Chapman and Cutler LLP

Chapman Client Alert

July 31, 2020

Current Issues Relevant to Our Clients

Strictly Speaking, Part III: How Can a Lender Incentivize Management in a Strict Foreclosure?

This is the third and final Client Alert of a three-part series relating to executing a Strict Foreclosure. This third part of the series includes contributions from Carl Marks Advisors.

As discussed in our previous Client Alerts, "Strictly Speaking: Strict Foreclosure Can Provide an Efficient Smooth Exit for Lenders in the Right Circumstances" and "Strictly Speaking, Part II: How Can a Lender Effect a Strict Foreclosure?," it is imperative to focus on who is going to run the business after consummating the Strict Foreclosure. After all, the lender is not going to run the business and a critical component of a successful turnaround and future sale of the business is retaining and incentivizing critical employees. Financially motivating employees can be accomplished through a couple of different tools, including retention plans and/or incentive plans that provide short-term financial stability, such as stay or retention bonuses, and long-term financial reward, such as equity ownership or compensation upon a sale of the business.

As any retention and incentive plan will be a Newco obligation, Newco's Board of Directors will need to approve or ratify the agreed upon plans; however, as the primary economic owner of NewCo, the Lender should solicit feedback from management to understand what they want and expect and then work with the Board of Directors in developing appropriate incentives. The people negotiating these key plans can be quite emotional. On the one hand, the Lender has just written off a sizable portion of its loans to right size Newco's balance sheet and on the other hand, management usually has not received a bonus or raise in the past several years while the business languished. In addition, Management may have lost all benefits under the business' prior incentive plans, not to mention their investment if they invested in the equity with the prior owners.

It is Important to note, there is maximum flexibility in creating retention and/or incentive plans outside of a bankruptcy. Retention plans implemented prior to a bankruptcy filing, or in connection with a bankruptcy filing, will be subject to significantly more scrutiny by junior creditors and, naturally, the bankruptcy court.

Assessment of Management

The first step in thinking about an incentive or retention plan is for the Lender to evaluate if they need to find a new executive team or make specific changes to the executive team. The first question that always has to be assessed is "What was management's role in the company's financial plight?" Did the situation result from or was it caused by mismanagement or from issues beyond management's control? Even if the management team was not responsible for the current situation, it is important for the Lender and management to have an honest discussion about the expectations for the business and what is needed from both parties for Newco to be successful. Some executives may not have the interest, desire or skill set to go through the challenges of a turnaround and it is important to discover this quickly. If there is confidence in the existing leadership team and they have a clear vision and strategic plan, then the Lender should prioritize retaining and motivating management for the short and long-term. If the Lender lacks trust in the current executive team, it may be better to find interim management until a new team can be recruited and on-boarded. Recruiting executives into distressed situations is not easy, but it is possible. Similarly, the Lender and management need to be on the same page as to the working capital needs for the business to effectuate the turnaround and the Lender's willingness to fund such working capital needs.

Retaining Management

Retaining a talented team to lead the financial turnaround is a critical early building block for a successful restructure and needs to be accomplished through a holistic approach that balances short-term certainty with long-term upside. The objective of the retention and incentive program is to secure the most talented employees in a challenging and uncertain environment. In addition to competitors soliciting Newco's employees, those employees who have transferable skills are typically the first to find new jobs, leaving Newco talent deficient and increasing the risk to executing a successful turnaround.

Annual Bonuses

Part of crafting the retention plan may be to allow management an opportunity to re-set the budget for the current year for purposes of determining whether the management team has earned a bonus. Often in distressed situations, the business has underperformed and the previous budget is no longer applicable and management may assume that it will be yet another year without earning a bonus. As an immediate incentive, Carl Marks Advisors (“CMA”) often suggests modifying bonus targets to reflect both the restructuring and reasonably achievable goals for the upcoming year.

Re-setting expectations allows management and their direct reports to develop a revised forecast. One of the benefits of this process is that it provides the Lender a real time view of management’s expectations for the remainder of the year and affords management the opportunity to buy into results and achieve financial targets which yields them a bonus.

Retention Plans

Retention Plans are fixed commitments that typically are paid out over a short time horizon, usually under one year, and are not subject to financial performance. When it comes to retaining and motivating management, retention plans can play an important role, because they provide key employees with some financial security when investing their time and effort in a distressed business that could still falter. Well-crafted retention plans have the following characteristics:

- Clear objectives for employees to earn payments;
- Structured over a nine to twelve-month period, allowing sufficient time to maintain continuity, while not being so distant as to diminish likelihood of being earned;
- Partial near-term cash payments (generally suggested to be under forty-five days) to build goodwill and trust;
- Claw back provisions for payments received, if service is not completed or if the employee is terminated for cause; and
- Certainty of funds; if the employees perceive that Newco may fail and the retention payments are never made, then the overall retention program loses much, if not all, of its value

Retention plans can vary in size and breadth. In establishing a retention plan, CMA recommends starting with the current compensation expectations. For mid-level staff, guaranteeing some or all of their annual target bonus usually is a meaningful gesture, especially if appearing on the heels of years of no bonus payouts. For senior executives, retentions may be more costly, depending on their level of seniority. It is appropriate for retention plans to go a few levels deep in the organizational structure. As the primary goal is to stabilize a fragile situation, having more people participate in a retention program can be beneficial without adding significant expense.

Incentive Plans

A Management Incentive Plan (“MIP”) is very different from a retention plan and it is important that the two are not confused. The primary objectives of a MIP is to (i) incentivize key employees to stay with the business during a period of significant uncertainty and challenges and (ii) financially reward key employees who will play a role in creating enterprise value during the period commencing from the implementation of the MIP and ending on the Lender’s ultimate exit.

It is important that the Lender, as new owner, align its ultimate interest of value creation with the reward structure of the incentive plans. Well-crafted incentive plans have the following characteristics:

- Clear objectives for employees to earn payments;
- Multi-year vesting, with the requirement to still be employed by Newco at the subsequent sale/exit date, unless fired without cause (death, disability and termination for “good cause” also has to be addressed); and
- Concentrated at the senior executive level and their key direct reports.

Value / Equity Percentages

The primary component of a MIP is the allocation of an equity interest to management. As mentioned above, this is often the most contentious and emotional of issues. It may be beneficial to have a third-party intermediary facilitate these discussions to avoid creating hostility. The natural tendency is for both parties to feel that they are entitled to the lion’s share of go-forward incremental enterprise value. Management believes that value accretion is the direct result of their hard work and the Lender/new equity owner believes that, without its willingness to restructure and fund the business, management would have no opportunity to create value. Both positions have merit and can complicate negotiations.

In CMA’s experience, they have seen initial equity carve-outs range from 10 to 15 percent at the outset, with the opportunity to increase the percentage if enterprise value upon exit out performs what was projected. Ownership should be concentrated among key employees. The Lender is best served when key employees are incentivized to create value, not when many employees have a small slice of the equity and hence a small potential upside. Frequently, management teams argue that the MIP should extend two to three levels down within the organization. This dilutes the effectiveness, as ownership shares are less meaningful to those who constitute the most integral part of the management team. It is critical to concentrate the upside among those that are in the best position to make a significant and positive contribution to future enterprise value.

Structure

When drafting MIPs, there is a lot of latitude, and the important goal is to reach agreement. Optimally, incentive plans are designed to provide incrementally higher returns for successful outcomes and more limited returns for more modest outcomes. One way to highly incentivize management, while limiting the amount of equity granted out of the gate, is to allow increased payouts if enterprise value exceeds target thresholds. CMA advised that they have seen MIPs structured with equity escalators worth 1 to 5 percent of the equity tied to exit valuations.

Depending on how the MIP is structured, management might be more or less concerned about the capital structure going forward. If the MIP provides common equity, the Lender is likely to face increased pressure to put less debt on NewCo so equity has a lower hurdle to clear. As you would expect, restructured distressed businesses are usually left with a lower, more manageable debt load. This should make common equity hurdles easier to achieve versus the business' former capital structure. Quantifying this benefit to management by showing potential recoveries is often helpful in the negotiation process. In addition, it is also important to leave some unallocated equity as part of the MIP program that might be needed in the future to attract important new hires.

The MIP can be either an actual grant of an equity interest or a contract right between Newco and management which provides a payment to management upon a liquidity event. Under a contract right, management would be paid before the equity as such a contract right would be a liability of Newco. The tax treatment to the executives and Newco will depend on certain factors, including the legal structure of Newco and the type of equity offered (e.g., an LLC can offer a capital interest or a profits interest), whether the payment is subject to a substantial risk of forfeiture (i.e., vesting), whether the payment is subject to Newco's general creditors, and whether, in the case of a grant of actual equity, the executive makes a "section 83(b)" election. To the extent that it is an actual grant of equity, it is important to make sure that the normal protections are afforded to the majority equity holders or in this case, the Lender. For instance, the Lender needs to have the ability to sell 100 percent of the equity in connection with a sale. Thus, a drag along provision (the right to cause all equity holders to sell their equity interests) is usually provided in the organizational documents of Newco or a separate equity holder agreement. Similarly, to the extent possible, the Lender should have express provisions as to their rights with respect to the business. Depending on the type of entity selected for Newco, management maybe afforded certain minority protection rights under applicable law.

Vesting Period

A typical vesting schedule is two to four years, depending upon the expected length for the turnaround. Thus, management must be with Newco (unless fired without cause) to receive a payout under the MIP upon exit. Typically, management would vest immediately if a sale or transaction should occur before management has otherwise fully vested.

Other Considerations

Senior executives, on occasion, want to co-invest in Newco. MIP negotiations can get messy when executives try to use their current positions to roll-forward their previous co-investments into a NewCo deal. While all negotiations are unique, a MIP should not consider past investments, but should focus on go-forward contributions.

For More Information

If you would like further information concerning the matters discussed in this article, please contact the Chapman attorney with whom you regularly work.

Chapman and Cutler LLP

Attorneys at Law · Focused on Finance®