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Here Today, Gone Tomorrow?

Financial Reform Act Requires Compensation Clawbacks

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[1] includes a number of provisions that regulate executive compensation. Among these is a requirement that public companies adopt a policy to recover excess incentive-based compensation paid to executive officers where the issuer must prepare an accounting restatement due to its material noncompliance with any financial reporting requirement under the securities laws.

Clawback Requirements

The Reform Act amends the Securities Exchange Act of 1934 by requiring the Securities and Exchange Commission to direct the national securities exchanges and associations to prohibit the listing of any securities (which would include public debt) of an issuer that fails to implement an incentive compensation clawback policy. The Reform Act directs the SEC to adopt rules that require each issuer to adopt a clawback policy that includes the following:

- If an issuer must prepare an accounting restatement due to its material noncompliance with financial reporting requirements under the securities laws, the issuer must recover certain incentive-based compensation (including stock options).
- The Reform Act clawback provisions cover current or former executive officers.
- The provisions apply to amounts received during the three-year period preceding the date on which the issuer is required to prepare the restatement.
- There is no requirement that the restatement result from misconduct by the issuer or any of its employees.

1 The Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, was signed by President Obama on July 21, 2010. For a general discussion of the compensation-related provisions of the Reform Act, see *Financial Reform Act Brings Significant Executive Compensation Change*, Shearman & Sterling LLP Client Publication, July 15, 2010, available at http://www.shearman.com/Financial-Reform-Act-Brings-Significant-Executive-Compensation-Change-07-15-2010/.

- The amount of compensation subject to recovery apparently would be limited to amounts that would not have been paid to the executive officer if the payment had been made in accordance with the corrected financials under the restatement.
- Issuers must disclose their clawback policy.

The Reform Act does not specify an effective date for implementing the clawback provisions.

Background

Clawbacks are not new. Under Section 304 of the Sarbanes-Oxley Act, issuers must recover compensation from their chief executive and chief financial officers where the issuer is required to prepare an accounting restatement as a result of misconduct.[2] Also, financial institutions that are subject to the Troubled Asset Relief Program must recover compensation from their top 25 employees (basically, their named executive officers and the 20 other most highly compensated employees) if certain incentive compensation is paid based on materially inaccurate financial statements or other materially inaccurate performance metrics. In addition, shareholder rights groups have strongly encouraged public companies to adopt clawback policies as an element of sound corporate governance, and clawback policies are now widespread among public companies.[3]

Compensation clawback policies, however, are hardly uniform and their application varies as to the events that trigger recovery, the individuals covered and the types of compensation subject to recovery. Most public companies that have adopted clawback policies will likely need to adjust their policies to ensure they comply with the Reform Act requirements.

Considerations and Ambiguities

The Reform Act does not specify the date by which issuers must adopt a clawback policy that comports with the new rules. Moreover, regulatory guidance will be required on several points before a compliant policy can be fully implemented, and the Reform Act does not require that guidance be issued by a specific date.

The Reform Act provides a baseline that issuers must meet in order to have a clawback policy that complies with these rules. Issuers are free to design a broader policy covering more individuals, additional types of compensation and longer recovery periods. The following is a summary of the material issues that should be considered in designing a clawback policy or reviewing an existing policy for compliance with the Reform Act.

- Who is covered? The Reform Act requires that the policy cover the "executive officers" of the issuer. For purposes of Rule 3b-7 of the Exchange Act, the term "executive officer" means an issuer's president, any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the issuer. Executive officers of an issuer's subsidiaries may also be deemed to be executive officers if they perform policy making functions for the issuer. It is possible, however, that the guidance could expand the definition of executive officer for purposes of the clawback rules to cover a broader group of current and former employees -- such as all officers subject to

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2 In a case of first impression, SEC v. Jenkins, No. CV-09-PHX-GMS (D. Ariz. June 9, 2010), the United States District Court for the District of Arizona held that the "misconduct" resulting in the restatement need not be the misconduct of the CEO or the CFO.

3 The annual survey by Shearman & Sterling LLP of the public filings of the top 100 U.S. companies by market capitalization shows that the number of companies that disclose that they maintain a clawback policy has increased from 35 in 2007 to 71 in 2010, *Shearman & Sterling LLP 2010 Corporate Governance of the Largest US Public Companies, Director & Executive Compensation*, to be available July 2010, at http://www.shearman.com/corporategovernance.

Section 16 of the Exchange Act. Foreign private issuers are not expressly covered by the clawback provisions of the Reform Act and future guidance may confirm whether they are subject to the rules.

- What type of conduct is covered? Recoupment is required if an issuer must prepare an accounting restatement due to its material noncompliance with any financial reporting requirement under the securities laws. There is no requirement that an accounting restatement result from the misconduct of the issuer or any of its employees, in contrast to Sarbanes-Oxley and the voluntary clawback policies of many companies. In addition, the Reform Act does not define what constitutes "material noncompliance" and the approach that rulemaking might take to this question is far from certain.

- What compensation is subject to clawback and how much must be recovered? "Incentive-based compensation" received by an executive officer is subject to recovery, and the Reform Act specifically calls out "stock options awarded as compensation" in this category. A major challenge in drafting and implementing a clawback policy will be determining how much excess compensation is attributable to the accounting restatement. To illustrate:

  - Many short term incentive plans use both objective and subjective metrics that are applied to determine the amount of the payment. It may be nearly impossible to isolate the amount of excess compensation when subjectivity factors into the determination of a bonus or other payment.

  - Plans that are structured to comply with the performance-based compensation provisions of Section 162(m) of the Internal Revenue Code are required to have objective compensation formulas based upon predetermined performance metrics. However, to accommodate negative discretion, these formulas often generate permissible payment amounts that exceed the amounts actually paid. It is unclear how a clawback amount will be calculated when negative discretion was exercised to determine the amount of the original compensation.

  - The Reform Act requires that an issuer must recover incentive-based compensation that current or former executive officers received during the three-year period preceding the date on which the issuer is required to prepare an accounting restatement. Determining the amount to be recovered may be challenging in certain circumstances.

    It is unclear whether all stock options and other equity-based compensation awards will be considered "incentive-based compensation" for purposes of the Reform Act's clawback requirements. Equity awards that are granted, or earned, contingent upon the achievement of financial performance metrics will likely be subject to clawback if such awards would not have been granted or earned after the issuer's accounting restatement. On the other hand, where the grant or earning of equity awards is not contingent on the satisfaction of financial performance metrics, serious questions exist as to whether such awards should be subject to clawback, even though the underlying stock price might have been affected by the accounting restatement. Even for equity awards that are contingent on financial performance, issues remain as to the application of the clawback requirement. The Reform Act provides no guidance on determining the amount "received" by executive officers in respect of equity awards that were erroneously granted or earned based on misstated financials. Possible determination methods could be to value the awards based on the underlying stock price at the time the relevant financial performance metric was incorrectly deemed satisfied, the time of exercise or payment of the award, or the time that the award vested. Presumably, if an equity award becomes subject to clawback prior to being exercised or paid, recoupment would be effected through the forfeiture of the award.

Stock options present a unique challenge, as the value of the option is, of course, based on the market value of the issuer's stock over the strike price of the option. Separate rules may need to be applied to address options that have already been exercised, unexercised vested options and unvested options. Special rules may also be needed for options that have vested or are scheduled to vest based on performance metrics that are affected by the accounting restatement. Issuers will also face similar challenges in determining the amount of excess compensation to be recovered with respect to vested stock rights and other forms of equity-based compensation.

- What period is covered by the policy? An issuer must recover incentive-based compensation received during the three-year period preceding the date on which the issuer is required to prepare an accounting restatement. It is not, however, entirely clear when that three-year period actually begins. The words "required to prepare" suggest that the three-year period is measured from the date that it is decided a restatement is required, but it is unclear how this date should be determined (outside of a determination by a regulatory authority or court).

- How is the policy to be enforced? One of the more significant areas requiring additional guidance is how a clawback policy will be administered and enforced by an issuer. The Reform Act requires an issuer to recover incentive compensation that is paid based on erroneous data contained in the issuer's financial statement. It is unclear whether an issuer must seek recovery of all amounts, including de minimis amounts, or seek recovery in situations where it is unlikely that the issuer will be able to recover any amounts (such as in the case of a former executive who resides in a non-U.S. jurisdiction that prohibits the recovery of wages).

  Additional guidance could clarify the mechanisms that may be used to enforce a clawback policy. Among the items that could be addressed are the following:

  - Whether an issuer may enforce a clawback policy by seeking the forfeiture or cancellation of unpaid or unrealized compensation (such as cancelling vested stock options or unvested stock rights) or by not granting future incentive compensation awards.
  - The interplay between the Reform Act and state wage laws that limit the circumstances under which an employer may offset amounts from an employee's wages.
  - Whether rulemaking will guide issuers in situations where they seek to recover compensation from employees residing in non-U.S. jurisdictions where the recovery may be problematic under local law.

Tax Treatment of Clawbacks

The clawback of compensation paid to an individual (and subject to Federal income tax) in a prior year should not affect the individual's tax return for that prior year. Instead, in the taxable year in which the clawback amounts are repaid, the individual should be entitled to a loss deduction for Federal income tax purposes under Section 165(a) of the Internal Revenue Code, or may be eligible for a tax credit relating to the inclusion of the clawback amount in income in the prior year under the "claim of right" principles of Section 1341 of the Internal Revenue Code.

Next Steps

Although further guidance is required before an issuer can implement a compensation clawback policy that complies with the Reform Act, issuers should begin to review their incentive compensation plans and arrangements to identify those arrangements that provide for the delivery of compensation based on the direct or indirect achievement of specific performance metrics or the performance of the issuer. Issuers that have already implemented a clawback policy should examine their policy to determine whether it complies with the Reform Act and subsequent guidance. Companies that have not yet adopted a clawback policy should consider potential design issues in light of the Reform Act requirements.

The introduction of a federal standard for clawbacks introduces the risk that companies will adopt or modify clawback policies in order to meet the federal standard, without doing more. Some companies have already implemented clawback policies that are more stringent than the standards mandated by the Reform Act, and, for example, require repayment of incentive compensation in situations where there has not been an accounting restatement or apply to employees other than executive officers. It remains to be seen whether the standards of the Reform Act will emerge as a de facto “least common denominator” for clawbacks and supplant company-specific policies.

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