Pearl Meyer

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Ground Rules When Facing Imminent Restructuring

Malcolm Adkins

MANAGING DIRECTOR

Starting in early 2015 and through 2016, there were over 200 bankruptcies in the oil and gas sector. Two-thirds of these were in Texas, but the impact was felt across the country involving almost $140 billion in total debt. Since that initial wave, the oilfield services segment alone has seen over 200 additional filings, with E&Ps also exceeding 200 additional bankruptcies in the same time period. By comparison, the pace of bankruptcy filings in the second quarter of 2020 exceeded all other quarters since 2016 for E&Ps and 2017 for oilfield services.

What will occur in 2020 depends upon the length of the current downturn, but it has the potential to repeat the impact we saw in the protracted period of the mid-1980s, when two-thirds of the small- to mid-sized domestic producers were wiped out. A similar impact was felt in the services sector and reverberated into companies in other industries that fed from energy industry activity.

What appears to be absent this year is the underlying optimism many stakeholders held onto in previous restructuring waves within the energy industry. Further, the scrutiny on compensation packages being put in place this year is unparalleled, regardless of industry. The current spotlight is bringing with it a heavy hand to the compensation management process. Now more than ever, companies should call on compensation ground rules learned from the past when navigating through a reorganization.

When a Bankruptcy or Reorganization is Imminent

There is no higher-risk time for a company than leading up to and through a bankruptcy process. During this time of uncertainty, it is crucial to retain a substantial portion of your high performing team and those with critical institutional knowledge. With fiduciary duties to all stakeholders, the company leadership and rank-and-file alike need to be operating on all cylinders and be motivated to get the company to a good outcome through the restructuring process.

Market-based compensation packages, including well-structured incentive arrangements, are necessary to ensure motivated and engaged workforces. The design of these compensation programs has to walk a fine line that balances retention, motivation, and reasonableness along with legal and regulatory restrictions. Keeping this in mind, when a reorganization is on the horizon, companies should focus on developing a compensation program with three key features.

- **Ensures company survival:** Survival is generally in the best interests of all stakeholders invested in the enterprise on a go-forward basis. This is particularly true for creditors and the broader (non-executive) employee base.
- **Incentivizes the successful execution of restructuring plan**: During bankruptcy, a company's human capital assets need to be laser-focused on one thing—assisting in the development of the restructuring plan and leading the charge in implementing

such plan to secure a successful emergence.

- **Is reasonable and defensible in terms of quantum, timing, and mechanism:** All compensation packages will eventually need to be court-approved and prima facie reasonable.

When compensation packages are properly designed with bankruptcy in mind and both market-competitive and supportable in costs and coverage, they act as the catalyst to processes that support a successful restructuring. When reasonable, they tend to get wide-spread support from the creditors, lenders, and large shareholders who most often play a sizeable role in deal structuring, and they secure the focus of human capital to the tasks at hand.

Compensation Design for Reorganization

When a company falls into financial distress, status quo compensation programs generally produce little forward incentive for key employees to stay put and face the upcoming challenges and turbulence a restructuring brings. Incentive plan payouts (both short- and long-term) are likely no longer achievable, vested and unvested equity awards have little to no value, and management is undoubtedly looking at additional work and longer hours. When transitioning to a distressed environment compensation program, there are a few key design aspects to keep in mind.

- Programs need to appropriately compensate for the additional efforts, timelines, milestones, and actions associated with navigating a restructuring.
- Performance hurdles should focus on short-term goals (even quarterly); often driven by milestones rather than financial targets and paid in cash.
- Total compensation opportunities should reflect either (i) current target compensation values or (ii) competitive market opportunities when determining the value of the redesigned program. In most cases, the total value will be less than, or at most equal to, previous target values. Such values are not designed to "make up" for lost performance-based compensation opportunity, but rather to be competitive to ensure retention of key talent through the reorganization of the company.

Be Aware of Clawback Pitfalls

Finally, if the desire is to roll the incentive plan(s) into a key employee incentive plan (KEIP) or a key employee retention plan (KERP) plan, there are additional guidelines and considerations to be aware of. Recent trends within the restructuring world suggest compensation for "insiders" in these environments includes an increasing prevalence of upfront, pre-petition payments that are subject to clawback (no proration) if the insider leaves the company or is terminated for cause. It is important to note that when these types of awards are implemented and a company subsequently commences reorganization, those payments may also be subject to clawback risk under Section 548 of the Bankruptcy Code, or non-payment risk if the insider's plan participation agreement is rejected. That said, case law as evidence of this type of risk is limited at this point in time.

Engage the Right Expertise for the Circumstances

Your company's legal teams, along with HR, will be stretched quite thin when a restructuring is looming. While those groups may have a solid understanding of many of the compensation rules that come into play, there are important details that cannot be left to chance, particularly when it comes to change-in-control provisions and potentially tricky tax rules. Ensure you have the support of experienced advisors for all of the technical aspects of executive compensation in this business stage, as well as the pay plan design levers that can keep needed management in place throughout the process.

About the Author

Malcolm Adkins is a managing director in Pearl Meyer's Houston office, and a staff manager and energy practice leader for the firm. He has over 15 years of compensation consulting experience with an emphasis on the assessment and design of executive and director pay programs, including assisting clients with compensation benchmarking and pay practices, annual and long-term incentive plan design, peer group development and pay-for-performance assessments, governance issues, and M&A support.

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