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Dodd-Frank's Mandatory Executive Compensation Clawback: A Practical Review and Assessment

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). Included in its more than 2,100 pages are a scant 25 lines that require every public company to: (1) disclose incentive-based compensation that is based on financial information required to be reported, and (2) adopt a policy whereby, in the event of a restatement, the company will recover from current and former executives any incentive-based compensation, for the three years preceding the restatement, that would not have been awarded under the restated financial statements. Under the Act, a failure to do so will result in delisting.

While the concept of "clawing back" executive compensation is not new, the Act goes well beyond what has been required before. For example, Section 304 of the Sarbanes-Oxley Act contains a clawback provision, but that provision is only triggered if the restatement is the result of misconduct, applies only to the CEO and CFO, and seeks to recoup only those amounts received in the year following the first improper filing. *See* 15 U.S.C. §7243. In contrast, the Act effectively imposes strict liability– if a company restates for any reason, then it *must* recover from current and former executive officers any excess incentive-based compensation awarded in the previous three years.

Much simpler said than done. Many companies do not presently have clawback policies at all, and among those that do, few have policies that contemplate a mandatory clawback regardless of the reason for restatement or an individual's responsibility for it.[1] Rarer still are clawback policies that encompass former executives. In addition, many companies have not historically identified what portion of an executive's incentive-based compensation was based solely on mandatorily reported financial metrics, as distinguished from other performance objectives.

> The Act requires a clawback of any incentive-based compensation erroneously awarded during the three-year period preceding the date on which the company is required to prepare an accounting restatement.

At present, there is no effective date for implementing the clawback provision, nor is there a deadline for regulatory guidance. But the basic statutory contours are apparent and, given the difficult issues they raise, companies may be well advised to begin evaluating their options now, to avoid a mad scramble later. What follows is a brief overview of the required clawback policy, and a basic checklist of issues that boards and compensation committees may wish to consider in developing an appropriate policy.

Who Is Covered?

The Act requires a company's clawback policy to cover any current or former "executive officer."

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The Act does not define "executive officer" – that task has been left to the SEC and the exchanges. The SEC may well turn to Rule 3b-7 of the Securities Exchange Act of 1934, which defines "executive officer" as a company's president; any vice-president in charge of a principal business unit, division or function; any other officer who performs a policy-making function; or any other person who performs similar policy making functions for the company. Alternatively, the SEC could turn to Section 16 of the Securities Exchange Act of 1934, which has been interpreted to cover any officer of a registered issuer, or it could develop a new definition for this section of the Act.

What Is Clawed Back?

The Act requires the clawback of all "incentive-based compensation" that would not have been awarded under the as-restated financials.

The term "incentive-based compensation" also is not defined, apart from the express inclusion of stock options. Presumably, the SEC and exchanges will provide guidance on the scope of this term, as well.

When Is a Clawback Required?

A clawback is mandatory if a company is "required" to prepare an accounting restatement due to its "material noncompliance" with any financial reporting requirement under the law.

Unlike Section 304 of the Sarbanes-Oxley Act, the restatement need not be due to fraud or misconduct; a restatement caused by an errant (or aggressive) interpretation of GAAP is sufficient. This vastly expands the number of companies that may be required to implement a clawback. In 2009 alone, public companies filed 674 restatements.[2] Which of these were "required," or merely prudent or advisable? Who makes this determination – the board, the auditors, the SEC? In egregious cases, the issue is easy. The majority of restatements, however, do not involve egregious circumstances, raising questions as to when a restatement will be considered "required" and what will constitute "material noncompliance."

How Far Back Do You Go?

The Act requires a clawback of any incentive-based compensation erroneously awarded during the three-year period preceding "the date" on which the company is required to prepare an accounting restatement.

What date is this? Item 4.02 of Form 8-K requires public companies to disclose, within four business days, a determination that past financial statements should no longer be relied upon. Is that the same date that a determination is made that an accounting restatement is required? Not necessarily. Without a well-defined start date, determining the look-back period and exactly what incentive-based compensation is subject to clawback will be more difficult.

To illustrate these challenges, assume that Jayne Smith is employed as ABC Corp.'s general counsel and senior vice-president, and that her incentive-based compensation over the past three years, as described in the sidebar, has included different forms of consideration, which is not uncommon.

How does a company go about developing a clawback policy for such a package?

Assume that in 2011, ABC Corp. is required to restate its 2008, 2009 and 2010 financials, resulting in an EPS for 2008 of $1.94 (down a penny), an EPS of $2.10 in 2009 (down 5 cents), and an EPS of $2.20 in 2010 (down 30 cents, or 12 percent).

First, how much of the GC's bonus for those years was "erroneously awarded"? In 2008 and 2009, the company did not directly link a percentage of the GC's award to the EPS goals. In 2008, would the GC nonetheless have received the same bonus, since the EPS "miss" was only a penny? If not, what would the bonus have been? It is unlikely that any contemporaneous document allocates a specific portion of the GC's bonus to achievement of the EPS goal. Who is supposed to decide this issue, and how do they do so three years after the fact?

Second, assuming a specific portion of the GC's overall bonus is ultimately allocated to the achievement of reported (and now restated) financial information, how does one address the equity components of her awards – the RSUs and stock options? If they have not vested, are they considered "received" under the Act? In addition, their value may have fluctuated over time, and the options may be underwater due to the restatement. When are the options and RSUs to be valued for clawback purposes – at date of grant, clawback, or some other time? Must the company obtain a complex Black-Scholes or comparable valuation, or can it (should it) proceed on a simple percentage basis, rather than dollar value? What about RSUs that vested early because a certain EPS was achieved – is the company required to "unvest" them? What if the GC net exercised some options or sold some RSUs?

Illustration: ABC Corp.

2008 – Bonus of $1 million. Achieved individual goals, fundamental in overseeing important strategic merger, and company met its financial goals, including earnings per share of $1.95:

- $250,000 in cash
- $500,000 in restricted stock units (RSUs) – 50 percent vests in two years; the other 50 percent vests after four years. However, if the company achieves an EPS of $2.25 before that time, the RSUs vest automatically. The RSUs were granted as of January 31, 2009.
- $250,000 in stock options, 25 percent vesting each year. Granted as of January 31, 2009.

2009 – Bonus of $1.5 million. Achieved personal goals and company achieved its financial goals, including EPS of $2.15:

- $500,000 in cash
- $1 million in RSUs, with same vesting arrangement as in 2008.

2010 – Bonus of $2 million.

- 50 percent of bonus – achievement of personal goals and overseeing recruitment efforts within the general counsel's office
- 50 percent of bonus – company achieved EPS goal of at least $2.22; actual EPS $2.50
- $500,000 in cash
- $1 million in RSUs. Company must have an EPS of $2.45 for accelerated vesting; otherwise, 25 percent vests each year
- $500,000 in options, same vesting schedule as in 2008 & 2009. Granted as of January 31, 2011.

Third, assuming ABC Corp. ultimately determines that it needs to clawback a particular amount from the GC, how does it go about doing so? Can it simply cancel options or RSUs that have not vested, or have not been exercised or sold, instead of seeking the return of cash? How are the tax and accounting implications handled? Can the GC agree to forego a portion of a future bonus instead?

Behind this minutia are broader, systemic implications. Public issuers may wish to step back and assess, in light of the Act, how their future incentive-based awards can best be structured, and how they can minimize their legal risks in implementing a clawback policy. What follows is a non-exhaustive checklist of issues for consideration.

1. *Review clawback policy, incentive-based compensation plans and compensation committee charters.*

   A company should first review its current clawback policy (if any) and determine whether, as written, it complies with the Act. Companies that lack a clawback policy will need to develop one. Once developed, companies will need to determine if the policy will be incorporated in the incentive-based compensation plan, in a stand-alone agreement, or both. The compensation committee's charter should also be reviewed to ensure that the committee has the authority necessary to adopt and implement a clawback policy.

2. *Review current executives' compensation agreements and former executives' severance agreements.*

   Companies should review employment agreements with current executives and severance agreements with former executives. Current executives' agreements may need to be revised to allow for clawbacks, in a manner that is consistent with the Act and the company's compensation philosophy. Consideration may be given to modifying option and RSU vesting schedules to more easily effect a required clawback, and if so, the accounting and tax implications should be taken into account.

   More problematic will be the severance agreements of former executives. In the typical scenario, a severance agreement will include a mutual release of claims, including those related to past compensation. If the company seeks to clawback part of a former executive's compensation, can it do so, or does the prior release bar the claim? As to this issue, companies would be wise to review severance agreements with executives who have left in the past three years to determine

whether these agreements allow for a clawback and, if not, to assess the company's options. Should the company attempt to revise these prior agreements – which, among other things, may require the payment of *additional* consideration – or let sleeping dogs lie? The courts could ultimately decide that the Act cannot (or should not) disrupt settled contract rights, at least as regards non-culpable individuals, or the SEC could, by regulation, provide practical guidance, but neither of these has yet occurred.

The Act also does not address the practical problem of the *de minimis* or unreasonable clawback effort. What if the amount at issue, for clawback purposes, is insufficient to justify the cost of litigation, or the former executive no longer *has* the erroneously awarded compensation or its equivalent in value? And what of such collateral considerations as the distraction of current management, diversion of internal resources, potential negative publicity, and the like? Historically, the weighing of such considerations is the province of the corporate board or committee. As written, however, the Act provides no room for directors to determine that a particular clawback is not economically justified or is otherwise not in the company's best interests. Here, the SEC could adopt a rule similar to that issued by the Treasury as part of the Troubled Asset Relief Program (TARP). That clawback provides for an "out" in cases in which the TARP recipient can demonstrate that a particular clawback would be "unreasonable" – for example, if the expense will exceed the potential recovery. The Act itself, however, does not provide for this discretion.

3. *Review indemnification arrangements.*

Public companies typically adopt mandatory indemnification provisions to the extent allowable by law, most frequently Delaware law. Such provisions are thought to incent qualified individuals to serve, by providing a defined level of protection against legal exposure and expense. Under Delaware law, a corporation can indemnify, *inter alia*, a person for expenses, including attorneys' fees, incurred in connection with defending or settling a suit brought by the corporation, if the person acted in good faith and in a manner the person reasonably believed to be in, or not opposed to, the best interests of the corporation. *See* 8 D.G.C.L. §145(b). Any such indemnification, however, is subject to the limitation that if the individual is adjudicated liable to the corporation, then it is a *court*, not the corporation, that will determine if the person is "fairly and reasonably entitled to indemni[fication]."

PUBLIC ISSUERS MAY WISH TO STEP BACK AND ASSESS, IN LIGHT OF THE ACT, HOW THEIR FUTURE INCENTIVE-BASED AWARDS CAN BEST BE STRUCTURED, AND HOW THEY CAN MINIMIZE THEIR LEGAL RISKS IN IMPLEMENTING A CLAWBACK POLICY.

How might this play out in the clawback context?

If, following a required restatement, the process begins to determine what should be clawed back, any current or recent executive officer would seem necessarily to be threatened with the possibility of a lawsuit, and the company may be required to advance their legal fees. Current executives may be unlikely to force the company to sue for a clawback, but it is not unreasonable to think that they may wish to consult counsel, given the level of uncertainty surrounding the Act.

If the restatement triggering the clawback was not the result of misconduct, or certain executives played no role in any misconduct, it is likely that they would be found entitled to indemnification. Similarly, an executive who successfully opposes a company's recovery attempts, either in whole or in part (*e.g.,* establishing that the amount sought in clawback was excessive), will be entitled to recover her fees. If the executive is unsuccessful, then another round of litigation would follow to determine whether she should nonetheless be entitled to indemnity. Given the strict liability nature of the Act's clawback provision, an adjudication of liability without more does not speak to any culpability on the executive's part. Thus, a court may find that even the unsuccessful executive is entitled to recover her fees.

In short, a company that effects a clawback may recoup the clawback amount, but it may also pay some or all of its executives' legal fees in the bargain. Companies could exclude

such fees from indemnification, but that may be a sensitive issue in light of the Act's "no fault" liability standard.

4. *Review applicable state wage acts.*

   Companies should also review state wage acts that may apply to incentive-based awards to executives and determine whether a clawback would violate such laws. Many states' wage acts carve out incentive-based compensation, but not all. If our hypothetical GC lives in Pennsylvania, for example, incentive-based compensation falls within the wage act's scope. As a federal statute, the Act presumably trumps such state laws, but no court will address the issue for some time.

5. *Step back and assess compensation strategy.*

   Beyond these immediate issues is the question whether, given the prospect of clawbacks and the issues identified above, a company may wish (or need) to adjust its overall approach to executive compensation. In recent decades, an increasing portion of executive compensation, including bonus, has consisted of equity, in line with the philosophy that executives should have "skin in the game," just as stockholders do. One simple adjustment, perhaps, would be to reduce the bonus pool and increase base salaries. In the present environment, however, one can anticipate a stockholder backlash if the adjustments are substantial.

   What are the alternatives? Companies may want to devote increased attention to identifying and allocating incentive awards among distinct performance objectives, including objectives that are not tied to reported financial metrics. These may include long-term and strategic objectives, such as entry into new markets, successful acquisitions, successful financings, and the like. Doing so would help to reduce troublesome allocation and valuation issues in the clawback context. In particular, a three-prong approach that (i) identifies the portion of the award that is tied to specific reported financial metrics, (ii) awards it in equity, and (iii) imposes a three-year vesting schedule or other "holdback" may be the cleanest way to provide for a potential clawback or its equivalent in forfeiture. The balance of the award could then be structured to support the company's own compensation philosophy and practice.

6. *Who drives the bus?*

   Finally, who should be tasked with drafting, implementing, interpreting and enforcing the clawback policy? In all likelihood, these tasks will be divided among the board and its committees.

   Presumably, the compensation committee will take the lead in preparing or revising a clawback policy to comply with the Act, making any necessary changes to the incentive-based compensation plan, and reviewing agreements with executives to determine whether any changes are necessary or desirable. The full board, however, will be required to approve any necessary changes to the compensation committee's charter and membership.[3] As to other matters – such as determining whether and when a restatement is required, the extent of the restatement, and making indemnification decisions – these types of tasks are more frequently the province of the audit committee, the full board, or a specially-formed independent committee, as circumstances may dictate.

   In particular, once a policy is in place, who should be charged with enforcing it and deciding whether the company should commence litigation against a recalcitrant individual? The Act does not provide for any discretion in this regard, and the question may seem gratuitous. However, the SEC may provide for such discretion via regulation, as was done with TARP, and issues of independence and efficiency are important in any event. Because a clawback under the Act is triggered by a restatement, the reality is that the audit committee is likely to be deeply involved in that process, and an independent committee may be formed to address the near-inevitable litigation. In that event, the independent committee may be best positioned to address clawback issues.

In sum, in light of the scope and complexity of issues raised by the Act, issuers are well advised to review the composition and authority of their compensation committees, and begin developing their Dodd-Frank clawback policies.

Endnotes

1 As of 2008, of 2,121 companies surveyed, only 13.9 percent had clawback policies. Of those, only 39 percent (5 percent overall) had a policy that applied to all executives, regardless of fault, who received an incentive payment based on errant financials, while 44 percent (6 percent overall) had a clawback policy that applied only to executives who engaged in fraudulent activity that caused a restatement. The Corporate Library, 2008 Proxy Season Foresights #11, Analyst Alert "Clawback Policies."

2 Audit Analytics, 2009 Financial Restatements, A Nine Year Comparison (February 2010) at 1.

3 Section 952 of the Act imposes new independence requirements on compensation committee members and requires the SEC to identify factors affecting the independence of committee advisors, including counsel and consultants, that committees must consider before hiring them. Thus, the membership and powers of some committees may require revision, and committees may need to review the independence of their consultants and counsel.

More Resources on the Dodd-Frank Act

Pepper Hamilton conducted a webinar on this topic, "What the Financial Services Reform Legislation Means for You," on July 15. The webinar recording and PowerPoint slides from our session are available on Pepper's Web site: www.pepperlaw.com/webinars_update.aspx?ArticleKey=1832.

For additional information, please visit Pepper's Financial Services Reform Resource Center available online at www.pepperlaw.com/news.aspx?AnnouncementKey=655

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