OIL AND GAS EXPLORATION & PRODUCTION (E&P) INCENTIVE COMPENSATION REPORT

ANALYSIS OF COMPENSATION ARRANGEMENTS AT 100 OF THE LARGEST U.S. E&P COMPANIES

2016

ALVAREZ & MARSAL

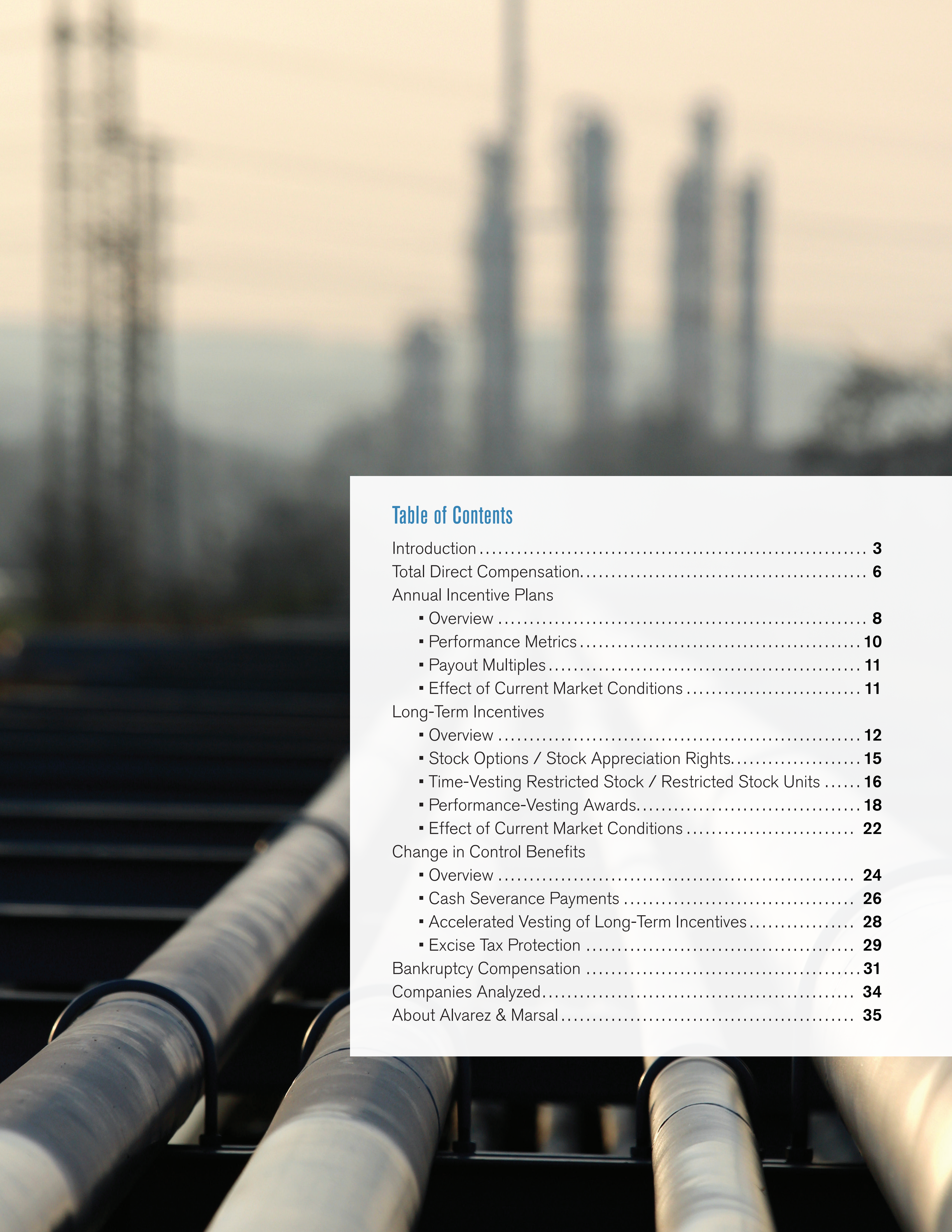


Table of Contents

Introduction 3
Total Direct Compensation 6
Annual Incentive Plans
- Overview 8
- Performance Metrics 10
- Payout Multiples 11
- Effect of Current Market Conditions 11

Long-Term Incentives
- Overview 12
- Stock Options / Stock Appreciation Rights 15
- Time-Vesting Restricted Stock / Restricted Stock Units 16
- Performance-Vesting Awards 18
- Effect of Current Market Conditions 22

Change in Control Benefits
- Overview 24
- Cash Severance Payments 26
- Accelerated Vesting of Long-Term Incentives 28
- Excise Tax Protection 29

Bankruptcy Compensation 31
Companies Analyzed 34
About Alvarez & Marsal 35

INTRODUCTION

Incentive compensation is an integral part of the total compensation package for executives at most large, publicly-traded companies. To understand compensation practices in the energy sector, specifically for exploration and production (E&P) companies, Alvarez & Marsal's (A&M) Executive Compensation and Benefits Practice examined the latest proxy statements for 100 of the largest E&P companies in the U.S. With the current downturn in the commodity markets, we also address compensation arrangements at distressed E&P companies.

INTRODUCTION

Key Takeaways

Total Direct Compensation

- On average, incentive compensation — including annual and long-term incentives (LTI) — comprises approximately 80% of a CEO's and CFO's total compensation package.
- The average total direct compensation for all CEOs was $5,899,439. The average total direct compensation for all CFOs was $2,786,292.

Annual and Long-Term Incentive Compensation

- 84% of companies in the top quartile utilize annual incentive plans where payout is at least partially determined in a formulaic manner, while only 60% of companies in the bottom quartile utilize formulaic performance metrics.
- The prevalence of long-term incentive awards varies by company size, but time-vesting restricted stock / restricted stock units are the most common form of award granted (used by 82% of all companies).
- 56% of companies grant long-term incentive awards where vesting or payout is determined by one or more performance metrics. Relative total shareholder return is the most commonly used performance metric and is used in 83% of such awards.

Change in Control Benefits

- The most common cash severance multiple for CEOs is three times compensation or greater (51%). The most common multiple for CFOs is between two and three times compensation (59%).
- The most valuable benefit received in connection with a change in control is accelerated vesting and payout of long-term incentives.
- Single trigger equity vesting (no termination required) is most prevalent (51%), although double trigger vesting provisions are nearly as common (45%).
- Only 19% of CEOs and CFOs are entitled to receive excise tax "gross-up" payments — meaning the company pays the executive the amount of any excise tax imposed, thereby making the executive "whole" on an after-tax basis. 47% of companies do not provide any excise tax protection at all.

Bankruptcy Compensation

- Incentive programs, when properly structured, can help bridge the compensation gap between the onset of financial hardship and a healthy go-forward restructuring. The most common metrics for E&P bankruptcy incentive plans are production, expense reduction (lease operating expenses [LOE] or general and administrative [G&A]) and EBITDA.
- Just as incentive plans may be effective tools prior to and during the bankruptcy process, equity granted by companies upon emergence from bankruptcy is utilized to motivate and retain employees after the company has emerged from bankruptcy protection.

Methodology

Where possible, this analysis only includes companies with revenue derived primarily from E&P activities (i.e., not primarily midstream, refining, etc.), and excludes companies that did not disclose sufficient data on their compensation programs, such as companies that recently went through an initial public offering and did not disclose the structure of their go-forward compensation. The data represents the most up-to-date plan structure disclosed by these companies. Where applicable, data from our prior study is shown in comparison to data captured in the current year.

The companies analyzed for this report are diverse in terms of size. For comparison purposes, we grouped the companies in quartiles based on market capitalization as shown below:

Quartile	Market Capitalization Range[1]	Median
Top Quartile	$3B - $58B	$10.7B
Second Quartile	$400M - $3B	$1.3B
Third Quartile	$100M - $400M	$218M
Bottom Quartile	Under $100M	$42M

[1] Market capitalization as of January 1, 2015.

TOTAL DIRECT COMPENSATION

We captured compensation data from the summary compensation table disclosed in the 2015 proxy statement for each company. The following tables show the average values for each element of compensation broken out by quartile for CEOs and CFOs:

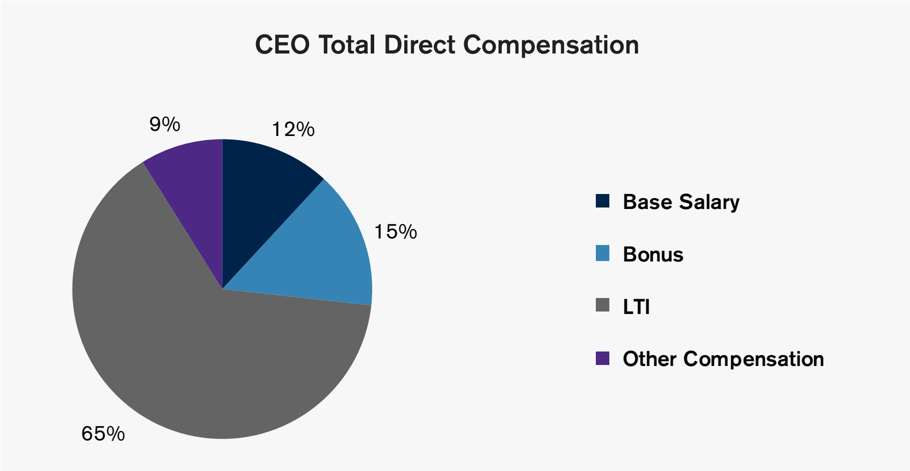
CHIEF EXECUTIVE OFFICER ANNUAL COMPENSATION					
Market Capitalization Rank	Base Salary	Annual Incentives	Long-Term Incentives	Other Compensation[1]	Total
Top Quartile Average	$1,079,630	$1,660,434	$8,193,316	$1,547,586	$12,480,966
Second Quartile Average	711,051	1,031,918	4,299,540	165,198	6,207,708
Third Quartile Average	499,419	577,917	1,425,907	149,357	2,652,600
Bottom Quartile Average	456,423	289,090	1,351,760	178,680	2,275,953
Average of All Quartiles	**$686,631**	**$889,840**	**$3,812,763**	**$510,205**	**$5,899,439**

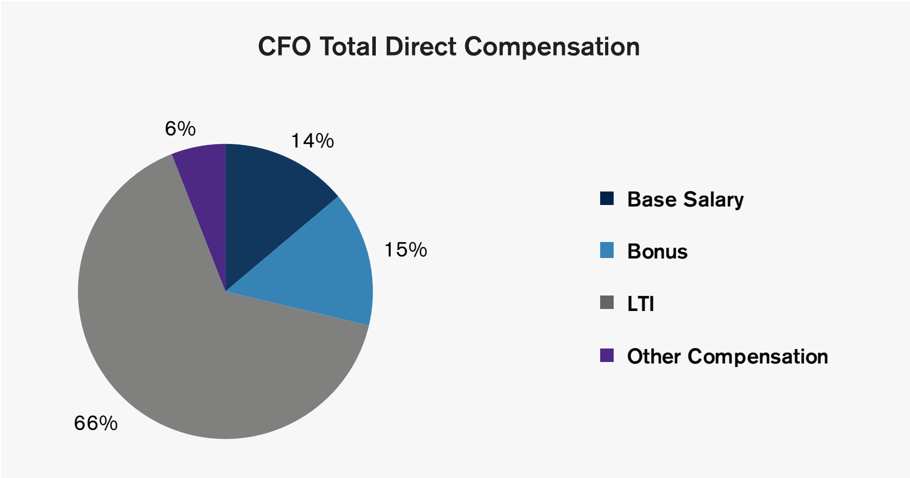
CHIEF FINANCIAL OFFICER ANNUAL COMPENSATION					
Market Capitalization Rank	Base Salary	Annual Incentives	Long-Term Incentives	Other Compensation[1]	Total
Top Quartile Average	$545,137	$644,357	$3,015,469	$466,983	$4,671,946
Second Quartile Average	415,690	550,521	2,560,467	64,310	3,590,988
Third Quartile Average	315,600	277,871	977,430	53,459	1,624,360
Bottom Quartile Average	296,572	163,894	763,775	35,047	1,259,288
Average of All Quartiles	**$395,012**	**$410,221**	**$1,825,194**	**$155,865**	**$2,786,292**

[1] Other Compensation includes: change in pension value, above market earnings, and "all other compensation" as disclosed in each company's proxy statement.

TOTAL DIRECT COMPENSATION

The following charts show the proportion of total direct compensation delivered in base salary, annual bonus, long-term incentive awards and other compensation for CEOs and CFOs:





On average, incentive compensation — including annual and long-term incentives — comprises approximately 80% of an executive's total compensation package. Because incentive compensation is such an integral part of the total compensation package for executives at most companies, we examine annual and long-term incentive programs in greater detail in the following section.

ANNUAL INCENTIVE PLANS

Overview

As is the case with most industries, companies in the E&P sector generally provide an opportunity for executives to participate in an annual incentive plan (AIP), also commonly called bonus programs. AIPs utilize performance metrics that are generally measured over a one-year period.

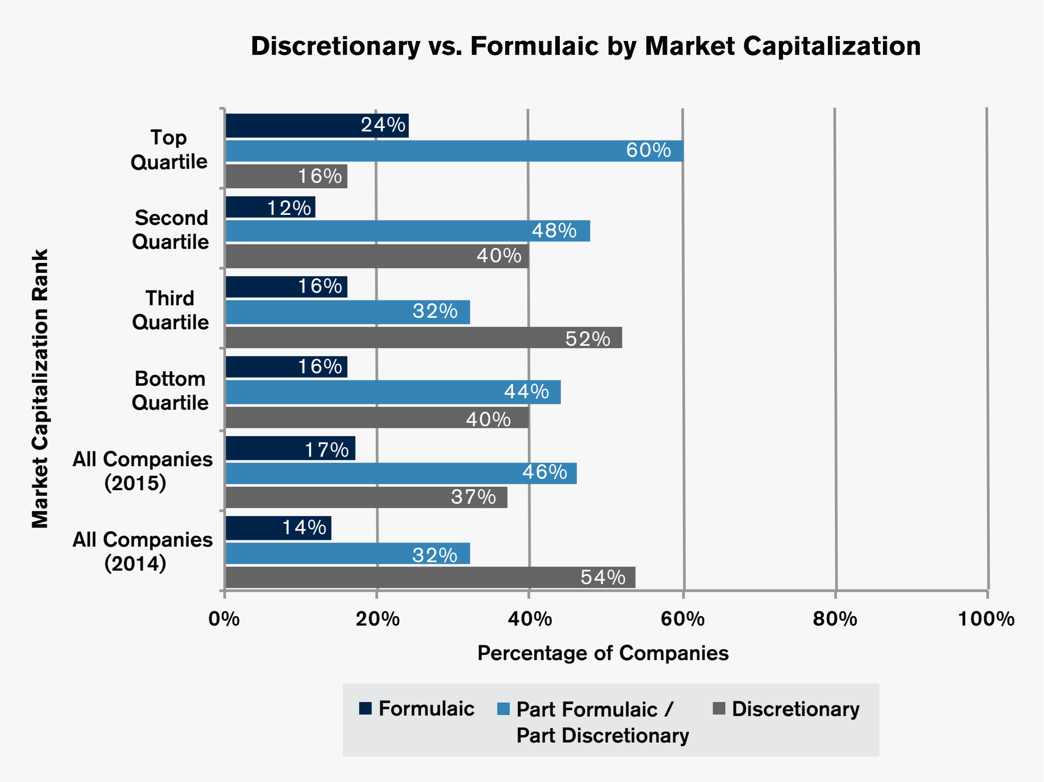
Discretionary vs. Formulaic

For this analysis, we grouped annual incentive plans into the following three categories based on how the annual bonus payout is determined:

- **Formulaic** – The plan utilizes predetermined performance criteria with established targets that will determine payout, and the compensation committee does not have discretion to adjust payouts (other than negative discretion).
- **Discretionary** – The plan may or may not utilize specific, pre-established performance criteria, but the compensation committee maintains absolute discretion to adjust payout levels upward or downward.
- **Part Formulaic / Part Discretionary** – The plan utilizes certain metrics in which payout is determined formulaically and others in which payout is determined at the discretion of the compensation committee.

ANNUAL INCENTIVE PLANS

As shown in the chart below, the majority of E&P companies maintain some form of discretion with respect to their AIP. However, these companies tend to move away from purely discretionary plans as market capitalization increases, as shown below:



Companies may utilize formulaic compensation programs to provide clarity to executives and shareholders on how compensation will be determined and to benefit from favorable tax treatment under the "performance-based compensation" exemption under Internal Revenue Code (IRC) section 162(m). IRC section 162(m) generally disallows a tax deduction for compensation paid in excess of $1 million. However, when properly structured, performance-based compensation, including payouts under a formulaic AIP, are exempt from the $1 million limit.

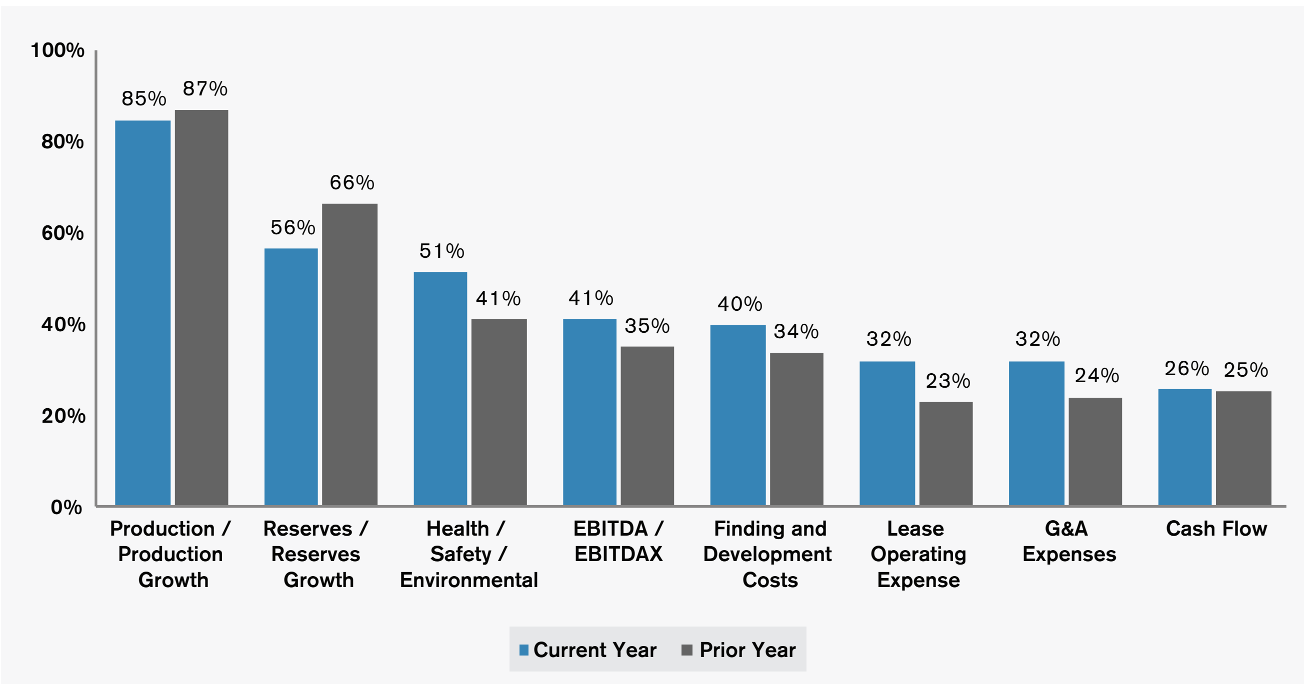
Notwithstanding the favorable tax treatment afforded to formulaic AIPs, some companies maintain discretion over the payout of annual bonus plans in order to adjust for events that are unforeseen and/or out of the executive's control. This is particularly useful considering the volatility of the commodity markets over recent years.

ANNUAL INCENTIVE PLANS

Performance Metrics

Generally, as market capitalization increases, companies have a stronger preference to utilize stated performance metrics, with 96% of companies in the top quartile utilizing at least one performance metric. It is important to note that simply because a plan utilizes performance metrics, it may not necessarily be classified as "formulaic." Based on the terms of the plan, it may ultimately be classified as "discretionary."

The following chart displays the most prevalent metrics used in AIPs. Production, including production growth, is the most prevalent metric and is used by 85% of E&P companies that utilize performance metrics. These performance metrics have remained fairly consistent over the past year.



The prevalence of production and reserve metrics is likely influenced by investors that utilize a "growth" investment style. We often find that these growth metrics are balanced with financial metrics on a company's scorecard to ensure that executives focus on profitable growth, rather than growth at any cost.

ANNUAL INCENTIVE PLANS

Payout Multiples

The following tables show the threshold, target and maximum level of annual incentive awards as a percentage of base salary for CEOs and CFOs. When disclosed, threshold payout is generally one-half of target payout and maximum payout is two times the target payout.

CEO			
Percentile	Threshold	Target	Maximum
25th	50%	100%	197%
Average	54%	108%	209%
50th	50%	100%	200%
75th	63%	125%	250%

CFO			
Percentile	Threshold	Target	Maximum
25th	40%	80%	150%
Average	42%	85%	167%
50th	45%	90%	180%
75th	50%	100%	200%

Effect of Current Market Conditions

Over the last year, the energy sector has been plagued with persistently low commodity prices. Therefore, current market conditions may not be reflected in some of the data captured. Many companies are adjusting their performance metrics to reflect the depressed commodity markets. Companies are shifting away from metrics such as production and other growth metrics to focus their efforts on existing, successful wells, scaling back on unprofitable production, and lowering costs. Some companies are considering adding a discretionary component to the AIP due to the current uncertainty.

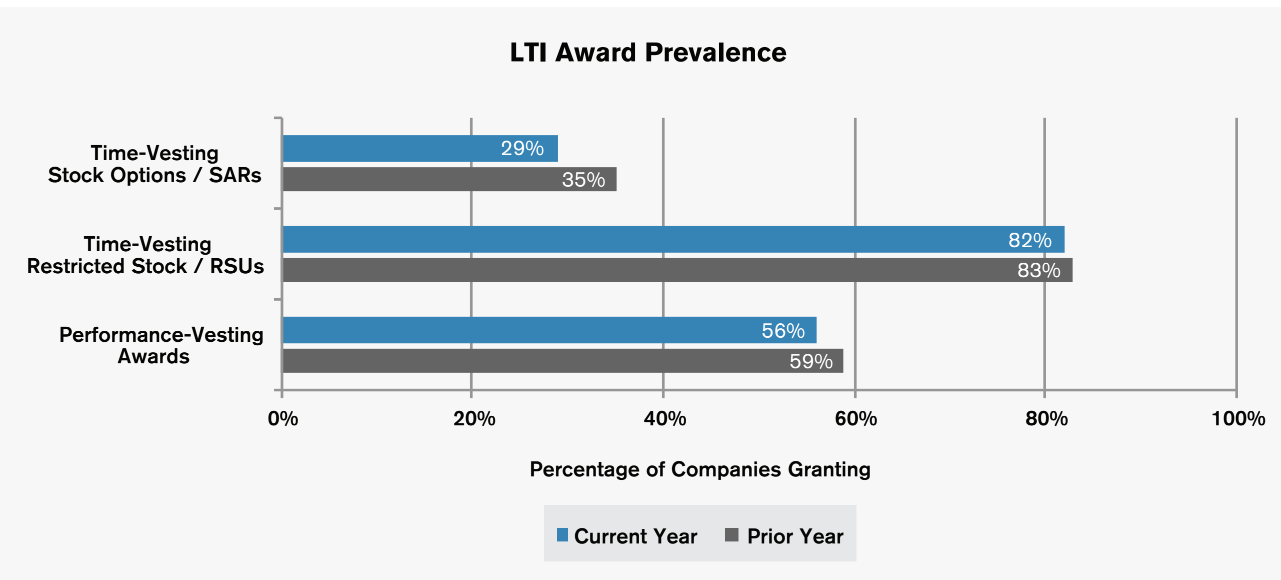
LONG-TERM INCENTIVES

Overview

Companies grant long-term incentives to motivate and retain executives and to align the interests of executives and shareholders. Nearly all E&P companies analyzed grant some form of long-term incentive award to executives. Long-term incentives generally consist of stock options, stock appreciation rights (SARs), time-vesting restricted stock or restricted stock units (RSUs), and performance-vesting awards (i.e., awards that vest upon satisfaction of some performance criteria rather than solely based on the passage of time). For purposes of this analysis, we grouped awards into three categories: (1) time-vesting stock options and SARs; (2) time-vesting restricted stock and RSUs; and (3) performance-vesting awards.

Award Prevalence

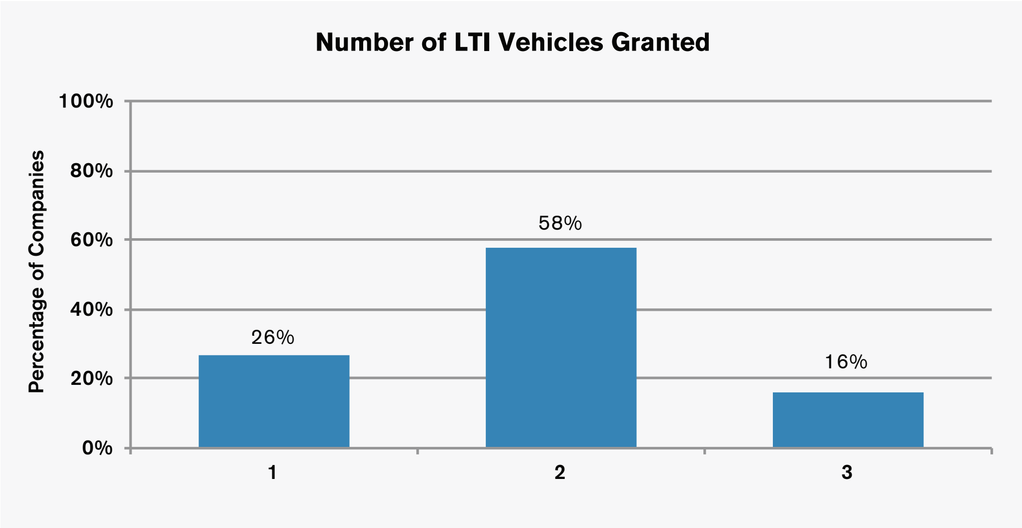
The chart below shows the prevalence of stock options / SARs, time-vesting restricted stock / RSUs, and performance-vesting awards for all companies:



LONG-TERM INCENTIVES

- Time-vesting restricted stock / RSUs are the most utilized award type followed by performance-vesting awards.
- Stock options / SARs are the least prevalent LTI vehicle utilized by U.S. E&P companies. Although stock options / SARs are still used by almost one-third of companies, these awards declined in popularity for several reasons:
  - A change in the accounting treatment that requires companies to recognize compensation expense for these awards;
  - The overall market shift toward performance-vesting equity; and
  - The view of proxy advisors that these types of awards are not "performance-based," even though to receive value from a stock option or SAR, the underlying stock price generally must increase.
- Additionally, stock options / SARs provide little to no value to an executive in a down or flat market, which also reduces (or eliminates) any retentive value from this type of award.
- Most companies that utilize performance-vesting awards or stock options also grant time-vesting restricted stock or RSUs to balance out the retentive goal of their LTI program.

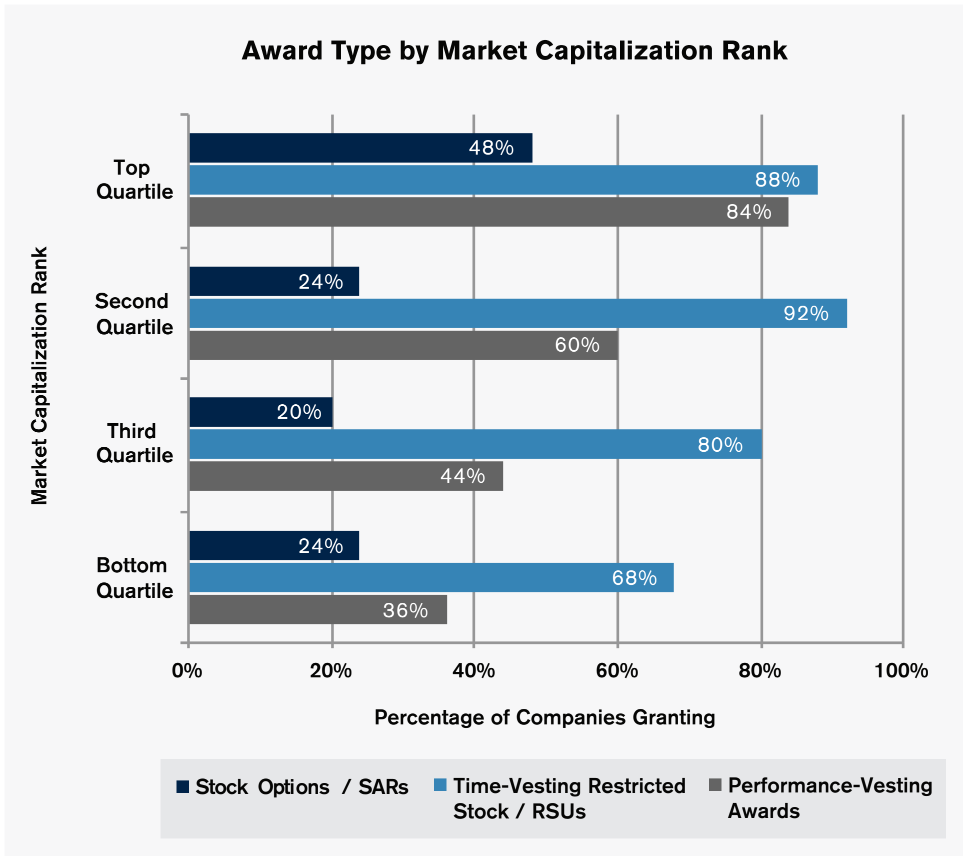
The chart below shows the number of LTI vehicles granted at each company. A majority of companies (74%) grant at least two types of LTI vehicles.



LONG-TERM INCENTIVES

Award Prevalence by Market Capitalization

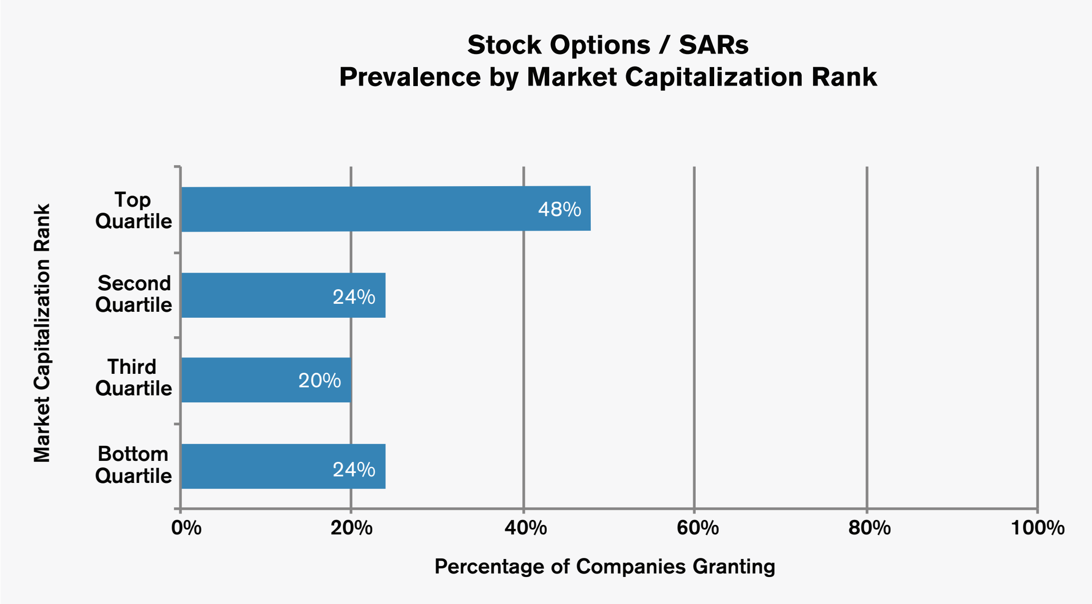
As shown in the chart below, A&M also analyzed whether a company's size (in terms of market capitalization) impacts the prevalence of awards that are provided.



- Stock options / SARs tend to be more prevalent at larger companies.
- Time-vesting restricted stock / RSUs are slightly more prevalent at larger companies.
- Performance-vesting awards are significantly more prevalent at larger companies (84% of companies in the top quartile and only 36% of companies in the bottom quartile).
- Companies in the bottom quartile grant long-term incentives with less regularity (68% of companies) than larger companies (100% of companies).

Stock Options / Stock Appreciation Rights

The chart below shows the percentage of companies that grant stock options / SARs by market capitalization. Stock options / SARs tend to be more prevalent at larger companies.



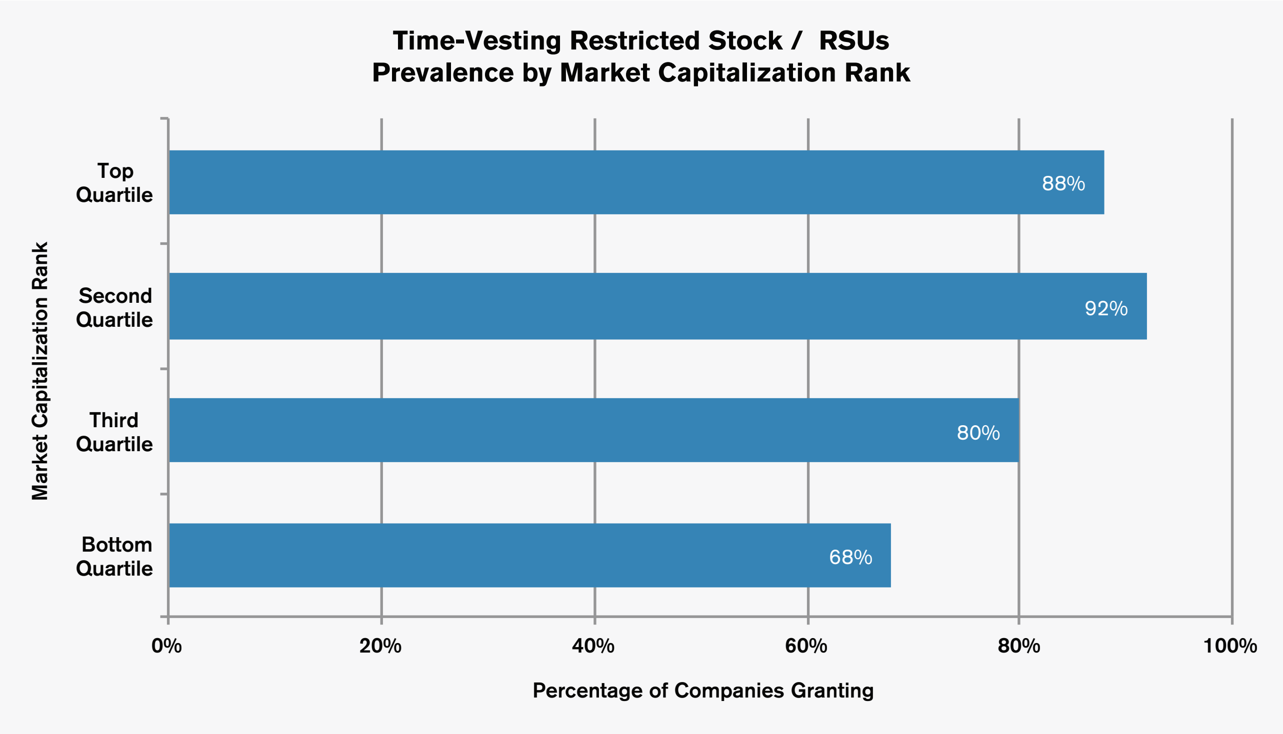
Award Provisions

- Stock option awards predominantly consisted of nonqualified stock options rather than tax-favored incentive stock options.
- Awards generally vest on a ratable basis rather than cliff vesting.
  - Ratable vesting is when a portion of the award vests each year during the vesting period (e.g., one-third of the award vests on each of the first three anniversaries of the grant date).
  - Cliff vesting is when the entire award vests at the end of the vesting period (e.g., 100% of the award vests on the third anniversary of the grant date).
- The most prevalent vesting period for stock options / SARs is three years (71% of companies), followed by four years (used by 19% of companies).
- The most prevalent contractual term for stock options / SARs is 10 years (65% of companies), but a seven-year or five-year term is also used at many companies (used by 23% and 10% of companies, respectively).
  - A shorter contractual term may be used by some companies in order to reduce the compensation expense attributable to stock options.

LONG-TERM INCENTIVES

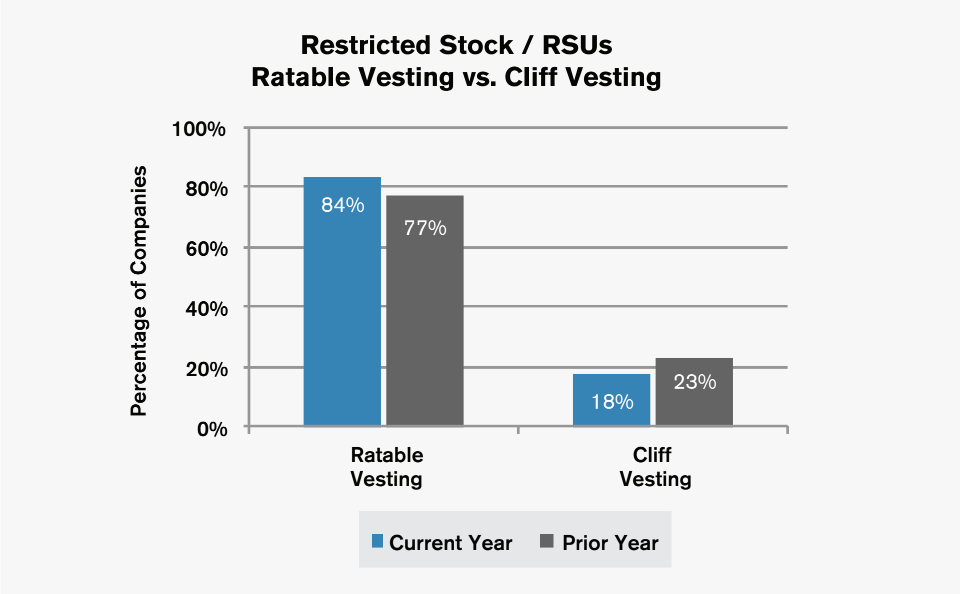
Time-Vesting Restricted Stock / Restricted Stock Units

The chart below shows the percentage of companies that grant time-vesting restricted stock / RSUs by market capitalization. The prevalence is fairly high (in the 60% to 90% range) for all sizes of companies and is more prevalent at larger companies.



Award Provisions

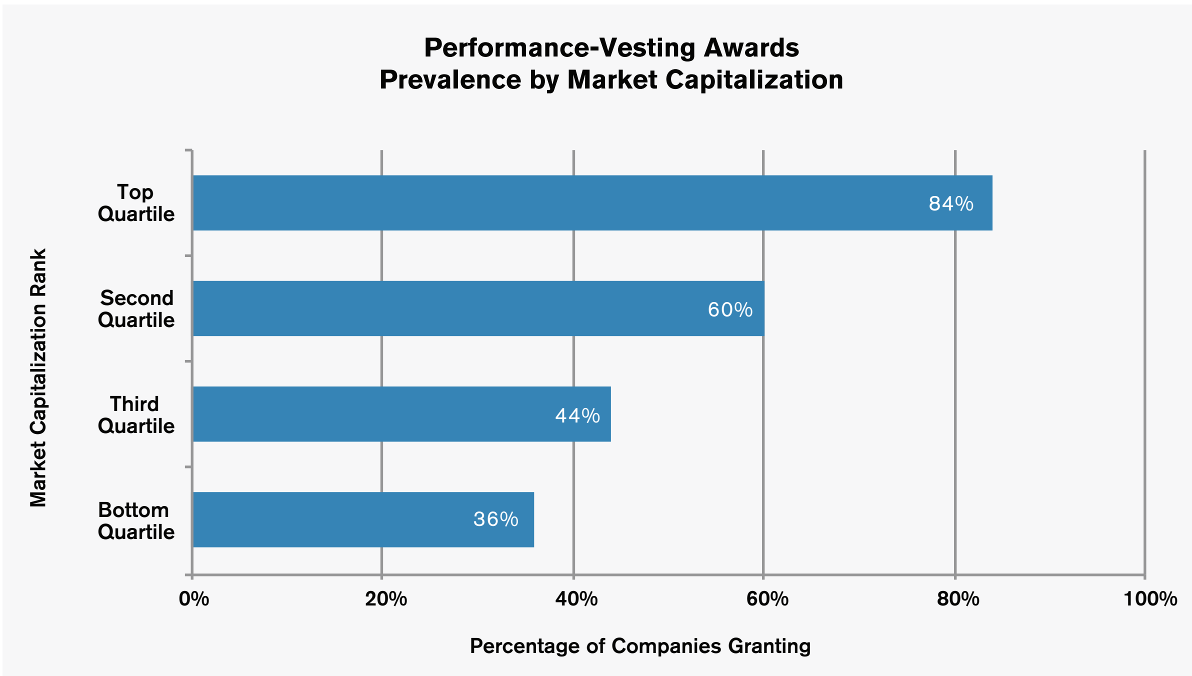
- Of companies that grant time-vesting restricted stock / RSUs, it is more common for companies to grant restricted stock (63% of companies) than RSUs (41% of companies).
- A three-year vesting period is the most common vesting period (utilized by 70% of companies), while a four-year vesting period is the second most common (utilized by 16% of companies).
- As shown in the chart below, more companies utilize awards that ratably vest than cliff vest.



LONG-TERM INCENTIVES

Performance-Vesting Awards

The chart below shows the percentage of companies that grant performance-vesting awards by market capitalization. Performance-vesting awards become significantly more prevalent as company value increases.

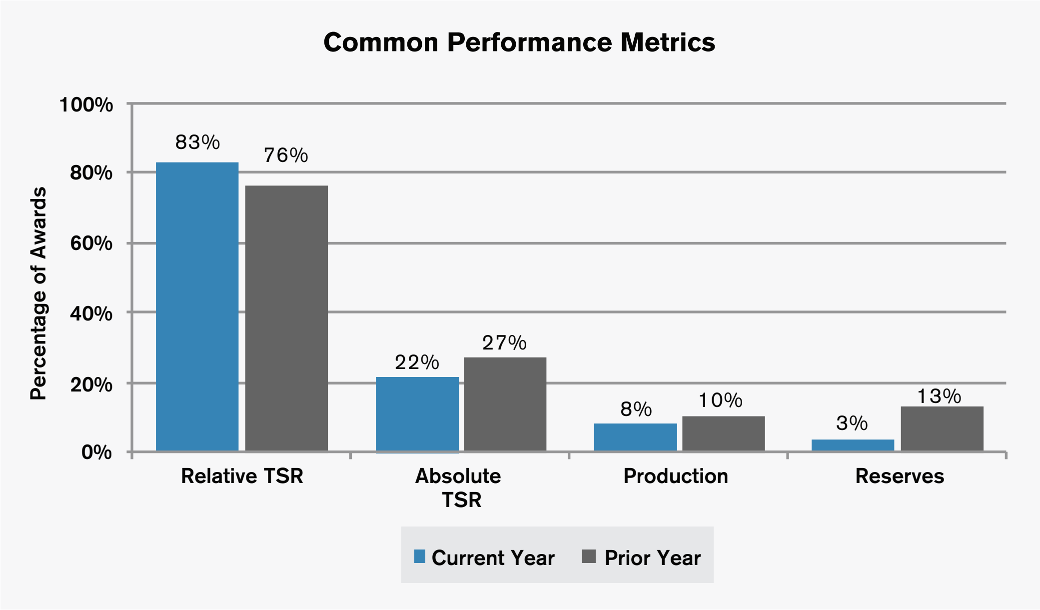


Performance Metrics

The most prevalent metric is total shareholder return (TSR) relative to a peer group, which is used for 83% of performance-vesting awards. Nearly one-quarter of performance-based awards use TSR on an absolute basis either as a standalone metric or to limit payout if absolute TSR is negative (i.e., if absolute TSR is negative, then the maximum payout is capped at a lower amount). The absolute TSR cap is designed for circumstances such as those we are seeing today; a company may have the highest TSR relative to its peer group, but absolute TSR is negative due to the recent, dramatic decline in the commodity markets.

41% of performance-based awards utilize more than one performance metric. For purposes of this analysis, an absolute TSR modifier was considered a separate metric.

The following chart shows the prevalence of the most common metrics used for performance-vesting awards:

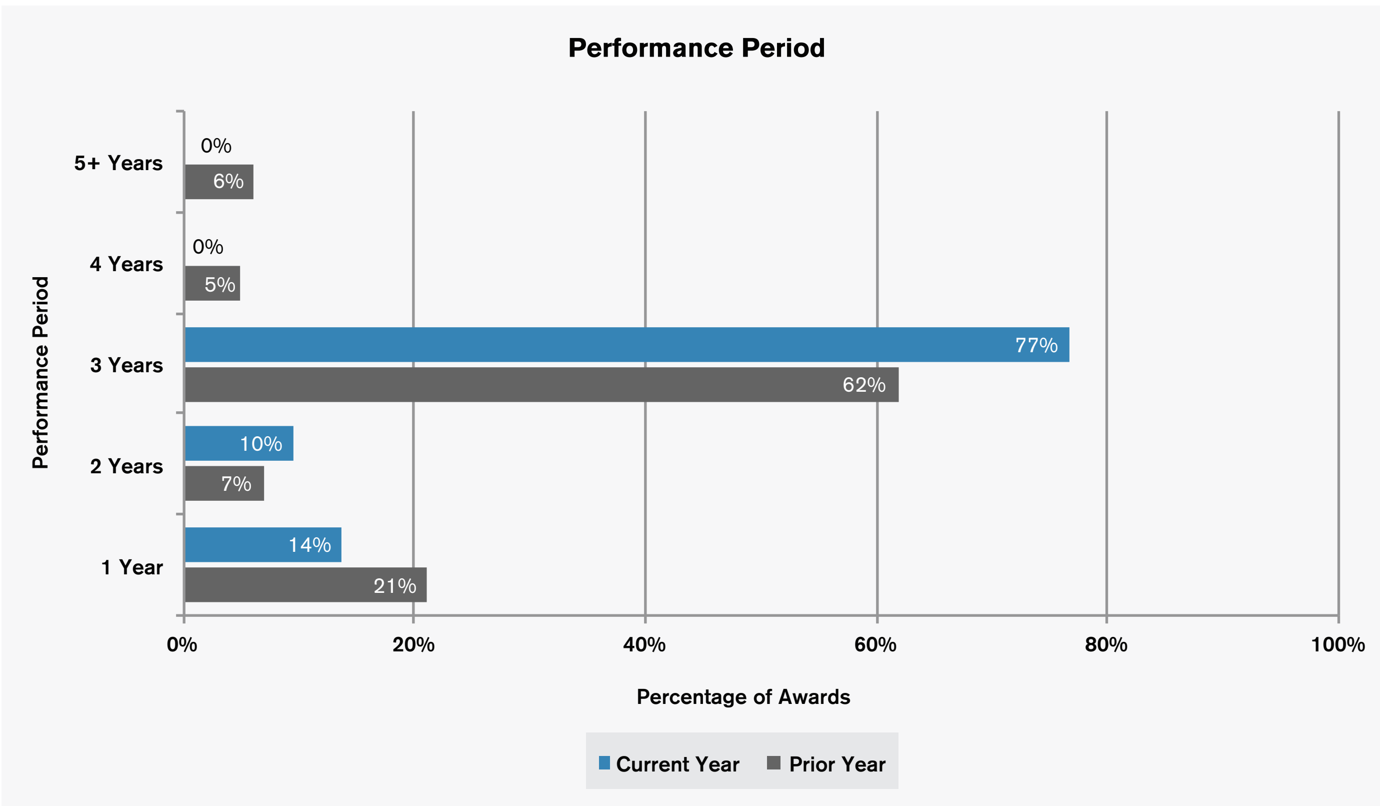


Although the pay-for-performance link for relative TSR awards is fairly straightforward (executives win if shareholders win), the valuation of these awards can be quite complex. The vesting of relative TSR awards is dependent on future market conditions for both the company and its peer group. Therefore, the valuation of these awards requires sophisticated modeling techniques, such as a Monte Carlo valuation.

LONG-TERM INCENTIVES

Performance Period

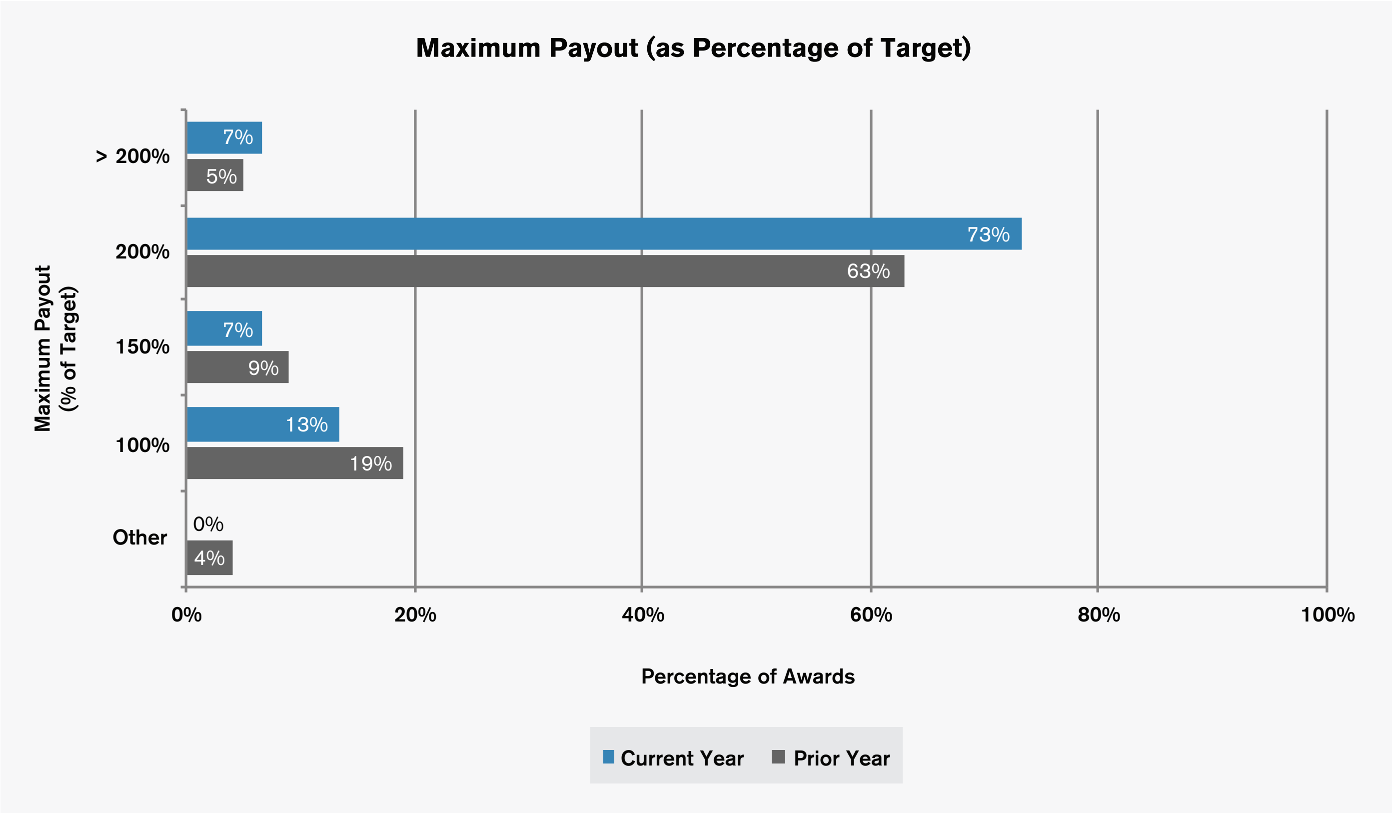
The performance period is the duration over which the applicable performance metrics are measured. As shown in the chart below, the most prevalent performance period for performance-vesting awards, by a wide margin, is three years (77% of awards) followed by one year (14% of awards).



Many companies use three-year performance periods to promote long-term sustainable growth, rather than shorter periods that tend to shift the focus toward short-term performance.

Maximum Payout

Oftentimes, performance-vesting awards provide for a range of payouts. For example, if the threshold level of performance is achieved, 50% of the award will be earned; if the target level of performance is achieved, 100% of the award will be earned; and if the maximum level of performance is achieved, 200% of the award will be earned. As shown in the chart below, a majority of performance-vesting awards granted by E&P companies provide for a maximum payout equal to 200% of the target.



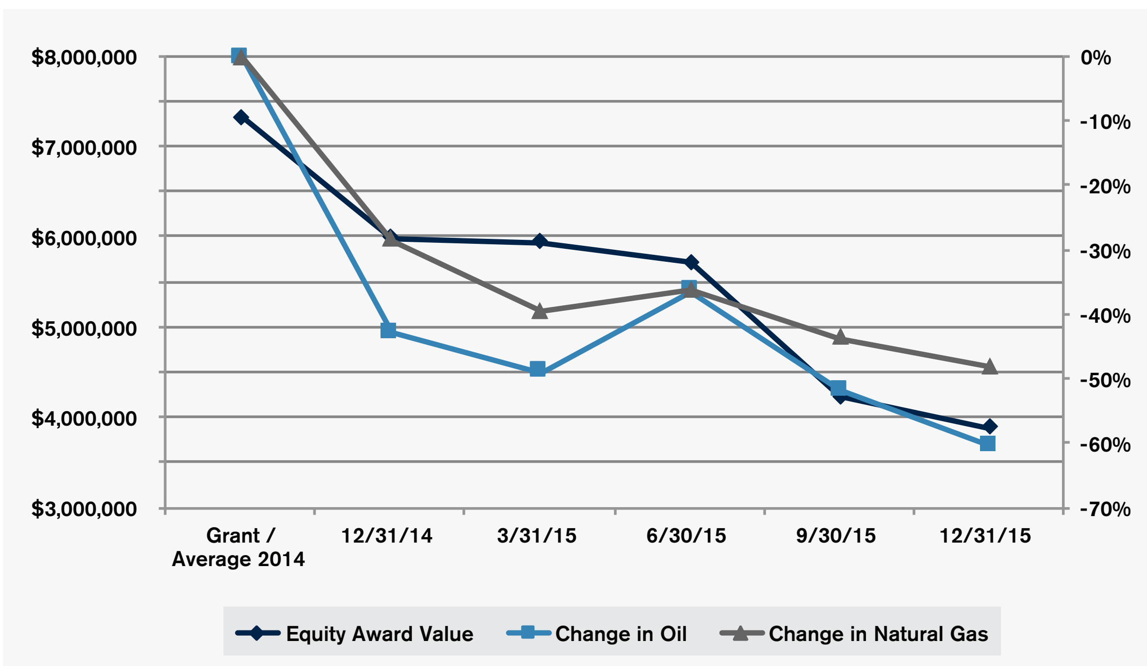
Although 200% of the target is the most prevalent maximum payout percentage, each company should examine its own circumstances and determine what target would be most effective for the company's unique position. For example, an established company that does not expect a sharp growth curve may consider granting more awards with a lower maximum payout. This will allow the company to grant additional awards with lower compensation expense, while preserving value for the executives.

LONG-TERM INCENTIVES

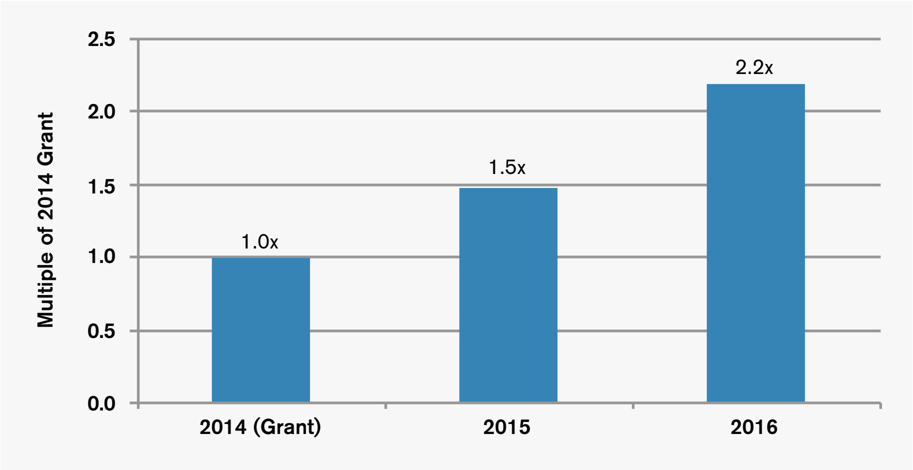
Effect of Current Market Conditions

The recent plunge in crude oil and natural gas prices has in many cases shaved over 50% off of the stock prices of many E&P companies. In a market where executive compensation has traditionally been tied to equity prices or total shareholder return, company boards and compensation committees are facing a quandary. With equity prices so depressed, long-term incentive awards have lost much, if not all, of their value. Restricted share awards, initially granted based on a value that compensation committees believed would support competitive compensation packages for their executives, are worth significantly less. Stock options, in many cases, are now so far “underwater” that they have become virtually worthless.

The following chart illustrates the decline in the average value of restricted stock and performance share awards made to the CEOs of the top 20 E&P companies in 2014, relative to the fall of crude oil and natural gas prices.



One alternative for dealing with depressed share prices would be to simply increase the number of shares granted in order to deliver the same competitive market compensation to the executives. There are several problems with this approach, including the additional dilution that other shareholders would be absorbing, whether enough shares would be available under the incentive plans (since this approach would greatly increase the "burn rate" of shares available for issuance under such plans) and the "upside risk" that a sudden bounce in share prices could result in an unintended windfall for the executives. The following chart reflects the change in the number of shares that would need to be granted to executives to achieve the same aggregate award value received in 2014, based on the decline in E&P company share prices, for 2015 and 2016.



Simply awarding additional equity has its challenges. In this atmosphere, we see many E&P companies utilizing the following tools to retain and motivate key executives:

- Reducing the participation in equity awards;
- Converting long-term incentive arrangements from equity-based awards to cash incentive programs;
- Modifying annual performance metrics to be more focused on cost-cutting;
- Modifying annual performance metrics to add a discretionary feature to combat the uncertainty;
- Implementing retention programs focused on key employees and executives; and/or
- Modifying performance metrics to factor out the impact of falling commodities prices.

Note that there is no "one-size-fits-all" solution that will be effective in every case. Rather, each company's circumstances must be individually examined in order to determine the best approach.

CHANGE IN CONTROL BENEFITS

Overview

Typical change in control benefits include severance payments, accelerated vesting of equity awards, retirement benefits and excise tax protection.

The tables below show the average value of change in control benefits for CEOs and CFOs:

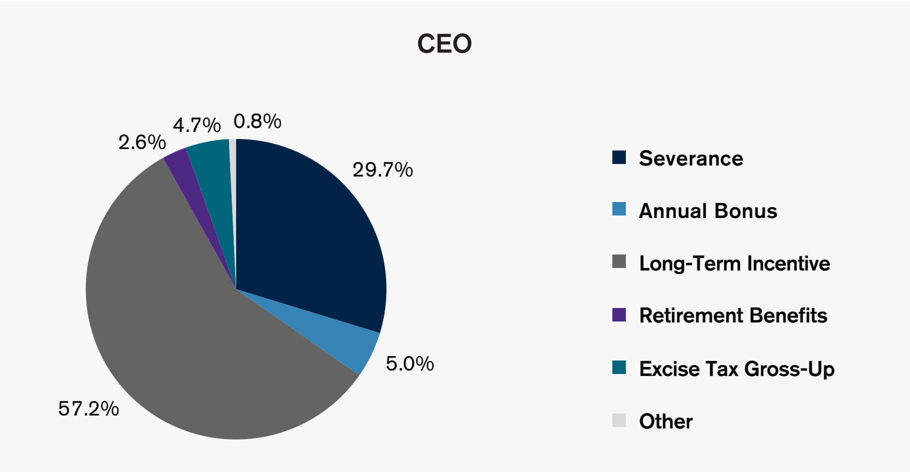
CHANGE IN CONTROL BENEFIT VALUES FOR CEOs							
Market Capitalization Rank	Severance	Annual Bonus	Long-Term Incentives	Retirement Benefits	Excise Tax Gross-Up	Other[1]	Average Total Benefit
Top Quartile	$7,091,045	$692,081	$17,373,214	$1,118,612	$1,542,581	$80,899	$27,898,432
Second Quartile	3,058,280	566,253	3,754,655	38,581	-	108,156	7,525,925
Third Quartile	1,849,241	297,355	2,674,364	26,865	50,592	29,106	4,927,523
Bottom Quartile	1,351,645	703,253	1,867,692	-	519,901	128,677	4,571,168
All	**$3,357,613**	**$563,336**	**$6,463,439**	**$299,004**	**$528,353**	**$86,286**	**$11,298,031**

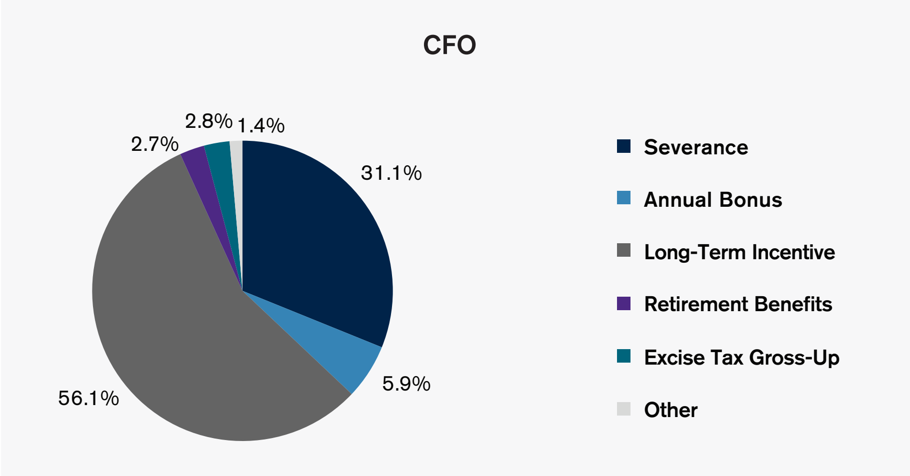
CHANGE IN CONTROL BENEFIT VALUES FOR CFOs							
Market Capitalization Rank	Severance	Annual Bonus	Long-Term Incentives	Retirement Benefits	Excise Tax Gross-Up	Other[1]	Average Total Benefit
Top Quartile	$2,338,501	$243,259	$6,663,965	$420,695	$387,252	$63,493	$10,117,165
Second Quartile	1,514,503	363,398	1,504,267	27,923	-	78,039	3,488,130
Third Quartile	717,692	134,606	785,198	-	-	24,136	1,661,632
Bottom Quartile	731,811	271,040	561,505	-	77,766	68,919	1,711,041
All	**$1,323,719**	**$251,962**	**$2,387,567**	**$113,005**	**$117,429**	**$58,451**	**$4,252,132**

[1] Other includes health & welfare benefit continuation, outplacement services, and other benefits received in connection with a change in control.

CHANGE IN CONTROL BENEFITS

The charts below illustrate the average value for each type of change in control benefit for CEOs and CFOs:

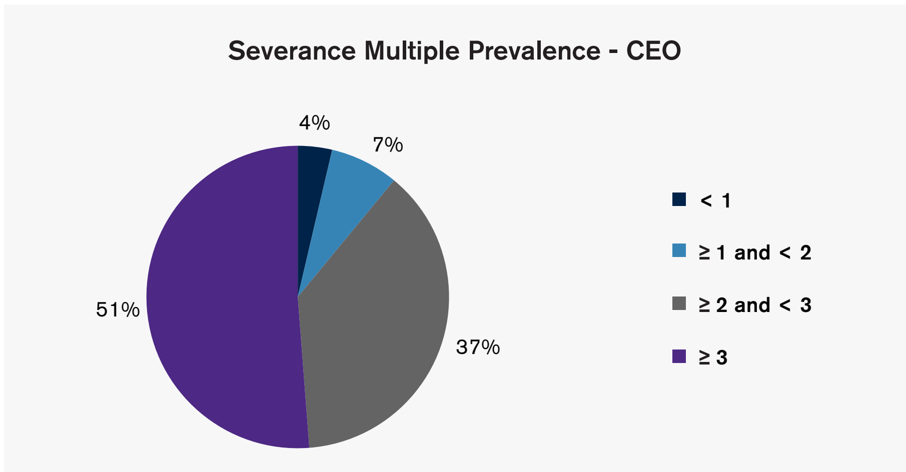




CHANGE IN CONTROL BENEFITS

Cash Severance Payments

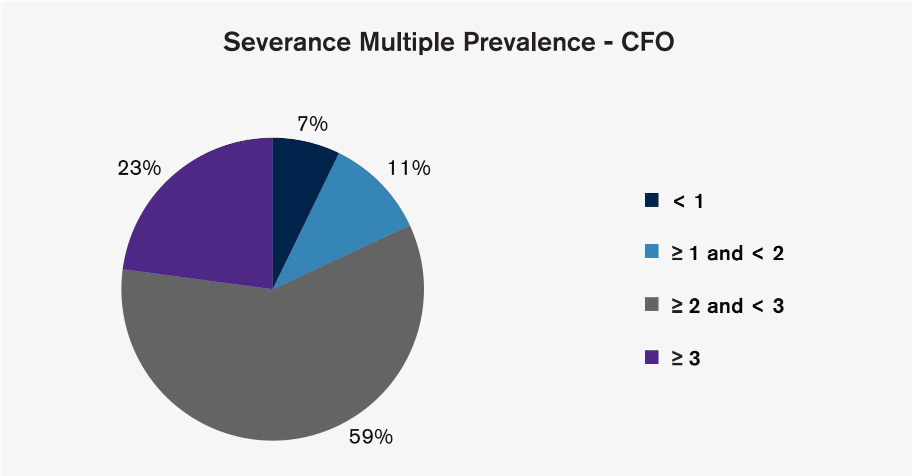
- Most agreements or policies with change in control protection provide for a cash severance payment, expressed as a multiple of compensation. The multiple is generally different at various levels within an organization. The definition of compensation used to determine the severance amount varies between companies. The two most prevalent definitions of severance are base salary plus annual bonus or base salary only.
- The pie chart below identifies the most common severance multiples provided to CEOs upon a termination in connection with a change in control:



- 82% of CEOs are entitled to receive a cash severance payment upon termination in connection with a change in control.
- The most common cash severance payment multiple for CEOs is three times compensation or greater. 51% of companies with cash severance payments provide this level of benefit while 37% provide between two and three times compensation.

CHANGE IN CONTROL BENEFITS

- The pie chart below identifies the most common severance multiples provided to CFOs upon a termination in connection with a change in control:



- 80% of CFOs are entitled to receive a cash severance payment upon termination in connection with a change in control.
- The most common cash severance payment multiple for CFOs is between two and three times compensation. 59% of companies with cash severance payments provide this level of benefit while 23% provide three times compensation or greater.

CHANGE IN CONTROL BENEFITS

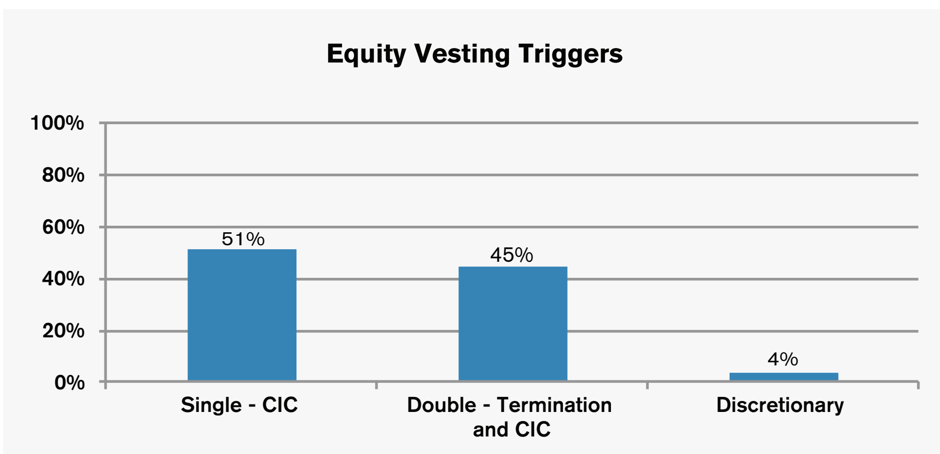
Accelerated Vesting of Long-Term Incentives

There are generally three types of change in control payout triggers for equity awards:

- **Single Trigger:** Only a change in control must occur.
- **Double Trigger**: A change in control plus the involuntary or constructive termination of an executive's employment without cause, or resignation for "good reason," must occur within a certain period after the change in control. "Good reason" is commonly defined as either a reduction in an executive's compensation or benefits, diminishment of duties or relocation.
- **Discretionary:** The board has the discretion to trigger the payout of an award after a change in control. Typically, this trigger occurs in the form of accelerated vesting of options and/or restricted stock in equity plans.

Sometimes companies provide for single trigger vesting if the acquiring company does not assume the equity awards, but double trigger vesting if the awards are assumed by the acquirer. For purposes of this survey, this treatment was included in the double trigger vesting category.

This chart shows the prevalence of change in control triggers for outstanding equity awards of CEOs and CFOs.



- The most common trigger found in equity plans is the single trigger (51%). However, 45% of companies have at least some equity awards outstanding with a double trigger. 4% of companies also provide the board with discretion to accelerate the vesting of some outstanding equity awards.
- Due to pressure from shareholders and shareholder advisory services, there has been a trend in recent years for companies to move to double trigger vesting provisions. As such, we expect more companies will implement double trigger vesting provisions in the future.

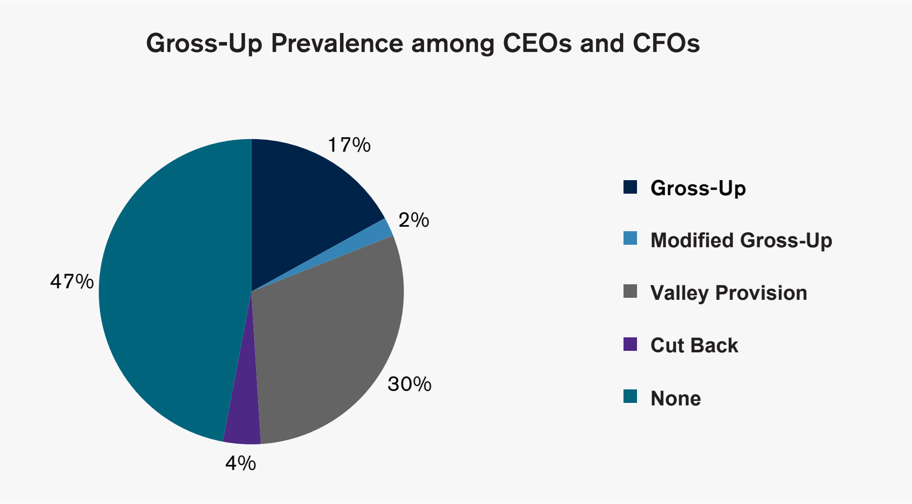
Excise Tax Protection

The "Golden Parachute" rules impose a 20% excise tax on an executive if the executive receives a parachute payment greater than the "safe harbor" limit. Companies may address this excise tax issue in one of the following ways:

- **Gross-up:** The company pays the executive the full amount of any excise tax imposed. The gross-up payment thereby makes the executive "whole" on an after-tax basis. The gross-up includes applicable federal, state and local taxes, as well as the additional excise taxes, resulting from the payment of the gross-up.
- **Modified Gross-up:** The company will gross-up the executive if the payments exceed the "safe harbor" limit by a certain amount (e.g., $50,000) or percentage (e.g., 10%). Otherwise, payments are cut back to the "safe harbor" limit to avoid any excise tax.
- **Cut Back:** The company cuts back parachute payments to the "safe harbor" limit to avoid any excise tax.
- **Valley Provision:** The company cuts back parachute payments to the "safe harbor" limit if it is more financially advantageous to the executive. Otherwise, the company does not adjust the payments and the executive is responsible for paying the excise tax.
- **None:** Some companies do not address the excise tax; therefore, executives are solely responsible for the excise tax.

CHANGE IN CONTROL BENEFITS

The prevalence of these provisions for CEOs and CFOs is illustrated in the pie chart below:



- 19% of companies provide either a gross-up or modified gross-up to their CEOs and CFOs. A majority of companies (47%) do not provide any form of excise tax protection. This is consistent with our broader study of change in control arrangements at the top 200 companies across 10 industries.

BANKRUPTCY COMPENSATION

To remain resilient under current market conditions, E&P companies must reevaluate their traditional executive incentive programs.

Bankruptcy Overview

Prior to 2005, companies entering into bankruptcy typically retained executives by implementing key employee retention plans (KERPs) whereby executives were paid for simply remaining on the job through specified dates. However, changes to the bankruptcy code enacted in 2005 effectively ended the use of KERPs for “insiders.” As a result, many companies today implement key employee incentive plans (KEIPs) for “insiders,” which are performance-based plans that are essentially designed to fall outside of the bankruptcy code restrictions on the use of KERPs. Conversely, retention plans continue to be utilized for “non-insiders.” An “insider” is generally defined as a director, an officer or a person in control of the company.

Balance Sheet Restructuring / Bankruptcy on the Horizon

If a balance sheet restructuring or bankruptcy filing is on the horizon, there are certain immediate changes to the incentive plans that should be considered in order to motivate and retain key talent. Because the debtor’s equity will generally become worthless in the event of a bankruptcy filing, a common defensive approach is to collapse the annual and long-term incentive program into a single cash-based incentive program that pays out over shorter measurement periods based on achieving established performance metrics. In addition, often the annual incentive program will be modified to incorporate performance metrics that are more commonly utilized in bankruptcy and acceptable to the creditors. This allows the annual incentive plan to be easily transitioned into a KEIP in the event of a filing, thus reducing disruption to the executive ranks.

BANKRUPTCY COMPENSATION

Bankruptcy Filing

In the event of a bankruptcy filing, the type and magnitude of the changes to the compensation plans will be influenced by the anticipated time frame to perform a restructuring or emergence from bankruptcy. In a "free fall" situation (where the debtor enters into bankruptcy proceedings in response to a significant liquidity event without having restructuring arrangements in place with its major stakeholders), the entire incentive compensation program will generally need to be revamped. In a prepackaged bankruptcy (where the debtor has negotiated, documented and disclosed to creditors a plan of reorganization that has been approved by creditors before the bankruptcy case is filed), there might be fewer changes to existing incentive programs and more of an emphasis on equity to be granted to management upon emergence from bankruptcy. Many bankruptcy filings will fall somewhere in between these two extremes, but in any case, the annual and long-term incentive programs will need to be adjusted or overhauled.

KEIP Performance Metrics

The KEIP performance metrics must be carefully chosen and structured to be sufficiently challenging. The metrics should also coincide with the company's business plan or objectives. Bankruptcy courts have refused to approve KEIPs where performance metrics are easily attainable and considered "lay-ups," finding such arrangements to be impermissible retention plans. Common performance metrics used by E&P companies in bankruptcy include:

- Production targets;
- Expense reductions (lease operating or general and administrative expenses);
- Financial metrics (EBITDA, EBITDAR);
- Confirmation of plan of reorganization / emergence from bankruptcy by a specified date; and/or
- Amount of proceeds realized from sale of company or designated assets.

The amount of potential payout is also a consideration, as it should be sufficiently motivating, but should be reasonable when compared to other similar payments made in bankruptcy. The potential payout should also result in total compensation that is reasonable when compared to market compensation levels and other bankruptcy filings.

Post-Emergence Incentive and Retention

When emerging from bankruptcy, most pre-bankruptcy company stock, along with unvested equity awards held by employees, have lost their value. Lack of meaningful equity ownership in the go-forward entity, coupled with an uncertain company future, leads to difficulties retaining and motivating key executives post-emergence. Consequently, many companies utilize emergence equity grants to ensure that companies retain motivated personnel who are vital to a successful post-emergence entity. Some important considerations for emergence grants include:

- What percentage of the new company's equity should be reserved for employee equity awards?
- What portion of the equity pool should actually be granted at emergence?
- Who should receive emergence grants (officers, middle management, all employees)?
- How will the emergence grants be structured (i.e., size and type of award, vesting, etc.)?
- Should the emergence grant be structured as time-vesting or performance-vesting?
- What should be the targeted total direct compensation upon emergence from bankruptcy?

When a company's financial health is not optimal, a general practitioner may not have the required expertise to guide the company through these issues during the recovery period, so retaining a qualified compensation specialist is critical.

COMPANIES ANALYZED

Abraxas Petroleum Corporation
Anadarko Petroleum Corporation
Antero Resources Corporation
Apache Corporation
Approach Resources, Inc.
Atlas Resource Partners, L.P.
Barnwell Industries, Inc.
Bill Barrett Corporation
Bonanza Creek Energy, Inc.
BreitBurn Energy Partners L.P.
Cabot Oil & Gas Corporation
California Resources Corporation
Callon Petroleum Company
Carrizo Oil & Gas, Inc.
Chesapeake Energy Corporation
Cimarex Energy Co.
Clayton Williams Energy, Inc.
Cobalt International Energy, Inc.
Comstock Resources, Inc.
Concho Resources Inc.
ConocoPhillips
Contango Oil & Gas Company
Continental Resources, Inc.
Denbury Resources, Inc.
Devon Energy Corporation
Diamondback Energy, Inc.
Eagle Rock Energy Partners, L.P.
Earthstone Energy, Inc.
Eclipse Resources Corporation
Energen Corporation
Energy XXI Limited
EOG Resources, Inc.
EP Energy Corporation
EQT Corporation
Erin Energy Corporation
EV Energy Partners, L.P.
Evolution Petroleum Corporation
EXCO Resources, Inc.
FX Energy, Inc.
Gastar Exploration, Inc.
Goodrich Petroleum Corporation
Gulfport Energy Corporation
Halcón Resources Corporation
Hess Corporation
Holloman Energy Corporation
Hydrocarb Energy Corporation
Isramco, Inc.
Jones Energy, Inc.
Laredo Petroleum, Inc.
LINN Energy, LLC
LRR Energy, L.P.
Magnum Hunter Resources Corporation
Marathon Oil Corporation
Matador Resources Company
Memorial Production Partners L.P.
Memorial Resource Development Corporation
Mid-Con Energy Partners, L.P.
Midstates Petroleum Company, Inc.
Murphy Oil Corporation
Newfield Exploration Company
Noble Energy, Inc.
Northern Oil and Gas, Inc.
Oasis Petroleum, Inc.
Occidental Petroleum Corporation
Panhandle Oil and Gas, Inc.
Parsley Energy, Inc.
PDC Energy, Inc.
Penn Virginia Corporation
PetroQuest Energy, Inc.
Pioneer Natural Resources Company
PrimeEnergy Corporation
QEP Resources, Inc.
Range Resources Corporation
Reserve Petroleum Company
Resolute Energy Corporation
Rex Energy Corporation
Rice Energy, Inc.
Ring Energy, Inc.
RSP Permian, Inc.
Sanchez Energy Corporation
SandRidge Energy, Inc.
SM Energy Company
Southwestern Energy Company
Stone Energy Corporation
Swift Energy Company
Synergy Resources Corporation
Tengasco, Inc.
Torchlight Energy Resources, Inc.
TransAtlantic Petroleum Ltd.
T-Rex Oil, Inc.
Triangle Petroleum Corporation
Ultra Petroleum Corporation
U.S. Energy Corporation
VAALCO Energy, Inc.
Vanguard Natural Resources, LLC
W&T Offshore, Inc.
Warren Resources, Inc.
Whiting Petroleum Corporation
WPX Energy, Inc.
Yuma Energy, Inc.

ABOUT ALVAREZ & MARSAL

For more information, contact:

Brian L. Cumberland
National Managing Director,
Compensation and Benefits
bcumberland@alvarezandmarsal.com
+1 214 438 1013

J.D. Ivy
Managing Director
jivy@alvarezandmarsal.com
+1 214 438 1028

Visit
www.alvarezandmarsal.com

Acknowledgments:
Research Assistance: Rob Casburn, Ryan Wells, Jack Raksnis and Nate Rudnick-Aldridge

Alvarez & Marsal Executive Compensation and Benefits Practice

As part of Alvarez & Marsal, the Executive Compensation and Benefits Practice assists tax, finance and human resource departments in designing compensation and benefits plans, evaluating and enhancing existing plans, benchmarking compensation, and reviewing programs for compliance with changing laws and regulations. We do so in a manner that manages risks associated with tax, financial and regulatory burdens related to such plans. Through our services, we can help companies lower costs, improve performance, boost the bottom line, and assist in attracting and retaining key performers.

Alvarez & Marsal's Executive Compensation and Benefits Practice offers services in the following areas:

- Executive Compensation Advisory Consulting
- Bankruptcy Compensation Consulting
- Risk Management Consulting
- Pre- and Post-Merger and Acquisition Advisory Services
- Incentive Plan Evaluation, Design and Implementation
- Global Incentive Compensation Advisory Services
- Valuation of Equity Awards

When action matters, find us at:

www.alvarezandmarsal.com

LEADERSHIP
ACTION
RESULTS

Companies, investors and government entities around the world turn to Alvarez & Marsal (A&M) when conventional approaches are not enough to activate change and achieve results.

Privately-held since 1983, A&M is a leading global professional services firm that delivers performance improvement, turnaround management and business advisory services to organizations seeking to transform operations, catapult growth and accelerate results through decisive action. Our senior professionals are experienced operators, world-class consultants and industry veterans who draw upon the firm's restructuring heritage to help leaders turn change into a strategic business asset, manage risk and unlock value at every stage.

ALVAREZ & MARSAL