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Feature

By Brian L. Cumberland and J.D. Ivy

Coronavirus's Impact on Executive and Board of Director Compensation

Brian L. Cumberland
Alvarez & Marsal
Dallas

J.D. Ivy
Alvarez & Marsal
Dallas

Brian Cumberland is a national managing director with Alvarez & Marsal and leads the firm's Restructuring Compensation Practice. J.D. Ivy is a national managing director with the firm and leads its Compensation & Benefit Practice. Both are based in Dallas.

Editor's Note: *ABI recently launched its Coronavirus Resources for Bankruptcy Professionals website (abi.org/covid19), which aggregates information for bankruptcy professionals to assist clients and provide guidance due to the fallout from the COVID-19 pandemic.*

The coronavirus crisis is causing unprecedented negative economic impacts and stock market fluctuations. This presents significant challenges to companies from an executive compensation and board of director standpoint. While many companies will survive the downturn, for many others, conditions will push them into a restructuring and perhaps even into bankruptcy.

Faced with these circumstances, executives will find little motivating value in their existing compensation programs. Annual bonus payouts will be reduced or eliminated by the negative short-term economic climate, and long-term incentive (LTI) plans in many cases will be rendered completely worthless. Therefore, it is imperative that organizations find alternative methods to motivate and retain key executive talent, or they may not be able to fight through these tumultuous times. This article highlights the key issues in executive compensation that employers should consider as they weather the COVID-19 crisis.

Annual Incentive Plans

Many companies undoubtedly have already set performance targets under their annual incentive plans for this year. Because of the precipitous fall in the markets since then, however, many executives are in a situation where their LTI plan awards — most often provided in the form of stock or stock-based awards — are losing value or have already become worthless.

Consideration should therefore be given to whether and to what extent performance targets should be reestablished, taking into account the impact of the coronavirus crisis. Since the scope and extent of the current crisis is unknown, companies may wish to adopt a "wait and see" approach as opposed to taking swift action to adjust performance metrics too quickly to avoid the need for multiple revisions to the performance criteria, which would undoubtedly be viewed negatively by shareholders and shareholder advisory firms alike.

There are some factors to consider when determining whether or how to modify the performance criteria. These may include, among other things, Securities and Exchange Commission (SEC) disclosure requirements (to the extent the revisions apply to a public company's named executive officers), the accounting impact of any changes, how the press might portray changes to performance metrics, and the message that such changes might convey to employees and investors.

Equity Compensation

Just as the unmodified annual incentive plan might be perceived as a disincentive by executives, current economic conditions have undoubtedly had a negative impact on equity awards, which typically constitute most executives' compensation. For example, full-value awards (*e.g.*, restricted stock) will have a greatly diminished value, and appreciation awards (*e.g.*, stock options or stock appreciation rights) might be completely worthless. Companies will need to consider measures to create value for executives, and to realign their interests with those of shareholders generally.

For appreciation awards, companies may want to consider resetting the awards based on the current lower stock value. When doing so, the

accounting impact and SEC reporting requirements should be considered, not to mention the backlash that this might create with institutional shareholders. Another option would be to issue new awards based on the current share price. Keep in mind, however, that in the event of a significant reversal in stock prices due to economic recovery, this approach could result in an unintended windfall for executives. Therefore, companies may want to consider this possibility when determining the number of supplemental awards to grant.

For full-value awards, companies may want to consider issuing additional awards so that the intended LTI value is achieved. Furthermore, with the uncertainty surrounding the duration of the crisis and the ultimate low point of the stock market, companies may consider granting awards that are paid in cash instead of shares to ensure that the intended value of the LTI award is able to be realized by the executive.

Whether the company elects to reset existing awards or issue additional awards, in either case negative factors are at play. For example, due to a depressed stock price, the "burn rate"[1] of shares authorized for awards may be too great, resulting in premature exhaustion of shares under the plan. Furthermore, issuing additional awards will have the negative impact of diluting the interests of the other shareholders to a much greater extent than in healthy market conditions.

Restructuring or Bankruptcy

While addressing annual incentive and stock compensation might help to alleviate immediate executive-compensation concerns, if a company finds itself heading toward a financial restructuring or bankruptcy, the considerations and strategy change substantially. Companies in bankruptcy want to retain key executives because their substantial industry experience and company-specific knowledge are necessary to continue the operation of the company's business and support the company's turnaround. On the other hand, such executives have very little incentive to remain with the company during bankruptcy amid job instability, especially where annual bonuses and other compensation may no longer offer attractive payouts. As the key executives' LTI awards are often rendered worthless as a result of bankruptcy, it is generally considered acceptable to target executives' bankruptcy compensation higher than the compensation actually realized prebankruptcy.

To address these conflicting interests, prior to 2005 companies typically retained executives by implementing key employee retention plans (KERPs), whereby executives were paid for simply remaining on the job through specified dates during the bankruptcy process. However, as a result of perceived abuses involving substantial payments to executives in bankruptcy, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) added restrictions on payments to "insiders." Section 503(c)(1) of the Bankruptcy Code generally prohibits payments "to an insider of a debtor for purposes of inducing such person to remain with the debtor's business" unless certain very stringent restrictions are met. The restrictions are of a nature that, for practical purposes, retention payments to insiders are no longer possible. However, KERPs still work for those who are not considered insiders.

KERPs

KERPs help organizations motivate, reward and retain critical talent when experiencing financial distress. In most cases, remuneration under KERPs is in the form of cash offered to rank-and-file employees to incentivize them to stay with the company through a future date. Stay bonuses are often expressed as a percentage of the employee's base salary. In addition, it is fairly common for a discretionary pool to be set aside for unanticipated needs that might arise.

However, as previously mentioned, while KERPs are a good tool for retaining critical workforce members, such arrangements are not permitted to include "insiders" within the meaning of the Bankruptcy Code. Therefore, retention payments to "insiders" paid prior to a bankruptcy filing, with a clawback based on failing to provide services, has become a more recent trend that has been utilized in the last five years. These types of payments are made to the executives or insiders at the time the arrangement is approved. It will be subject to clawback if the executive terminates his/her employment without good reason or is terminated for "cause" prior to the earlier of (1) a specified period of time, (2) emergence from bankruptcy, or (3) a sale of substantially all the company's assets.

Insiders: KEIP Candidates

In formulating a key employee incentive plan (KEIP), one of the first issues to understand is which company executives are "insiders." Section 101(31)(B) of the Bankruptcy Code provides the definition of "insider," which includes a director, an officer, a person in control or a general partner of the debtor, or a relative thereof, as well as a partnership in which the debtor is a general partner. However, the list in § 101(31)(B) is not exhaustive, and the terms "director" and "officer" are not defined. Therefore, a bankruptcy court's determination of insider status is often based on the facts and circumstances of each case.

Some courts[2] have found that a person with an officer title is, *per se*, an insider, as he/she satisfies the definition, while other courts[3] have found that a person's title is not determinative and that it is necessary to investigate the extent to which the individual exerts control over the company. Once a company determines the identity of its insiders, the company should move toward implementing a KEIP for that group of executives.

1 "Burn rate" is the percentage of equity awards a company grants per year, divided by the total number of outstanding shares. It measures how quickly a company's stock grants will dilute its outstanding common stock.

2 *In re Pilgrim's Pride Corp.*, 401 B.R. 229, 236 n.11 (Bankr. N.D. Tex. 2009) (for purposes of § 503(c), anyone who holds title of "officer" or "director" as of commencement of debtor's case is insider under plain meaning of § 101(31)); *Office of the U.S. Trustee v. Fieldstone Mortg. Co.*, 2008 U.S. Dist. LEXIS 91479 (D. Md. Nov. 5, 2008) (reversing bankruptcy court's decision to conduct separate factual inquiry into authority exercised by seven employees with "vice president" titles to determine whether they were officers and thus insiders in connection with proposed KERP).

3 *In re Borders Grp. Inc.*, 453 B.R. 459, 469 (Bankr. S.D.N.Y. 2011) (employee's title is not enough to establish insider status, which should be "determined on a case-by-case basis based on the totality of the circumstances, including the degree of an individual's involvement in a debtor's affairs"); *In re Global Aviation Holdings Inc.*, 478 B.R. 142, 147-48 (Bankr. E.D.N.Y. 2012) (employees covered by proposed plan were not insiders despite their job titles (including two employees with "director" titles)).

The KEIP Plan

KEIPs covering "insider" participants are intended to avoid the restrictions of § 503(c)(1) by being designed in such a fashion that they primarily incentivize such persons and do not simply induce them to remain employed. Courts have found that a KEIP that is shown to be primarily incentivizing will not be subject to § 503(c)(1) restrictions — even if it has some retentive effect.[4]

Thus, KEIPs should be structured to pay out based on the achievement of challenging performance metrics and goals, as determined by the company. Common performance metrics used by companies include financial metrics (EBITDA, cash flow, operating income, liquidity, etc.), sales of assets, confirmation of reorganization/emergence plans from bankruptcy (usually by a specified time), cost-reduction/expense control, creditor recovery and product sales. Bankruptcy courts have denied KEIPs where performance metrics are too easy to satisfy, and have also required that performance metrics be closely tied to any payout under the plan.[5]

Board Compensation Arrangements

When companies prepare for a potential restructuring, adjustments to board of directors' compensation programs are often overlooked. Normal-course board compensation is comprised of two elements: (1) cash retainers, including an annual board retainer and committee retainers; and (2) equity retainers, which is typically restricted stock that vests if the director remains on the board for one to three years from grant. At the time of a potential restructuring, however, previous equity awards issued by the company typically have little to no value, and the company might not have enough available equity to compensate its board members properly.

According to the 2018-19 NACD Public Company Governance Survey, the average public company director's time commitment equated to nearly 245 hours each calendar year. During (and in preparation for) a restructuring, the workload significantly increases for board members. This is particularly true during the early stages of a restructuring, when many important decisions require the board's timely attention. The increased time commitment is one factor that should be considered when evaluating board compensation practices and levels during a restructuring.

Moreover, in a bankruptcy setting, board members are also likely working themselves out of a job, as most board members do not continue service after the company emerges from bankruptcy with the new owners or the company is sold. The authors' experience has shown that there is a 98 percent board member turnover. These factors highlight the need to appropriately compensate essential board members in order to maximize the value of the company over the course of the restructuring process.

Common Changes to Board Compensation

Before making any changes to compensation, boards should evaluate market levels of pay by benchmarking compensations of similar companies. Appropriate compensation is essential to maintaining the directors' focus during a time of distress and increased workload. Benchmarking director compensation also provides assurances to companies that their board members are being compensated fairly and within market, which might reduce the company's risk associated with utilizing out-of-market pay practices.

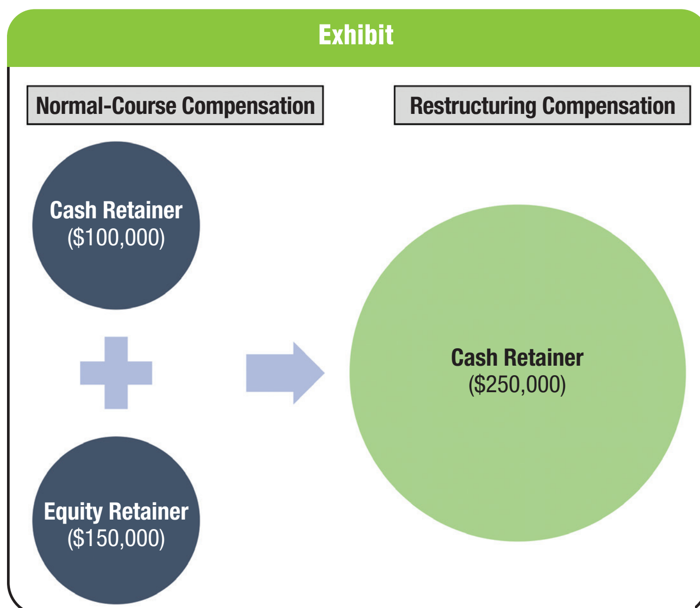
Conversion to Cash Compensation

As a company approaches a restructuring event, equity compensation generally does not provide an appropriate incentive due to its diminished value. The most common process boards undertake during this time is to conduct a market analysis to ensure competitive levels of compensation, then convert the board compensation to a fully cash-based program. As shown in the exhibit, a company with a $100,000 cash retainer and a $150,000 equity retainer would convert to a $250,000 cash retainer.

Adjustments to payout timing are also considered in order to maintain the directors' focus throughout the restructuring process. For example, companies with programs that pay out annually often convert into a quarterly program that is payable in advance. In addition, a director's increased time commitment should be considered when evaluating potential changes to go-forward compensation, as additional compensation might be warranted.

Special Restructuring Committee

In certain cases, the board will form a separate restructuring committee in anticipation of the specialized tasks associated with the restructuring. In addition, a board



4 *In re Global Home Prods. LLC*, 369 B.R. 778, 783 (Bankr. D. Del. 2007) (§ 503(c) restrictions were inapplicable to plans, as they were primarily incentivizing, and fact that all compensation has retention element does not reduce conviction that debtor's primary goal is to create value by motivating performance); *In re Nellson Nutraceutical Inc.*, 369 B.R. 787, 802 (Bankr. D. Del. 2007) (as long as plan's primary purpose is to incentivize insiders and other employees, rather than merely retain them, it remains incentive plan).

5 *In re Dana Corp.*, 351 B.R. 96, 102 n.3 (Bankr. S.D.N.Y. 2006) (completion bonus was not incentive bonus but retention bonus because (1) fixed component was not tied to anything other than staying with company until effective date of reorganization plan and (2) thresholds for variable component were so artificially low that it guaranteed that bonuses would be paid; as court observed, "this compensation scheme walks, talks and is a retention bonus"); *In re Residential Capital LLC*, 478 B.R. 154, 173 (Bankr. S.D.N.Y. 2012) (largest component of KEIP in this case was primarily retentive because it (1) provided for nearly two-thirds of bonuses to vest upon closing of asset sales that were already negotiated pre-petition and (2) KEIP did not impose any additional challenging performance metrics or hurdles in order for those bonuses to vest); *In re Hawker Beechcraft Inc.*, 479 B.R. 308, 309 (Bankr. S.D.N.Y. 2012) (rejecting KEIP and noting that, "[a]lthough the KEIP includes elements of incentive compensation, when viewed as a whole, it sets the minimum bonus bar too low to qualify as anything other than a retention program for insiders"). *See also In re Velo Holdings Inc.*, 472 B.R. at 201, 205-06 (Bankr. S.D.N.Y. 2012).

member might be appointed the chief restructuring officer (CRO). In exchange for service on the special committee or as a CRO, additional compensation commensurate with additional duties and extraordinary workload is warranted. Compensation for service on a special restructuring committee or a CRO varies widely based on the company's needs and the individual director's contributions.

A Return to Meeting Fees

For steady-state companies, the general market trend has been for boards to move away from paying per-meeting fees, instead focusing on a fixed-retainer structure. However, in a restructuring context, the use of meeting fees might be more appropriate as a means to reflect the additional workload during the restructuring process. On the other hand, a fixed retainer, with no meeting fees, simplifies the administrative process and removes the challenge of determining what is considered a "meeting."

Conclusion

Companies experiencing financial distress due to current economic conditions must carefully consider whether and how to modify their compensation programs in order to ensure that executives and boards of directors stay engaged and motivated through these trying times. In the unfortunate event that a company is facing a restructuring or potential bankruptcy, additional challenges arise. KEIPs and KERPs, when properly structured, can help bridge the compensation gap between the time in bankruptcy and the successful go-forward organization. Finally, do not forget to consider the board of directors' compensation arrangements. abi

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