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JANUARY 2019

WORKSPAN

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THE SHIFTING WINDS OF CLAWBACKS

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Clawbacks are a hot topic in executive compensation. With each new corporate scandal, there is a renewed desire among shareholder interest groups and the public more generally to broaden the circumstances under which companies can recover compensation from executives and potentially other employees if the compensation is viewed as ill-gotten gains.

Stemming from corporate scandals in the early 2000s, initial clawback rhetoric in the United States focused on recoupment in the event of a financial restatement where an executive had engaged in misconduct. Over time, there has been increased pressure to apply clawbacks in the event of a restatement whether or not there was executive misconduct. More recently, there has been a push to apply clawbacks when employee actions significantly harm a company's finances or reputation. This move comes in response to the scandals at Wells Fargo and Equifax where there was no financial restatement although events had a significant impact on the reputation and finances of the company and its relationship with customers.

In this article, we will walk through a brief history of clawbacks, current market practice on clawbacks and the key issues that management teams and compensation committees are considering as they develop and refine clawback policies.

History of Clawbacks

Clawbacks hit the executive compensation lexicon in 2002 with the passage of the

Sarbanes-Oxley Act (SOX). Section 304 of SOX enables the Securities and Exchange Commission (SEC) to claw back specified incentive compensation from the CEO and CFO only of publicly traded companies during the 12-month period following a restatement resulting from material noncompliance and executive misconduct.

From a U.S. regulatory standpoint, there has been no new legislation in effect since Sarbanes-Oxley that requires companies to implement clawbacks. Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 included a requirement for a clawback that applied to all executive officers with respect to incentive compensation earned in the 36 months preceding a restatement, whether or not the executive officer engaged in misconduct. And in 2015, the SEC finally came out with proposed rules for implementing this clawback requirement. However, at this article's writing, the rules have not been finalized and there is not a clear timeframe for finalized clawback requirements. As such, the Dodd-Frank clawback is still not effective law.

While the Dodd-Frank requirements have never been implemented, market practice has moved toward public companies adopting, at a minimum, a clawback policy that would comply with the Dodd-Frank requirements, (i.e., requiring a clawback in the event of a financial restatement, using a three-year look-back and applying the clawback to all executive officers). Many companies had been taking a wait-and-see approach in anticipation of the proposed and final rules from the SEC. But because of the long delay in SEC rulemaking and investor and public pressure, this wait-and-see approach is becoming less common.

Current State of Clawbacks

Shearman & Sterling's "Corporate Governance & Executive Compensation Survey 2018," its 16th annual survey of the 100 largest U.S. public companies, found that 92 of the top 100 companies disclosed that they had clawback policies in place. (The survey defined the top 100 companies as the 100 largest U.S. public, noncontrolled companies that have equity securities listed on the NYSE or Nasdaq, measured by market capitalization and revenue.) Based on company disclosure, 34 companies did not require fraud or misconduct to implement a clawback in the event of a financial restatement or material error. Further, 54 companies publicly disclosed that they have clawback policies triggered by detrimental conduct unrelated to financial restatements. Survey findings also showed expansion of covered employees, with 21 companies covering all employees (or all participants in a particular compensation plan or program).

Key Considerations for Clawback Policies

When designing a clawback policy for your company, among the design considerations are five critical questions to address:

- What should trigger the clawback?
- Who should be subject to the clawback policy?
- What forms of compensation should be subject to the clawback?
- How far back should the company be able to go to claw back compensation?
- Will the clawback be mandatory or discretionary?

Clawback Triggers

The most critical aspect of the clawback policy design process is defining what events will trigger a clawback. Currently, there are two main approaches in the marketplace to clawback triggers:

- Financial restatement (with or without executive misconduct)
- Misconduct independent of a financial restatement.

Financial Restatement

At this point, best practice suggests that if there is a material financial restatement tied to overpayment of incentive compensation due to executive misconduct, then a clawback should apply to any executives engaging in misconduct that resulted in the need for the financial restatement. This is generally the threshold level of the trigger used by companies with clawback policies in place, and is consistent with the approach under SOX.

Many companies have moved beyond this threshold approach to extend the triggering event to any material financial restatement tied to overpayment of incentive compensation, whether or not the employees subject to recoupment were responsible for the financial issues that resulted in a material restatement. This is essentially the standard that would be used for clawbacks under Dodd-Frank Section 954. The key rationale for this clawback trigger is that even though the executives did not "do anything wrong," they were overpaid because the company paid incentives based on incorrect financial information. This is akin to a bank incorrectly crediting your account with additional funds. Understandably, this clawback provision can be unpopular with employees because it introduces uncertainty with respect to retention of their incentive compensation. In particular, employees can face a difficult situation if they have spent their incentive compensation only to have to repay it if the company claws back the compensation at a later time.

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Compensation committees will need to use judgment to ensure that they have a solid basis for application of a clawback.

Misconduct Independent of a Financial Restatement

There is growing board of director interest to have the ability to apply a clawback when there has been executive misconduct beyond financial restatements or errors that result in financial or reputational harm. That interest has been heightened in light of recent corporate scandals where executives have engaged in misconduct, failed to comply with company policies or failed to appropriately supervise staff. While these scandals have not triggered financial restatements, there is a sense that the behaviors hurt the company to a degree that the implementation of a clawback could be appropriate.

Equifax had a highly publicized data breach in 2017, but at the time did not have a clawback policy that covered executive misconduct independent of a financial restatement. Following the data breach, the company expanded its clawback policy to add a trigger of "misconduct resulting in significant financial and/or reputational harm and the employee either engaged in the misconduct or failed to fulfill his or her supervisory responsibility to prevent another employee from engaging in such misconduct." We may see other companies looking to this event as an example of needing to be proactive with the coverage of a clawback policy.

While this type of clawback has appeal to protect the company in times of crisis, it raises many challenging issues for companies to consider in its administration. It may be straightforward to determine if someone has failed to comply with a company's policies. However, some such failures or a failure to supervise could be harder to assess. Similarly, it may require judgment to determine whether an action resulted in material financial or reputational harm, and if so, to what degree. Many corporate scandals have significant short-term impact, but limited sustained impact on a company's reputation or stock price. Compensation committees will need to use judgment to ensure that they have a solid basis for application of a clawback, and that implementation of the clawback is in the best interest of the company.

From an employee perspective, there could be concern that clawbacks will be used to punish employees for what was really necessary and appropriate risk taking that fell short of its goal. If employees feel that clawbacks can be applied in too broad a set of circumstances, they may be reluctant to take risks that can help the company and place limited value on incentive compensation that is subject to clawback.

Covered Employees

In our experience, most companies limit the clawback policy to executive officers or senior employees, although as noted earlier, the Shearman & Sterling survey is showing expansion to broader employee coverage. Executive and senior employees tend to have more of their compensation delivered in the form of incentive pay and have the greatest ability to affect the performance of the company, making them the key group to cover for potential recoupment. However, companies are appreciating that in certain circumstances it is appropriate to cover other employees as well, particularly when they participate in incentive compensation plans tied to financial performance that is at risk of being affected by a financial restatement. We have found that sales employees are subject to incentive pay clawback in certain industries where improper sales activities (e.g., financial services) can have potentially far-reaching impact on the reputation and/or financial performance of the company. In most cases, though, we expect that clawbacks are more likely to be applied to senior executives where there is sufficient incentive compensation to be clawed back and level of oversight responsibility to potentially address the cost of applying the clawback and increase the chance of enforcement.

Compensation Subject to Clawback
Most commonly, companies with clawback policies apply the clawback to cash and equity incentive compensation. Under the proposed SEC rules implementing the Dodd-Frank regulations, the clawback would apply only to incentive compensation with formulaic performance assessments based on objective performance criteria. Most clawback policies we have reviewed allow the administrator of the policy (generally the company's board of directors or compensation committee of the board) discretion in determining how much of the incentive compensation would be clawed back. It is particularly challenging to determine how much (if any) time-vested equity compensation (e.g., restricted stock or stock options) should be clawed back in the event of a financial restatement. Under policies with broader clawback triggers, compensation beyond that with direct performance ties is likely to be covered as well.

Many clawback policies are silent on how far back in time a clawback can reach.

Timeframe for Clawback Applicability
One challenge in applying a clawback policy is that significant time can pass between the triggering act and its discovery. For example, it could take several years before an error in financial reporting is discovered. As a result, there may be several years where incentives were paid incorrectly based on inaccurate financial statements or paid in circumstances that the company would not have thought appropriate if it knew of actions taken by recipients of the compensation. Many clawback policies are silent on how far back in time a clawback can reach. We may find that a three-year look-back period becomes best practice in light of the SEC's proposed rules under Dodd-Frank. In practice, we expect that boards and compensation committees will be reluctant to go too much farther back to recover compensation.

Mandatory or Discretionary Clawback
While the clawback under SOX and the proposed clawback under Dodd-Frank Section 954 are mandatory policies, we expect that most companies will continue to have discretionary clawback policies that provide the board, compensation committee or other administrator the ability to exercise discretion in determining whether to implement the policy. Clawbacks triggered by financial restatements are the most straightforward to apply, and even they require the application of judgment to be most effectively administered for the best interests of the company. For clawbacks triggered by misconduct that results in financial or reputational harm, judgment needs to be applied at each step of the process, including questions such as: 1) Was the conduct misconduct? 2) Did it result in material financial or reputational harm? 3) How much financial or reputational harm? 4) How much compensation should be clawed back? 5) How do the legal and administrative costs of recovering the compensation compare to the potential compensation recovered?

Putting More Bite into Clawbacks

We expect that clawbacks will grow in prevalence, and that the breadth of the triggering events used by companies pushed by ongoing shareholder pressure will continue to expand. We expect that the broader clawback policies being implemented at the largest companies will begin to be adopted by smaller companies and become seen as a best practice.

As more companies adopt broader clawback policies, key questions will arise over implementation and enforcement: Will we see more companies implementing clawback policies, in particular those unrelated to financial restatements? And, will companies be able to enforce these policies and in fact recoup the compensation they go after?

It will be interesting to see what practices are most effective in successfully recovering compensation. WS

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