AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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Feature

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Management Incentive Plans Under a Microscope

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Bankruptcy practitioners, strategic investors and other chapter 11 actors have become increasingly focused on the key economic and legal terms of management incentive plans (MIPs).[1] One view is that an MIP properly aligns the economic interests of employees with shareholders, and might offer employees with an opportunity to share in future gains generated by their efforts where, in many cases, previously granted equity awards (or shares issued on the vesting of such awards) will lose all or a significant portion of their value as a result of a reorganization. Critics often cast MIPs as an unwarranted bargain by key stakeholders with management to secure support for the stakeholders' restructuring plan, with the new equity of the reorganized company reserved under MIPs (often around 10 percent of the total equity) as an unjustified "bleed" from creditors' recoveries.[2]

Finding agreement on the terms of an MIP can be among the most daunting obstacles toward building consensus around a restructuring plan. The timing of negotiating the terms of an MIP may itself be the subject of negotiation, with certain parties seeking to forge agreement early in restructuring negotiations and others seeking to defer committing to MIP terms until a new board of directors is seated. This article provides a brief overview of the key elements of MIPs and certain hotly negotiated legal issues that arise in connection with their negotiation.

Background: Post-Emergence MIPs

In general, MIPs are intended to serve the same purposes as equity incentive plans adopted by financially healthy companies — namely, to attract and retain executives and other key employees and incentivize them to improve the business results of the reorganized company by providing them with an opportunity to acquire a proprietary interest in the company's success. For certain companies that reorganize through a chapter 11 process, retaining or attracting a talented and experienced management team that can stabilize the post-emergence business and execute strategic opportunities might prove difficult because of the stigma associated with bankruptcy or the uncertainty around compensation and job security. Moreover, reorganized companies might be vulnerable to the same economic headwinds that existed prior to its bankruptcy, which often exacerbate executive retention and recruitment concerns unless executives have the opportunity for potential upside gain to outweigh downside risk.

The Bankruptcy Code makes no reference to MIPs specifically. Section 1123(b)(6) of the Bankruptcy Code permits a chapter 11 reorganization plan to include any "appropriate provision not inconsistent with the applicable [Code] provisions."[3] This general catch-all provision is thought to authorize a debtor to include a MIP as part of a reorganization plan, most often in the form of a plan supplement. As a technical matter, a reorganization plan often authorizes — and in some cases, directs — the adoption and implementation of a MIP by the reorganized debtor on the plan's effective date.[4] Because MIPs are incorporated into and made a part of a reorganization plan, objections to MIPs are generally made

1 MIPs are also often referred to as "employee-incentive" or "equity-incentive" plans. In addition to providing for equity grants to senior management, MIPs generally also provide for grants to non-management employees, including rank-and-file employees.

2 Equity awards issued under MIPs to management teams have drawn particular scrutiny in cases where the equity value of the reorganized debtor increased dramatically following a restructuring, resulting in a management team reaping tremendous profits very shortly after the company it led emerged from bankruptcy. *See* Ryan December, "Most Lucrative Energy Job? Some Say It's CEO of a Bankrupt Company," *Wall Street Journal*, April 3, 2017.

3 *See* 11 U.S.C. § 1123(b)(6).

in the form of plan objections, commonly on bad-faith grounds (*i.e.*, an allegation that the MIP is proposed in bad faith in order to enrich existing management at the expense of other parties),[5] or as objections to the amount of disclosure regarding the MIP in the disclosure statement accompanying a chapter 11 plan.

Key Elements of an MIP

Generally speaking, an MIP authorizes a reorganized company (most often, the compensation committee of the company's board of directors) to grant equity awards to MIP participants, subject to certain parameters set forth in the MIP or in the individual award agreements issued thereunder. These parameters (*e.g.*, forms of awards, vesting requirements and amount of shares available to be awarded) are discussed below.

Forms of Awards

From an economic perspective, equity-based awards granted under MIPs generally fall into one of two award categories: "full value" (*e.g.*, restricted stock or restricted stock units (RSUs)) or appreciation (*e.g.*, stock options or stock appreciation rights (SARs)).[6] A full-value award provides the participant with the value of the shares covered by the award once the vesting conditions are met.[7] As such, they are often viewed as the most advantageous from an MIP participant's perspective, as they provide value even if the company's share price fails to appreciate or declines. By contrast, when a participant exercises an appreciation award, the participant receives value only to the extent that the company's share price has increased from the grant date. For that reason, appreciation awards are often favored by shareholders, who might believe that management should not be compensated unless shareholders benefit from gains.

On the other hand, shareholders of a reorganized company who are subject to legal or practical restrictions on their ability to sell their shares for a period post-emergence may prefer that at least some awards be granted in the form of restricted stock or RSUs so that management is incentivized to preserve the company's value until these restrictions lapse. If the share price declines significantly following emergence (a not infrequent occurrence), appreciation awards might be so far "underwater" that the holders might assume that the awards will never have value and therefore be insensitive to share price performance.

Vesting Requirements

A participant's right to receive the value of the shares covered by an MIP award is generally subject to specified vesting requirements; to the extent that these requirements are not met, the award is forfeited. These vesting requirements generally include a service condition, which is satisfied if the participant remains employed through a specified date or dates, and might also include one or more performance conditions, which are satisfied based on the level of attainment of specified metrics related to the individual or a company's performance, such as revenues, earnings, income, cash flows or stock prices.

It might be challenging for a company and its advisors to determine appropriate financial performance conditions in the context of a post-emergence company with a potentially changing management team and an evolving business plan. Therefore, many companies limit initial post-emergence grants to service-vesting awards and wait until subsequent grants to incorporate performance conditions.

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Hotly Negotiated Issues

The most hotly negotiated issues related to MIPs often pertain to (1) the size of the MIP pool, (2) the form and amount of any emergence grants, (3) the definition of a "change-in-control" transaction that triggers accelerated vesting of awards and (4) the circumstances by which awards vest or are forfeited when an employee is terminated. An agreement between the company and consenting creditor constituencies on some or all of such issues is typically memorialized in the restructuring support agreement and/or plan.

MIP Pool

The maximum amount of shares reserved for issuance under the MIP is commonly referred to as the "MIP pool." The percentage of new common stock in a reorganized debtor reserved for the MIP pool is often around 10 percent of the total equity of the reorganized company.[8] Because awards under an MIP might be granted simultaneously with or subsequent to equity-based distributions to creditors and other stakeholders (including stock, warrants or options to purchase common stock) made under a chapter 11 plan, whether the MIP awards dilute, or are diluted by, such equity-based plan distributions should be made clear. Awards granted under an MIP are typically dilutive of — not diluted by — other equity-based plan distributions that are made on the effective date of a chapter 11 plan.

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4 The U.S. Trustee's office has objected to chapter 11 disclosure statements and reorganization plans on the grounds that grants made under the MIP to insiders (as defined in § 101(31) of the Bankruptcy Code) of the chapter 11 debtor run afoul of the restrictions set forth in § 503(c) of the Bankruptcy Code. *See, e.g., In re Vanguard Natural Res. LLC*, Case No. 17-30560 (Bankr. S.D. Tex. May 16, 2017) [ECF No. 733] (objection of U.S. Trustee to approval of a chapter 11 disclosure statement for, among other things, failure to provide sufficient information to determine whether debtors complied with § 503(c)); *In re Mem'l Prod. Partners LP*, Case No. 17-30262 (Bankr. S.D. Tex. April 10, 2017) [ECF No. 336] (objection of U.S. Trustee to confirmation of reorganization plan because such plan "improperly provides for [an MIP] in a manner that does not comply with 11 U.S.C. § 503(c)"). In response to such objections, chapter 11 debtors have argued that because the adoption of the MIP is a post-emergence act of the reorganized debtor, grants made thereunder are not subject to the restrictions set forth in § 503(c).

5 *See* 11 U.S.C. § 1129(a)(3); *see also In re AbitibiBowater Inc.*, Case No. 09-11296 (KJC), 2010 WL 4823839 at *13 (Bankr. D. Del. Nov. 22, 2010) (discussing objection to plan confirmation "on the grounds that the proposed management compensation plans are too generous").

6 The form of an MIP award might also have advantageous or disadvantageous tax implications under, among other provisions, §§ 83(b), 409A and 422 of the Internal Revenue Code. An analysis of such tax implications is outside the scope of this article.

7 Restricted stock is granted as actual stock that is subject to surrender back to the company if the vesting conditions are not met, whereas RSUs provide a contractual right to receive stock (or the cash value thereof) if the vesting conditions are met.

8 A survey by the authors of 13 companies in the energy sector that recently filed for chapter 11 found that the average percentage of total shares of common stock of the post-chapter 11 reorganized company reserved in the MIP pool was 9.4 percent, with a range of 5.5 to 11 percent. Where a company's capitalization is so large that the dollar value of a MIP pool that is around 10 percent appears unreasonably high, the stakeholders that become new shareholders of the company in a reorganization may advocate for a smaller MIP pool.

Emergence Grants

Awards issued under an MIP at or shortly after the adoption of the MIP and the reorganized company's emergence from chapter 11 are referred to as "emergence grants." Whether to issue emergence grants to existing members of a management team and, if so, in what forms and amounts are among the more difficult points negotiated in connection with a restructuring. Failure to provide for emergence grants might alienate a company's existing management as it embarks on its restructuring process or breed mistrust between a management team and the entities that will become the majority owners of the reorganized company. Conversely, pre-agreeing to issue a certain amount of equity-based awards to an existing management team before a new board of directors is impaneled has the effect of reducing the size of the overall MIP pool from which the new board might wish to grant future awards to other or new executives, and potentially giving awards to executives who the new board might want to terminate.

If emergence grants are contemplated in a restructuring, the key issues negotiated are (1) the percentage of the MIP pool that will be awarded as emergence grants; (2) the recipients of the emergence grants or, if the recipients are not preselected, the person(s) responsible for selecting the recipients, and whether any consultation or consent rights over the selection are given to other parties (such as the existing CEO); and (3) the forms of the emergence grants.[9] In the course of negotiations, the forms, amounts and key terms of the emergence grants might be adjusted in parallel in order to reach a deal. For example, the percentage of the MIP pool awarded as emergence grants might be reduced in exchange for an increase in the percentage of full-value awards — as opposed to appreciation awards — that make up the emergence grants. Alternatively, the amount of the emergence grants might be increased in exchange for longer vesting periods or more challenging performance conditions.

Change in Control

The definition of "change in control" — in particular, the exceptions carved out of the definition — set forth in an MIP might be of great consequence to the future owners of a reorganized company. Generally speaking, a "change in control" is defined to include (among other events) a stock sale, a merger, a sale of all or substantially all assets, or a board takeover. From the executives' perspective, a broad definition of "change in control" protects them from uncertainty over the status of unvested awards following a strategic transaction.

However, a potential acquirer or other strategic actor might view an expansive "change in control" definition as an anti-takeover measure that benefits an ensconced management team and would generally prefer a narrow "change of control" definition instead in order to avoid the associated costs with honoring unvested awards that accelerate. A clash between competing visions for a reorganized company — such as where the future owners are intent on consummating a strategic transaction post-emergence, but the management team wishes to instead pursue a more traditional business plan — could lead to disputes over the definition of change in control and the degree to which certain transactions are carved out.

Termination of Employment

The circumstances in which unvested awards granted under an MIP vest or are forfeited on termination of employment are also hotly negotiated, with executives (who have an interest in protecting their unvested awards) often advocating for an expansive range of scenarios that trigger accelerated vesting. Vesting often accelerates if an executive is terminated without "cause." The definition of "cause" is negotiated to balance the company's interest in deterring misfeasance with the executive's interest in ensuring that the company cannot unfairly rescind previously granted unvested awards by terminating the executive. In most cases, mere poor performance is not sufficient to trigger a company's right to terminate an employee for cause, and the negotiation typically centers around the types of bad acts (*e.g.*, crimes, misconduct, violations of company policies, etc.) that constitute cause, and any cure rights or other procedural protections afforded to the executives. Executives often push for their MIP awards to accelerate also on resignation for "good reason," which is typically defined to include events that are adverse to the executives, such as a reduction in compensation, relocation or diminution in duties.

Conclusion

As companies seek to build consensus among creditor constituencies in order to avoid the costs that are associated with protracted chapter 11 cases, MIPs will remain at the forefront of restructuring negotiations, requiring practitioners and bankruptcy participants to consider how best to structure an MIP and resolve certain hotly negotiated issues. **abi**

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9 A survey by the authors of 13 companies in the energy sector that recently filed for chapter 11 found that for those companies issuing emergence grants, the average percentage of total shares of common stock of the post-chapter 11 reorganized company granted as emergence grants, either to all employees or only to members of a senior executive teams, ranged from 1.8 to 7.5 percent, with the majority of emergence grants taking the form of a mix of full value and appreciation awards.