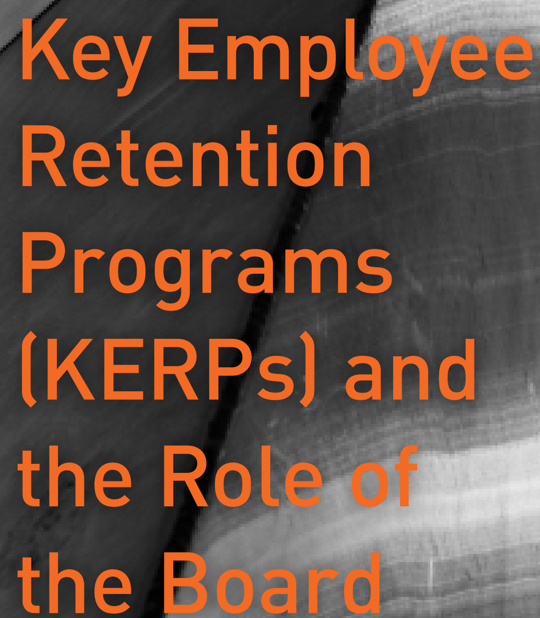

Key Employee Retention Programs (KERPs) and the Role of the Board

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The past few years have been increasingly challenging for some Canadian sectors where companies have struggled with rapid share price decline and pending debt renegotiations. There are many cases where the company's going-concern status is at risk and debt restructuring under the Canadian Business Corporation Act ("CBCA") or the Companies' Creditors Arrangement Act ("CCAA") is on the horizon. These pressures have accelerated with the impact of COVID-19 on public and private companies, particularly in industries that have been most impacted or faced additional pressures (energy sector, retail, tourism, etc.). While the ultimate impact of the crises of recent months is still to be determined, Boards and management teams have been forced to consider the impact of these challenging business conditions on their employees.

This briefing provides insight on the use of a key employee retention program ("KERP") in preparation for situations where a CCAA/CBCA filing is expected and provides insight on the Board's role in KERP implementation.

What is a KERP designed to motivate?

KERPs are designed to motivate employee behavior to advance a successful restructuring outcome. However, defining "success" in these situations is a balancing act: senior lenders will pressure the Board to design a KERP that will focus on the execution of a timely sale process to regain their proceeds, while the Board may define success to drive value more broadly into the company's capital structure. This basic difference in intentions and definitions of success can result in negotiations regarding the design of the KERP between the company and its senior lenders.

While the concept of seemingly adding to executive pay ahead of a potential restructuring may seem counterintuitive, stakeholders have an interest in retaining key talent to ensure the best possible outcome of the restructuring process. This concept assumes the Board remains supportive of the management team as certain management decisions may have contributed to the financial situation that led to the restructuring. As a company shifts from business as usual to CBCA/CCAA filings, the following may need to be considered:

Some executive roles may not need to be retained, and those individuals may exit/be severed.

Other key executive roles will become critical, requiring some form of retention plan if some or all the following factors are present:

- The executive has valuable company specific knowledge
- The executive has a specific skill set that is in high demand
- The executive is aware of the status of the business and may consider exiting
- The executive wants clarity as to how she or he will be treated with respect to termination without cause in the event of a restructuring

The Basics – CBCA vs. CCAA

The arrangement provisions under CBCA (or the equivalent provincial statutes) permit changes to the corporate capital structure while ensuring fair treatment of stakeholders. CBCA is used almost exclusively for Balance Sheet restructuring because it is not seen as an insolvency process (even though a corporation may be in the zone of insolvency). It has reduced risk to share price/company reputation, maintains management and Board control, and involves fewer professionals (no monitor like a CCAA). As such, it is generally less costly to implement.

CCAA, on the other hand, allows financially distressed companies the opportunity to restructure (operationally and financially) through a formal plan of compromise and arrangement voted on by their creditors with the intention of avoiding bankruptcy. The process begins with the company applying for court protection under CCAA and the appointment of an independent monitor for the business who reports to the court and creditors. Generally, restructuring under CBCA is preferable; however, companies may consider the implications of ultimately filing for CCAA if their initial attempt at restructuring under CBCA is unsuccessful and they become increasingly insolvent.

Under both CBCA and CCAA restructuring proceedings, the company typically continues to compensate employees in the normal course. However, some elements of compensation may be compromised under a CCAA in the event of termination of employment during the process. Notably, in CCAA, termination and severance claims would be treated as ordinary unsecured creditor claims against the company and would not be paid in full at the level originally provided in the employment agreement.

The Purpose of Key Employee Retention Plans

It is inevitable that key employees will be aware of the company's financial situation if a restructuring under CBCA / CCAA is being contemplated. As such, KERPs are implemented to support the retention of key employees throughout the restructuring process. Under either a CCAA/CBCA, the court may grant a KERP charge over the assets of the company which would have priority over unsecured creditors, and in some cases over the existing secured lender. In a rare circumstance where a company has free cash flow available, they may develop a KERP consisting of funds held in trust for distribution to eligible participants in the event of a dismissal during the restructuring process.

While KERPs may appear to provide "additional compensation," the intention is not to make individuals wealthy. An organization entering a restructuring is not in the position to provide substantial wealth to individuals as the majority (if not all) forms of equity incentive compensation provided in recent years will have minimal to no value. While KERPs are often provided to executives, sometimes they are important for knowledge-based employees, particularly in technology-based business and heavily regulated industries such as Cannabis or Pharmaceuticals. Often, without a court approved KERP, the Board can not guarantee severance to those employees who agree to work through the CCAA restructuring and may eventually be terminated because of the restructuring.

Sears Canada: Example of a KERP Attracting Media Attention

Companies should be aware that court approved KERP arrangements made under CCAA are in the public record (though the specific terms of the KERP itself are typically sealed by court order) and therefore open to external scrutiny. For example, in 2017 Sears Canada implemented a KERP valued at $9.3 million to be provided to 43 key executives and 116 stores managers to create incentives for management to stay and focus on operations to maximize value for the stakeholders at the end of the process. The Sears example was particularly controversial given the lack of CCAA plan or going-concern sale transaction, the resulting liquidation of the stores and inventory, and the significant losses to creditors. While the Ontario Superior Court approved the KERP, 2,900 store level employees were laid off with only unsecured claims for their severance amounts. The Court accepted the company's evidence that it believed a lack of a KERP could contribute to an even worse outcome for creditors, which was not disputed by the monitor.

The Board's Role in Implementing a KERP

Given a KERP is most often provided to executives (including the CEO), the Board needs to be confident in the proposed plan and in its role to:

- Independently assess the overall reasonability of the plan (from a structure and quantum perspective) given the scrutiny that any plan may attract from employees, shareholders, and bondholders and other creditors
- Engage with these key stakeholders as necessary to explain the role of the KERP in the restructuring process, ahead of the approval of the plan of arrangement and court filing

The Board ensures the proposed plan encourages several outcomes:

Returning the business back to operational stability (stabilizing revenue, cutting costs)

Finding a reasonable deal if there is an acquirer who may be interested in the assets

Restructuring debt and preserving value for debtholders and if possible, shareholders

Approval of a plan of arrangement/court filing or of a going concern sale that preserves a material percentage of the jobs

Implementing a KERP

A typical process for a company facing financial distress may involve transitioning from the regular long-term incentive programs, towards a modified form of the regular program, to a simple retention plan over several compensation cycles. A KERP is a last resort for companies, and typically signifies that all other incentive plans have minimal value and are ineffective in retaining key talent and incentivizing performance.

The design of a KERP is company-specific and there is no "one size fits all" approach. Prior to implementing a KERP, the company must determine the intention of the plan and eligibility, with oversight of the Board. The KERP may consist of separate awards that provide clarity of treatment and/or compensation under multiple scenarios. For example, these awards to key employees might include either or both of the following:

- **An incentive to encourage performance in a challenging environment of restructuring (in lieu of a LTIP to reward results)**
- **Simple "pay to stay" plan to retain individuals until completion of restructuring (in lieu of severance to protect in the event of termination without cause)**

Design of a KERP

Prior to implementing the KERP, there are three key decisions that need to be made: the appropriate instrument (cash vs. equity), the quantum, and the vesting provisions

Instrument

while the use of equity may be appealing in order to preserve cash flow, equity may be ineffective (and is rarely used when insolvency looms) if the employees have already received numerous equity grants that have paid out substantially below target, and if the future equity value continues to be in doubt due to the depressed business operations and/or significant debt. This leaves us with cash-based plans – albeit with salary deferral rules (must be settled within 3-years) and subject to any affordability constraints.

Quantum

there are no specific guidelines on what the quantum of a KERP should be, however simple guidelines may be a payment equivalent to the target annual long-term incentive. In a near insolvency situation the Board must balance the flight risk of key employees against the likely outcome of the restructuring to its creditors generally and in particular its non-KERP employees, since the aggregate quantum of proposed KERP payments and number of employee participants will inevitably become public. Typically, the design of the KERP relates to the appropriate quantum (e.g., a KERP with rigorous performance criteria may have a more generous upside opportunity).

Vesting Provisions

In most restructurings, some portion of the KERP payments are tied to "success" to encourage key employees to stay with the company until the restructuring or sale transaction is complete. The definition of success and the intention of the plan may dictate the appropriate vesting provisions. The Company may consider if some form of interim vesting is appropriate upon certain milestones being reached in the restructuring, or if a vesting 100% at the end of the intended restructuring period is more appropriate. Any related transitional period should also be considered, allowing the successor owner/company the ability to re-engage any employees they may want to retain.

In addition to these above initial considerations, companies should engage legal counsel and accounting support to explore initiatives.

Ongoing Board Oversight

It is important to acknowledge that the needs of the company may change over the restructuring period and the KERP should withstand various scenarios such as a re-financing or sale of assets. The less insolvent a company is, the alternatives are available to a Board to design KERP. While there is general acceptance on the use of KERPs, implementation of multiple KERPs within a short period of time would be subject to scrutiny. Many (if not all) of the provisions should be captured within the termination scenarios of the plan. If the company chooses to restructure under CBCA, they may consider the likelihood of an eventual CCAA filing and design the KERP to transition accordingly to maintain continuity with KERP participants.

Final Thoughts

The Board has a significant role to ensure independent oversight of executive compensation in the face of CBCA / CCAA. In addition to Board oversight, communication throughout the KERP implementation process is critical to manage and address external perceptions. While these plans may seem egregious to creditors who may be impacted by the restructuring, they are often carefully considered instruments, designed to benefit all of a corporation's stakeholders, recognizing that key employees will have employment alternatives and may be actively recruited by competitors trying to take advantage of the company's weakened financial position. While the process of restructuring during a time of financial hardship can be stressful, having a KERP or some form of compensation program in place to provide retention and protection of the key employees may establish the necessary stability that will provide a sense of loyalty and relief and allow the key management team to focus on the required corporate restructuring activities with less personal distraction.