Proskauer

Private Credit Trends: Executive Compensation Considerations in Out-of-Court Restructurings

February 20, 2024

Retaining key management at a distressed company in the midst of an out-of-court restructuring can be necessary for the success of the restructuring. To realign incentives, private credit lenders need to consider reloading and restructuring equity awards, retention bonuses and change in control payments to maximize the possibility of recouping their investment and promoting future profitability.

Though every out-of-court restructuring raises different issues, creditors taking the keys to a distressed company must: (1) identify talent for retention through the restructuring process and continued retention by the post-closing organization; (2) assess the efficacy and potential liabilities of existing compensation arrangements; and (3) structure new incentive compensation programs that are designed to encourage the repayment of debt and growth of the company after the restructuring.

Identify Key Talent and Go-Forward Organizational Structure. A distressed company may have a management team that is essential to retain through a restructuring process. Alternatively, it may be desirable to bring on new leaders or replace previous team members to align management with the company's renewed priorities. Furthermore, changes to the organizational structure of the business that are implemented in the restructuring may impact the job functions or roles of management team members and may need to be accounted for through redefining roles and reassessing reporting lines and responsibilities. It is important for companies and their restructuring partners to have a clear vision of their restructuring goals and to identify key talent that will propel the company forward once the restructuring is complete.

Assess Existing Incentive Arrangements and Liabilities. Many distressed companies do not have effective incentive compensation structures in place. This can be due to their inherent design, the company's distressed circumstances or both. Outstanding equity awards or stock options may have little to no value. Existing cash-based performance compensation is often insufficient to retain talented managers through a restructuring. Further, in some situations (such as a debt-for-equity transaction), existing change in control payment obligations may be triggered, or certain executives may be able to exercise "good reason" rights and receive severance. These payouts can cause a further liquidity drain on an already distressed company, an unintended windfall to the management team, and may incentivize executives to leave the organization immediately upon the consummation of a restructuring, even if those executives are important to the long-term success of the company. By restructuring incentive compensation plans and payments focused on the post-restructuring goals of the company and its stakeholders, distressed companies can attempt to preserve liquidity, minimize departures and retain executives through the transition and beyond.

If the restructuring qualifies as a change in control, companies must also consider whether any of these payments would be parachute payments under Section 280G of the Internal Revenue Code of 1986, as amended (the "Code") or trigger an excise tax under Section 4999 of the Code. It may be unlikely that the change in control of a distressed company would trigger high enough payouts that would implicate Section 280G of the Code, but in some cases (including where an officer or highly compensated individual was hired shortly before the restructuring) Section 280G of the Code could be a factor to be concerned about. Companies must undertake the required analysis to verify that no such problems exist.

Structure New Post-Closing Incentives. The new incentives should be specific to the company's unique financial circumstances. Most successful post-closing compensation structures prioritize profitability and providing management with market compensation while avoiding a liquidity drain. Many restructured companies create one or more incentive plans, including short-or medium-term cash plans and longer-term equity plans.

Cash Incentive Plans. New incentives often take the form of a cash plan, with features that focus on short- or medium-term retention of the management team. Usually, those retention awards will have time-based vesting, as well as performance goals that prioritize the company's profitability and debt repayment. Such performance metrics could include free cash flow, net income, net operating profit after tax, net debt to EBITDA (earnings before interest, taxes, depreciation and amortization) ratio or amount of debt repaid.

Equity-Based Incentive Plans. In addition to cash plans, distressed companies undergoing a debt-for-equity transaction may adopt an equity-based plan which is focused on increasing the value of the company upon a future change in control. These plans seek to measure the increase in value of the company, and companies can work with creditors to build an equity-based plan that reflects their mutually desired outcome, allowing the creditor to exit after recouping their investment and allowing the surviving business to continue to grow. Depending on the company's previous incentive structure, the equity-based plans could award profits interests, stock options, restricted stock units or function as a "phantom plan" where change in equity value is measured and awarded with a cash payment, or that awards a pre-determined cash payment upon a change in control. Depending on the population of employees who would be eligible for equity-based awards, a combination of equity and "phantom" equity plans may be advisable. These awards often have vesting criteria which align with the company's goals of profitability and debt repayment. In addition, in structuring vesting and payout of equity-based awards, companies must consider how to approach a sale of company assets or ownership that does not trigger a full change in control.

Limitations on Compensation Restructuring. When constructing their new approach to incentive compensation and retention awards, companies must consider the same issues that they considered for their previous incentives, including contractual requirements, and tax and securities laws. If the company is choosing to replace pre-existing awards, they may have to seek consent from current award holders. Companies must also be careful to avoid triggering a tender offer under applicable securities rules when replacing existing equity-based awards with new equity-based awards or cash awards. The restructuring of awards should be done in a manner that considers the impact of Section 409A of the Code. If option awards are granted, the strike price must be based on an up-to-date valuation of the company and options cannot be granted with a strike price less than the fair market value of a share of the company's common stock as of the date of grant. Restructurings may also provide an opportunity to provide tax advantaged incentives, giving managers potential to achieve consideration at capital gains rates as opposed to ordinary income rates. Companies should work with tax advisors to maximize the tax efficiency of their incentive programs and to confirm that they are withholding income taxes and payroll taxes appropriately. Finally, companies must examine whether the adoption or award of new grants triggers any state or federal securities filing or disclosure requirements.

Out-of-court restructurings can provide an opportunity for distressed companies to reimagine their ideal business model going forward. By locking in strong incentive compensation and retention goals for star talent, distressed companies can ensure that once the restructuring period comes to an end, the business will have a solid foundation for success into the future.

Related Professionals

- **Charles A. Dale**
  Partner
- **Colleen Hart**
  Partner
- **David M. Hillman**
  Partner
- **Vincent Indelicato**

Partner

- **Steven M. Peck**
  Partner