

Dodd-Frank Compensation Clawbacks

Key Issues and Action Items for Corporate Counsel

By Adam Cohen and Rob Neis

One of the significant executive compensation reforms in the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) is a requirement that all public companies establish a clawback policy for incentive compensation paid to executive officers. The requirement is not effective until the U.S. Securities and Exchange Commission (SEC) issues interpretive guidance. The guidance is expected in the middle of 2011, and companies may need to act quickly once guidance is issued.



Background on Clawbacks

A clawback is a provision or policy that allows a company to demand that an executive repay some or all of a bonus or other compensation previously paid. Typically, a clawback is applicable upon some triggering event, such as a discovery that the executive was involved in the preparation of inaccurate financial statements. Until 2002, the use of clawbacks was fairly limited, although some employment agreements contained “bad boy” clauses that applied when an executive violated a confidentiality, noncompete or similar covenant.

The Sarbanes-Oxley Act of 2002 expanded the prevalence of clawbacks by requiring the CEO and CFO of a public company to repay bonuses and other incentive compensation received after the release of financial information that is later restated because of noncompliance due to misconduct. Since 2002, broader clawbacks applicable to executives beyond the CEO and CFO have become more common, particularly as institutional shareholders and shareholder advocacy groups have emphasized the importance of these policies.

Dodd-Frank Act Clawback Requirements

The Dodd-Frank Act, signed into law by President Barack Obama on July 21, 2010, includes a requirement that all public companies have a clawback policy for incentive compensation paid to executive officers. The clawback applies to all executive officers, not just the CEO and CFO as under the Sarbanes-Oxley Act. It also applies to any material restatement of the company financials, regardless of misconduct.

In the event of a material restatement, executive officers and former executive officers must repay the company their incentive compensation including options. The amount of the repayment is the excess of what they actually received over what they would have received had the financial statements been accurate initially. Repayment is required with respect to anything paid in the three years before the restatement. Enforcement by the board of directors appears to be mandatory if a material restatement occurs.

The Dodd-Frank Act requires the SEC to issue regulations under which having a clawback policy will be a condition for being listed on a national stock exchange. The substantive requirements are not effective until the SEC issues its guidance. The SEC has indicated informally that it hopes to have guidance out in the near future.

Open Issues

There are a variety of open issues with respect to the Dodd-Frank Act clawback requirement. Awareness is helpful as corporate counsel may receive questions regarding these open issues.

- The clawback requirement will not be effective until the SEC issues regulations; the SEC has stated that it expects to issue regulations between April and July 2011. It is uncertain how long the SEC will give companies to come into compliance with the regulations once they are finalized. Additionally, it is unclear whether the clawback policy will need to cover only incentive compensation and option grants awarded after the regulations are issued or whether past awards and grants will be swept in.

- The statutory language specifically includes stock options as a type of incentive compensation subject to a clawback. Still, it is ambiguous whether or not restricted stock and restricted stock units are included.
- Guidance is needed on determining the repayment amount for incentive compensation that has a discretionary element, such as some types of annual bonus programs. Furthermore, as it is not obvious how an incorrect financial statement may impact stock price, guidance is also needed on how the repayment amount would be calculated for exercised stock options.
- Although it appears that the board of directors may be required to enforce the clawback policy in the event of a material restatement, the rules governing the board's duties have not yet been adopted. Therefore, the scope of any obligation is uncertain. For example, it is unclear whether the clawback must be enforced even when the cost of enforcement might outweigh the benefits.
- The Dodd-Frank Act mandates that the clawback cover any current or former executive officer, however, the statute does not define the term "executive officer." It is expected, but not definite, that the SEC will define "executive officer" by reference to rules under the Securities Exchange Act of 1934. Moreover, the statute does not address if the clawback policy must apply to incentive compensation paid to an employee before being promoted to an executive-level position.
- It is not yet evident if a unilaterally adopted clawback policy would be sufficient for discretionary awards or if the SEC will take the position that it is necessary for an executive to affirmatively agree to the clawback (for example, through an employment agreement or award agreement).



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Current Actions

There are a number of steps that corporate counsel can take now to begin the process of implementing the Dodd-Frank Act clawback requirement:

- Take inventory of clawback provisions already in place and identify areas in which the clawback provisions would be insufficient under the statutory Dodd-Frank Act requirements.
- Ensure that the relevant stakeholders at the company—including executive officers, human resources, the corporate secretary's office and the compensation committee of the board—are aware of the Dodd-Frank Act clawback requirement, the key issues involved, the decision points for implementation and the potential timeline. Implementing clawback provisions could impact upcoming incentive plan design, employment agreement drafting, shareholder communications and proxy compensation disclosure, among other things.
- Consider whether to limit the clawback to executive officers or to implement a broader clawback policy.
- Consider if it would be appropriate to add other types of clawbacks at the same time, such as clawbacks in the event of a "for cause" termination of employment, discovery that the executive could have been terminated for cause or violation of restrictive covenants, including noncompete provisions and confidentiality provisions.
- Begin thinking about the form of the clawback. In some ways, a written, unilateral policy is simpler, but mutually executed agreements may be more enforceable and may promote executive awareness of the requirement.

Because the SEC has not yet issued guidance, it may be premature to begin amending agreements and establishing new clawback policies at this time. However, ignoring the new requirements until SEC guidance is issued carries risks. Corporate counsel may wish to take steps to become familiar with the clawback requirements and open issues, ensure that key stakeholders are aware of the requirements and start the discussion on important decision points, such as the scope and form of the future clawback provisions.

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