BNA

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Executive Compensation

Experts Advise Compensation Committees To Prepare for SEC Clawback Requirements

■ ***Practice Tip:*** *All public company compensation committees should consider tax and enforcement issues relating to clawbacks when negotiating new executive compensation agreements, and also consider modifying existing compensation and separation agreements, to avoid compliance problems when the Securities and Exchange Commission adopts its final rules concerning mandatory executive compensation clawbacks.*

Despite the uncertainty surrounding the pending adoption of mandatory clawback requirements authorized in Section 954 of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, companies should take action now to ensure that executive compensation agreements will comply with the forthcoming SEC rules, executive compensation experts recently told BNA.

Some companies have taken precautionary measures while others are taking a wait-and-see approach, but experts said that most companies are not yet in compliance with what is already known about Section 954 and that this could cause problems once the final rules go into effect. Compensation experts said they are advising clients to weigh the different methods of enforcing a clawback, consider potential tax issues arising from Internal Revenue Code Section 409A, and facilitate compliance by inserting clawback language into existing compensation agreements and new agreements.

The SEC said April 8 that rules to implement Dodd-Frank Section 954 are scheduled to be proposed and adopted in the August to December time frame (9 CARE 434, 4/15/11). Interested parties have been providing input about the rules since July 2010, when the Act was signed into law, by submitting comments and meeting with SEC officials.

Most Companies Not in Compliance. Melissa Burek, a partner at the New York-based compensation firm Compensation Advisory Partners LLC, said July 14 that clawbacks will be an important issue for many large companies in the coming months.

Burek said that from what she's seen, "most companies are not in compliance." While the vast majority of top companies have some kind of clawback policy, she said, few are even in compliance with what is already known about the upcoming Dodd-Frank requirements on executive compensation.

Of the companies she has examined, Burek said that most do not include former executives in their clawback policies and not all policies cover pay in the three years preceding the clawback, as required by Dodd-Frank. She added that most policies currently require that misconduct take place before a clawback is triggered. Section 954, however, requires companies to adopt clawback policies that recoup incentive pay awarded based on "erroneous data," even if the error was not the result of misconduct. Burek also said many companies' clawback policies do not apply to all forms of equity compensation. The language in Dodd-Frank is unclear

Basic Clawback Requirements.

Regulations have not yet been issued under new Section 10D of the Securities Exchanges Act of 1934, but some basic requirements are clear. A compliant clawback policy must:

- cover current and former officers,
- apply to stock option awards,
- use a three-year clawback window, and
- trigger without requiring misconduct or fault.

Text of Dodd-Frank Section 954.

The Securities Exchange Act of 1934 is amended by inserting after section 10C, as added by section 952, the following:

SEC. 10D. RECOVERY OF ERRONEOUSLY AWARDED COMPENSATION POLICY.

(a) LISTING STANDARDS.—The Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not comply with the requirements of this section.

(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.

about which kinds of equity compensation will be subject to recoupment, but the legislation does explicitly mention stock options.

Companies are concerned about enforcement issues surrounding clawbacks, Burek said, but most have not yet addressed this concern. ''They haven't thought through the enforcement yet,'' she said. Most clawback policies call for recoupment of compensation paid rather than withholding future pay or holding pay in escrow until the three-year clawback window expires, Burek observed.

Burek said the implementation of clawback provisions has increased scrutiny on the alignment of pay for performance, but this will not cause companies to shy away from performance bonuses. ''This won't influence the structure or prevalence of incentive compensation,'' she predicted. Burek added that she does not expect the new Dodd-Frank rules to cause major changes in the corporate governance arena either. ''This all falls under the umbrella of risk mitigation,'' she said. ''Clawback policies used to be a negative for recruiting, but now everyone has one.''

What Companies Can Do Now.

Many public companies have already taken action to facilitate compliance with what is already known about new Section 10D of the 1934 Act, even though regulations have not yet been promulgated under that section. Steve Barth, co-chair of Foley & Lardner LLP's national Transactional & Securities Practice, told BNA that companies would be wise to:

- Use clawback language that references Dodd-Frank to incorporate the final rules,
- Insert clawback language into new executive compensation agreements,
- Modify existing agreements to get written acknowledgment of consent to clawbacks, and
- Check indemnification and mandatory arbitration clauses for clawback litigation issues.

Executive Compensation Study. An August 2010 report by Equilar,[1] a California-based executive compensation data firm, corroborates Burek's observations. ''From 2006 to 2010, the number of *Fortune* 100 companies with publicly disclosed clawback policies increased from less than 20 percent to over 80 percent,'' according to Equilar's 2010 Clawback Policy Report. However, fewer than 20 percent of *Fortune* 100 clawback policies are triggered by the issuance of a financial restatement, while nearly 80 percent of *Fortune* 100 clawback policies have provisions allowing companies to recoup pay if an executive behaves unethically. Dodd-Frank mandates clawback policies that trigger on a required financial restatement even if no ethics violations or misconduct occurred.

While there is still some uncertainty about which forms of compensation will be subject to the Dodd-Frank clawback rules, the report found that only 25 percent of *Fortune* 100 clawback policies allowed for recoupment of stock option compensation, which is specifically mentioned in Dodd-Frank.

One area where most companies' policies are probably already in compliance with the eventual rules is the scope of current employees covered. The Equilar report found that over two-thirds of *Fortune* 100 clawback policies cover at least the Section 16 officers, with some policies extending to all employees who receive incentive-based compensation.

Companies Should Take Precautions. Steve Barth, co-chair of Foley & Lardner LLP's national Transactional & Securities Practice, said July 11 that companies should take precautions to facilitate compliance when the eventual rules go into effect.

Barth said that some companies have adopted very general clawback language in their current incentive compensation agreements that references the Dodd-Frank requirements. That language can be adapted later, he explained, when the final rules are adopted. ''There needs to be some kind of written agreement, a contractual acknowledgement'' of the coming mandatory clawbacks, he said. ''When should companies have these in place? The sooner the better,'' Barth said.

[1] www.equilar.com.

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MELISSA BUREK
COMPENSATION ADVISORY PARTNERS LLC

Companies have adopted clawback provisions in their corporate governance policies, in general incentive plans, and in compensation agreements. Generalized clawback policies may be enforceable, but Barth said that he recommends against that approach. Clawback provisions written in the incentive plan and referenced in compensation agreements are better than general clawback policies, but the best approach is to put the clawback language directly in the individual compensation agreements, he explained.

Barth said that once the final rules come out, some companies will need to get executives to sign contract modifications indicating consent to clawbacks. As consideration for these contract modifications, he suggested that companies can make them a requirement for eligibility for future incentive plans.

Much Uncertainty Remains. It is not yet known precisely which executives need to be covered by a company's clawback policy, but Barth said that many companies' clawback policies have been broad—even broader than the rules will likely require. He said he recommends that companies include clawbacks for all Section 16 officers, but he reported that some companies have taken the position that anyone receiving incentive compensation should be included. "There is a sense that having broad-based no-fault clawbacks will encourage everyone to get financial statements right the first time," he said. Getting incentive-based compensation clawed back would be worse than having never received the compensation at all, Barth noted, because of the complex tax issues involved.

Barth predicted that modification of indemnification clauses will definitely be an issue under the forthcoming clawback rules, but companies haven't started implementing these changes. However, Barth said that without modification these clauses could complicate litigation in the event of a clawback. He suggested that mandatory arbitration clauses should be explored as a way to avoid those types of situations.

Example: Incentive Plan Clawback Language.

Ex. 10.1 to Form 8-K, United States Cellular Corp., June 27, 2011

"Any compensation earned or paid pursuant to this Plan is subject to forfeiture, recovery by USCC or other action pursuant to any clawback or recoupment policy which USCC may adopt from time to time, including without limitation any such policy which USCC may be required to adopt under the Dodd-Frank Wall Street Reform and Consumer Protection Act and implementing rules and regulations there under, or as otherwise required by law."

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FOLEY & LARDNER LLP

As for global executives in countries where clawbacks are disfavored, Barth said that one option is holding incentive compensation in escrow in case a clawback becomes necessary. However, firms have been extremely reluctant to implement these "holdbacks," he said. Executives are "incensed at the presumption of guilt" they perceive in such a policy, he said, and in many cases would be required to pay taxes on compensation they hadn't yet received.

What to Expect. John E. McGrady III, a member of the Executive Compensation Practice Group at Buchanan, Ingersoll & Rooney PC in Pittsburgh, Pa., explained July 19 how decisions regarding similar laws could provide some idea of what to expect when the final SEC rules go into effect. He noted that in 2010, the Second Circuit in *In re DHB Industries Inc. Derivative Litigation,* (2d Cir., No. 08-3860-cv, 9/30/10) struck down provisions in a settlement agreement indemnifying executives against liability under the clawback provisions in Sarbanes-Oxley (8 CARE 1087, 10/8/10). "While this case will not serve as legal precedent under Section 954 of the Dodd-Frank Act," he said, "it strongly suggests that executive officers will not likely be able to negotiate an end-run around the statutory claw back requirements." McGrady added that in light of the increased risk posed by no-fault clawback liability, "compensation committees are likely to receive pressure to increase non-performance based compensation, and otherwise increase the overall levels of compensation."

"Employers, however, will have the burden of enforcing the policy," McGrady said, "and it is uncertain whether employers will be permitted to exercise any discretion in the enforcement of the policy." The board typically retains discretion in existing clawback policies, he explained, which allows it to exercise judgment in the enforcement of the policy when, for example, enforcement costs may exceed the amount of compensation to be repaid.

"Enforcement of the policy and the development of a meaningful enforcement mechanism will likely prove to be one of the most challenging issues employers will face," McGrady said. "In addressing enforcement issues, compensation committees and/or the Board of Directors may find it necessary to retain independent legal counsel," he suggested, "as the use of independent counsel may be necessary as a practical matter to ensure a meaningful and harmonious working relationship between internal counsel and the employer's executive officers."

While recoupment of awarded compensation is currently the most common clawback enforcement method, McGrady said, employers will need to evaluate

Example: Individual Clawback Language.

Ex. 10.10 to Form 8-K, Biozone Pharmaceuticals Inc., July 7, 2011

''The parties acknowledge it is their intention that the foregoing Clawback Rights as relates to Restatement conform in all respects to the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the 'Dodd Frank Act') and requires recovery of all 'incentive-based' compensation, pursuant to the provisions of the Dodd Frank Act and any and all rules and regulations promulgated thereunder from time to time in effect. Accordingly, the terms and provisions of this Agreement shall be deemed automatically amended from time to time to assure compliance with the Dodd Frank Act and such rules and regulation as hereafter may be adopted and in effect.''

whether holdbacks or deferments warrant consideration. These other arrangements ''will potentially allow for easier recovery,'' he noted, ''particularly with respect to former executive officers.'' However, because of the limitations on deferring, accelerating, offsetting, or substituting compensation in Internal Revenue Code Section 409A, ''employers must be very careful in designing repayment obligations'' involving holdbacks and deferments, he cautioned. ''In this regard, the exercise of employer discretion or an employee election as to the manner in which a clawback is enforced will also need to be thoroughly vetted to address potential issues under Section 409A of the Code,'' he said. However, he added that the current guidance under 409A does not cover all of the potential situations that could arise under Section 954 of Dodd-Frank, and that ''additional relief from the IRS will likely be necessary and desirable.''

For calculating taxes, generally if wages are recouped in the same taxable year that they were received, the recouped amount is excluded from the employee's taxable wages for that year, McGrady said. However, if an employee is required to repay wages from a prior year, he continued, the employee may not offset the current year's wages and may not amend the tax return for the prior year in which the wages were originally paid. Instead, the employee must claim a deduction in the year of repayment to attempt to recover prior tax payments, subject to the two-percent floor for itemized deductions and the Alternative Minimum Tax limits. ''The tax treatment of holdbacks is potentially more favorable,'' he said. McGrady observed that ''at least two IRS Revenue Rulings have concluded that holdbacks from the current year's wages to repay amounts received in a prior year are excluded from the employee's current year's wages.'' [2]

[2] Rev. Rul. 2002-84 (Situations 1 & 2) and Rev. Rul. 80-9.

Example: Clawback Policy Consent Language.

Ex. 10.6 to Form 8-K, Robbins & Myers, Inc., October 12, 2010

''2. The Executive hereby acknowledges and agrees that the Policy shall apply to any annual incentives, equity-based awards (including, without limitation, performance-based restricted stock units, time-based restricted stock units and stock options) and other performance-based awards granted on or after October 1, 2010 (collectively, the 'Compensation'), and all such Compensation shall be subject to repayment or forfeiture under the Policy . . .

5. The Executive acknowledges that the Executive's execution of this Agreement is in consideration of, and is a condition to, the receipt by the Executive of future Awards from the Company; provided, however, that nothing in this Agreement shall be deemed to obligate the Company to make any Awards to the Executive in the future.''

''Compensation committees are likely to receive pressure to increase non-performance based compensation, and otherwise increase the overall levels of compensation.''

JOHN E. MCGRADY III
BUCHANAN INGERSOLL & ROONEY PC

''The IRS and the courts, however, have not been consistent in this area and uncertainty remains. Under either approach, however, employers have a web of complexity to resolve in designing and implementing their clawback policy,'' he said.

Barth predicted that once SEC rules are proposed, they are not likely to be finalized hastily. He expects to see a lot of comments from compensation advisors and shareholder representatives like ISS. ''This issue is at the top of the list at compensation firms,'' Barth said. He expects a flurry of activity when the proposed rules are announced, and again when the final rules are adopted. McGrady said that ''employers may still have an opportunity to influence the scope of these rules by submitting public comments to the SEC once the proposed rules are issued.''

BY PIERRE GREENE