

New York Law Journal

GC New York

Labor & Employment

WWW.NYLJ.COM

©2010 ALM An ALM Publication

VOLUME 243—NO. 46

MONDAY, MARCH 29, 2010

Executive Compensation Clawbacks

Focus grows on recovering money already paid or on the way.

BY DOREEN E. LILIENTHAL
AND ALICIA M. O'CONNELL

fallout from the recent financial crisis has further subjected executive compensation programs to public scrutiny. Of particular focus are bonuses and incentive compensation paid to executives at failing companies. Congress, regulators and investors are outraged over the fact that executives—those who arguably had a hand in the mistakes (or fraud) that led to their employer's financial troubles—received bonuses, option gains or other incentive compensation based on erroneous financials. This backlash has resulted in increased focus on compensation recovery, or “clawback” policies.

Generally, an executive compensation clawback refers to an employer's right to recovery of compensation paid or owed to an employee upon the occurrence of a specific type of triggering event. The clawback may be a recoupment of compensation already paid to the employee or a cancellation of an outstanding but unvested and unpaid future award.

Executive compensation clawbacks are not new. Employers' equity compensation arrangements (particularly in the financial services industry) have historically included so-called “bad boy” provisions that discourage executives from violating non-competition and confidentiality provisions, and other restrictive covenants, or from engaging in misconduct (such as misappropriating company assets, or engaging in unethical conduct, illegal acts or similar malfeasance).

Clawbacks can also be a feature of employment agreements, where they are used to recover severance payments if the employee violates non-competition, non-solicitation or confidentiality obligations. More and more often, clawback policies are being adopted as part of an employer's corporate governance guidelines to ensure broad application of the clawback across compensation programs. According to Shearman & Sterling's survey of the corporate governance practices of the largest 100 companies in the United States, 56 companies disclosed that they had clawback policies in 2009, up from 35 in the year 2007.¹ This represents a 60 percent increase over two years.

DOREEN E. LILIENTHAL is a partner in the executive compensation and employee benefits group of Shearman & Sterling. ALICIA M. O'CONNELL is an associate in that group.

Like all other contracts, employers must take steps to ensure that their clawback policies will ultimately be enforced if challenged. Careful consideration must be given as to how clawbacks will be introduced, particularly for employees who have existing rights to bonuses or other compensation that are not currently subject to clawback rights. It may be necessary to consider whether an existing plan or agreement permits a unilateral amendment or whether employee consent is necessary to impose a clawback provision on outstanding awards.

As to the granting of annual awards or rolling out of new compensation programs, a clawback policy could require, as a condition to the receipt of the compensation, that the employee consent to the policy (possibly with respect to both past and future compensation). While consent can be implicit in the acceptance of the award or compensation, employers may also consider whether obtaining express written or electronic consent is feasible or would be beneficial.

When implementing clawback policies, employers should also be cautious of applicable state wage-deduction laws. These statutes typically limit the circumstances under which an employer may recoup “wages” from employees. Since the rules vary from state to state, employers with a national presence should be mindful of the differing local regimes that could make the implementation of a uniform clawback more challenging. We examine several of these state statutes in this article as they have been applied to non-compete clawbacks.

New York

The New York Labor Law defines “wages” as “the earnings of an employee for labor or services rendered, regardless of whether the

amount of earnings is determined on a time, piece, commission or other basis.”² Section 193 of the New York Labor Law provides that “no employer shall make any deduction from the wages of an employee” and “no employer shall make any charge against wages, or require an employee to make any payment by separate transaction,” unless expressly authorized in writing by the employer for his or her benefit. If an employer willfully fails to pay owed wages, §198 of the New York Labor Law allows for the recovery of liquidated damages equal to 25 percent of the total amount of wages due.

There is a well-developed body of case law in New York regarding when various components of pay are considered protected “wages.” In New York, compensation—whether a commission, bonus, or incentive payment—constitutes a “wage” once it is actually earned and vested.³ Deferred compensation that has been earned also qualifies as a “wage.”⁴ Unvested stock options and other forms of equity compensation, however, do not qualify as “wages”⁵ in New York and may be subject to clawback. Discretionary bonuses that are based on the employer's overall financial performance also do not constitute statutory wages.⁶

Non-competition clawbacks that provide for the forfeiture of unpaid amounts have been determined to not run afoul of New York's wage-deduction statute under the “employee choice” doctrine, which assumes that a terminating employee makes an informed choice between forfeiting a certain benefit or retaining the benefit by avoiding competitive employment.⁷ The U.S. Court of Appeals for the Second Circuit relied on the employee choice doctrine in *Lucente v. International Business Machines Corporation* when it held that IBM's cancellation of a former executive's equity awards when he went to work for a competitor did not violate New York law.⁸

Employers may also seek to rely on New York's “faithless servant” doctrine to enforce a clawback. New York law with respect to disloyal or faithless performance of employment duties is grounded in agency law. Agents must be loyal to their employers, are prohibited from acting in any manner inconsistent with their agency, and are at all times bound to exercise the utmost good faith and loyalty in exercising their duties.⁹ Those who owe a duty of fidelity to a principal and who are faithless in the performance of services are generally not entitled to recover their

compensation, whether commissions or salary.

Principals are entitled to recover commissions paid to their unfaithful agents, even if the services were beneficial to the principal, or the principal suffered no provable damage as a result of the agent's breach of fidelity. The Second Circuit has held that an employee had to forfeit all compensation received after his first disloyal act.¹⁰ However, if an employee enters into an express agreement to be paid on a transaction-by-transaction basis, then forfeiture is limited to the compensation the employee received in return for transactions in which he acted disloyally.¹¹ The court held in *Design Strategy Inc. v. Davis* that where the employee was compensated with base salary plus commission for specific tasks, forfeiture applied only to salary for the period during which the employee had been disloyal but would not apply to any specific commissions earned before or after the period of disloyalty.¹²

California

"Wages" are defined broadly in California to include "all amounts for labor performed by employees of every description, whether the amount is fixed or ascertained by the standard of time, task, piece, commission basis, or other method of calculation."¹³ Section 221 of the California Labor Code makes it unlawful for "any employer to collect or receive from an employee any part of wages" previously paid by the employer to the employee. Authorized deductions, however, include deductions expressly authorized in writing by the employee.¹⁴ The wage-deduction statute reflects California's strong public policy favoring the protection of employees' wages.¹⁵ California courts have recognized that "wages" include bonuses and incentive plans,¹⁶ but not unvested shares of restricted stock.¹⁷

The U.S. Court of Appeals for the Ninth Circuit examined a non-competition clawback in *International Business Machines v. Bajorek*.¹⁸ The executive received stock options from IBM as part of his compensation, and the relevant stock option agreement contained a non-competition provision that required the executive to repay any option gain from previously exercised options in the event that he went to work for a competitor within six months of exercising his options. When that happened, IBM notified the executive that his options were cancelled and that he had to repay the option gain. The court found that stock options did not constitute "wages" under the California Labor Code¹⁹ (and therefore could be clawed back) because they "are not 'amounts'" and, as contractual rights to buy shares of stock, "are not money at all."²⁰

Texas

The Texas Labor Code defines "wages" as "compensation owed by an employer for labor or services rendered by an employee, whether computed on a time, task, piece, commission or other basis."²¹ It provides that "an employer may not withhold or divert any part of an employee's wages" unless the employer has written authorization from the employee to do so for a lawful purpose.²² The U.S. Court of Appeals for the Fifth Circuit found a non-competition clawback valid as applied to stock options.²³

Connecticut

"Wages" are defined in Connecticut as "compensation for labor or services rendered by an employee, whether the amount is determined on a time, task, piece, commission, or other basis of calculation."²⁴ Accordingly, no employer may withhold any portion of an employee's wages without written authorization on a form approved by the state Labor Commissioner, or for medical, surgical or hospital care or service.²⁵ Under Connecticut case law, bonuses constitute "wages" when "the payment is premised upon work or services the employee has performed as opposed to the general success of the company or the whim of management."²⁶ Vested stock options qualify as "wages,"²⁷ while unvested stock options generally do not.²⁸

New Jersey

In New Jersey, "wages" are "direct monetary compensation for labor or services rendered by an employee, where the amount is determined on a time, task, piece, or commission basis."²⁹ Employers are generally prohibited from withholding or diverting any portion of an employee's wages, although an employer may divert or withhold wages if the employee authorizes the diversion or withholding in writing.³⁰ Any form of supplementary incentives and bonuses that are calculated independently of regular wages and paid in addition to regular wages are explicitly excluded from the definition of "wages" by statute,³¹ although New Jersey courts still examine the issue.³²

More and more often, clawback policies are being adopted as part of an employer's corporate governance guidelines to ensure broad application of the clawback across compensation programs.

Outside the United States

Employers with an international presence should also consider local labor and employment laws to determine the enforceability of clawback provisions. In many countries, it is currently not possible as a matter of underlying employment law to require an employee to repay any compensation that has already been paid. Austrian labor rules, for example, give employees the right to receive incentive payments that are promised in a binding manner.³³ Fundamental principles of Polish law provide that compensation cannot be subject to repayment to the employer.

Employment law rules in the Czech Republic presume that once a salary payment (which may include bonuses) has been paid, it is salary for work done that may not be recouped. In the Netherlands, once wages have been paid to an employee, they cannot be clawed back. Clawback provisions also do not comply with Argentinean statutory rules regarding the payment of salaries. Similarly, in France, the French high court has invalidated contractual provisions mandating the repayment of compensation following a resignation of employment.

In the United Kingdom, clawbacks may be viewed as indirect restrictive covenants that are subject to the restraint of trade doctrine in the same manner as covenants that impose express prohibitions. The restraint of trade doctrine provides that agreements that prohibit an employee from working for a competitor following a termination of employment, or from soliciting employees or clients post-termination will be unenforceable unless (a) the employer has a legitimate business interest to protect (such as confidential information, client relationships and the stability of the work force), and (b) the scope of the restraint is no wider than is reasonably necessary to protect that legitimate business interest.

Conclusion

As clawbacks become more and more prevalent, we believe that the case law in this area will continue to develop and that we will see more litigation over the application of clawback provisions that would apply more broadly than in the context of restrictive covenants. Employers should carefully review their existing clawback policies to ensure that they will be enforced as intended and remain mindful of employment law considerations when changing compensation policy.

.....●●.....

1. 2009 Trends in the Corporate Governance of the Largest U.S. Public Companies: Director & Executive Compensation, Shearman & Sterling LLP Publication, available at www.shearman.com/corporategovernance/.

2. N.Y. LAB. LAW §190(1).

3. *Reilly v. NatWest Markets Group Inc.*, 181 F.3d 253, 264 (2d Cir. 1999).

4. *Tuttle v. Geo. McQuesten Co. Inc.*, 642 N.Y.S.2d 356, 358 (3d Dept. 1996).

5. *Guiry v. Goldman Sachs & Co.*, 814 N.Y.S.2d 617, 619 (1st Dept. 2006).

6. *Truelove v. Northeast Capital & Advisory Inc.*, 95 N.Y. 2d 220, 223-24 (2000).

7. *Lucente v. Int'l Bus. Mach. Corp.*, 310 F.3d 243, 254 (2d Cir. 2002).

8. *Id.* at 263.

9. *Phansalkar v. Andersen Wienroth & Co. L.P.*, 344 F.3d 184, 200 (2d Cir. 2003).

10. *Id.* at 211.

11. See *Musicco v. Champion Credit Corp.*, 764 F.2d 102, 114 (2d Cir. 1985).

12. *Design Strategy Inc. v. Davis*, 469 F.3d 284 (2d Cir. 2006).

13. CAL. LAB. CODE §200(a).

14. CAL. LAB. CODE §224.

15. *Harris v. Investor's Business Daily Inc.*, 41 Cal. Rptr. 3d 108, 117-18 (2d Dist. 2006).

16. *Schachter v. Citigroup Inc.*, 101 Cal. Rptr. 3d 2, 9 (2009).

17. *Id.* at 11-12.

18. *Int'l Bus. Mach. Corp. v. Bajorek*, 191 F.3d 1003 (9th Cir. 1999).

19. *Id.* at 1039.

20. *Id.*

21. TEX. LAB. CODE ANN. §61.001(7).

22. TEX. LAB. CODE ANN. §61.018.

23. *Olander v. Compass Bank*, 363 F.3d 560 (5th Cir. 2004).

24. CONN. GEN. STAT. §31-71a(3).

25. CONN. GEN. STAT. §31-71e.

26. *Feilbogen v. AIG Trading Group Inc.*, No. 3:03CV1624 (DJS), 2006 U.S. Dist. LEXIS 29184, at *27 (D. Conn. May 15, 2006).

27. *Randolph v. Cas Med. Sys. Inc.*, CV085020807S, 2008 Conn. Super. LEXIS 3275, at *5 (Conn. Super. Ct. Dec. 22, 2008).

28. *Nofs v. Gemini Network Inc.*, CV020818599S, 2003 Conn. Super. LEXIS 316, at *19 (Conn. Super. Ct. Feb. 4, 2003).

29. N.J. STAT. ANN. §34:11-4.1.

30. N.J. STAT. ANN. §34:11-4.4.

31. *Id.*

32. See *Moran v. DaVita Inc.*, No. 06-5620 (JAP), 2009 WL 792074, at *18 (D. N.J. March 23, 2009).

33. Angestelltengesetz [Employee Act] §16 (Austria).