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TRENDS IN DISTRESSED COMPENSATION: OIL & GAS COMPANIES SHIFT FOCUS TO RETENTION AS COVID-19 REMEDY

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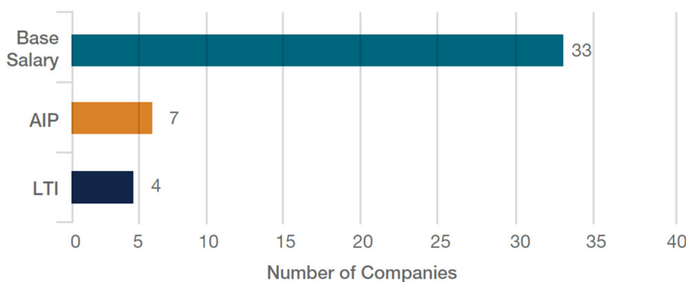
So far, 2020 has seen over 80 oil and gas companies file for Chapter 11 bankruptcy.[1] An oversupply of crude, driven in part by the Russia-Saudi Arabia oil price war, weakened demand caused by COVID-19 fears and travel restrictions, and a mounting wave of maturing debt all culminated in a significant increase in energy sector bankruptcies.[2] In a historical first, the price to take physical delivery of a barrel of West Texas Intermediate briefly turned negative, as speculators rushed to unload orders that suddenly exceeded short-term storage capacity.[3] With little sign of a recovery in sight, the energy sector has largely missed out on recent market rallies, lagging behind nearly all other industries.[4]

The collapse of the oil and gas market was met with swift changes in compensation plans at many of the largest oil and gas companies. A study by Alvarez & Marsal (A&M) of executive compensation practices of the largest US public Exploration & Production (E&P) and Oilfield Services (OFS) companies found that 56% and 69% of E&P and OFS companies, respectively, announced reductions in executive compensation in the first half of 2020.[5]

Exhibit 1: Oilfield Services Companies Reducing Compensation (first half of 2020)



Source: Alvarez & Marsal, analysis of data from SEC filings.

Reducing executive compensation was not unique to the energy industry, as over 350 companies announced similar reductions over that time period, with the retail sector leading the count.[6] For E&P and OFS companies, base salary reductions were most common, followed by annual and long-term incentives (see Exhibits 1 and 2).[7]

It was also found in the A&M study that although a majority of OFS companies reduced base salary equally for all executives, E&P companies were more likely to provide a greater percent reduction for the CEO than other executive officers.[8]

Recent compensation changes in the oil and gas industry have gone beyond simply reducing executive salaries. Some of the most significant trends in the sector are presented in the following discussion.

Refocusing Incentives

As many companies teetered on the edge of insolvency, employee retention became an increased focus in 2020. Future uncertainty often tips the scales in favor of short-

[1] *Haynes & Boone Oil Patch Bankruptcy Monitor* (2020).

[2] Houstonchronicle.com (2020). "Energy bankruptcies up 62 percent from last year.". Retrieved from https://www.houstonchronicle.com/business/energy/article/Energy-bankruptcies-up-62-percent-from-last-year-15566899.php.

[3] BBC.com (2020). "US Oil Prices Turn Negative as Demand Dries Up." Retrieved from https://www.bbc.com/news/business-52350082#:~:text=The%20price%20of%20US%20oil,world%20have%20kept%20people%20inside.

[4] ETF.com (2020). "Best and Worst Sectors ETFs of the Year." Retrieved from https://www.etf.com/sections/features-and-news/best-worst-sector-etfs-year?nopaging=1

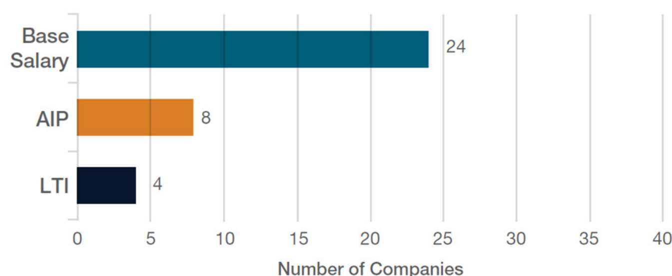
[5] See *2020/2021 Alvarez & Marsal Oil and Gas Exploration & Production (E&P) Compensation Report* (2020), ("2020/2021 A&M E&P Report"); https://www.alvarezandmarsal.com/insights/2021-oil-and-gas-exploration-production-ep-compensation-report; and *2020/2021 Alvarez & Marsal Oil and Gas Oilfield Services (OFS) Compensation Report* (2020), ("2020/2021 A&M OFS Report"), https://www.alvarezandmarsal.com/insights/2021-oil-and-gas-oilfield-services-ofs-compensation-report.

[6] Based on A&M's analysis of SEC Form 8-Ks and other public announcements.

[7] 2020/2021 A&M E&P Report and 2020/2021 A&M OFS Report (Op. cit., fn. 5).

[8] Id.

Exhibit 2: Exploration & Production Companies Reducing Compensation (first half of 2020)



term security at the expense of long-term upside. For distressed companies, the trend has been to adjust annual and long-term incentives to better address the current post-COVID-19 environment.

For annual incentive programs, an increase in the following practices has been observed:

- adjusting existing metrics downward to better reflect post-COVID-19 forecasts;
- replacing metrics that are difficult to forecast (such as revenue or EBITDA) with metrics that are more within management's control (such as safety and cost reductions);
- eliminating metrics and making all or a portion of the payout based solely on continued employment; and
- increasing payout frequency to semi-annually or quarterly.

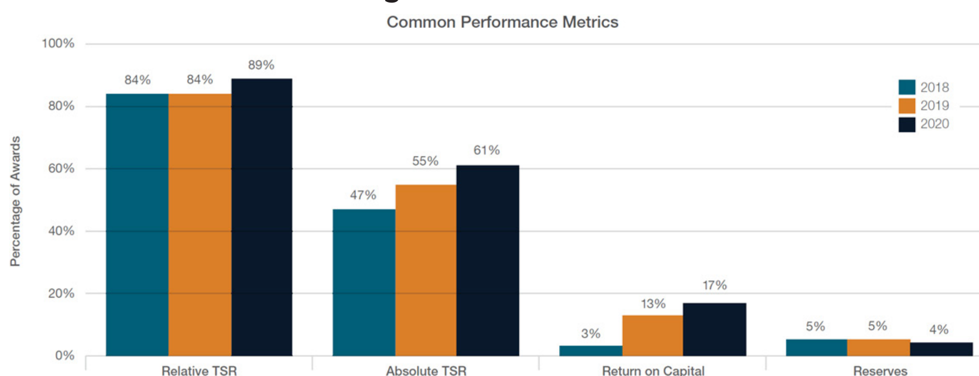
Depressed share prices and uncertain long-term prospects have resulted in similar changes to equity-based incentive plans, including:

- collapsing long-term and short-term programs into a single, annual program;
- granting cash instead of equity, to both limit downside and slow the burn rate on rapidly depleting share reserves; and
- utilizing industry-relative metrics that account for systemic underperformance in the sector as a whole.

The use of industry or peer-relative long-term incentive metrics is nothing new. Over the last several years, relative Total Shareholder Return (TSR) has remained the most widely used performance metric in the OFS and E&P sectors (Exhibits 3 and 4).

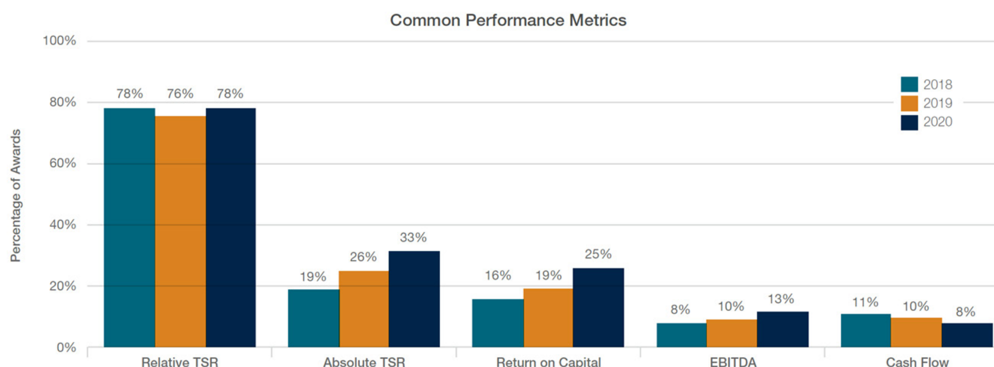
It is expected this trend will continue in the years ahead, as the E&P and OFS sectors attempt to navigate uncertain global markets.

Exhibit 3: E&P Historical Long-Term Incentives Metrics



2020/2021 A&M E&P Report.

Exhibit 4: OFS Historical Long-Term Incentives Metrics



2020/2021 A&M OFS Report.

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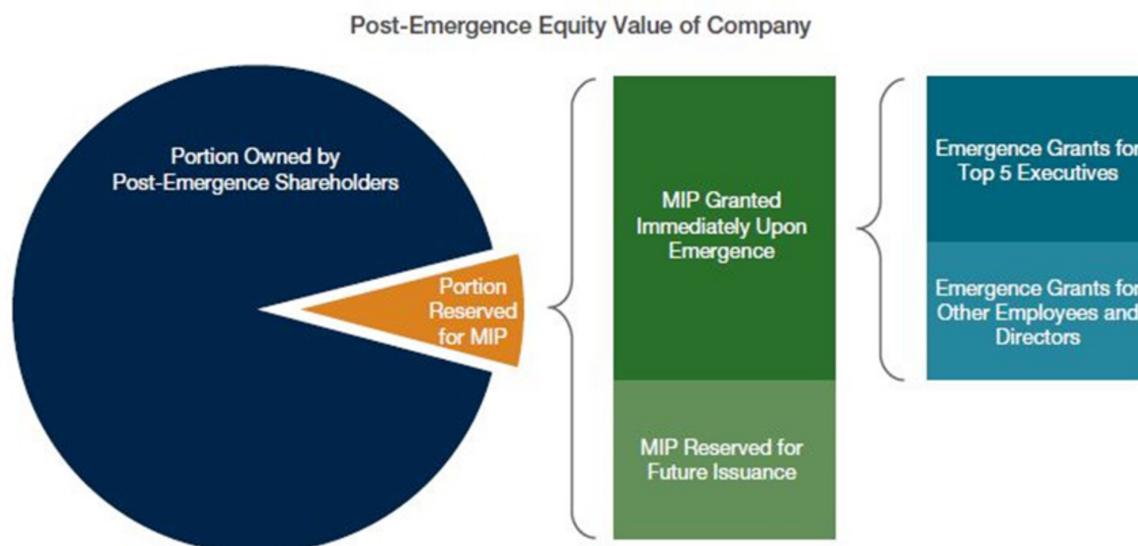
Exhibit 5: Illustration of Management Incentive Plan for Emergence



Source: Alvarez & Marsal, analysis of data from SEC filings.

Shifting to Retention

When simply modifying existing incentive programs is not enough, companies often resort to more aggressive measures. This often takes the form of a pre-paid retention bonus program that replaces all or a portion of the recipients' existing incentive compensation. There have been public announcements by over 40 companies about the adoption of such plans since the beginning of the COVID-19 pandemic.[9]

Pre-paid retention programs contain two main components:

- an immediate, up-front cash payment (sometimes representing the entire award amount or the first in a series of installments); and
- a clawback provision that requires the recipient to repay the value of the award if they voluntarily resign prior to the end of a designated retention period (commonly one year from the date of grant).

A more recent trend for these programs is to also include performance-based conditions, in which all or a portion of the award is clawed back if preestablished performance criteria are not satisfied.

These programs have many benefits. By making the payment up front, there is less concern about an employer's ability to pay bonuses after year end – a legitimate worry for employees of a struggling company. Receiving cash now subject to a risk of repayment appears to have a greater retentive effect than the promise of a future payment. For the rank and file, this has the added benefit of putting cash in the hands of employees at a time when many are struggling to make ends meet. For highly compensated employees, the prepayment results in immediate taxation at current rates, avoiding the uncertainty of future tax policy.

Taking the Dive into Chapter 11

Once a company has entered bankruptcy, most post-petition compensation must be approved by the court, and programs are often challenged by the UCC, the US Trustee, and other creditors. Payments to "insiders" are subject to increased scrutiny of the metrics, payout levels, and plan design.[10] Insider incentive plans with metrics deemed to be "lay ups" are tossed out as a matter of law.[11]

Once in bankruptcy, the job of designing performance metrics that are challenging yet attainable and drive corporate performance does not become any easier. The unpredictable commodities market and post-COVID-19 downturn makes forecasting traditional financial and operational performance metrics difficult, if not impossible. And the risk of error runs both ways: while conservative projections may lead to easily achievable metrics and undeserved payouts, aspirational goals can quickly become impossible to achieve, losing all incentivizing effect and leading to a mass exodus of key talent.

Despite these difficulties, the traditional KEIP and KERP are still mainstays in the bankruptcy process and are often used in conjunction with, not as a replacement for, pre-paid retention programs. The following are also notable trends in COVID-19 bankruptcy programs:

- Quarterly payout structures for both insiders and non-insiders are now the norm.

[9] Based on analysis by A&M of SEC Form 8-K announcements.

[10] See 11 U.S.C. § 503(c)(3).

[11] *In re Hawker Beechcraft, Inc.,* 479 B.R. 308, 313 (Bankr. S.D.N.Y. 2012).

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- Traditional top-line metrics like production and revenue are being replaced with operational and safety metrics that are more easily forecasted.
- Traditional bottom-line metrics like EBITDA and net income are being replaced with cost reduction measures, such as reduction in SG&A expense, that management can control even as commodity prices swing.

Emerging Positioned to Succeed

Compensation challenges continue long after emergence from bankruptcy. Equity incentives are typically wiped out as part of the Chapter 11 process, leaving executive management with a lack of meaningful ownership in the emerging entity. To quickly align the interests of management and shareholders, companies typically establish a management incentive plan (MIP) that carves out a percentage of the company's equity to be reserved for grants to management at or after emergence (Exhibit 5). In the energy sector, approximately 10% of fully diluted equity is commonly reserved for this purpose. The majority of this pool is usually granted immediately, with a significant amount allocated to the executive officers and the remainder left available for future annual grants – providing additional "runway" for the company to establish a steady-state long-term incentive plan, file the required SEC forms, and seek shareholder approval.

While the size of the MIP pool and the initial grants are often the immediate focus of negotiations, unfortunately less time and effort are spent on the types of equity vehicles, their vesting terms, and related termination provisions. Advisors should carefully consider the effects of these provisions in connection with the post-emergence goals of the company and the current market environment.

While widespread restructurings dominated the headlines in 2020, we believe sector consolidation will be the story of 2021. Consolidation is not a new trend in the oil and gas industries. As widely reported, 2019 saw major players, like Occidental and Chevron, fight over high-value Permian Basin acreage.[12] Still, depressed current valuations and more attractive, restructured balance sheets could prove irresistible for mega-cap corporations and private equity with sufficient dry powder. For the E&P sector, M&A activity has already begun to accelerate with publicly noted large acquisitions by Chevron, ConocoPhillips, and Pioneer Natural Resources. Similar moves are expected in the OFS sector in 2021, particularly among the hardest-hit offshore drilling names.

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Given the potential for consolidation in the coming months, companies nearing emergence from Chapter 11 should implement compensation packages that incentivize management, directing behaviors that maximize shareholder value. Executives are keenly aware of the risks of takeover. It is hard to motivate executives to actively pursue attractive bids, knowing all too well it may mean working themselves out of a job. Prudent advisors should keep these principles in mind when deciding the terms and provisions of executive MIP grants:

- Grants should be large enough – often 2 to 3 times the size of a typical annual grant for executive officers – to create a meaningful alignment between the interests of executives and shareholders;

[12] "Chevron drops Anadarko takeover battle after Occidental raises bid," Reuters.com (2019), retrieved from https://www.reuters.com/article/us-anadarko-petrol-m-a-chevron/chevron-drops-anadarko-takeover-battle-after-occidental-raises-bid-idUSKCN1SF1GX.

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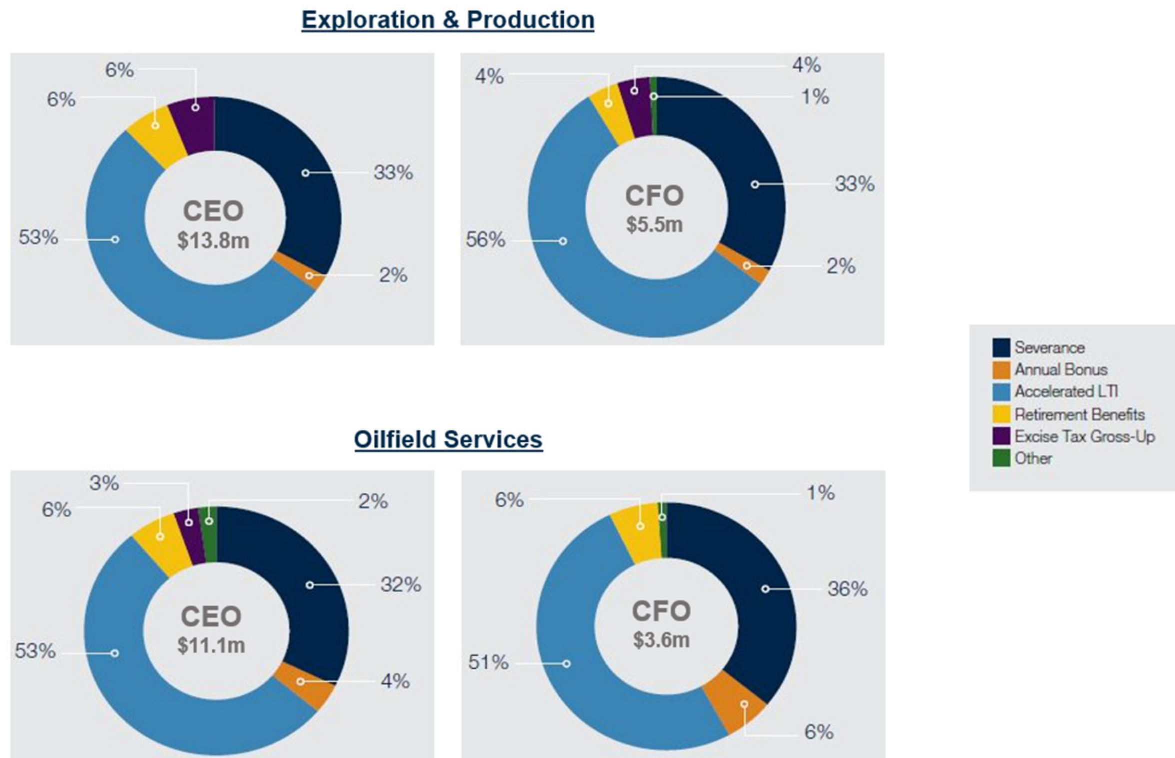
Exhibit 6: Termination Benefits for Executives Following Change in Control



2020/2021 A&M E&P Report; 2020/2021 A&M OFS Report.

- 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 ownership.

While 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 in the E&P and OFS sectors (Exhibit 6).

If the Board's strategy is to immediately solicit a buyer, additional 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 time to generate appreciable value. It may also make sense to choose to grant time-vesting, as opposed to performance-vesting, awards due to the favorable valuation rules available under the "Golden Parachute" regulations – potentially limiting additional excise tax on the executive and lost compensation expense deductions for the company.[13]

Conclusion

From the start of a business downturn to the end of a restructuring, understanding current market trends in compensation and related strategies is essential to retaining and incentivizing a productive workforce. With over 150 additional E&P companies expected to file bankruptcy by the end of 2022, oil and gas companies should actively assess their current compensation programs and consider appropriate adjustments when warranted.[14] Effective planning and forethought can help avoid costly restructuring compensation missteps before they occur. The biggest mistake is usually waiting until it is too late.

[13] See 26 USC §§ 280G and 4999.

[14] "Even at $40 WTI, about 150 more North American E&Ps will need Chapter 11 protection by end-2022." Rystadenergy.com (2020), retrieved from https://www.rystadenergy.com/newsevents/news/press-releases/even-at-%2440wti-about-150-more-north-american-eps-will-need-chapter-11-protection-by-end-2022/.

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