



Lowenstein Sandler's Executive Compensation and Employee Benefits Podcast: Just Compensation

Episode 63

By [Christopher A. Ward](#), [Eric Chafetz](#), [Taryn E. Cannataro](#)

OCTOBER 2026

Megan Monson:

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Taryn E. Cannataro:

Welcome to the latest episode of Just Compensation. I'm Taryn Cannataro, counsel in the Executive Compensation, Employment & Employee Benefits Group. I'll turn it over to my guests to introduce themselves.

Eric Chafetz:

Hi, my name's Eric Chafetz. I am a partner in Lowenstein's Bankruptcy & Restructuring Group.

Christopher A. Ward:

Hi, I'm Christopher Ward. I am the managing partner at Lowenstein's Wilmington, Delaware office and a partner in our Bankruptcy & Restructuring department.

Taryn E. Cannataro:

As companies experience financial distress, executive compensation decisions become increasingly complex and increasingly scrutinized. Today's episode will explore the intersection of executive compensation and bankruptcy law, focusing on the practical issues companies should consider before, and during, a Chapter 11 restructuring. The discussion will focus on how compensation decisions are viewed through the lens of creditors, bankruptcy courts, and other stakeholders, and best practices to ensure you're making decisions that will be respected by the bankruptcy court.

As always, this is not intended to be an exhaustive discussion. We encourage you to consult with your legal counsel if you're considering a restructuring.

Let's set the stage. At what point should a company start thinking about a transition from ordinary course compensation planning to distressed compensation planning?

Eric Chafetz:

There's not necessarily a bright-line moment per se, and I like to say it's you know it when you see it, but there are some relevant indicators that folks should be focusing on. They include liquidity

constraints, the decreasing value of equity when compensation and bonuses were historically equity-based, covenant or financing issues, declining business performance, loss of a major customer or contract, loss of key personnel in the C-suite especially, restructuring or strategic alternative discussions, some type of change in control, and the possibility of an eventual bankruptcy filing.

The key that you need to focus on is that compensation decisions made before Chapter 11 may be viewed with the benefit of hindsight. It's extremely important for there to be early coordination among management, the board, compensation council, and restructuring council in order to preserve options. If there's one major takeaway, it's "don't wait too long." If you sense an issue, you should really start your planning as soon as possible.

Taryn E. Cannataro: Why does executive compensation tend to attract so much attention once a company's in financial distress?

Christopher A. Ward: The press is focused heavily on large compensation packages for senior executives. These executive compensation packages gain a particular focus when a company is facing a liquidity situation and is forced to lay off employees by conducting a RIF, or reduction in force, or is facing for in an actual bankruptcy filing. In these types of situations, there is always a tension between the need to retain the current management team on one hand, and concerns about rewarding executives that, from the perspective of the employees, and the outside world, may have been the root cause of the company's distress, or bankruptcy filing.

We've seen shareholders revolt when they realize their stock may be worthless, but senior executives are being paid a premium to remain on board at the company during the restructuring. As a result, creditors and other stakeholders may scrutinize payments to insiders, especially payments to insiders made shortly before the bankruptcy filing that would be subject to higher scrutiny during a bankruptcy case, which we'll get into later. Optics play a large part in these situations, in addition to the underlying legal analysis. Decisions that may be routine for a healthy company can look very different in times of distress or in a restructuring.

Taryn E. Cannataro: What types of executive compensation decisions made in the period leading up to a Chapter 11 filing are most likely to receive scrutiny later?

Eric Chafetz: That's a great question. It often turns on the timing of payments relative to the company's deteriorating financial condition or bankruptcy filing. There's a variety of potential causes of action that creditors, committees, and other state fiduciaries will focus on when scrutinizing executive compensation and compensation and

bonus-type payments. Those include preferential payments, which are payments to non-insiders made within 90 days prior to a bankruptcy filing and one year for insiders.

Fraudulent transfers, which are payments, and we'll talk about this a little bit more later, those are payments where the debtors didn't receive reasonably equivalent value. There's generally a two to four-year lookback period for those. Then breach of fiduciary duty type claims whereby a board is granting or authorizing the payment of compensation to various executives. That usually has up to a six-year lookback period.

Some of the most scrutinized compensation arrangements include bonuses and other cash incentive payments, retention arrangements, newer enhanced severance protections, equity awards or modifications to outstanding equity, and changes to employment agreements or other executive arrangements.

Taryn E. Cannataro:

If a board and compensation committee knows that financial distress is a possibility, what additional lens should they apply?

Christopher A. Ward:

The issue we have here is the board and the compensation committee does not have the benefit of hindsight when making these decisions, but they do need to be forward-thinking when coming to executive compensation decisions. The board and any special committee need to consider how the decision could be viewed later by creditors, by a creditors' committee, by the United States trustee, a bankruptcy court, or even a judge in an out-of-court proceeding.

They also need to consider whether such parties may challenge these decisions with that actual benefit of hindsight, knowing that decisions were made, and later on the outcome was not what was expected.

How do you deal with the unknown? You develop a proper process; research and document a clear business rationale and document the decision-making process, establish why the compensation is necessary and appropriate under the circumstances, and consider benchmarking or other support from third-party consultants for the amount and the structure, including relying on comparable company programs and market research.

Boards and committees need to get ahead of any potential situation with proper messaging, assuming that everything is going to go well, but knowing that there are certain circumstances where things may not go well.

Taryn E. Cannataro:

One of the obvious challenges for a distressed company is that the company may need its management team more than ever at precisely the same time when executives may be most likely to

leave. How do companies balance the need to retain key executives with the restrictions and scrutiny surrounding retention arrangements in bankruptcy?

Eric Chafetz:

Continuity of management is critical to operating the business and executing a successful restructuring, or sale. As you pointed out, at the same time, the bankruptcy code places restrictions on certain retention payments to insiders. Practically speaking, high-level executives and even mid-level executives are oftentimes asked to do two separate jobs, especially in the context of a sale and a bankruptcy process. They're doing their normal day-to-day job. They're also providing diligence to third-party bidders. There's also the ordinary course bankruptcy reporting, which is sometimes a heavy lift.

There's a natural tension where certain of these folks realize that they may not have a job once the company exits from bankruptcy. How do you incentivize them to stay? There's also the alternative problem, and Chris may disagree with me, as he's predominantly a debtor's attorney, is every single debtor claims that they are or will be losing employees. That proposition has to be tested, and there's a variety of ways to do that.

A retention arrangement principally rewards an executive for remaining with the company. The key being the retention is for future service, not for past services. An incentive arrangement is compensation tied to achieving specific performance objectives. There's two main ways that these plans are implemented, which Chris will talk about now in a bankruptcy case.

Christopher A. Ward:

As Eric said, there are two ways it's handled, the bankruptcy case. The reason that this has come about is everyone may recall the Enron bankruptcy case, the Chapter 11 filing from many years ago. It was one of the most covered mainstream bankruptcy cases in the press.

In that case, there was tremendous backlash over the executive compensation packages when those same executives were being blamed for running the company into bankruptcy itself. As a direct result of Enron and similar cases that occurred around that time, Congress acted and revised the bankruptcy code to deal with overreaching executive compensation packages. As Eric said, the overreaching compensation package may depend on which side of the bar you're on. Are you representing the borrower, or are you representing one of the creditors who has the hindsight, and is looking back at that package?

What has come about as a result of the congressional action, was Section 503 of the bankruptcy code is amended to add a KEIP and a KERP perspective. A KEIP and KERP are financial bonus frameworks used by companies in Chapter 11 bankruptcy to

balance the interests of all parties. KERP, which stands for Key Employee Retention Plan, is a plan that pays out based on the employee staying through certain milestones, regardless of performance. KERPs apply to rank-and-file employees in order to keep them employed and motivated during the bankruptcy case in order to achieve the goal of the bankruptcy, which, in a lot of cases nowadays, is a sale of substantially all the assets.

What you typically see is, if a employee stays through closing of the sale, they will receive a payment in addition to their salary as compensation to incentivize them to stay through the bankruptcy. Now, a KEIP, which stands for Key Employee Incentive Plan, is a plan to motivate key employees to hit specific performance targets that benefit the company. Those would include maximizing sale price, hitting EBITDA targets, meeting reorganization timelines, or a closing of a sale in particular circumstances.

A KEIP applies to what we call insiders in bankruptcy. That is, senior executives who are typically subject to large compensation packages prior to bankruptcy that now are going to be getting paid under a similar program post-bankruptcy. That program is going to be subject to higher scrutiny under a KEIP program, under the new revisions of the bankruptcy code.

Payout in those programs is contingent on achieving measurable goals and not just staying employed. Bankruptcy courts review these KEIPs much more stringently than they do KERPs, as they apply to insiders, the senior executives, as opposed to the KERPs, which apply to the rank-and-file employees.

Eric Chafetz:

A few factors that help support an incentive plan include performance metrics that are actually meaningful, goals that require actual performance rather than merely just staying employed, targets that are sufficiently challenging but realistically achievable. You want to motivate folks, but there can't be colloquially what courts sometimes refer to as layups. The metrics should connect to the company's restructuring objectives, and there should be a board process in supporting analysis and comparable company transactions from third-party consultants that are documented in board minutes and board packages and the like.

Taryn E. Cannataro:

We talked about incentive arrangements, but what about employment agreements, severance agreements, change in control agreements, or other pre-petition compensation arrangements? How are those treated in restructuring?

Eric Chafetz:

Chapter 11 doesn't necessarily erase contractual rights, but it can significantly affect how those rights are treated and ultimately paid out. Existing employment agreements may be assumed or rejected in bankruptcy, assuming that they are executory

agreements. Rejection, unfortunately, if you're the employee, can leave the executive with an unsecured claim for damages potentially worth pennies on the dollar rather than the actual contractual benefits that they expected to receive.

Severance and change in control protections may be subject to bankruptcy code limitations, including potential caps on claims arising from termination of employment, and are also typically treated as general and secure claims deemed to be breaches of contract, regardless of when the claim arises. There are certain provisions in the bankruptcy code that provide priority treatment for certain wage and severance-related payments, but the cap on those is only about \$17,000, subject to periodic congressional adjustment.

There is a key distinction, though, between having a contractual entitlement and actually recovering the full value of that entitlement in bankruptcy. It's something that folks should be cognizant of.

Taryn E. Cannataro:

What should boards and compensation committees be doing differently when making compensation decisions during a period of financial distress?

Christopher A. Ward:

That is a very important question. Once a company is in what people like to refer to as the zone of insolvency, everything changes for the board and any special committee serving under the board. If there's a fear that decisions may lead to insolvency or a bankruptcy filing, a board needs to consider the effect of those decisions on all parties in interest of the company, and not just shareholders.

There is a shifting duty when you're insolvent that you owe a duty beyond shareholders, that you owe that duty to creditors and to parties in interest.

Therefore, the board needs to be incredibly diligent in its decision-making process. It should establish a thoughtful, defensible, and well-documented process and rationale for all decisions, not just compensation decisions. The board should clearly identify the business justification for any of these compensation decisions. The board should also rely on the advice of its outside counsel and its advisors, including any advice that it's received on compensation packages.

The board must coordinate compensation and restructuring advice together when addressing these issues. Once you are approaching a bankruptcy, all decisions are intertwined, whether it's a bankruptcy decision, an executive compensation decision, whether it's a real estate decision, everything becomes intertwined

leading up to a bankruptcy because the bankruptcy code will change everything once there is an ultimate filing.

As I mentioned, the board needs to consider creditors and stakeholders' perspectives when making decisions. That becomes paramount in the zone of insolvency.

Taryn E. Cannataro:

Are there any trends that you're seeing or lessons from recent restructurings that compensation professionals should have on their radar?

Eric Chafetz:

I'll discuss a few and then turn it over to Chris. The biggest hot-button issue that I've seen recently is the payment of pre-petition retention bonuses for insiders. Those are closely scrutinized by creditors' committees and other state fiduciaries and the United States Trustee for fraudulent transfer liability, which I referenced before, just like breaches of fiduciary duty and other potential claims and causes of action.

This issue has come up in some pretty high-profile cases that folks would likely be very aware of. That includes Hostess, Toys "R" Us, Hertz, JCPenney. Creditors' committees will seek to challenge these payments, and judges frown upon them because, eve of bankruptcy, or close to eve of bankruptcy, payments that are styled as bonuses to insiders, are arguably an end around the bankruptcy codes protections. It's timely, but there was actually an oral argument yesterday in the Rite Aid bankruptcy case whereby a post-confirmation trust is seeking to avoid on breach of fiduciary duty grounds, approximately \$21.7 million of bonuses that were approved by the board of Rite Aid.

Not surprisingly, the plaintiffs were arguing that those bonuses were improperly labeled as discretionary performance bonuses, but there was no metrics that folks had to meet. The executives, they argued that those bonuses are market-based and that they relied on third-party consultants. We'll see what happens, but this is a pretty hot-button issue.

Another hot-button issue that we've seen recently is focusing on how KEIP milestones must not be layoffs or, in other words, be easy to satisfy by the persons eligible for the bonuses. The milestones don't have to be impossible to meet, but creditors' committees and the United States Trustee will closely scrutinize the metrics relied upon.

Christopher A. Ward:

Picking up on Eric's point, taking it one step further on this first issue, another issue we've seen heavily litigated is not just the payments that were made pre-bankruptcy, but what is the definition of an insider? Who qualifies for clawback on those payments?

What is an insider? It's pretty straightforward that a member of the board or an actual officer of the company is an insider, but what about other titles? Is a manager an insider? Is a vice president an insider? Different jurisdictions take different views on what constitutes an insider, but in general, if you have any control over the debtor, the company in bankruptcy, you are deemed an insider. What we recommend is a company should clearly specify in their corporate governance documents which employees are insiders, have control over the company, in order to avoid any unnecessary fights later on down the road.

Another issue I've seen recently that's been litigated is the payment of executive compensation and stay bonuses prior to bankruptcy, as Eric was talking about, and whether they should have been made in the bankruptcy. We had talked about that if they're made pre-bankruptcy, then they're not subject to the strictures of a KEIP and a KERP program, but there's nothing that stops the creditors' committee, the US Trustee, or the judge, him or herself, from going back and seeking to have those payments clawed back if they should have been made during a bankruptcy.

Our best advice on how to deal with this is if you have a MIP, a management incentive program in place prior to a bankruptcy filing, and those payments are made pursuant to that MIP, a written document that has been approved by the board, then you have a better opportunity to insulate those payments from clawback later.

Taryn E. Cannataro:

If you could leave boards, HR teams, and compensation professionals with two or three things they should do today to be better prepared if a company's financial condition deteriorates, what would they be?

Christopher A. Ward:

The answer's pretty easy. It's plan early. Waiting until a Chapter 11 is imminent will significantly reduce your options. As a bankruptcy and restructuring professional, the one problem I run into far too often, is that a distressed company does not reach out to you until it is too late. Don't be a penny-wise and a pound-foolish in these situations. If you see signs of distress, get financial restructuring professionals in there to help you through these situations, not just on executive compensation, but on all board decisions leading up to these scenarios.

Taryn E. Cannataro:

Eric, Chris, thank you for joining us. This was a great discussion and a helpful reminder that companies should not wait until Chapter 11 filing to start thinking about these issues. Early, careful planning can help preserve a company's compensation structure during a bankruptcy restructuring. As always, companies should consult with counsel if they're considering a restructuring.

Thank you for joining us today. If you enjoy today's discussion, please subscribe, leave us a review, and share this episode with your colleagues. You can also reach out to us via email if you have any questions or ideas for future topics. We look forward to having you back on the next episode of Just Compensation.

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