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Payback Time: Issues and Answers on Clawback Provisions

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Clawbacks - Overview

- History of Clawbacks
- Pre-Dodd-Frank surge in popularity of Clawbacks
- The Dodd-Frank Act
- Clawback Issues and best practices
- Tax Issues

On December 8, 1941, the day after the surprise attack on Pearl Harbor, Congress passed a declaration of war against Japan. At the same time as the attack on Pearl – *but December 8 local time* - the Japanese invaded Hong Kong, British Malaya and the Dutch East Indies, and also bombed Singapore and American bases in the Philippines. The devastating effect of the bombing raid on the stately, British-ruled paradise of Singapore was quickly overshadowed by news of Pearl and America's likely entry into the war.

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Great Moments in Clawback History

- Guidry v. United States Steelworkers
- IBM v. Bajorek (1991)
- Aramony v. United Way Replacement Benefit Plan (1999)
- Tatom v. Ameritech Corp. (2002)
- Sarbanes-Oxley Act of 2002
- SEC v. Yuen (Gemstar-TV Guide, 2004)
- Troubled Asset Relief Program (TARP - 2009/2010)
- The Dodd-Frank Act

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Sarbanes-Oxley Act of 2002

Sarbanes-Oxley Act of 2002 ("SOX"), Section 304, imposed limited clawback provisions:

> *If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for--*
>
> *(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and*
>
> *(2) any profits realized from the sale of securities of the issuer during that 12-month period.*

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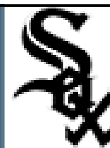
SOX 304



- The SEC has enforced Section 304 sparingly
- Early actions were limited to fraud as to which CEO and CFO were personally involved, and that resulted in restatement
  - Examples include option-backdating cases involving specific allegations of wrongdoing by CEO or CFO, *e.g., SEC v. McGuire; SEC v. Schroeder; SEC v. Brooks; SEC v. Sabhlok & Pattison*
- Recent actions
  - More aggressive actions against CEOs and CFOs with no personal involvement in wrongdoing that led to restatement (no-fault actions), *e.g., SEC v. Jenkins; SEC v. O'Dell; SEC v. McCarthy*

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Recent Actions: No-Fault

- *SEC v. Jenkins* (CEO of CSK)
  - During Jenkins's tenure, CSK engaged in fraud leading to restatement of financials from 2002-2004, which he signed; no allegation Jenkins was involved in the fraud
  - SEC argued Congress "expressly repudiated" a personal misconduct requirement
  - Commissioners rejected settlement proposal in July, signaling intention to seek favorable case law
- *SEC v. O'Dell* (former CEO of Diebold)
  - Same facts as *Jenkins*; in addition, SEC sought to recoup compensation during 12-month period after the year of restated financials; O'Dell settled
- *SEC v. McCarthy* (CEO of Beazer Homes USA)
  - Same facts as *Jenkins*; McCarthy settled

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No-Fault Actions

- Issues raised by no-fault actions
  - In connection with *Jenkins*, SEC brought separate actions against CSK and four of Jenkins's former co-workers (including CFO), none of which involve SOX Section 304, relying instead on claims of fraud, deceptive practices, and reporting violations.
  - Message to CEOs and CFOs seems clear: SEC appears to view them as guarantors of the company's financial statements to the extent of their incentive compensation.

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SOX Section 304

- Enforceable against company that *should have* restated?
  - *SEC v. Shanahan* suit against CEO of Engineered Support Systems, Inc. alleged misrepresentation that options were granted at FMV, failure to report in-the-money grants, repricing of underwater options, and director grants in excess of authorized amounts
  - SEC argued that company should have accounted for $9.8 million in compensation expense and overstated pre-tax income by 25%
  - SEC demanded repayment of compensation earned during period prior to when financials should have been--*but were not*--restated
  - Court dismissed SEC's claims: "before penalties may be imposed, an issuer must be compelled or ordered to prepare a financial restatement, and must actually file the restatement"

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No Private Cause of Action

- Neither SOX Section 304 nor Dodd-Frank Section 954 has any provision creating a private cause of action for stockholders.
- Courts have held that SOX Section 304 does <u>not</u> create a private right of action for stockholders, *e.g.*, *In re Digimarc Corp. Derivative Litig.* (9th Cir. 2008); *Neer v. Pelino* (E.D. Pa. 2005).
- Plaintiffs' bar likely to test in court whether the same is true for Dodd-Frank.

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TARP

- In the Emergency Economic Stabilization Act of 2008 and The American Recovery and Reinvestment Act of 2009 ("ARRA"), Congress created the Trouble Asset Relief Program ("TARP")
- ARRA Sec. 111 **requires** <u>TARP recipients</u> to implement "clawback" provisions to ***recover bonuses, retention awards, or incentive compensation paid to any senior executive officer (SEO) or any of the next twenty most highly compensated employees based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate***.

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TARP vs. SOX

- The TARP restrictions were *substantially broader than the SOX restrictions*:
  1. Covered up to 25 (rather than two) employees,
  2. Did not require misconduct,
  3. Did not require a restated financial statement, and
  4. Were not limited to compensation paid in the 12-month window following an inaccurate financial statement.
- The *SOX rules also were narrower in requiring a connection* between the compensation being recouped and the inaccurate financial information.

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SEC

- December 2009, SEC Final Rule on executive compensation disclosure and corporate governance, with an effective date of February 28, 2010.
- Examples of issues that would potentially be appropriate for a company to address, including:

  How the company's compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short-term and the long-term, such as through policies requiring clawbacks or imposing holding periods;

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The Dodd-Frank Wall Street Reform and Consumer Protection Act

- Section 954 of Dodd-Frank adds new Section 10D, entitled "Recovery of Erroneously Awarded Compensation Policy," to the Exchange Act.
- Requires SEC to direct the national securities exchanges to prohibit the listing of any security of an issuer that does not develop and implement a clawback policy.
- Requires companies to disclose compensation clawback policy in their proxy statement.
- Proposed Rules not yet issued.

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Dodd-Frank Section 954 Clawback

(b) RECOVERY OF FUNDS.—The rules of the Commission under subsection (a) shall require each issuer to develop and implement a policy providing—

(1) for **disclosure** of the policy of the issuer on *incentive-based compensation that is based on financial information required to be reported under the securities laws*; and

(2) that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.

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Dodd-Frank Section 954 Clawback

- incentive-based compensation that is **based on financial information required to be reported under the securities laws**
- the issuer is **required** to prepare an accounting restatement due to the **material noncompliance** of the issuer with any financial reporting requirement under the securities laws,
- incentive-based compensation (including stock options awarded as compensation) based on the erroneous data
- during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement,
- in excess of what would have been paid to the executive officer under the accounting restatement.

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Dodd-Frank Section 954 Clawback

- Individuals Covered: Compensation clawback policy must apply at least to the individuals who are executive officers and individuals who *formerly* were executive officers.

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Dodd-Frank Section 954 Clawback

- Compensation Covered: Is it
  - incentive-based compensation that is **based on financial information required to be reported under the securities laws**
  - incentive-based compensation (including stock options awarded as compensation) based on the erroneous data?
- All annual and long-term incentive compensation and stock options in excess of what have been paid but for the erroneous data in the restated financials.

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Dodd-Frank Section 954 Clawback

- Clawback Period: The 3-year period preceding the date the Company is "required to prepare an accounting restatement."
- Triggering Event: The company is required to restate its financial statements as the result of material noncompliance *with any financial reporting requirement under the securities laws*.
- Committee Discretion: None -- "will recover"

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Dodd-Frank vs. SOX

Dodd-Frank expands on SOX Section 304, which

- Only applies to CEO and CFO,
- Only requires a look-back period of one year, instead of 3, and
- Only applies if the financial restatement is a result of misconduct.

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Dodd-Frank Act FDIC Clawbacks

- Dodd-Frank Act Section 210(s)(3) directed the FDIC to promulgate regulations with respect to recoupment of compensation from senior executives or directors materially responsible for the failed condition of a covered financial company.
- In July 2011, the FDIC finalized rules for the "Recoupment of Compensation from Executives of Failed Financial Institutions"
- **The final rule adopts a rebuttable presumption that certain senior executives or directors are substantially responsible for the failed condition of a financial entity company that is placed into receivership under the orderly liquidation authority of the Dodd-Frank Act.**

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Dodd-Frank FDIC Clawbacks

- The senior executive or director would only be able to rebut the presumption by evidence that the senior executive or director:
  - conducted his or her responsibilities with the degree of skill and care an ordinarily prudent person in a like position would exercise under similar circumstances, or
  - did not cause a loss to the financial entity that materially contributed to the failure of the entity under the facts and circumstances.
- However, the final rules emphasize that (i) *the burden of proof will be on the former senior executive or director to establish that he or she exercised his or her business judgment*, and (ii) State "business judgment rules" and "insulating statutes" will not shift the burden of proof to the FDIC or increase the standard of care under which the FDIC as receiver may recoup compensation.

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Dodd-Frank Section 956 - Holdbacks

- Section 956 of the Dodd Frank Act, "Enhanced Compensation Structure Reporting," applies only to financial institutions with assets in excess of $1 billion
- Requires federal regulators to prescribe (jointly) regulations or guidelines that require each covered financial institution to disclose to the appropriate federal regulator the structures of all incentive-based compensation arrangements offered by the institution, sufficient to determine whether the compensation structure:

  (A) provides an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation, fees, or benefits; or

  (B) could lead to material financial loss to the covered financial institution.
- The regulations must prohibit any such incentive-based payment arrangement or features.

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Dodd-Frank Section 956 - Holdbacks

- In March 2011, the OCC, FDIC, OTS, SEC, the Federal Reserve, National Credit Union Administration, and Federal Housing Finance Agency jointly issued *proposed rules* pursuant to Section 956.
- The proposed rules would establish a mandatory deferral requirement for the incentive-based compensation of an executive officer at a covered financial institution with total consolidated assets of $50 billion:

  At least 50% of the annual incentive-based compensation of each executive officer must be deferred over a period of no less than three years, with the institution allowed to release (or allow vesting of) the full deferred amount in a lump-sum at the end of the deferral period in equal increments, pro rata, for each year of the deferral period)

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Dodd-Frank Act Section 922 - Whistleblower Incentives

- Dodd-Frank also adds: "Securities Whistleblower Incentives and Protection" [Section 922, adding a new Section 21F to the Exchange Act]
- Requires a payment of between 10% – 30% of the amount of monetary sanctions to "1 or more whistleblowers who voluntarily provided original information" to SEC that leads to successful enforcement (The SEC settlement with AIG was $800 million)
- SEC adopted final rules in May (3-2 vote)
- So, why is this relevant to a presentation on clawbacks? *[Hint: More "whistle blowing" could lead to more SEC enforcement actions and more financial restatements, which could lead to more compensation clawbacks under Section 954.]*

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Dodd-Frank Whistleblower Incentives

- Officers, directors, employees, shareholders, business competitors, agents, consultants, distributors, vendors, contractors, service providers, or customers all generally can qualify as whistleblowers.
- Certain individuals cannot receive bounties as whistleblowers:
  - Persons who provide information obtained through communications protected by the attorney-client privilege, in connection with the legal representation, the required independent public accountants engagement, or through a company's legal, compliance, audit, supervisory, or governance functions;
  - Persons who obtained the provided information in a manner that violates federal or state criminal law;
  - Persons with legal, compliance, audit, supervisory, or governance responsibilities to whom information about potential misconduct was communicated with the expectation that they would take appropriate steps to respond (unless the company does not disclose the information to the SEC in a timely manner or proceeds in bad faith);
  - Persons who provide information that was obtained from those who would otherwise be excluded under any of the foregoing limitations.

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Dodd-Frank Whistleblower Incentives

- Instead of requiring whistleblowers to report violations or concerns under the company's internal policy first, in order to be eligible to receive a bounty, the SEC's final rules provide "*incentives*" for whistleblowers to use the company’s internal reporting program.
- Note that 334 whistleblower "tips" were filed with the SEC in the 31 business days between August 12, 2011 effective date of the final whistleblower rules (the first date the SEC Office of the Whistleblower started keeping track) and September 30, 2011 end of the SEC's fiscal year.
- More than 10 tips per day
- SEC received whistleblower submissions from individuals in 37 states, as well as from several foreign countries, including China (10) and the UK (9).

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Clawbacks: Pre-Dodd-Frank

- Rationale for implementation of the clawback policy
  - Good governance credit from institutional shareholders and the media
  - Only for compensation that was earned by fraud?
  - Only from those individuals who perpetrated the fraud?
- Unjust enrichment theory
  - If the financial result or performance measure were incorrectly reported, then the company should claw back all compensation earned as a result of that error, regardless of any individual's fault.
  - Regardless of fault, employment level or the passage of time, and even if the fraud was outside the US, no one should receive or keep dollars to which he or she was not entitled.
- Is it that simple?

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Clawback Issues

- Balance the interests of the company with those of the employees
- Consider the realities of the marketplace
- Front-page article in *The Wall Street J*ournal: "U.S. Effort to Remove Drug CEO Jolts Firms."

  "A government attempt to oust a long-time drug company chief executive over his company's marketing violations is raising alarms in that industry and beyond about a potential expansion of federal involvement in the business world."
- Department of Health and Human Services notified the company that it intends to exclude it from doing business with the federal government if it continues with its CEO, despite the fact that the government had never accused the CEO of misconduct or wrongdoing.

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Clawback Issues

- Whom should the policy cover?
  - Senior Executives, Officers, Section 16 Officers?
  - Board of Directors
  - Senior finance personnel
  - All plan participants? How deep into the organization?
    - Unjust enrichment?
    - Only those at fault?
    - Balance the cost vs. amount of recovery

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Clawback Issues

- What forms of compensation should be affected by the clawback?
  - Annual incentive bonus plan
  - Stock options, vested but unexercised stock options
  - Restricted stock; Performance shares; RSUs
- How far back in time does the provision reach? (For what period do we clawback?)
  - All $ gained in past 12 months?
  - Consider the breadth of the clawback policy and the reason for the clawback
- Different treatment of cash vs. equity?
  - Precise equity gains are more difficult to calculate – and harder to recover

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Clawback Issues

- Procedures for clawback: Who is the decision maker and how much discretion does it have?
- Who decides whether and how much to clawback?
  - Board
  - Compensation Committee
  - CEO
- Specified or left to decision maker (breadth of the clawback is relevant)
- "Can" clawback or "shall" clawback

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Clawback Issues

- For what reasons should we claw back?
  - When there is a restated financial statement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws. [SOX 304]
  - Any statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate. [ARRA 111]
  - Restatement of earnings due to errors, omissions or fraud?
- Must the employee be at fault in order for the clawback to apply, or just be a beneficiary of the overstated payment?
  - Violating a non-compete agreement or other restrictive covenant?
  - Termination for "cause" (how strictly do we define cause)?
  - Other misconduct?

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Clawback Issues

- Should Company require full payback, partial payment or reduce future payments?
  - Note: Annual Incentive Bonus Plan measures many factors.
  - Desire to capture terminated employees
- Whether to apply the clawback provisions retroactively to payments and awards or prospectively. [Legal document review.]
- When should the determination of the clawback be made? At the time of restatement?

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Clawback Issues

- Location of the clawback policy: as part of the plans or as a stand-alone document
  - Employment agreements
  - Annual and Long-Term Incentive Plans
  - Corporate governance guideline/code of conduct?
- How should Company communicate the new clawback policy?
  - Signatures needed?
  - Consequences for not accepting the clawback provision?

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State Wage Payment Laws

- Are clawbacks legal in all states? Internationally?
- State wage and hour laws generally prohibit forfeiture of compensation considered earned "wages."
- California: Equity compensation is wages when earned, *i.e.*, "when an employee satisfies the condition(s) precedent to receiving incentive compensation, which often includes remaining employed for a particular period of time." *Schacter v Citigroup* (Cal. 2009)
- New York: Unvested equity awards are not wages. *Guiry v. Goldman, Sachs* (N.Y. App. Div. 2006) (unvested options and RSUs). Options are not wages, so it is permissible to recoup profit earned from exercised options following breach of noncompete covenant. *IBM v. Martson*, 37 F. Supp. 2d 613, 617 (S.D.N.Y. 1999).

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Clawback Issues

- How will affected employees view the clawback?
- Unintended consequences?
- Changes in pay practices

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Clawback Issues

- Consequences under:
  - FAS 123R/ASC 718?
  - 409A?
- Tax issues?

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Clawback Issues

- Should D&O insurance and/or indemnification provisions make whole an innocent executive whose compensation is clawed-back under Dodd-Frank Act Section 954?"
- Insurance policies being sold to protect innocent executives - that is, those who did not commit misconduct leading to a financial restatement - against compensation clawbacks.
- Public policy ordinarily would prevent an individual (or company) from insuring or being indemnified against his own misconduct (as opposed to negligence). However, where a clawback occurs due to a financial restatement necessitated by the misconduct or errors of another, insurance or indemnification provisions may be permitted to make whole an innocent executive whose compensation was clawed-back.

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Compensation Committee Action Items

- Take an inventory of all plans, programs and arrangements that provide for incentive compensation tied to financial metrics
- Review the structure of compensation packages
- Review who within the company should be subject to the clawback policy
- Check indemnification and mandatory arbitration clauses for clawback litigation issues
- Check enforceability of choice-of-law provisions
- Include clawback language that references Dodd-Frank to incorporate the final rules into any new executive compensation grants and agreements.

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The Tax Treatment of Compensation Clawbacks

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Repaying Compensation in the Same Year - Easy

Repayment in same year as payment – treated as if never paid

EXAMPLE 1

- 2012 compensation = $100,000 base + $10,000 bonus paid February 15, 2012
- $10,000 bonus repaid December 1, 2012
- Employer reports $100,000 as wages and income on Employee's Form W-2 for 2012

Same tax treatment applies whether $10,000 repayment is set-off from other wages in 2012, or paid directly by check

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Repaying Compensation in Later Year – Hard. Revenue Ruling 79-311

EXAMPLE 2

- Employee receives $100,000 bonus in 2010
- Employee repays $100,000 bonus in 2012, when pay was set at $500,000, by having repayment set-off against compensation otherwise payable

- 2010 tax return
  - Employee cannot amend 2010 tax return, under "claim of right" doctrine
- 2012 tax return under Revenue Ruling 79-311
  - Net compensation paid in 2012 = $400,000
  - W-2 income and wages = $500,000
  - Employee deducts $100,000 as miscellaneous itemized deduction
- But 2012 deduction is limited by
  - 2% floor
  - Alternative minimum tax (AMT)
- Employee claims section 1341 relief to avoid 2% floor and AMT

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Compensation Committee Action Item

- Companies should consider drafting clawback policies and provisions to expressly allow for a clawback to be accomplished by reducing compensation that would be payable in a future year, in order to give the executive and the company the best possible argument for a "net tax reporting position."
- That is, if the company is required to claw back $100,000 from an executive in 2012, per its policy, due to a restatement of financial results from 2010, and the executive's base salary for 2012 is $500,000, the company can simply pay the executive $400,000 and report that amount to him/her as taxable income on Form W-2 for 2012.

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Section 409A Issues Raised by Set-Offs

- If clawback is paid by set-off against nonqualified deferred compensation, the prohibited substitution rule of Section 409A may be violated unless the set-off is included in income under Revenue Ruling 79-311 at same time that compensation originally was scheduled to be paid

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409A Issues Raised by Set-Offs

EXAMPLE 3

- Employee receives $100,000 bonus in 2010, subject to clawback in 2012
- Employee is owed $500,000 SERP benefit (which is nonqualified deferred compensation under section 409A) in 2012
- $100,000 bonus repayment obligation is set-off from SERP benefit
- Net SERP benefit paid in 2012 is thus $400,000.
- Employer reports $500,000 SERP benefit (rather than net $400,000 actually paid) on employee's 2012 Form W-2 or 1099
- Employee reports $500,000 SERP benefit as ordinary income on his/her Form 1040

  This should be permitted under Section 409A, because the taxable income inclusion is "payment" under 409A. Full $500,000 SERP benefit is "paid" in 2012 as scheduled, in compliance with 409A.

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409A Issues Raised by Set-Offs *(cont.)*

EXAMPLE 4

- Same as Example 3 except that $100,000 repayment obligation must be satisfied in 2012, and $500,000 SERP benefit is payable in 2015
- 2015 SERP payment/account is reduced to $400,000, to effectuate $100,000 repayment obligation due in 2012
- Employer reports $400,000 net SERP benefit actually paid on employee's Form W-2 or 1099 filed for 2015

  This could be a *prohibited acceleration under Section 409A*, because $100,000 of SERP benefit payable 2015 is accelerated to pay obligation due in 2012

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Questions & Answers

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Mike is the author of the CCH treatise Executive Compensation, the American Bankers Association's Compliance Guide to Employee Benefit Trusts, and writes the popular "Melbinger's Executive Compensation Blog" for *CompensationStandards.com*.

He is frequently quoted in *The New York Times*, *The Wall Street Journal*, *Business Week* and other national publications. He has appeared as a guest on the *Jim Lehrer News Hour*, the *Fox News Business Report* and other nationally broadcast television programs.

Mike practices exclusively in the area of executive compensation and employee benefit issues for corporations, partnerships, executives, boards of directors and fiduciaries. He also handles the benefits and compensation issues in litigation, bankruptcy, change in control, and public offering situations.

Mike was elected as a fellow into the American College of Employee Benefits Counsel in 2005. Each year since 2007, he has named a Leading Lawyer for Business by *Chamber & Partners* and one of the top 100 lawyers in Illinois by "*Illinois Super Lawyers*." He is a member of the ABA and NASPP. He also handles *pro bono* matters for Adoptive Families of America, the Muscular Dystrophy Association, and other non-profit entities.

Mike received a B.A. from the University of Notre Dame in 1980 and a J.D. from the University of Illinois College of Law in 1983. He serves on the Board of the University of Illinois College of Law.

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