



Compensation
Advisory Partners

CAPintel // October 5, 2020

In Bankruptcies Triggered by COVID, Retention is Key for Executive Pay

■ By Chris Earnest, Bonnie Schindler and Whitney Cook

COVID-19 has caused a surge of bankruptcies in 2020. The increased number of bankruptcies has prompted interest in and scrutiny of executive compensation during corporate restructurings. CAP explains the evolution of prepaid executive retention awards in bankruptcy situations and examines executive pay arrangements at a number of companies that filed for bankruptcy in 2020.

NEW YORK

1133 Avenue of the Americas
New York, NY 10036
Phone: (212) 921-9350 | Fax: (212) 921-9227
www.capartners.com

HOUSTON

840 Gessner
Suite 375
Houston, TX 77024
Phone: (713) 559-2715

CHICAGO

200 S Wacker Drive
Suite 3100
Chicago, IL 60606
Phone: (312) 462-4500

LOS ANGELES

400 Continental Blvd
6th Floor
El Segundo, CA 90245
Phone: (310) 426-2340

The COVID-19 pandemic dealt an unexpected blow that pushed a number of companies into bankruptcy. The impact of pandemic-related shutdowns was broad: Companies in a diverse range of industries – including retail, oil and gas, consumer goods, restaurants, and entertainment and recreation – filed for Chapter 11 bankruptcy protection in the first half of 2020. While the number of filings has not yet reached the level seen in the 2008 financial crisis, the number of bankruptcies is expected to rise through the remainder of the year.

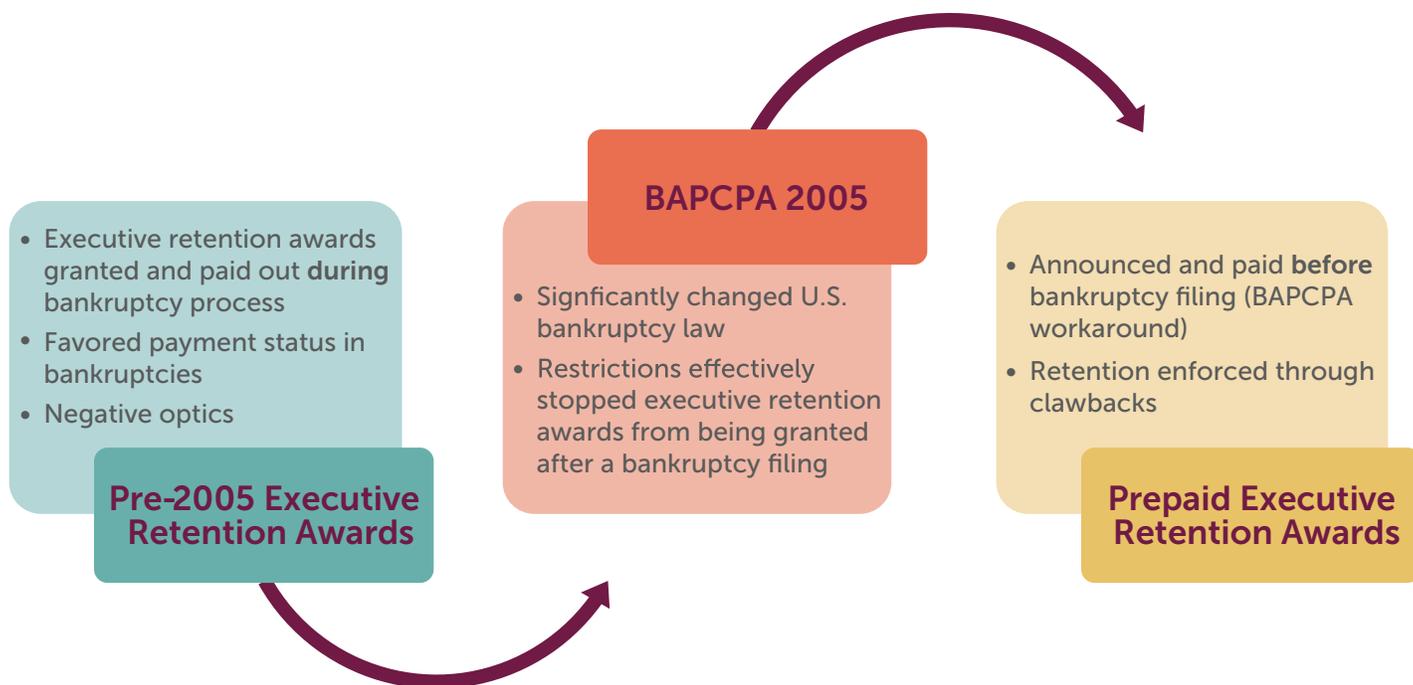
The 2020 surge in bankruptcies has been accompanied by heightened scrutiny of executive pay in restructuring situations. Bankruptcy filings are often preceded by announcements of executive retention and other short-term performance-based awards. These awards can draw criticism as excessive and even inappropriate given the impact of bankruptcy on shareholders and the broader employee population. However, 2020 is unique. While situations vary by industry, most agree that this flurry of bankruptcy filings is not the result of poor management but rather the inevitable impact of unprecedented and unforeseeable broad shutdowns across the country to contain the pandemic. The companies entering bankruptcy need continuity, stability, and motivated leadership. Carefully designed and communicated retention and performance awards can play an important role in keeping leadership in place and focused on moving the company through the restructuring process.

The Evolution of Prepaid Awards

Corporate bankruptcies cause a significant amount of uncertainty for executives and employees, who can be tempted to leave for more stable work situations with predictable, secure compensation streams. Poor company performance means that annual incentives are unlikely to pay out, and equity holdings lose almost all value. In situations where shareholders need to retain executives through the bankruptcy period, cash retention awards to critical members of management can be effective by providing compensation stability. These programs are often called Key Executive Retention Programs (KERPs).

Executive retention awards in bankruptcy situations today have a unique design: they are paid before the bankruptcy filing and are subject to clawback provisions. Clawback provisions are triggered if the executive terminates employment during a specified time period or is terminated for cause. In addition, some clawbacks are tied to performance goals not being achieved. If triggered, the clawback provisions require executives to pay back the after-tax award value. The fact that the awards are prepaid differentiates them from most other cash incentives and makes them the subject of criticism and misunderstanding.

The Evolution of Prepaid Executive Retention Awards in Bankruptcies



The unique design for executive retention awards emerged from changes to the U.S. bankruptcy code made through the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). Prior to BAPCPA, a large portion of executive compensation in bankruptcy situations was delivered through retention awards. Executive retention awards were typically paid out in a lump sum or through several payments based on the executive's continued employment. Executive retention awards also had special status in the bankruptcy proceedings that ensured payment ahead of many other company obligations. As a result of the special status and lack of performance features, executive retention awards were not viewed favorably.

BAPCPA imposed stringent restrictions on awards to "insiders" implemented during the bankruptcy process that are based solely on retention and that lack performance features ("Insiders" are defined as directors, officers, individuals in control of the corporation, and relatives of such individuals). BAPCPA's restrictions effectively stopped the use of executive retention awards once companies file for bankruptcy. Despite BAPCPA, executive retention awards eventually re-emerged – as prepaid awards subject to clawbacks. By paying the awards before the bankruptcy filing, companies can generally avoid the BAPCPA restrictions and avoid having the award subject to Bankruptcy Court approval.

Prevalent Executive and Employee Pay Practices during Bankruptcy

CAP analyzed the 8-K filings of a number of companies that entered bankruptcy in 2020. Based on this analysis, companies today often use a mix of compensation programs to retain and motivate executives and employees leading up to, and during, the bankruptcy process:

- Pre-filing, prepaid executive retention awards
- Performance-based Key Employee Incentive Plans (KEIPs)
- Employee retention and incentive programs

Pre-Filing, Prepaid Executive Retention Awards

A number of companies that filed for bankruptcy during 2020 announced prepaid retention awards for executives anywhere from days to months before the legal filing. The 8-K filings indicate that the prepaid retention awards are designed by the board with advice from compensation consultants, as well as bankruptcy and other advisors. Typical design parameters for executive retention bonus awards include:

| | |
|------------------------------------|--|
| Participation: | CEO, other key executives and officers |
| Objectives: | Retain key employees before and during the bankruptcy proceedings |
| Award Value: | <ul style="list-style-type: none">• Retention award values often range from 1X to 2X base salary• Any previously issued retention awards can serve as precedent |
| Form of Payment and Timing: | Awards are made in cash, prepaid in a lump sum prior to the bankruptcy filing |
| Clawback Provisions: | Executives must repay the awards, net of taxes, if they 1) Terminate employment prior to the earlier of a specified period or the conclusion of the bankruptcy period, or 2) Are terminated by the company for cause |
| Clawback Period: | Most often one year |

While less common, some companies, including Chesapeake Energy and Ascena Retail Group, include base-level performance criteria in the clawback provisions to add a performance element to the prepaid retention awards. This improves the overall optics of such awards and helps avoid additional scrutiny during bankruptcy.

Select Pre-Filing Retention and Incentive Programs

| Company | Revenue FY2019 (\$000s) | Industry | Bankruptcy Date | Program | Award Term | Description |
|---------------------------|-------------------------|----------------------------|-----------------|-----------------------|-------------------------|--|
| J.C. Penney | \$12,019 | Retailing | 5/15/2020 | Retention & Incentive | 0.6Y | Adopted a prepaid cash compensation program equal to a portion of NEO annual target variable compensation; NEO awards ranged from \$1M to \$4.5M; clawbacks are tied 80% to continued employment through January 31, 2021, and 20% to milestone-based performance goals |
| | | | | Retention | 1.6Y | Accelerated the earned 2019 portion of three-year long-term incentive awards (\$2.4M for NEOs); clawbacks are tied to continued employment through January 31, 2022 |
| Hertz Global Holdings | \$9,779 | Transportation | 5/22/2020 | Retention | 0.8Y | Cash retention payments to 340 key employees at the director level and above (\$16.2M in aggregate); NEO awards ranged from \$190K to \$700K; clawbacks tied to continued employment through March 31, 2021 |
| Chesapeake Energy | \$8,408 | Energy | 6/28/2020 | Retention & Incentive | 1.0Y | Executives: Prepaid 100% of NEO and designated VP target variable compensation (\$25M in aggregate for 27 executives) based 50% on continued employment and 50% on the achievement of specified incentive metrics Employees (retention only): Converted annual incentive plan into a 12-month cash retention plan paid quarterly, subject to continued employment |
| Ascena Retail Group | \$5,493 | Retailing | 7/23/2020 | Retention & Incentive | 0.5Y | Executive and Employee Retention and Performance Awards: Six-month cash award for NEOs (NEO awards ranged from \$600K to \$1.1M), 3 other executives, and employees who are eligible for the company's incentive programs based 50% on continued employment through Q4 2020 and 50% on performance; award amounts are based on a percentage of annual and long-term incentive targets Earned Performance-Based LTIP Awards: Accelerated earned 2018 and 2019 performance-based cash awards for all employees (\$1.1M for 2 NEOs), subject to continued employment through August 1, 2020 for the 2018 award and August 3, 2021 for the 2019 award |
| Whiting Petroleum | \$1,572 | Energy | 4/1/2020 | Retention | 1.0Y or Chapter 11 Exit | NEO awards were prepaid and ranged from \$1.1M-\$6.4M; clawbacks are based on termination of employment before the earlier of March 30, 2021, or Chapter 11 exit; employees receive quarterly cash awards that in aggregate may not exceed that employee's target annual and long-term incentive compensation |
| GNC Holdings | \$1,446 | Food, Beverage and Tobacco | 6/23/2020 | Retention | 1.0Y | Cash exit incentive awards for key employees (including executives) based 75% on the Company's exit from bankruptcy and 25% on the 60th day following an emergence event that occurs on or prior to June 23, 2021. Prepaid NEO awards ranged from \$300K to \$2.2M |
| Diamond Offshore Drilling | \$935 | Energy | 4/26/2020 | Retention | 1.0Y | Past Executive Long-Term Cash Incentives: Payment of a portion of past three-year cash incentive awards was accelerated for retention; awards are subject to clawbacks based on termination of employment for one year; NEO payouts ranged from \$140,208 to \$1.75 million. Other Plans: The Company announced a Key Employee Incentive Plan, a Non-Executive Incentive Plan and a Key Employee Retention Plan, which are all subject to approval by the Bankruptcy Court |

Performance-Based Key Employee Incentive Plans (KEIPs)

After BAPCPA, KEIPs emerged to provide incentives to executives without running afoul of the bankruptcy code. KEIPs, which are approved during the bankruptcy process, are performance-based incentives that pay out in cash based on the achievement of financial and operational goals. The goals can be very short-term in nature, such as quarterly performance periods.

Typical design parameters for KEIPs include:

| | |
|------------------------------------|---|
| Participation: | CEO, other key executives and officers (ultimately those designated as “insiders” in the bankruptcy proceeding) |
| Objectives: | Incentivize key executives before, but primarily during, the bankruptcy proceedings |
| Award Value: | <ul style="list-style-type: none"> • KEIPs often collapse the annual and long-term incentive opportunities into a single program • In most cases, the executives can earn 100% of their target annual incentive and between 50% and 100% of their prior long-term incentive award value • The KEIP must be performance based to receive court approval, and payouts are often determined using absolute measures, such as earnings before interest and taxes (EBIT) or earnings before interest, taxes, depreciation and amortization (EBITDA) |
| Form of Payment and Timing: | <ul style="list-style-type: none"> • Awards are paid in cash upon certification of performance in pre-established goals • Performance periods range from quarterly to annual |

A current trend is to design and implement the KEIP prior to filing. This is especially true in pre-packaged bankruptcies where the financial reorganization of the company is prepared in advance in cooperation with its creditors. Having these programs in place with payouts contingent on performance improves continuity throughout the entire process, incentivizes the management team to perform, and meets the court’s requirement that any variable compensation to executives be performance based.

One recent example of a company announcing a KEIP before the bankruptcy filing is Diamond Offshore Drilling. The company announced a prepaid retention program for executives, as well as a KEIP, a non-executive incentive plan and an additional retention plan. All plans except for the prepaid executive retention program are subject to Bankruptcy Court approval, according to the [8-K](#). The KEIP, nonexecutive incentive plan and the additional retention plan replace past incentives – including requiring the forfeiture of past restricted stock unit awards and stock appreciation rights – and current incentives that would have been granted in 2020. The KEIP includes nine participants, including the senior executive team.

Employee Retention and Incentive Programs

Retention and incentive programs for employees are also used during the bankruptcy process. The use of employee programs depends on the company's business needs and other factors, such as size and industry. Retention and incentive programs for non-executives typically replace the value of annual incentives and sometimes long-term incentives. Employee retention programs are cash-based and pay out at specific intervals, often quarterly given the uncertainties associated with companies in restructuring situations. The duration of employee retention programs often mirrors those for executives.

Severance programs, which provide compensation to individuals at termination, are also used in bankruptcy situations. When communicated broadly during bankruptcy, severance can be considered a retention program as it helps employees have some financial security and focus on their current jobs rather than finding new positions. Severance programs tend to be used more commonly for employees than executives because BAPCPA limits the value that can be delivered to "insiders." However, a recent example of a severance program for executives came from Hertz Global Holdings, which announced amendments to its executive severance programs prior to its bankruptcy filing in May 2020. The severance programs, which were disclosed in the same [8-K](#) filing as a prepaid key employee retention program, cover senior executives and vice presidents, and the payment multiple was reduced to 1X salary and bonus from 1.5X.

Conclusion

Executive compensation programs implemented in conjunction with a bankruptcy should be carefully designed and reviewed with outside advisors to ensure that the company is complying with bankruptcy code. Companies should carefully review the value of executive awards to ensure that they are reasonable while also in line with competitive practices and past incentive opportunities. Executive award amounts should be considered in the context of employee awards and the company's overall financial situation to ensure fairness and avoid the appearance of excess. Lastly, companies should carefully communicate the rationale for executive awards and what the company is doing for employees in the 8-K current report or other announcement. Clear communication up front can help head off later public relations and optics headaches.



Compensation Advisory Partners

Please contact us at (713) 559-2715 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at www.capartners.com for more information on executive compensation.