STRICTLY SPEAKING

What Lenders Need to Know about Strict Foreclosure and Restructurings

September 2020

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Introduction

The pandemic has hit all businesses hard, causing an increase in business failures, bankruptcies and restructurings. As companies default under their credit agreements, lenders have to decide what course of action is appropriate to effectuate their goals. Should the lender give the borrower breathing room by entering into a forbearance agreement in exchange for certain milestones, or is more aggressive enforcement action required?

If more aggressive enforcement action is desired, many lenders' first reaction is to force the company into bankruptcy. Bankruptcy, however, is a tool, not a result. Bankruptcy may be an appropriate or necessary path to recovery, as the Bankruptcy Code has helpful and special provisions that may be needed to effectuate a restructuring. However, we all know, bankruptcy is expensive and the process can be lengthy and frustrating.

Lenders need to remember there are alternatives to bankruptcy. If the collateral is stock or other critical personal property, lenders can use their enforcement provisions in their credit documents to effectuate remedies under the Uniform Commercial Code ("UCC"). Not all circumstances lend themselves to effectuating remedies under the UCC. Lenders need to know the alternatives and select the best strategy for their goals.

One potential strategy may be to execute a Strict Foreclosure. It is often a less expensive and faster option than pursuing a bankruptcy process. A Strict Foreclosure is a process under the UCC whereby a lender receives all or a portion of its collateral in exchange for reducing all or part of the obligations owed by the company to the lender. There are many nuisances and potential pitfalls in exercising a Strict Foreclosure, but it can be used by a lender to reshape the business through a newly created entity, acquiring assets and assuming only those liabilities consistent with the future of the reorganized business. The lender should be prepared to restructure the capital structure of the business and provide liquidity to the business to effectuate a turnaround of the business with the ultimate goal of increasing the lender's recovery.

This paper explains the process and highlights many issues relating to effectuating the Strict Foreclosure Strategy. The first section addresses the issues in determining whether a Strict Foreclosure Strategy may be viable and effective. The second section addresses how to effectuate the Strict Foreclosure Strategy and the third, and final, section addresses the important issues relating to retaining and incentivizing management so the reorganized business with its modified capital structure can be positioned for a successful restructuring.

We hope you find this material insightful and helpful. We invite your questions and welcome the opportunity to be of assistance with a restructuring or bankruptcy situation. Please don't hesitate to contact us.

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Strict Foreclosure Can Provide an Efficient, Smooth Exit for Lenders in the Right Circumstances

The current pandemic has hit all businesses hard, causing an increase in bankruptcies and restructurings. As companies default under their credit agreements, lenders have to decide what course of action is appropriate to effectuate their goals. Should the lender give the borrower breathing room by entering into a forbearance agreement in exchange for certain milestones or is more aggressive enforcement action required?

Obviously, every circumstance is different and, to the extent more drastic action is required, a lender has to assess its goals and tailor its enforcement actions accordingly. In cases where the senior secured debt is the fulcrum security (*i.e.,* the value of the company is not sufficient to fully satisfy the amount owed on the secured debt) and all parties in the capital structure are prepared to engage in a consensual reorganization of the borrower that would result in the lenders owning the borrower with a new "right-sized" balance sheet, the process will be relatively easy. However, more often than not, one or more of the other parties in the capital structure will demand too high a price for their consent and a consensual deal will not be feasible.

BANKRUPTCY

One alternative is to have the borrower file for bankruptcy and execute a restructuring and transfer of the equity to the lenders under the requirements and protections of the Bankruptcy Code, whether it be a 363 sale, a debt-for-equity swap or some other restructuring through a plan of reorganization. For instance, lenders may purchase the business or assets of the borrower with the protection of a bankruptcy court order that approves the lenders' acquisition of the assets free and clear of all liens. Pursuant to such an order, the lenders may also be able to obtain a release from liability by means of provisions commonly contained in a plan of reorganization. Of course, in cases where the amount owed under the secured debt is greater than the value of the business, the lenders will bear the not-insignificant expense of the bankruptcy.

STRICT FORECLOSURE UNDER ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE

If the protections afforded by the Bankruptcy Code are considered to be less valuable to the lenders than the cost of the bankruptcy, then exercising remedies under the Uniform Commercial Code ("UCC"), particularly a Strict Foreclosure under Article 9-620, may be an excellent alternative to bankruptcy. For purposes of this paper, we refer to a Strict Foreclosure as a transaction whereby lenders receive, with the consent of the borrower, the borrower's assets and also assume certain liabilities necessary to operate the business in exchange for all or part of the senior secured debt. A Strict Foreclosure certainly is not viable in all circumstances but often is a potential alternative where the secured debt is the fulcrum security and the lenders are willing to write down their debt to right-size the balance sheet and try to recoup their initial loss through the equity ownership in the reorganized business. If the relative values are such that only the secured lender will obtain a recovery from the sale of the business, and if the other constituents generally agree on the value of the business, a Strict Foreclosure should be explored. In this circumstance, neither the board nor any other creditor has any financial incentive to object to a Strict Foreclosure by a secured lender because a sale of the business would provide no additional recovery for the borrower's other constituents. However, if a secured lender proposes a Strict Foreclosure where the value of the business either exceeds or is relatively close to the amount of the secured debt, Strict Foreclosure will likely not be a viable alternative. The board, which must consider the interests of all constituents in exercising its fiduciary duties, should object to the Strict Foreclosure and consider other restructuring alternatives, including filing for bankruptcy protection.

A. Replacing the Board of Directors

Once the lenders make the decision to pursue a Strict Foreclosure, the first step is usually exercising rights under a pledge or security agreement to vote the equity interests of the borrower and replace the board of directors or managers with independent directors or managers. There are a plethora of reasons for initially changing the board, including (i) the existing equity holders may realize they are out of the money and no longer want to spend time and resources on the borrower, (ii) even if the equity is willing to participate and facilitate a transaction, they may be unwilling to affirmatively take action that eliminates the position of another lender or creditor in the capital structure, particularly, for instance, if a mezzanine lender has participated in several of the equity sponsor's other deals, (iii) the existing board may not be versed or comfortable with the issues associated with a distressed situation, and (iv) the board may want to put the borrower into bankruptcy to obtain the comfort and protection of a court overseeing the restructuring process.

An important initial point to note is that the newly appointed director(s) or manager(s) should be independent and not beholden to the lenders, as they are going to be the governing body that will negotiate the terms of the Strict Foreclosure. Subject to exculpation provisions in the borrower's organizational documents, the directors or managers will have fiduciary duties to the borrower and will need to consider the interests of the borrower's creditors and equity holders. The fulfillment of those duties will be carefully scrutinized by the creditors and equity holders that are not going to be receiving any recovery. Many individuals, who are willing to serve on boards that are well-versed in distressed situations and the contours of the attendant fiduciary duties, would be comfortable approving the Strict Foreclosure under appropriate circumstances.

B. Exercising Voting Rights

A well-drafted pledge agreement will entitle a secured party, as the pledgee, not only to foreclose on the equity interests but, even prior to such foreclosure, to vote the pledged equity interest following an event of default with prior or simultaneous notice to the borrower and the pledgor. Many state statutes require the pledge of the equity interest to be coupled with an interest—meaning, for lending situations, the right to exercise the voting rights needs to be given in connection with the lending of money. Lenders receiving an equity pledge must be cognizant of two important issues in addition to ensuring appropriate granting language: (i) the lender needs to ensure that appropriate steps were taken to perfect the security interest in the equity, and (ii) the lender should confirm that the underlying organizational documents of the borrower provide the authority to receive not only the economic rights represented by the pledged equity, but also the control rights associated with such equity interests.

(i) Perfection of the Security Interest. Equity interests in a limited liability company and a partnership are generally treated under the UCC as general intangibles, and lien perfection occurs by filing a UCC-1 financing statement unless the borrower opts to treat the equity interest as investment property under Article 8 of the UCC. In such a case, lien perfection can be obtained by filing, possession or control over the collateral. Security interests perfected by control or possession generally have priority over a competing security interest perfected by filing. Thus, if the equity interests are certificated, then the collateral agent or

lender should take physical possession or control of the certificated interest in order to perfect the security interest. Shares in a corporation are generally certificated and should be perfected in a manner similar to a certificated limited liability company or partnership interest.

(ii) *Control Rights.* State statutes governing limited liability companies, partnerships and corporations dictate a specific result unless specifically overridden by the entity's governing documents (*e.g.*, the operating agreement, partnership agreement or certificate of incorporation or bylaws). For instance, under Delaware law, the economic rights are generally transferable except as prohibited under the operating agreement. Control rights, such as voting, however, are generally prohibited from being transferred except to the extent permitted under the operating agreement. Furthermore, under Delaware law, an assignee of a membership interest may only become a member of the limited liability company with unanimous approval of the members unless an alternative provision is contained in the operating agreement. In addition, there could be provisions in the organizational documents that could prohibit or trip up the action that the lenders want to take. For example, minority equity holders may have negotiated for minority protections which may require their consent for the action to be taken by the lenders. Thus, the governing documents must themselves be analyzed to make sure the action to be taken by the lenders is permitted or not otherwise prohibited.

Similarly, under New York law, unless otherwise provided in the operating agreement, assignment of a membership interest is only effective as to the economic rights of the member in the limited liability company, and voting rights do not transfer. In addition, by making an assignment of 100 percent of its membership interest, the assigning member ceases to be a member and loses the ability to exercise its membership rights; unfortunately, the assignee of the interest does not obtain the ability to exercise the membership rights. However, simply pledging or granting a security interest, lien or other encumbrance against any or all of a membership interest does not trigger the loss of such membership interest or governance rights.

If the borrower is organized under the laws of a state other than Delaware or New York, then the applicable state's laws will need to be analyzed, as states can vary in their approach to a member's ability to transfer control as well as to admit new members.

Accordingly, if a lender wishes to effectuate a Strict Foreclosure and actually "step into the shoes" of the pledgor under the applicable governing document, it needs to make certain that it has the full ability to do so under the pledge or security agreement, the applicable state law and the underlying organizational documents. The lender needs to make sure that, after an event of default, it can vote the pledged equity to change the composition of the board. The lender may also want to reduce the number of board members, so it needs to be certain it has the requisite authority to amend the operating agreement or the borrower's bylaws, as applicable. It is important to remember that at this stage of the enforcement process, the existing equity holder still owns, and continues to be, the existing equity holder; the lender is simply exercising voting/control rights over the equity interest. If the lender plans on selling the equity interest, the lender will also need to make sure that it has the power to have the buyer of the interest admitted as an equity holder of the company under the relevant organizational documents.

While it is important for lenders to understand their rights under applicable law and the governing loan documents prior to exercising their remedies, it is critical that the ability to exercise remedies is appropriately drafted at the time the loan is originated. The lenders' enforcement strategy will be shaped by the rights the lenders have under the applicable loan documents and relevant state law. As stated above, the key factor in determining if a Strict Foreclosure is viable starts with value.

How Can a Lender Effect a Strict Foreclosure?

As discussed in the previous chapter, the first step in executing the Strict Foreclosure is for the lender to consider exercising voting rights under the pledge agreement to remove the old board and appoint an independent board to act on behalf of the borrower. The independence of the board will ensure that the borrower will consider, in earnest, the lender's desire to effectuate the Strict Foreclosure enforcement remedy.

While some view these decisions as limited to their unique facts, we disagree. Upon a closer examination, these rulings appear to break new ground from prior case law in their application of fundamental bankruptcy principles and significantly undermine the protections afforded secured creditors under the Bankruptcy Code. Therefore, purchasers of loans in the secondary market, especially those investors seeking to effect a "loan-to-own" strategy, and even original lenders seeking to exercise the right to credit bid in order to maximize their recovery, should be mindful of these decisions and how they may impact their rights to credit bid in 363 sales.

STEP 1: PROPOSAL FOR EXCHANGE OF ASSETS FOR OBLIGATIONS

The lender will first need to present a proposal to the borrower for the terms of the Strict Foreclosure and specify which assets of the business will be accepted and which liabilities of the business will be assumed in exchange for the satisfaction of all or a portion of the existing debt. Once the proposal is accepted by the borrower, a Strict Foreclosure agreement is typically structured such that a new entity ("Newco") will acquire the assets of the business, other than specifically designated assets that will be retained by the borrower; conversely, Newco will assume only specifically designated liabilities such that the borrower retains all other liabilities, including but not limited to unknown and undisclosed liabilities.

A. Confirm Perfection of Liens

The Uniform Commercial Code ("UCC") provisions providing for a lender to accept assets for existing loan obligations is premised upon the lender having a validly perfected security interest in the assets accepted by the lender. When a lender has a blanket "all-asset" lien on the borrower's assets, however, there often are some assets where a lien was not perfected because it may have been too cumbersome to perfect the lien when the loan was initially made or the asset may have had insufficient value, such as perfecting on vehicle certificates of title or real property leases. In such cases, if the lender would like to receive those assets, the borrower can agree to sell those assets to Newco in exchange for the release of a portion of other loan obligations not part of the original exchange.

There may also be validly perfected non-UCC collateral, such as real estate. Real estate can similarly be sold to Newco in exchange for a release of a portion of the loan obligations. To the extent that lender wishes to exercise an enforcement action (such as a deed-in-lieu of payment) on real estate, compliance with state and local laws may be required to transfer the real property (*e.g.*, some states require court intervention to transfer real property).

Lastly, it might be possible to structure the transaction as a transfer of stock of such subsidiary if the desired assets are held by a subsidiary. This would avoid the transfer of assets and the need to obtain third-party consents that may otherwise be required. Naturally, when Newco acquires stock of a subsidiary it automatically inherits all liabilities of that subsidiary. If Newco plans to leave behind any subordinated debt or other unsecured obligations (trade payables), it will be imperative, if taking stock, to understand what obligations are at the subsidiary level, including whether that subsidiary is an obligor on such subordinated debt.

B. Releasing or Terminating Senior and Junior Liens

The provisions of the UCC, along with any applicable subordination agreement and/or intercreditor agreement between the senior debt and the subordinated debt, may assist the senior lender in effecting the release or termination of junior liens on the applicable property being transferred to the senior lender. To the extent another creditor has a lien that is senior in priority to the liens of the lender, Newco will not able to obtain a release of that lien and will have to assume that asset subject to the senior lien. In our experience, this situation is most common with a creditor that holds a purchase money security interest in a particular piece of equipment. Newco can notify the creditor after the Strict Foreclosure to consent to Newco assuming the payment obligations of the borrower or to decide to leave the asset behind with the borrower.

C. Obtaining Consents

Another factor to consider is whether any consents are necessary for the transfer of the borrower's contracts. To the extent a contract is material to the business, Newco and management can discuss with the contract counterparty its willingness to allow the assumption of the contract prior to or contemporaneously with the consummation of the Strict Foreclosure. To the extent the contract is not material to the business, the counterparty can be contacted after the effectiveness of the Strict Foreclosure. Absent such comfort, Newco takes the risk that a particular contract is not ultimately transferred to Newco. To the extent a contract is critical to the business and a contract counterparty is unwilling to allow the transfer, then a bankruptcy filing may be necessary to address the transfer restriction.

D. Confirmation of Ownership of Assets

Another potential pitfall is whether all the assets used in the business are actually owned by the borrower and its subsidiaries. It is not uncommon for a borrower's holding company("Holdco") not to be an obligor under the senior secured facility, and Holdco may inadvertently hold title to certain assets necessary for the business. Although covenants in credit agreements usually prohibit necessary assets for the business from being owned by a party that is not an obligor under the credit agreement, such a situation is not uncommon — and it may be just another breach under the credit agreement, along with the failure to pay the principal and interest. If this is the situation, Newco will need to negotiate with the owners of Holdco for their cooperation in the transfer of such assets. One possibility is that payment or consideration to the equity for such assets may be provided in the form of a release of liability from the borrower and the lender. That approach may not work, however, if Holdco is not a true holding company; *i.e.,* if Holdco has creditors of its own.

CREATING NEWCO CAPITAL STRUCTURE

The lender will need to create a capital structure for Newco and provide answers to such questions as: (i) what is the right amount of leverage for the business to "right size" the balance sheet; (ii) what interest rate should be charged under the new loan facility undertaken by Newco (the lender should consider a pay-in-kind interest component so that if the business hits a liquidity speed bump, the business will have the ability to clear that bump); (iii) how do the contemplated interest payments match up to cash flow projections; and (iv) are additional capital and liquidity needed? The terms of the new facility will also need to be flexible to ensure feasibility of the business going forward. Accordingly, given that the lender will own the equity of Newco, negative financial covenants should be drafted liberally in applicability (*i.e.,* start testing at a later time period) and in compliance. The lender needs to balance putting the maximum amount of debt on Newco that the business can support with the rightsizing of the balance sheet so vendors will provide non-distressed credit terms and customers have confidence that the business is financially stable. Because the lender will own all of the equity of Newco and look to recapture the debt write-down based on returns on the equity, the lender must remember that with respect to its equity position, it is moving from a senior position in the capital structure to a position that is subordinated to all liabilities of the business.

Although it is an issue for the borrower's equity and not an issue for the lender, the forgiveness of indebtedness generated by the foreclosure will generally create income for the borrower. Depending on whether the borrower is taxed as partnership, as a pass-through entity or as a corporation, there may be an exception to recognizing income. In addition, the borrower may be able to utilize net operating losses to shelter its equity from income generated from the forgiveness of indebtedness.

STRUCTURE OF TRANSACTION

To effectuate the Strict Foreclosure, the lender generally transfers or assigns the existing senior secured debt owed by the borrower ("Borrower Debt") to a new entity (*i.e.*, Newco) in exchange for (i) new secured debt from Newco ("New Debt") and (ii) 100 percent of the equity of Newco. It is therefore Newco, as the holder of the Borrower Debt, that will actually foreclose on and accept the assets of the borrower in exchange for satisfaction of some or all of the Borrower Debt.

As discussed above, the amount of New Debt placed on Newco needs to be supportable by Newco's business and consistent with the value of Borrower Debt transferred to Newco. In the unlikely event that Newco stumbles going forward, Newco's creditors could attempt to argue that the transfer of Borrower Debt to Newco was a fraudulent conveyance — in other words, that the value of Borrower Debt that was transferred to Newco was not equivalent to the amount of New Debt placed on Newco. In any event, Newco should receive all of the lender's right, title and interest in and to Borrower Debt even though the actual market value of Borrower Debt may be less than the face amount of Borrower Debt under the existing facility.

Upon completion of the transfer, Newco (as the holder of Borrower Debt) will have sufficient consideration (in the form of loans) to effectuate the Strict Foreclosure. If the borrower agrees that the acceptance of the borrower's assets is for less than the full face amount of Borrower Debt, then any excess amounts can remain on Newco's balance sheet and stay an obligation of the borrower. This will protect Newco and the lender should some unforeseen value be realized by the borrower, as Newco will still be senior in right to any subordinated debt and any other creditor's claim that is not assumed by Newco.

ADMINISTRATIVE CONSIDERATIONS

There are many administrative matters that must be attended to in connection with a Strict Foreclosure. Newco will need to obtain a new suite of insurance, including a directors and officers policy (without such a policy, new board members will be unwilling to sit on the board). New bank accounts will need to be opened. Although old bank accounts could be transferred to Newco, opening up new accounts with Newco's EIN is often more efficient, as many banking institutions will not allow the transfer of accounts. Payroll services under Newco's EIN will need to be established. Procedures for collecting outstanding accounts receivable (which were transferred to Newco) will need to be established because payments on them will likely be made to the borrower for some time following the Strict Foreclosure.

Employees will also need to receive offers of employment from Newco. It is important to note that employees will be concerned about the business and how the lender's exercise of remedies will affect their jobs and compensation. A communication plan needs to be put in place and timely town hall meetings need to be held to address employee concerns. Similarly, customers and vendors will need to be informed and assured of the support of the business by its new owner.

It should be kept in mind that competitors of the business may try to spread rumors in the market and try to pick off talented employees. It is thus imperative that employees understand their new compensation and benefit arrangements and receive assurances that Newco has the financial capital it needs for its future success.

CONCLUSION

In any Strict Foreclosure transaction, the newly appointed independent directors of Newco will need to understand and assess what liabilities are proposed to be left behind with the borrower. The more liabilities Newco is going to assume, the easier it will be for the independent directors to conclude that Strict Foreclosure is in the best interests of the borrower's constituents and that the lender's proposal should be accepted. In addition, the independent directors will want to negotiate a wind-down budget for the borrower because, after giving effect to the Strict Foreclosure, the borrower will have no ability to fund the costs associated with its liquidation, whether through a state liquidation proceeding or the filing of bankruptcy under Chapter 7 of the Bankruptcy Code. Upon the liquidation of the borrower, Newco can write off the remaining obligations owed by the borrower on the Borrower Debt. Lastly, the independent directors will likely want a third-party valuation of the borrower so that they can rely on such valuation to comply with their duty of care and ensure that there is a sound basis for accepting the lender's proposal and consummating the Strict Foreclosure.

How Can a Lender Incentivize Management in 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; 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 that 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, by the bankruptcy court.

Assessment of Management

The first step in thinking about an incentive or retention plan is for the lender to evaluate if it needs 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 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 onboarded. 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 adding increased risk to the execution of a successful turnaround.

A. Annual Bonuses

Part of crafting the retention plan may be to allow management an opportunity to reset 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.

Resetting 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 that yield them a bonus.

B. 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;
- Clawback 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 it appears on the heels of years of no bonus payouts. For senior executives, retentions may be more costly, depending on the 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.

C. 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 are (i) to incentivize key employees to stay with the business during a period of significant uncertainty and challenges and (ii) financially to 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 have to be addressed); and
- Concentrated at the senior executive level and their key direct reports.

(i) 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 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, initial equity carve-outs generally range from 10 to 15 percent at the outset, with the opportunity to increase the percentage if enterprise value upon exit outperforms 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 who are in the best position to make a significant and positive contribution to future enterprise value.

(ii) 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 has 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 in a separate equity holder agreement. Similarly, to the extent possible, the lender should have express provisions as to its 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.

(iii) *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.

(iv) *Other Considerations.* Senior executives, on occasion, may 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 any of the matters discussed in this paper, please contact any of the following Chapman attorneys or Carl Marks advisors, or any other Chapman attorney or Carl Marks advisor with whom you regularly work:

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