

# Clawback Policy Considerations Checklist

A Lexis Practice Advisor® Checklist by Doreen E. Lilienfeld and Gillian Emmett Moldowan, Shearman & Sterling LLP



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This checklist outlines considerations for companies contemplating the implementation of a compensation recoupment, or clawback, policy. Until recently, clawback policies generally had been applied only in cases of accounting irregularities and misconduct in the event of a required accounting restatement, and were often limited to the chief executive officer and the chief financial officer, consistent with the scope of Section 304 of the Sarbanes-Oxley Act of 2002 (SOX). SOX Section 304 (15 U.S.C. § 7243) allows the Securities Exchange Commission (SEC) to recoup from CEOs and CFOs incentive compensation and gains on sales of company stock received during the 12-month period following the issuance or filing of a public company's financials that are later required to be restated due to material noncompliance with any financial reporting requirement under the securities laws arising from misconduct.

Over the last decade, institutional shareholders and governance activists have increased focus on clawback

provisions as a significant corporate governance and executive compensation issue. The requirement for companies to implement a clawback was a key component of the government's Troubled Asset Relief Program coming out of the financial crisis, and the Dodd-Frank Act requires companies to maintain clawback policies (although implementation rules are still pending). Recent corporate scandals have highlighted the reputational and financial harm that can result from inappropriate actions by employees and failures in board oversight, shining a spotlight on the need for effective risk management. As a result, the prevalence of voluntary clawback policies, which act as a risk mitigator, has been on the rise.

## First Steps for Adopting a Clawback Policy

- Identify whether the company currently has any form(s) of clawback in place (e.g., cancellation provisions for violation of restrictive covenants, offset provisions).
- Identify incentive programs to be covered by the clawback policy.
- Identify employment or other individual agreements that could require amendments to implement the clawback policy.

## Primary Design Considerations for Clawback Policies

Nine fundamental considerations for establishing a clawback policy are addressed below.

## 1. Covered Conduct—Triggering Events

Clawback policies may provide for a range of triggering events, which may be categorized as follows:

- Recoupment triggered by errors in financial performance measures or reporting (regardless of whether any individual engaged in fraud or misconduct), for example, when incentive compensation was paid based on:
  - A misstatement of the company's financial statements –or–
  - Materially inaccurate performance metrics or other criteria
- Recoupment triggered if the individual engaged in fraud or misconduct (regardless of whether there is a financial restatement or a material error in calculating the compensation paid). Typically, this would include one or more of the following:
  - Fraudulent or intentional misconduct
  - Engaging in conduct detrimental to the company
  - Gross negligence
  - Violation of company policies
  - Failure to supervise
- Recoupment only if both of the above triggers are satisfied
- Recoupment triggers for emergency events (e.g., significant litigation loss, force majeure event)

## 2. Individuals Covered

The group of covered individuals should be broad enough to cover at least those individuals who influence decision-making with respect to critical business issues. Clawback policies generally cover one or more of the following groups:

- All named executive officers in the proxy statement
- All Section 16 officers
- All directors
- Selected senior managers or employee groups
- All employees and directors

Where a clawback is triggered by a mistake in the computation of a bonus pool and payments are made based on this inaccuracy, clawbacks are sometimes extended to all bonus recipients who benefited from the inaccuracy.

Clawback policies may cover current and former employees and directors.

## 3. Types of Compensation Subject to the Policy

Clawback policies can cover several forms of compensation paid to an individual, but is usually limited to incentive compensation, which may include, without limitation:

- Annual cash bonuses
- Long-term cash incentive awards
- Equity awards (both full-value awards, such as restricted stock or restricted stock units (RSUs), and appreciation-only awards, such as stock options and stock appreciation rights (SARs))
- Gains from equity-based compensation
- Nonqualified deferred compensation

Base salary is generally not linked to specific performance targets and, therefore, is not typically covered by clawback policies. Additionally, state wage laws may complicate a clawback of base salaries. Thus, the general trend is for clawbacks to apply to equity awards and cash incentives.

## 4. Amount of Compensation Subject to Clawback

The amount to be recouped may depend on the clawback trigger. Clawback policies typically provide that, in the event of a financial restatement or a recalculation of performance metrics or other criteria, the amount recoverable is the difference between:

- The payment actually made to the covered individual (or the number of shares granted or that became vested under an equity award grant to the covered individual) – and –
- The payment that would have been made (or number of shares that would have been granted or become vested) based on the restated financial results or the recalculated or adjusted performance metrics or other criteria

In cases of fraud or misconduct, clawback policies may provide that the amount recoverable is:

- The additional amount paid, granted, or vested during the period relating to the fraud or misconduct –and–
- Any equity award that vested or was exercised after the act of fraud or misconduct, including the gain on the award if the shares have been sold

Alternatively, in cases of fraud or misconduct, the clawback may cover all compensation paid under certain plans or programs. In either case, you should ensure that the policy is consistent with forfeiture restrictions under state wage and hour laws.

## 5. Discretionary versus Nondiscretionary Enforcement

Alternatives for enforcement discretion include:

- The clawback will automatically trigger when a covered event occurs.
- As a modification to automatic application, the clawback may instead provide that it is automatic unless the amount to be recovered would be less than the anticipated cost of recovery or a specified threshold amount.
- The clawback may be designed such that the board of directors (or another body) has discretion to determine whether to apply the clawback. If discretion is provided, the limits of that discretion should be addressed in the policy.

## 6. Compensation Structures to Preclude Clawbacks or Enhance Enforceability

Compensation plans, programs, and agreements that are subject to the clawback policy can be designed to mitigate the need to recoup amounts previously paid or otherwise enhance enforceability of the clawback policy. Consider implementing the following terms:

- Amend compensation plans, program documents, and agreements to explicitly incorporate the clawback policy for covered compensation. Consider obtaining consent of covered individuals to extend the policy to covered compensation previously paid and equity grants previously awarded.
- Require the deferral of incentive compensation to allow for cancellation, forfeiture, or offset.
- Use explicit language that the covered compensation is not earned unless all conditions are satisfied (even if discovered after payment) and all unearned amounts are subject to forfeiture or cancellation, whether paid or unpaid, and subject to recoupment (or offset, where permissible) if paid in error.
- Require retention of a significant portion of shares acquired through equity compensation programs (to facilitate clawback enforcement).
- Explicitly retain the discretion to withhold future incentive compensation awards and equity awards as a clawback enforcement mechanism.
- Set forth specific terms and establish procedures for recoupment of compensation previously paid.
- Retain the right of offset against amounts otherwise payable (although tax rules for nonqualified deferred compensation and state wage and hour laws may prevent this technique in certain circumstances).

Clawback policies may provide for both the recovery of incentive compensation previously paid to an individual and vested but not yet released compensation. Similar triggering events can also be applied to forfeiture provisions in compensation arrangements that provide for the cancellation or reduction of unvested incentive compensation, deferred compensation, or equity awards that may otherwise become due or payable in the future (subject to complying with the tax code).

If a clawback is to be implemented after termination of employment, it is not uncommon for policies to limit the clawback to a specified time period following termination. It can be administratively impracticable to recoup amounts from long-terminated employees, and the enforcement barriers can become more challenging when the connection between the former employee and the company becomes more attenuated.

## 7. Duration of Clawback Right

Amounts subject to recoupment are generally those amounts that are attributable to the period affected by the restatement, the materially inaccurate performance metric criteria, or the misconduct. Consider whether the clawback should be limited to compensation that is paid within a specified period (typically 24 to 48 months) prior to the discovery of the triggering event. The specified period may be different (and possibly unlimited) if misconduct is involved. Recent high-profile executive sexual misconduct cases, in which the misconduct spanned several years, illustrates the need to consider longer clawback periods when misconduct is involved.

## 8. Administration

Administrative considerations include:

- A clawback policy should address which body determines whether a clawback is triggered and is generally responsible for making determinations under the policy.
- Often, clawback policies provide the board of directors (or a committee thereof) with the discretion to enforce the clawback.
- Consideration should be given to establishing a claims procedure in the event that an individual challenges any determinations under the clawback policy.
- The clawback policy should be revisited annually as part of the company's analysis of material risks.

## 9. Documentation and Disclosure

Consideration should be given as to whether a company will adopt a clawback policy or incorporate clawback provisions in the operative compensation documents. If a

clawback policy is adopted, it is generally adopted through a resolution of the board of directors.

After its adoption, the clawback policy may be incorporated into the operative documents, including:

- Shareholder-approved equity incentive plans and arrangements and corresponding award agreements
- Employment agreements and severance arrangements
- Cash bonus plans or other plans and arrangements
- Governance policies of the board of directors (or a committee thereof)

The documents may include specific clawback provisions or incorporate an external clawback policy by reference.

Consideration should be given as to whether to include forward-looking provisions in incentive documentation that provide that the compensation under that agreement is subject to future clawback policies.

The SEC lists clawback policies as an example of an item that should be described in a company's CD&A.

## Drawbacks to Clawback Policies

- Covered individuals may become overly cautious and risk averse.
- Clawbacks might chill performance-based compensation and result in a move toward more fixed pay (i.e., higher base salary).
- The potential application of a clawback to incentive compensation could result in the perception by the covered individual that the value of the incentive compensation is reduced.
- Covered individuals might be less willing to identify situations that might trigger a restatement or a recalculation of performance metrics or other criteria.
- Depending on clawback design, covered individuals may feel pressure to retain previously paid amounts.
- Clawbacks that are currently in place are largely untested.
- It can be difficult to recoup amounts from terminated employees and previously paid amounts to covered individuals depending on their specific financial circumstances.

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