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Navigating Talent Retention and Executive Compensation in Bankruptcy

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When a company faces financial distress, leadership retention becomes both more challenging and more scrutinized. Creditors, courts, employees, and the public often watch an organization's every move. In such an environment, pay decisions are not just about dollars and cents; they are about preserving talent, protecting credibility, and ultimately maximizing the underlying value of the enterprise.

Locking in Talent Before Filing

One of the most reliable ways to retain executives is to act before a bankruptcy filing. Once a filing is made, restrictions multiply with court oversight and outside scrutiny intensifies. A pre-petition retention program should be structured to withstand both creditor review and public scrutiny.

A strong retention program typically includes lump-sum cash payments made before the filing, paired with strict clawback provisions that require repayment if the executive departs before a specified date. Boards should also require participants to waive their rights to current variable compensation, such as annual bonuses or equity awards, to create a clear exchange of value for retention payments. In addition, programs should be benchmarked against recent, comparable pre-petition retention plans to ensure the payment amounts and plan design are defensible. For comparable plans, boards should consider industry and size of the organizations paying them.

Timing is equally important but subjective. Payments should be made with enough distance from a filing to avoid the appearance of impropriety, but close enough to reinforce stability through the restructuring period. Large payouts issued just before a petition date almost guarantee negative headlines and objections from creditors.

For example, Hertz Global Holdings paid about $16 million in retention bonuses to more than 300 executives days before filing Chapter 11 bankruptcy in 2020. This sparked widespread media scrutiny but ultimately provided a model for pre-petition payments with clawbacks.

Building a Key Executive Incentive Plan

Once a company enters Chapter 11 bankruptcy, traditional retention bonuses for insiders are essentially off the table. Courts will only approve pay programs that are clearly tied to performance. The US Bankruptcy Code defines "insiders" broadly and includes directors, officers, and those who exercise control over the debtor, as well as their relatives and affiliates.

Courts may also apply this label to others, depending on the facts of the case, and examine the role of insiders at a functional level, such as their control and influence within the organization. Congress added Section 503(c) to the US Bankruptcy Code in 2005 to restrict excessive insider pay. It created three important limits:

- 503(c)(1) prohibits insider retention bonuses unless the executive has a bona fide outside job offer, the executive's services are essential to survival, and payments are capped relative to nonmanagement employees.
- 503(c)(2) restricts insider severance pay, which must be part of a broad program available to all employees and capped at 10 times the average nonmanagement severance.
- 503(c)(3) requires that all other payments outside the ordinary course of business be justified by the facts and circumstances of the case.

For insiders, incentive plans should be designed around stretch goals, such as achieving cash flow or earnings before interest, taxes, depreciation, and amortization targets; meeting liquidity milestones; or securing confirmation of a reorganization plan. Successful plans are well-documented, supported by market data, and structured in tranches that require results, not just continued employment.

The Dana Corp. case in 2006 established factors that courts still use to evaluate whether a key executive incentive plan (KEIP) is legitimate. More recently, in the Country Fresh Holding Co. bankruptcy in 2021, a Texas court approved some—but not all—of the proposed KEIP payments, emphasizing that plans must be carefully tailored.

By contrast, the Aviation Safety Resources case in 2023 shows what happens when incentives are too easily achieved: The court denied bonuses that were effectively "don't quit" payments.

Using Key Employee Retention Plans for Non-Insiders

While restrictions on insider pay are strict, the US Bankruptcy Code allows companies more flexibility for non-insiders. These employees, though not part of senior leadership, are often critical to maintaining daily operations and business continuity. Key employee retention plans (KERPs) remain common for this group and usually take the form of cash bonuses paid in installments if employees remain through key points in the restructuring process.

Courts generally approve these programs when companies show that the payment amounts and design reflect market practice. The objective is straightforward: Keep essential employees engaged and in place during the turbulence of restructuring. By providing stability to a broad base of employees, KERPs help preserve operations and support a smoother emergence from bankruptcy.

For instance, in 2023, WeWork disclosed more than $3 million in retention payments to non-insiders as it prepared to file for bankruptcy, illustrating how KERPs remain a practical and accepted tool to stabilize the broader workforce.

Post-Bankruptcy Equity

Pre-bankruptcy equity awards typically lose their value, leaving little long-term retention power after emergence. As a result, most reorganizations establish a new equity pool to support long-term incentives after the restructuring is complete.

Boards should work with creditors to determine how large the post-emergence equity pool should be, how much should be granted immediately, and how much should be reserved for future grants. They must also decide how to allocate equity between insiders and broader employee groups, and whether awards will be time-based, performance-based, or a mix of the two. Looking at how comparable companies, by industry and size, structured their post-emergence equity can provide a helpful starting point for negotiations.

By proactively planning for post-bankruptcy incentives, boards can ensure that executives and employees remain motivated to rebuild the company after restructuring.

Winning Support from Stakeholders

Boards should be prepared to defend not only the quantum of payments but also the reasoning behind their decisions. This involves documenting the rationale for each pay element, defining the objectives of any proposed program, reviewing external benchmarks, and assessing potential optics before the plan is finalized. Independent advisors play a crucial role in validating plan design and compensation committees must ensure a thorough record of business judgment factors. The US Trustee Program has shown a willingness to challenge pay plans for insiders it views as mere attempts at retention, so anticipating objections is part of the process.

Just as important, however, is balancing competitiveness with fairness. Creditors, investors, employees, and the media all have a stake in how executive compensation is handled during bankruptcy, and perception can be as crucial as legal compliance.

The Restructuring Compensation Checklist

Boards of companies facing distress should consider doing the following:

- Act early, if liquidity allows, through pre-petition awards with clawbacks, which are now standard practice.
- Tie insider pay to stretch performance, where KEIPs, if needed, are real incentives that are not disguised as retention.
- Use KERPs for non-insiders to stabilize the broader workforce.
- Plan for post-emergence equity pay by reserving a meaningful equity pool to reestablish long-term incentives.
- Don't ignore the back office since payroll and tax compliance are essential during a bankruptcy.
- Document everything, as independent validation and transparency are critical for court and stakeholder approval of the pay plans.

In today's restructuring landscape, executive pay is about more than keeping leaders in their seats. Effective programs balance retention, performance, compliance, and optics. When done well, these tools allow companies to retain critical talent, maintain credibility, and navigate distress toward a stronger future.

About the Authors

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About Pearl Meyer

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