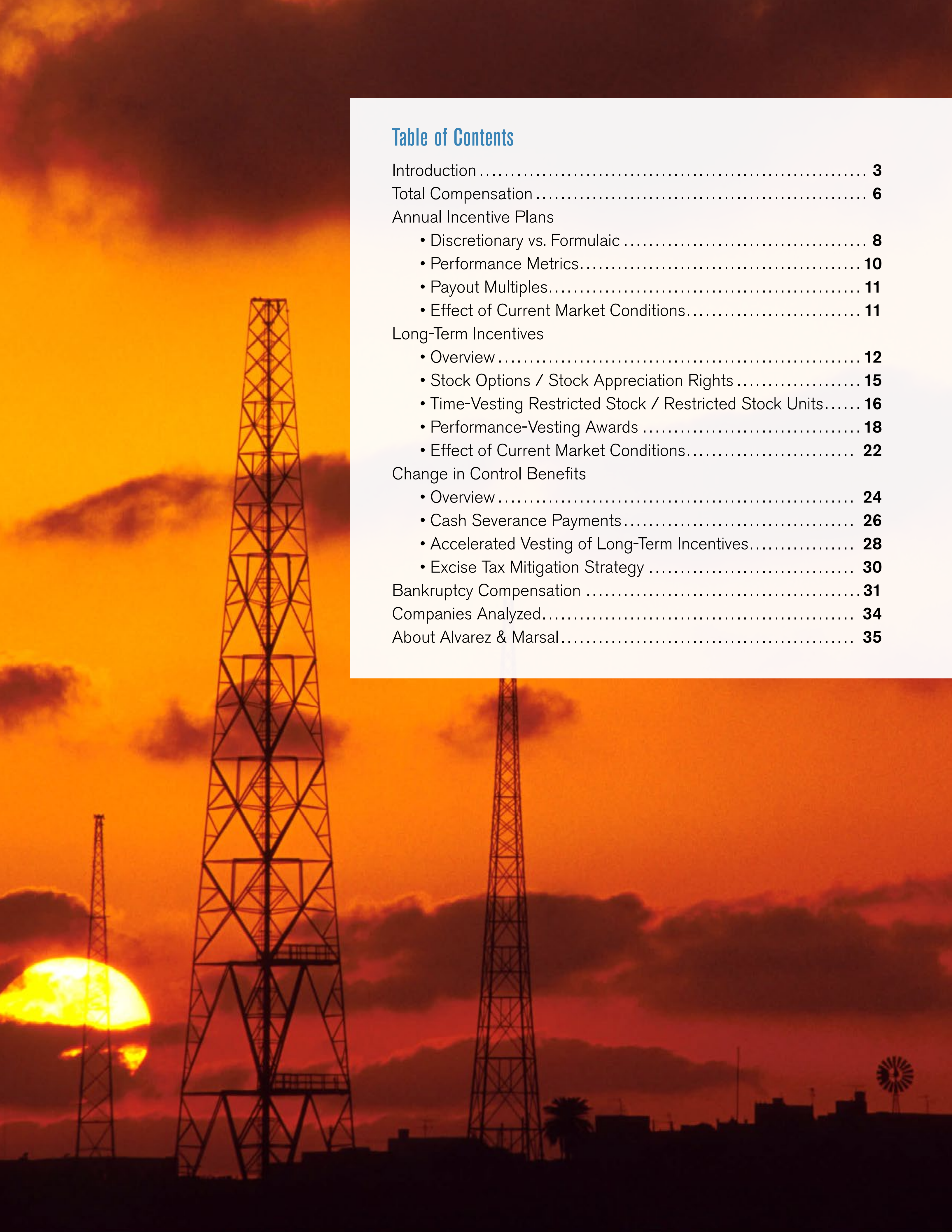
OIL AND GAS EXPLORATION & PRODUCTION (E&P) INCENTIVE COMPENSATION REPORT

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

2017

ALVAREZ & MARSAL



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INTRODUCTION

Incentive compensation is an integral part of the total compensation package for executives at most large, publicly traded companies. To understand annual and long-term incentive (LTI) compensation pay practices in the energy sector, specifically for exploration and production (E&P) companies, the Executive Compensation and Benefits Practice of Alvarez & Marsal (A&M) examined 2016 proxy statements of the 100 largest E&P companies in the United States. This report also reviews the total compensation packages for Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs) in the energy sector and the benefits to which those executives are entitled upon a change in control. Finally, with the current state of the commodity markets, we address compensation arrangements at distressed E&P companies, including equity plans put into place for companies emerging from bankruptcy.

Where possible, this analysis includes only 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 studies is shown in comparison format.

Company Statistics

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	$2.7B - $58B	$8.5B
Second Quartile	$350M - $2.7B	$1.4B
Third Quartile	$99M - $350M	$160M
Bottom Quartile	Under $99M	$33M

[1] Market capitalization as of January 4, 2016.

INTRODUCTION

Key Takeaways

Total Compensation

- On average, incentive compensation — including annual and long-term incentives — comprises approximately 80% of a CEO's and CFO's total compensation package.
- The average total compensation for CEOs was $5,053,904, up 13% compared to last year. The average total compensation for CFOs was $2,156,402, which is relatively flat compared to last year.

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 32% of companies in the bottom quartile utilize formulaic performance metrics.
- Production / production growth is the most prevalent performance metric in annual incentive plans and is utilized by 79% of companies.
- With the continued depression in the energy sector, we have seen a substantial increase in the use of cost control metrics in annual incentive plans, while the use of growth metrics such as production and reserves has decreased.
- 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 77% of all companies).
- 59% 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 (used in 92% of performance awards).

Change in Control Benefits

- The most common cash severance multiple for CEOs is three times compensation or greater (47%). The most common multiple for CFOs is between two and three times compensation (62%).
- The most valuable benefit received in connection with a change in control is accelerated vesting and payout of long-term incentives, making up 47% of the total benefit value.
- Single trigger equity vesting (no termination required) and double trigger equity vesting (termination required) are nearly identical in prevalence (47% and 46%, respectively).
- Only 18% 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. 48% 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. Some common metrics for E&P bankruptcy incentive plans include 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 emergence from bankruptcy.

TOTAL COMPENSATION

We captured compensation data from the summary compensation table disclosed in the 2016 proxy statement for each company. The most prevalent forms of annual compensation include base salary, bonus and long-term incentive awards.

Compared to compensation disclosed in 2015, CEOs experienced an overall increase in total compensation, while CFOs remained relatively flat. The increase in total compensation for CEOs was primarily driven by an increase in the grant date value of LTI awarded.

The following charts 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	$1,023,217	$1,459,398	$7,591,109	$588,499	$10,662,222
Second Quartile Average	747,898	660,788	3,533,310	92,618	5,034,614
Third Quartile Average	540,471	410,940	2,146,014	178,874	3,276,299
Bottom Quartile Average	368,500	171,550	402,934	299,496	1,242,480
Average of All Quartiles	**$670,022**	**$675,669**	**$3,812,763**	**$289,872**	**$5,053,904**

Year-Over-Year Increase / Decrease [2]	**13.1%**

CHIEF FINANCIAL OFFICER ANNUAL COMPENSATION

Market Capitalization Rank	Base Salary	Annual Incentives	Long-Term Incentives	Other Compensation[1]	Total
Top Quartile Average	$534,880	$597,577	$2,665,494	$271,851	$4,069,803
Second Quartile Average	410,660	367,955	1,497,878	74,891	2,351,384
Third Quartile Average	302,694	167,601	743,484	49,774	1,263,553
Bottom Quartile Average	292,308	72,467	245,277	66,055	676,108
Average of All Quartiles	**$389,691**	**$311,857**	**$1,335,966**	**$118,887**	**$2,156,402**

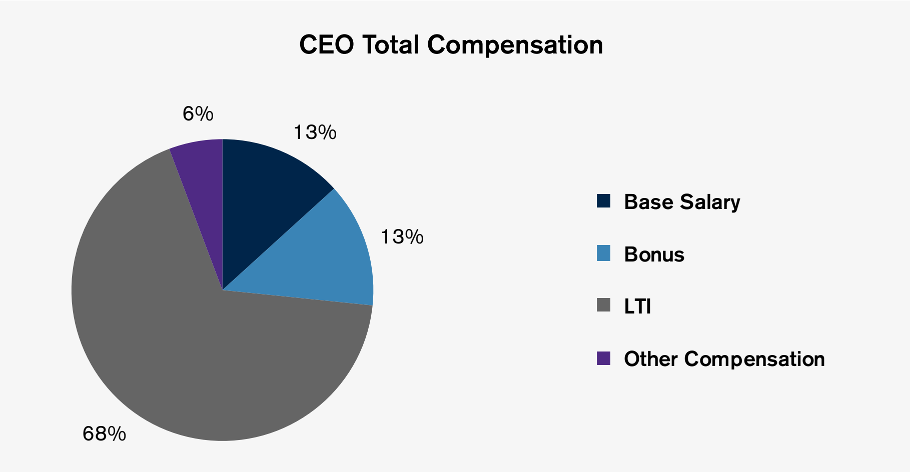
Year-Over-Year Increase / Decrease [2]	**-1.4%**

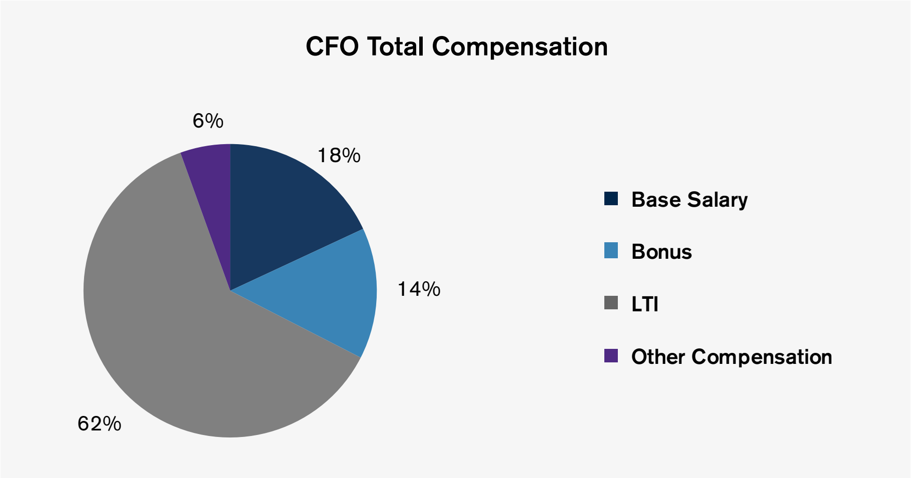
[1] Other Compensation includes: change in pension value, above market earnings, and “all other compensation” as disclosed in each company’s proxy statement.

[2] Includes only executives in both 2016 and 2017 studies.

TOTAL COMPENSATION

On average, incentive compensation — including annual and long-term incentives — comprises approximately 80% of an executive's total compensation package. 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. These findings are consistent with our prior studies.





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

Annual Incentive Plans

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:

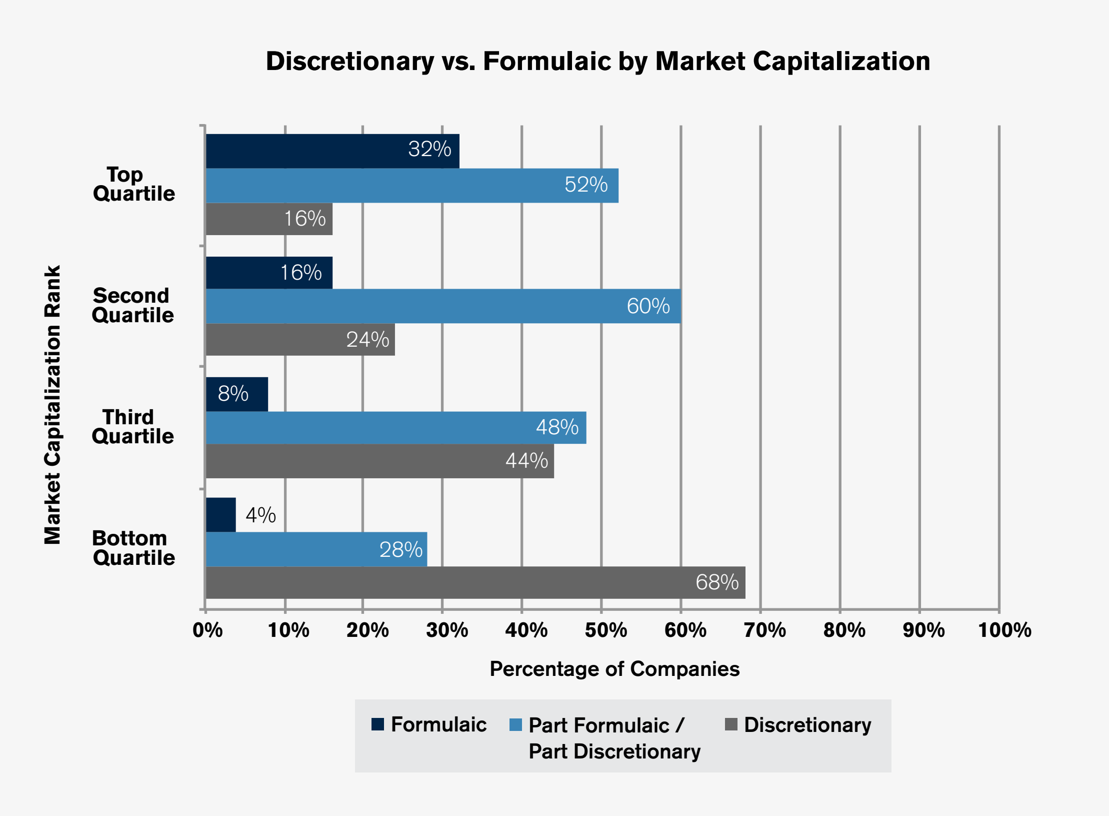
- **Formulaic** – The plan utilizes predetermined performance criteria with established targets that will determine payout, and the compensation committee does not have discretion to adjust payouts (other than negative discretion).
- **Discretionary** – The plan may or may not utilize specific, pre-established 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.

As shown in the chart on the following page, the majority of E&P companies maintain some form of discretion with respect to their AIP. However, larger companies tend to use less purely discretionary plans, as shown on the next page.

ANNUAL INCENTIVE PLANS

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. Some companies exercise discretion and maintain compliance with IRC Section 162(m) by implementing an AIP with a formulaic trigger (e.g., achieving a certain level of EBITDA or cash flow, etc.) to fund the bonus pool, which can then be allocated at the discretion of the board (commonly called a "plan within a plan" or an "umbrella plan").

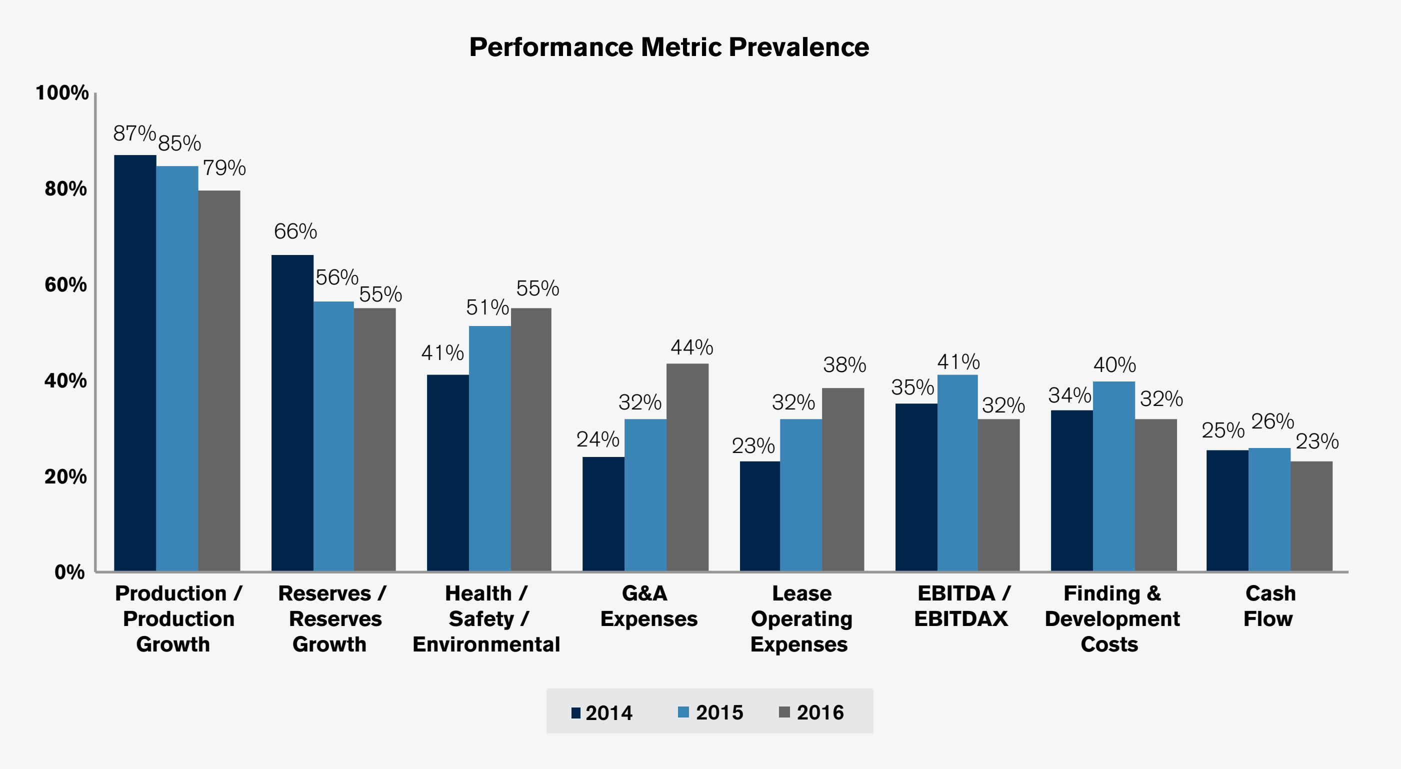


ANNUAL INCENTIVE PLANS

Performance Metrics

Generally, as market capitalization increases, companies have a stronger preference to utilize stated performance metrics. 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" if the board retains full discretion to adjust payouts (higher or lower) under the plan.

The following chart displays the most prevalent metrics used in AIPs. Production, including production growth, is again the most prevalent metric used by E&P companies, followed by reserves / reserve growth and health / safety / environmental metrics, each used by 55% of companies. With the depression in the energy sector, we have seen a substantial increase in the use of cost control metrics, while the use of growth metrics such as production and reserves has decreased. Furthermore, we found that the companies that utilize production and/or reserve metrics oftentimes balance their AIP with financial metrics to ensure that executives focus on profitable growth, rather than growth at any cost.



Payout Multiples

The following charts 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 the target and maximum payout is two times the target. These findings are consistent with our prior studies.

CEO			
Percentile	Threshold	Target	Maximum
25th	50%	100%	191%
Average	57%	110%	219%
50th	50%	100%	200%
75th	63%	125%	250%

CFO			
Percentile	Threshold	Target	Maximum
25th	43%	85%	150%
Average	47%	89%	201%
50th	45%	90%	180%
75th	50%	100%	200%

Effect of Current Market Conditions

Many companies are continuing to adjust their performance metrics to reflect the current state of the commodity markets. Companies are shifting away from solely using metrics such as production and other growth metrics (as previously shown) to focus their efforts on existing, successful wells, scaling back on unprofitable production and lowering costs. Additionally, some companies have added a discretionary component to the AIP due to the current uncertainty.

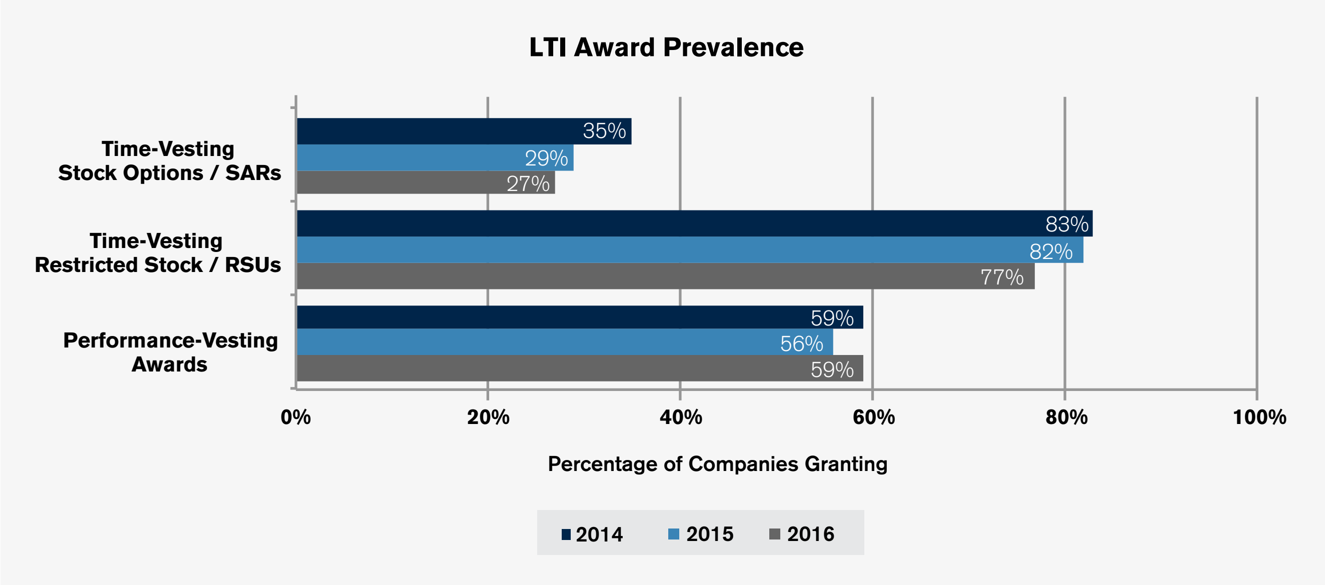
LONG-TERM INCENTIVES

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 that 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.

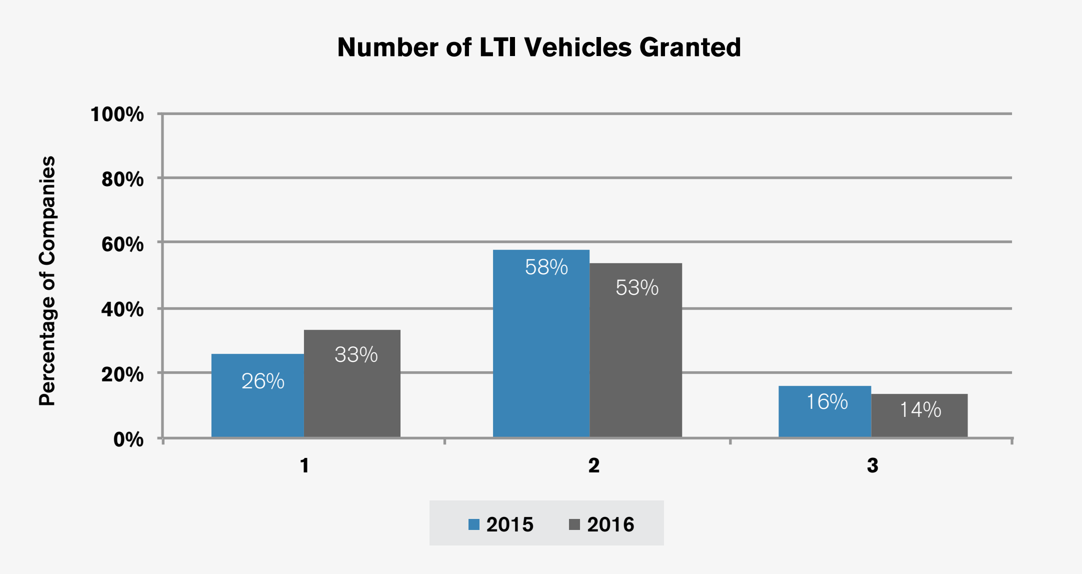
Award Prevalence

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



- Time-vesting restricted stock / RSUs continue to be the most utilized award type followed by performance-vesting awards.
- Stock options / SARs are the least prevalent LTI vehicle utilized. Although stock options / SARs are still used by almost one-third of companies, these awards have declined in popularity for reasons including:
  - The overall market shift toward performance-vesting equity; and
  - The view of proxy advisers 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.

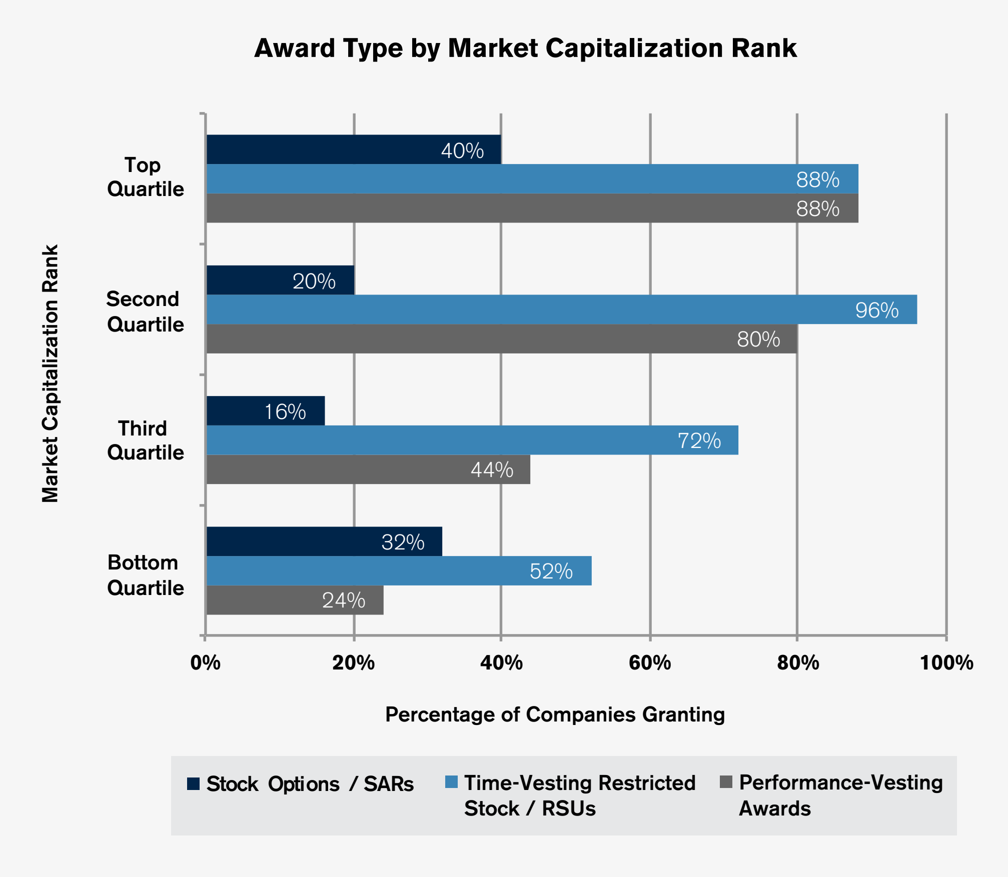
The chart below shows the number of LTI vehicles granted at each company. Consistent with previous years, a majority of companies (67%) grant at least two types of LTI vehicles.



LONG-TERM INCENTIVES

Award Prevalence by Market Capitalization

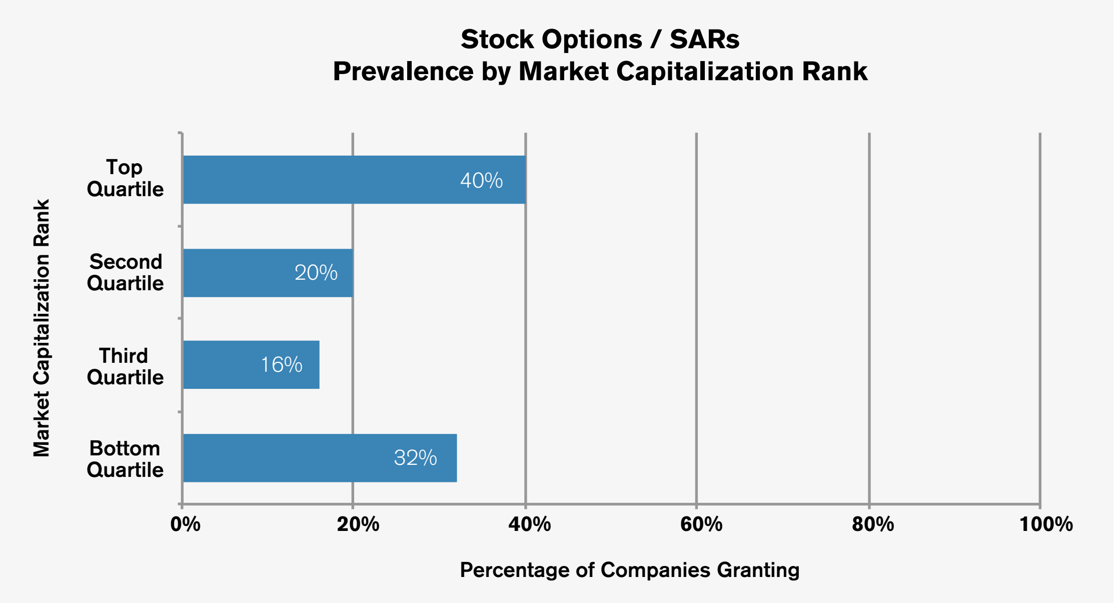
As shown in the chart below, A&M also analyzed whether a company's size (in terms of market capitalization) impacts the prevalence of awards that are provided.



- Stock options / SARs vary in their usage.
- Time-vesting restricted stock / RSUs are slightly more prevalent at larger companies.
- Performance-vesting awards are significantly more prevalent at larger companies (88% of companies in the top quartile and only 24% of companies in the bottom quartile).
- Companies in the bottom quartile grant long-term incentives with less regularity (64% of companies grant annually) than larger companies (100% of companies grant annually).

Stock Options / Stock Appreciation Rights

The chart below shows the percentage of companies that grant stock options / SARs by market capitalization.



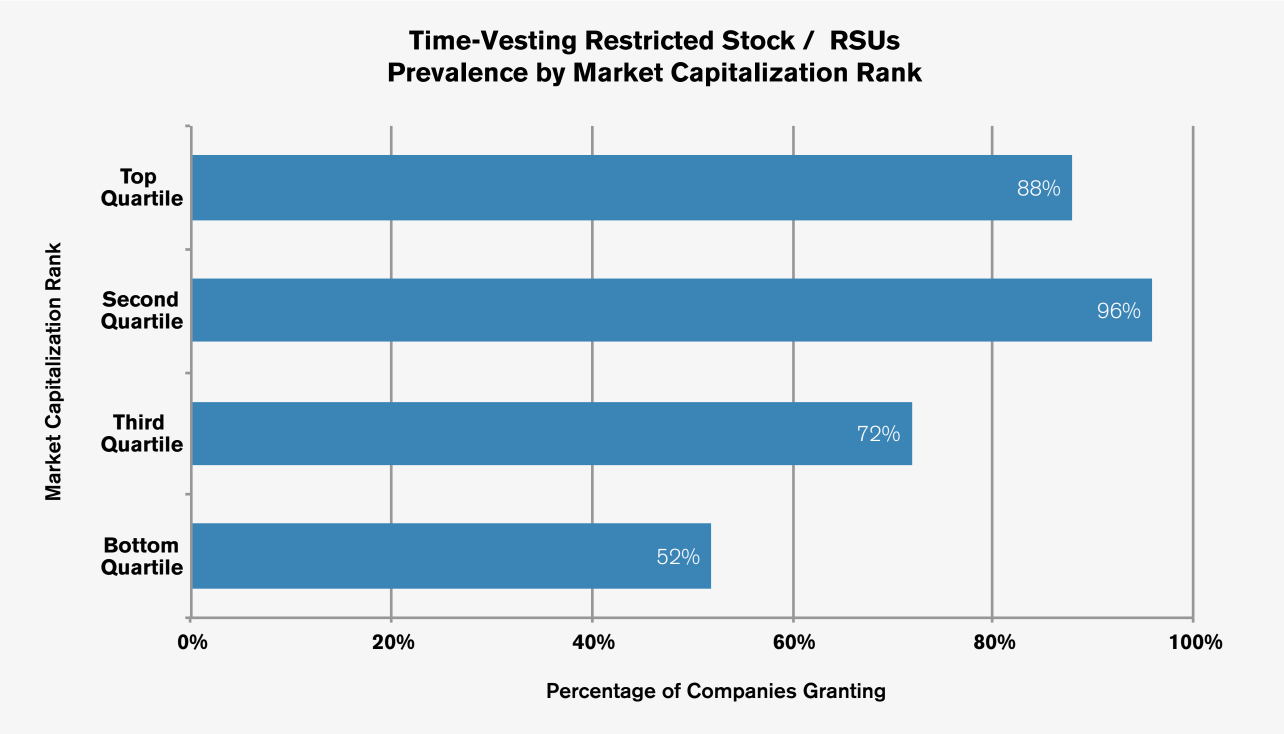
Award Provisions

- 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 (i.e., 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 (i.e., 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 (70% of companies), followed by four years (used by 11% of companies).
- The most prevalent contractual term for stock options / SARs is 10 years (48% of companies), but a seven-year or five-year term is also used at many companies (used by 30% and 22% 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

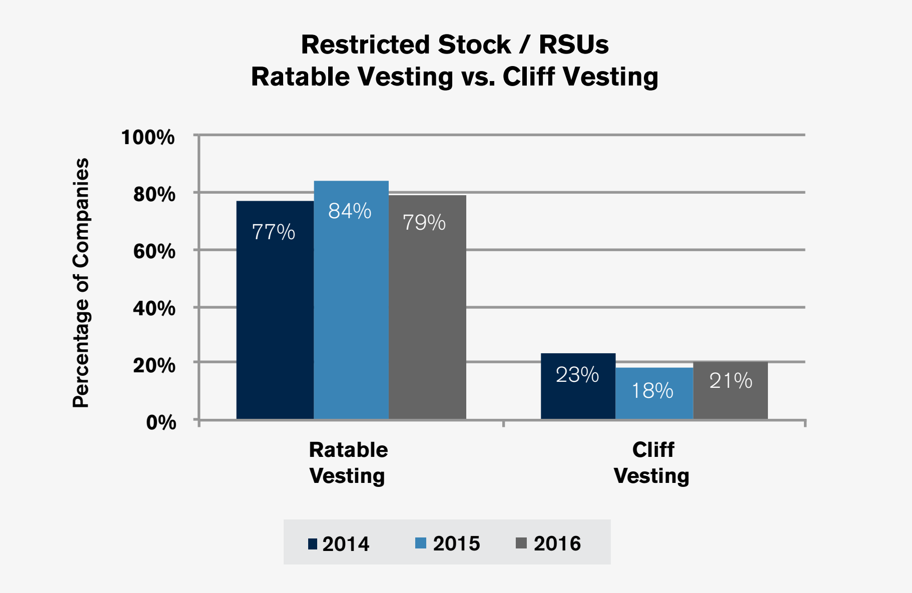
Time-Vesting Restricted Stock / Restricted Stock Units

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 50% to 90% range) for all sizes of companies and is more prevalent at larger companies.



Award Provisions

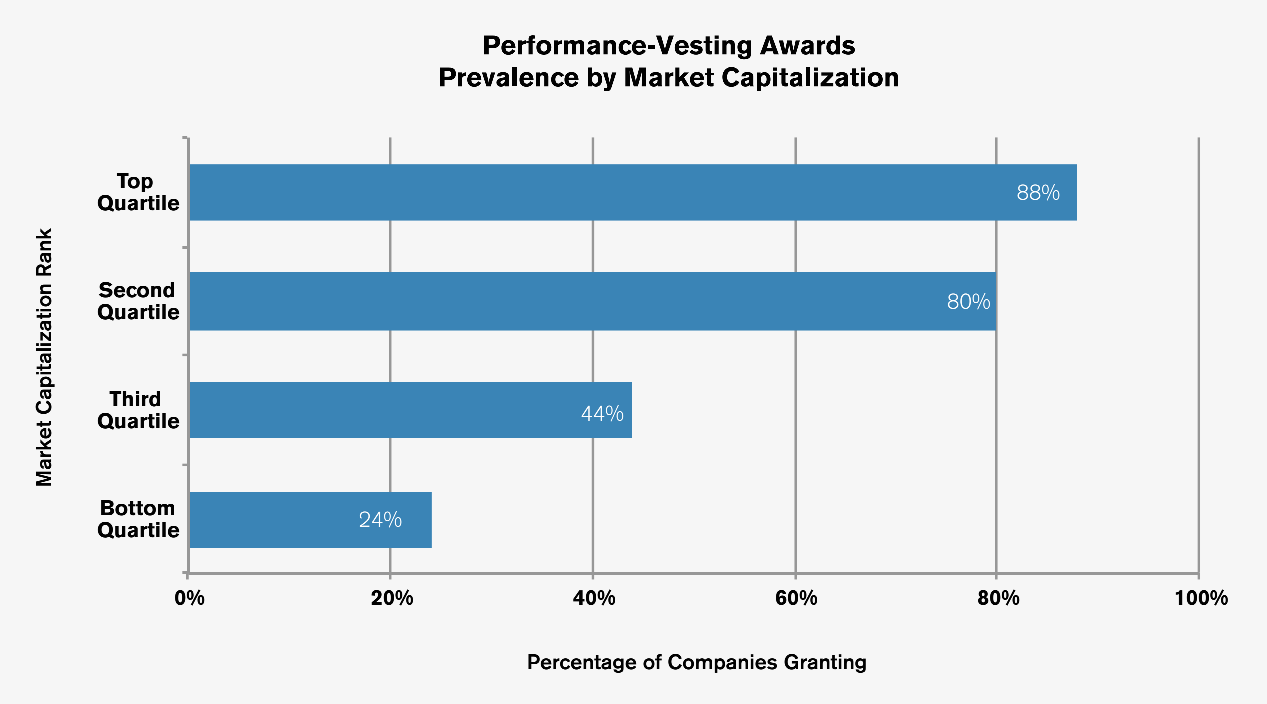
- Of companies that grant time-vesting restricted stock / RSUs, it is more common for companies to grant restricted stock than RSUs.
- A three-year vesting period is the most common vesting period (utilized by 74% of companies), while a four-year vesting period is the second most common (utilized by 12% of companies).
- As shown in the chart below, more companies continue to utilize awards that vest ratably rather 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.



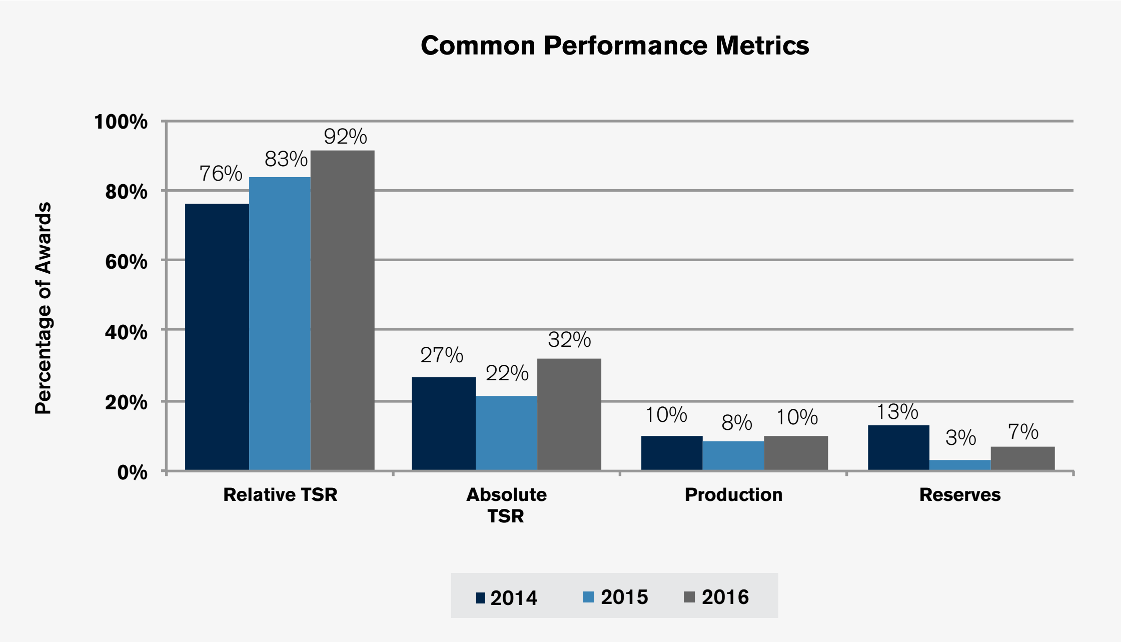
Performance Metrics

The most prevalent metric is relative total shareholder return (TSR), which is used for 92% of performance-vesting awards. Nearly one-third 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 similar to what the energy sector is experiencing; a company may have the highest TSR relative to its peer group, but absolute TSR is negative due to the sustained decline in the commodity markets.

44% 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.

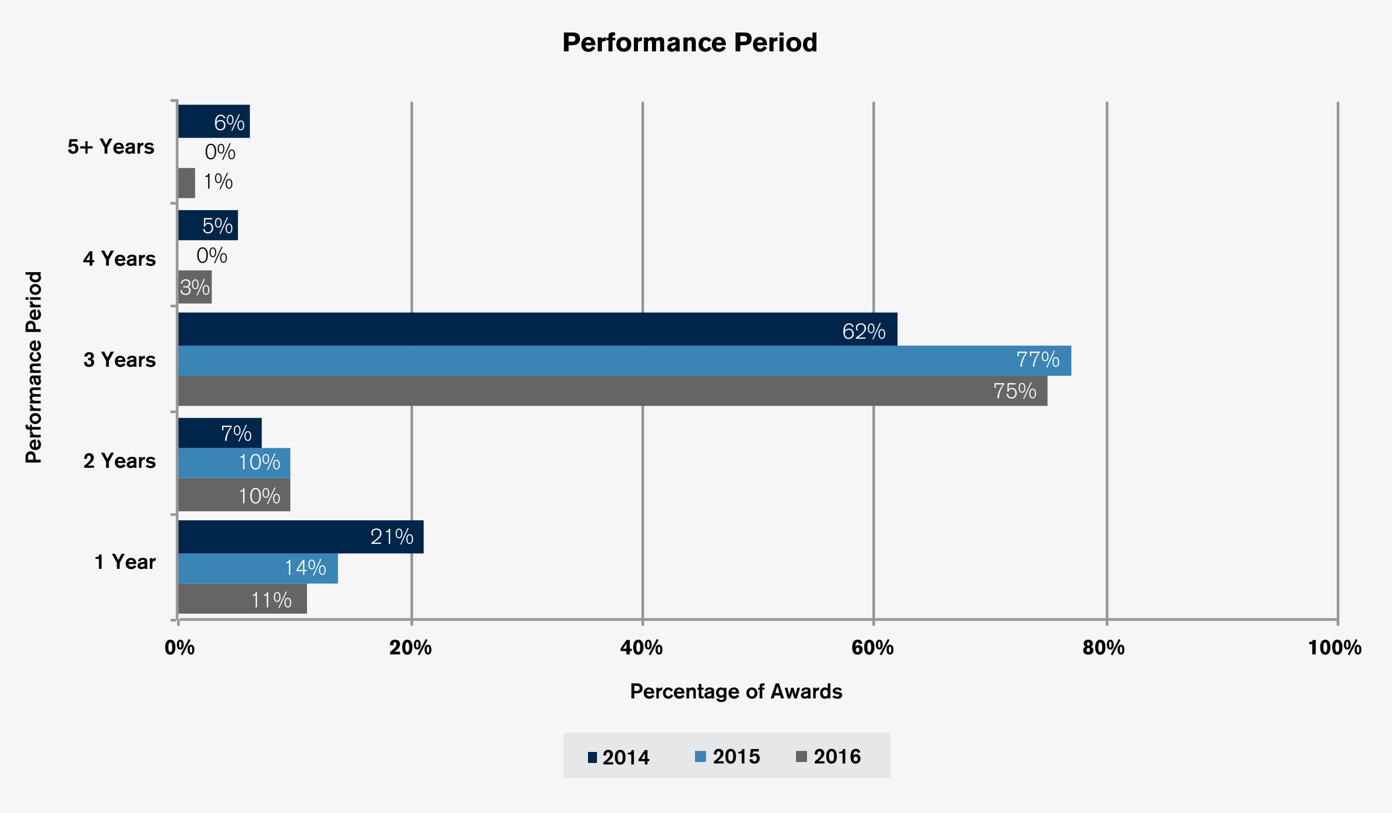


LONG-TERM INCENTIVES

Performance Period

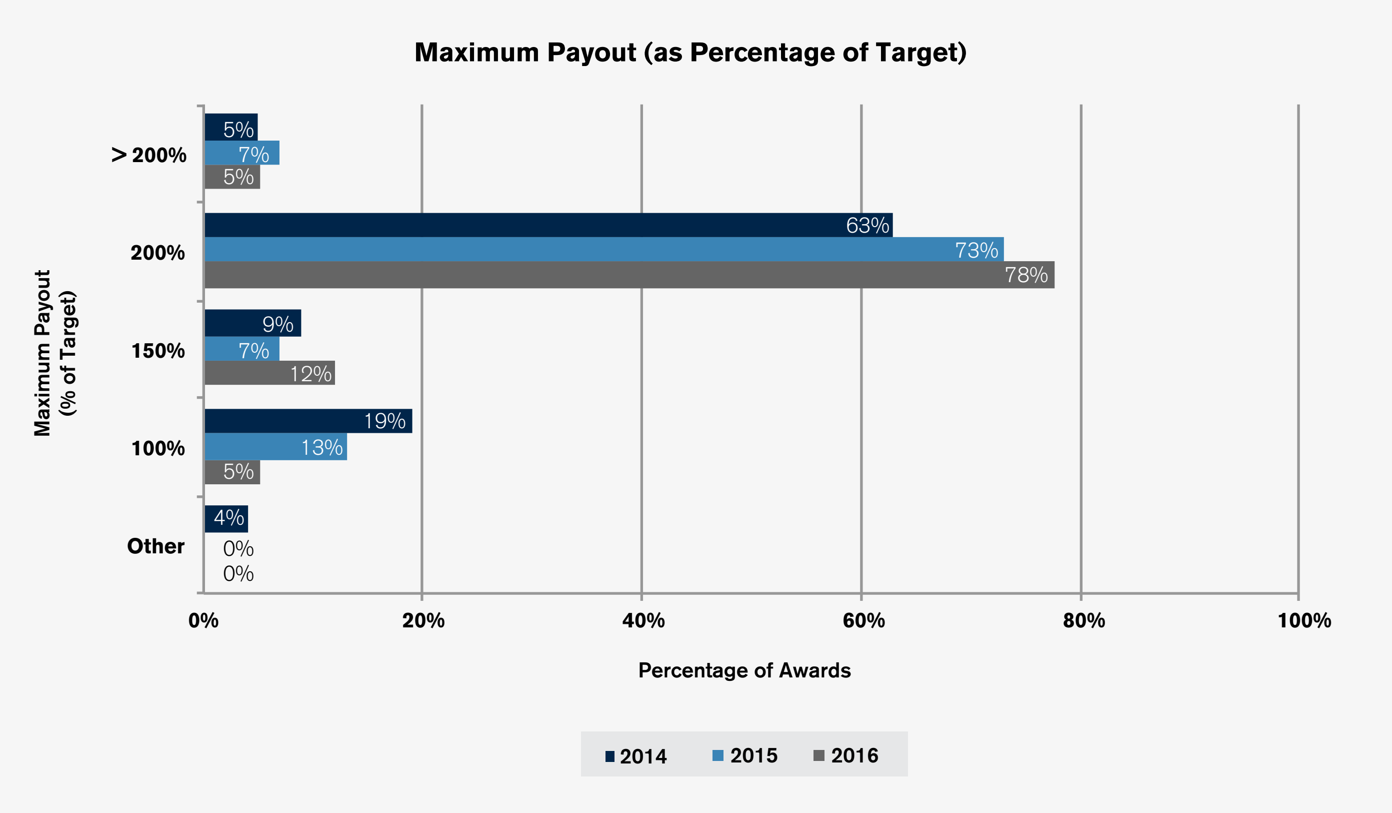
The performance period is the duration over which the applicable performance metrics are measured. As shown in the chart below, the most prevalent performance period for performance-vesting awards, by a wide margin, continues to be three years (75% of awards) followed by one year (11% of awards).

Many companies use three-year performance periods to promote long-term sustainable growth, rather than shorter periods that tend to focus only on 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.



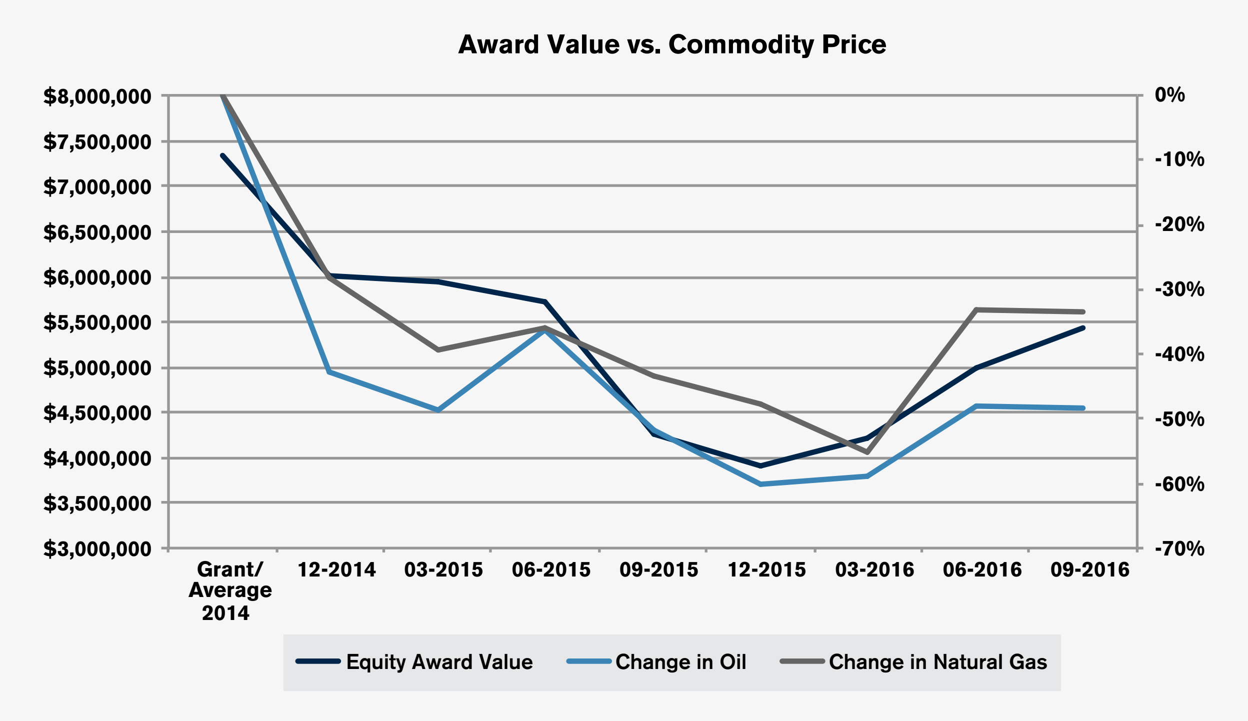
Although 200% of target payout is the most prevalent maximum payout percentage, each company should examine its own circumstances and determine what target would be most effective for the company's unique position. For example, an established company that does not expect a sharp growth curve may consider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

LONG-TERM INCENTIVES

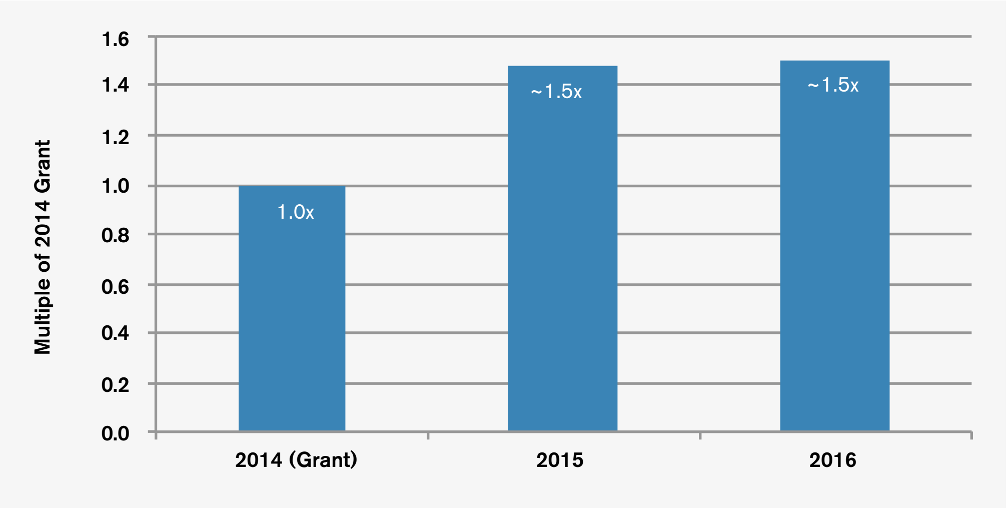
Effect of Current Market Conditions

The plunge in crude oil and natural gas prices has in many cases shaved substantial value from 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;
- Converting 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 remedy that will be effective in every case. Rather, each company's condition must be individually examined in order to determine the best treatment.

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 average total value of change in control benefits has decreased over the last two years, primarily attributable to the decreased value of LTI that would accelerate vesting upon a change in control. This decrease in LTI value is due to the depressed stock price of each executive's respective company.

The charts below show the average value of change in control benefits for CEOs and CFOs over the last two years:

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	$6,312,931	$708,350	$11,872,571	$1,390,217	$1,462,698	$173,839	$21,920,605
Second Quartile	3,431,113	295,254	3,446,990	43,095	-	32,181	7,248,634
Third Quartile	2,046,553	144,306	1,631,749	360	364,891	31,865	4,219,724
Bottom Quartile	1,471,680	122,237	229,513	97,752	69,194	17,243	2,007,618
All	**$3,315,569**	**$317,537**	**$4,295,206**	**$382,856**	**$474,196**	**$63,782**	**$8,849,145**

Year-Over-Year Increase / Decrease [2]	**-7.6%**

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	$2,458,128	$248,904	$3,556,719	$656,065	$538,503	$75,103	$7,533,422
Second Quartile	1,558,352	245,888	1,512,507	32,279	-	32,395	3,381,422
Third Quartile	923,512	82,757	279,184	375	-	19,051	1,304,879
Bottom Quartile	756,129	66,795	143,456	57,830	17,314	19,279	1,060,801
All	**$1,456,347**	**$165,030**	**$1,435,438**	**$195,742**	**$147,087**	**$37,416**	**$3,437,059**

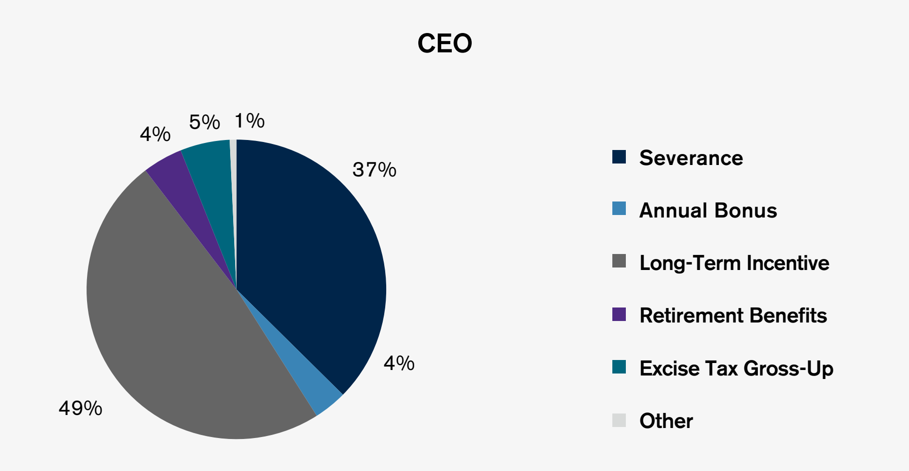
Year-Over-Year Increase / Decrease [2]	**-1.4%**

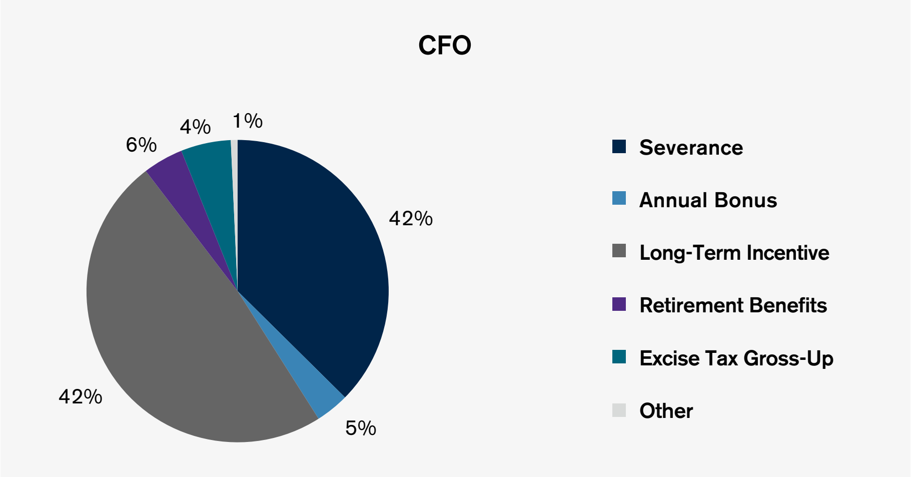
[1] Other includes health & welfare benefit continuation, outplacement services, and other benefits received in connection with a change in control.

[2] Includes only executives in both 2016 and 2017 studies.

CHANGE IN CONTROL BENEFITS

The charts below illustrate the average value for each type of change in control benefit for CEOs and CFOs. Severance and LTI value comprise more than 80% of the total change in control benefits value for CEOs and CFOs.





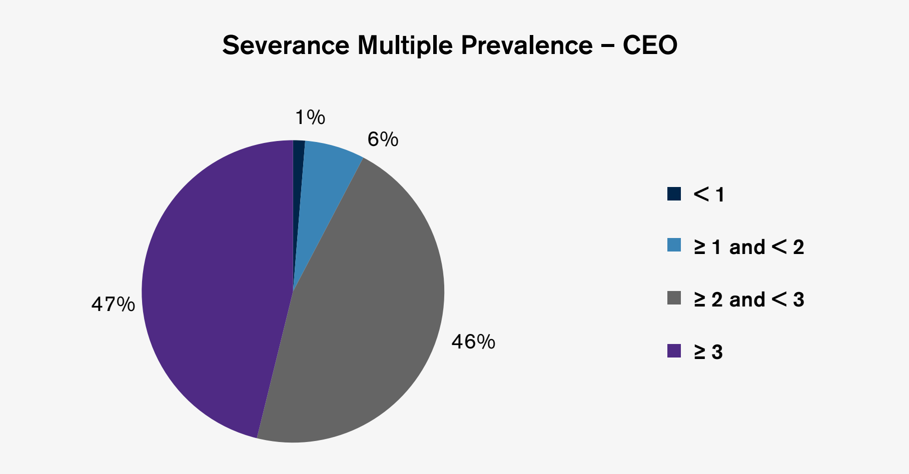
CHANGE IN CONTROL BENEFITS

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.

CEOs

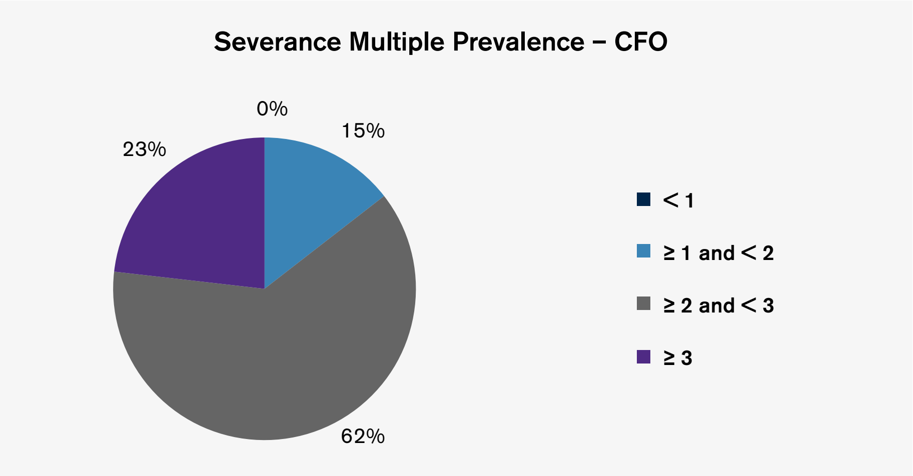
- 72% of CEOs are entitled to receive a cash severance payment upon termination in connection with a change in control.
- The most common cash severance payment multiple for CEOs is three times compensation or greater. 47% of companies with cash severance payments provide this level of benefit while 46% provide between two and three times compensation.
- The pie chart below identifies the most common severance multiples provided to CEOs upon a termination in connection with a change in control:



CHANGE IN CONTROL BENEFITS

CFOs

- 68% 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. 62% of companies with cash severance payments provide this level of benefit while 23% provide three times compensation or greater.
- The pie chart below identifies the most common severance multiples provided to CFOs upon a termination in connection with a change in control:



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.

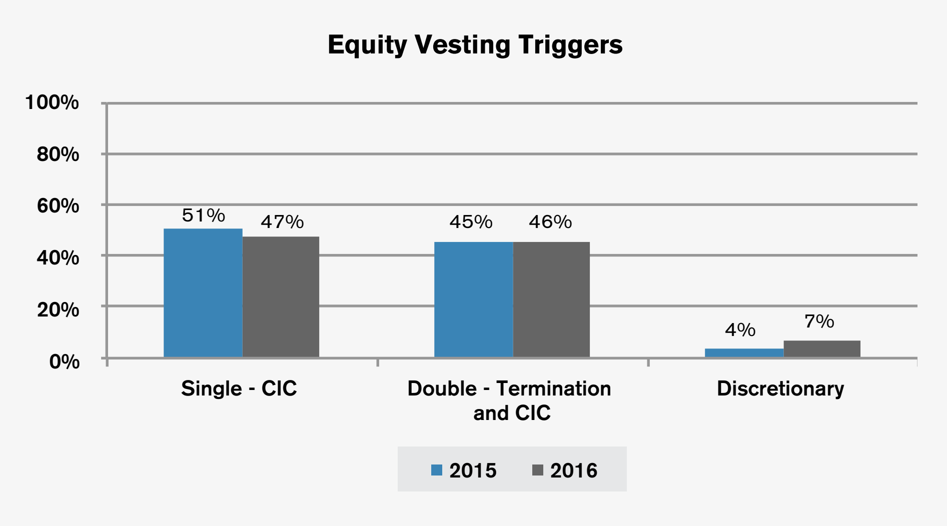
Sometimes companies provide for single trigger vesting if the acquiring company does not assume the equity awards, but double trigger vesting if the awards are assumed by the acquirer. For purposes of this survey, this treatment was included in the double trigger vesting category.

CHANGE IN CONTROL BENEFITS

The prevalence of single trigger vesting and double trigger vesting is virtually identical (47% and 46%, respectively). 7% of companies 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.

The chart below shows the prevalence of change in control triggers for outstanding equity awards of CEOs and CFOs over the last two years:



CHANGE IN CONTROL BENEFITS

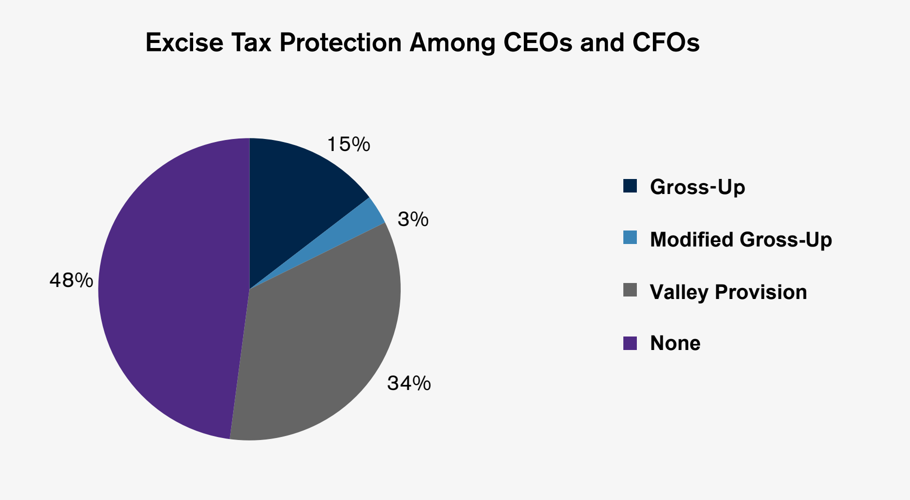
Excise Tax Mitigation Strategy

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.
- **Valley Provision:** The company cuts back parachute payments to the “safe harbor” limit to avoid any excise tax.
- **None:** The company does not attempt to mitigate the excise tax; therefore, executives are solely responsible for the excise tax.

18% of companies provide either a gross-up or modified gross-up to their CEOs and CFOs. A majority of companies (48%) 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.

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



BANKRUPTCY COMPENSATION

In recent years, many E&P companies have sought to reorganize or liquidate with bankruptcy court protection and assistance. These situations require special compensation arrangements in order to engage and motivate executives through the process.

Bankruptcy Compensation Overview

Under current bankruptcy law, companies may adopt a purely time-based retention program or a key employee retention plan (KERP) for "non-insider" employees. However, "insiders" are essentially precluded from participation in a KERP, but can be provided incentive-based compensation in connection with the bankruptcy process. These arrangements are generally known as key employee incentive plans (KEIPs) and require that the payments be earned based on specified performance criteria. 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 company'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 hitting 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 key employees.

We have also observed a recent trend where companies, prior to a bankruptcy filing, will enter into pre-paid retention arrangements with executives and other key employees (including potential insiders) and subject those pre-payments to a clawback.

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. Some 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, emergence equity grants are a way 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 Corp.
Anadarko Petroleum Corporation
Antero Resources Corporation
Apache Corp.
Approach Resources, Inc.
Atlas Resource Partners, L.P.
Barnwell Industries
Bill Barrett Corp.
BNK Petroleum Inc.
Bonanza Creek Energy, Inc.
Breitburn Energy Partners LP
Cabot Oil & Gas Corporation
California Resources Corporation
Callon Petroleum Company
Carbon Natural Gas 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.
Diversified Resources Inc.
Earthstone Energy, Inc.
Eclipse Resources Corporation
Energen Corp.
Energy XXI
EOG Resources, Inc.
EP Energy Corporation
EQT Corporation
Erin Energy Corporation
EV Energy Partners LP
Evolution Petroleum Corp.
EXCO Resources Inc.
Gastar Exploration Inc.
Gulfport Energy Corp.
Halcón Resources Corporation
Hess Corporation
Holloman Energy
Isramco Inc.
Jones Energy, Inc.
Kosmos Energy Ltd.
Laredo Petroleum, Inc.
Legacy Reserves LP
Linn Energy, LLC
Lonestar Resources Limited
Magellan Petroleum Corp.
Marathon Oil Corporation
Matador Resources Company
Memorial Production Partners LP
Memorial Resource Development Corp.
Mid-Con Energy Partners, LP
Murphy Oil Corporation
Newfield Exploration Co.
Noble Energy, Inc.
Northern Oil and Gas, Inc.
Oasis Petroleum Inc.
Occidental Petroleum Co.
Panhandle Oil and Gas Inc.
Parsley Energy, Inc.
PDC Energy, Inc.
PEDEVCO Corp.
PetroQuest Energy Inc.
Pioneer Natural Resources Co.
PrimeEnergy Corp.
QEP Resources, Inc.
Range Resources Corporation
Reserve Petroleum
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
Spindletop Oil & Gas Co.
Stone Energy Corp.
Swift Energy Company
Synergy Resources Corporation
Tengasco, Inc.
Torchlight Energy Resources, Inc.
TransAtlantic Petroleum Ltd.
Trans Energy Inc.
Triangle Petroleum Corporation
Ultra Petroleum Corp.
U.S. Energy Corp.
Vaalco Energy Inc.
Vanguard Natural Resources, LLC
W&T Offshore Inc.
Whiting Petroleum Corp.
WPX Energy, Inc.
Yuma Energy, Inc.

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