated set of peer companies within a similar industry while considering factors such as company size and business model. Appropriate compensation is crucial for maintaining directors' focus during a time of distress and increased workload. Benchmarking also provides assurance that board members are being compensated fairly and within market standards, reducing the risk associated with utilizing out-of-market pay practices. Furthermore, benchmarking board compensation demonstrates to stakeholders that pay practices are prudent and reasonable even in distressed environments.

Considerations for Management Incentive Plans Post-Emergence

Spectrum of Bankruptcy Filings

There are several types of bankruptcy filings, each with distinct characteristics that can influence the company's restructuring efforts. Understanding these differences helps inform how compensation should be considered entering into, during, and following a restructuring process.

A freefall bankruptcy typically occurs when a company files for Chapter 11 with little to no negotiation with creditors, even if it has taken preparatory steps such as first-day motions or setting up plans to pay employees. In this scenario, the lack of any formal discussions with creditors and the absence of a structured restructuring plan means that, despite some internal measures, the filing remains reactive and its outcome uncertain.

In contrast, a pre-arranged bankruptcy not only incorporates these preparatory measures but also involves proactive engagement with creditors before filing. In this scenario, the company works out key elements of its restructuring strategy in advance, including discussions about potential management incentive plans (MIPs) for executives, thereby creating a more orderly process and a clearer path forward.

A pre-packaged bankruptcy represents the most structured approach. Under a pre-packaged bankruptcy, the company negotiates and finalizes a reorganization plan before the filing of Chapter 11 bankruptcy. This plan includes detailed provisions for updating board compensation and implementing MIPs, or some MIP terms, and is submitted to the court with the bankruptcy petition. Pre-packaged filings can reduce the time and cost associated with bankruptcy proceedings as the major terms have already been agreed upon by all relevant parties.

The Importance of Management Incentive Plans

Post-emergence, boards must quickly align the interests of management and shareholders to ensure a successful turnaround. Compared to "steady state" companies, management teams of companies completing a restructuring have no long-term alignment of interests with stockholders. Companies often utilize MIPs as an alignment tool. MIPs play an important role in the alignment process by providing executives with meaningful ownership in the emerging entity. These plans are designed to motivate and retain key executives, whose industry experience and company-specific knowledge are vital for the company's continued operation and success.

Certain terms of a MIP may be negotiated as part of the broader restructuring plan. In these cases, it is important to consider market comparable companies to ensure the terms align with the broader market. In cases where limited or no terms of the MIP are negotiated, more weight is placed on the emergence board to come up with a plan that will properly retain and incentivize key employees.

The size of the MIP grant may be larger than the typical annual grant to create immediately meaningful incentives and aid with long-term retention of key executives, which is especially critical during the first few years post-emergence. Absent a MIP grant, it usually takes several years of annual grants to build substantial "at-risk" pay that executives would forfeit if they were to leave a company. Without sizeable unvested long-term incentive awards, companies risk losing valuable talent during the crucial transition period.

Key Elements of Effective MIPs

Size of the MIP Pool

The size of the MIP pool is often a focal point of negotiations during the restructuring process. Most companies emerging from restructuring will reserve a percentage of their new equity to grant MIP awards to key employees in connection with emergence. In the energy sector, for example, approximately 10% of fully diluted equity is commonly reserved for MIPs. The typical share reserve will depend on the company's size, among other factors. A significant portion of this pool is typically granted immediately, with the majority allocated to executive officers. The remainder is left available for directors and other employees and future annual grants, providing additional "runway" for the company to establish a steady-state long-term incentive plan.

The portion of the MIP pool granted immediately can vary significantly between public and private companies. Private companies often grant a large percentage of the MIP pool upfront, reserving only a small portion for future grants to new hires or promotions. On the other hand, public companies also grant a substantial portion of the MIP pool initially but tend to reserve enough shares to support future annual grants under a steady-state long-term incentive plan. This approach allows public companies to maintain a consistent incentive structure over time.

Types of Equity Vehicles

The types of equity vehicles used in MIPs are critical to their effectiveness. For public companies, full-value awards, such as restricted stock or restricted stock units, are often preferred over stock options because they offer immediate value to recipients without the presence of stock price appreciation, which can be volatile during periods of uncertainty. Given the potential for consolidation and M&A activity post-emergence, full-value awards can offer strategic advantages. They can provide immediate alignment between executives' and shareholders' interests. Unlike stock options, which do not have any value if the company's stock price does not appreciate above the option strike price, full-value awards retain worth even under fluctuations in market conditions.

Awards can be structured such that there are performance-based vesting provisions to the MIP grants. These include the achievement of certain financial goals, completing key transactions, or meeting certain operational targets as determined by the board. Performance metrics such as relative total shareholder return (TSR) which are popular in public company equity arrangements, may be harder to implement with newly emerging companies given the stock price volatility that occurs following an emergence. For private companies, performance conditions like multiple on invested capital (MOIC) and internal rate of return (IRR) are more commonly used as performance conditions in MIP awards.

Vesting Terms and Termination Provisions

Vesting terms and termination provisions are essential considerations when designing MIPs. Time-vesting awards, as opposed to performance-vesting awards, may be more favorable due to the "Golden Parachute" regulations (under Section 280G of the Internal Revenue Code), and can limit additional excise tax on executives and lost compensation expense deductions for the company. Time-based awards vest over a specified period, regardless of company performance. This structure is particularly advantageous in times of financial uncertainty. Additionally, these awards can provide a clearer and more predictable path for executives to realize their compensation, which is crucial during the uncertain post-emergence period.

Termination provisions should also be carefully crafted to balance the need to retain key executives with the flexibility to make necessary changes in leadership. Provisions for "good leaver" scenarios, such as termination without cause or resignation for good reason, should be included to ensure that executives are not unduly penalized if they leave under acceptable circumstances.

Retention and Incentive Balance

Companies emerging from bankruptcy must balance the need to retain and incentivize employees with the potential adverse tax ramifications of the Golden Parachute rules. This balance is critical to ensure that key executives remain motivated and aligned with the company's goals without incurring excessive tax liabilities.

Future Acquisition Considerations

Companies emerging from bankruptcy with clean balance sheets are often prime targets for acquisition. Therefore, MIPs should be designed with potential future transactions in mind. This includes ensuring that equity awards are structured to provide value in the event of a change in control, which can help align executives' interests with those of potential acquirers and existing shareholders.

Emerging from bankruptcy often involves significant tax considerations, particularly concerning the Golden Parachute rules. These rules can impose a 20% excise tax on certain compensatory payments made to executives if they exceed a specified threshold in the event of a change of control, such as during a merger or acquisition. To mitigate the impact of these rules, companies must carefully design MIPs with a strategic approach to compensation structure. One option is to structure payments such that they fall below the threshold amount, therefore avoiding excise tax exposure. An alternative mitigation strategy companies can consider is to seek shareholder approval for the payments, which will eliminate the excise tax under certain circumstances. This alternative is applicable to private companies only and requires the approval of most shareholders to be feasible, particularly for a distressed company emerging from bankruptcy.

In addition to section 280G considerations, companies should be mindful of the tax implications under section 409A of the Internal Revenue Code. MIPs that are not implemented correctly could potentially trigger penalties if the plan is not in compliance with 409A requirements. It is critical for companies to consider seeking legal counsel and to partner with tax advisors when designing MIPs. Thoughtful planning and implementation can minimize tax liabilities when incentivizing executives.

One strategy a company can implement is ensuring the terms of the MIP are not rigid in nature such that they can adapt to future transactions. Flexibility of the MIP awards can be achieved by including provisions that allow for equity awards to be adjusted based on the details of a potential future transaction. It is important for the company to consider the tax implications of equity awards and any future adjustments.

Conclusion

Navigating board of director compensation during bankruptcy and establishing effective management incentive plans post-emergence are complex but critical tasks. By carefully considering the unique challenges and opportunities presented during these periods, boards can ensure that they retain and motivate key executives, align their interests with those of shareholders, and position the company for a successful turnaround. Through thoughtful design and strategic planning, companies can emerge from bankruptcy stronger and better equipped to achieve long-term success.

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J.D. is the Co-leader and Managing Director of the Compensation and Benefits Practice. With a robust background in executive compensation, J.D. advises clients on everything from developing tailored compensation strategies to designing both annual and long-term remuneration packages. His work involves a careful assessment of competitive pay levels as well as a detailed analysis of tax and accounting implications. J.D.'s expertise extends to complex areas such as stock options, restricted stock, non-qualified retirement plans, deferred compensation, and innovative key employee programs—ensuring that each compensation plan is not only competitive but also compliant with critical regulatory standards, including golden parachute provisions and the one-million dollar deduction limitation.

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