

Morgan Lewis

Executive Compensation Clawbacks

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Clawbacks

- Clawback (klô bǎk) *noun*: An arrangement to take money back from people that they were given in another way

or



Agenda

- Historic development and use of clawbacks:
 - Non-compete or “bad boy” provisions
 - Reimbursement of advances (sign-on bonuses, relocation bonuses)
 - Sarbanes-Oxley clawback requirements
 - TARP clawback requirements
- The future of clawbacks:
 - Trends and best practices
 - RiskMetrics Group (RMG or ISS)

Noncompete Clawbacks

- Historical use and development
 - Employment agreements/equity compensation plans
 - Non-compete
 - “Bad boy”
 - Reimbursement of advances
 - Sarbanes-Oxley
 - Limited coverage
 - Limited applicability
 - TARP
 - Broader coverage and applicability than SOX

Noncompete Clawbacks

- Clawbacks have historically been used to enforce non-compete and “bad boy” provisions in employment agreements
- Bad boy triggers can include:
 - Disclosure of confidential information
 - Violation of non-solicitation restrictions
 - Conviction of a crime, whether or not related to service at the company
 - Violation of company rules and policies
 - Engaging in “detrimental conduct”
- Clawback extends to option gains, performance based compensation (cash or stock)

Noncompete Clawbacks

- State law concerns
 - Many state wage payment laws prohibit employers from withholding employees' wages, absent narrow exceptions
 - E.g., in Connecticut, state wage laws permit deductions from wages if the employee provides written authorization on a form approved by the state labor commissioner
 - In California, all deductions are prohibited unless the employee expressly authorizes AND the deduction does not amount to a rebate or deduction from the standard wage pursuant to a wage agreement
 - Where state laws broadly define "wages," deductions in the form of forfeiture of earned compensation may be problematic
 - For example, state laws may construe a clawback as a violation of state law prohibitions on non-competes (e.g., California)
 - However, state laws against self-help would not necessarily limit the employer from suing the employee for repayment – issue in that case would be enforceability (e.g., public policy)

State Law Concerns

- What constitutes “wages”
 - California takes an expansive view of the term “wages” – all amounts for labor performed by employees of every description, including bonuses and incentive plans (but not options)
 - California also generally prohibits all noncompetes with only limited exceptions
 - Other state laws vary as to whether (and when) incentive compensation is treated as wages
 - Issue is when bonuses subject to a clawback become “wages” – when earned initially, or only after clawback conditions are satisfied?

SOX Clawback

- Sarbanes-Oxley Act of 2002 – Section 304
 - Requires compensation disgorgement for violations of federal securities law
 - Trigger: If issuer is required to prepare an *accounting restatement* due to the material noncompliance of the issuer, as a result of *misconduct*, with any financial reporting requirement under the securities laws
 - Applicable only to CEO and CFO

SOX Clawback (continued)

- Scope of compensation to be recovered:
 - Bonus or other incentive-based or equity-based compensation received during the *12-month period* following the first to occur of public issuance or filing with the SEC of the financial document
 - Profits realized from the sale of securities of the issuer during that *12-month period*
- SEC has enforced where CEO or CFO was personally involved in misconduct at issue
- No private right of action

TARP Clawback

- Emergency Economic Stabilization Act of 2008 (“EESA”) (10/3/08) establishes TARP
 - Requires institutions receiving TARP funds to establish executive compensation standards (e.g., clawbacks)
 - Trigger: If bonus or incentive compensation paid is based on statements of earnings, gains or *other criteria* that are later proven to be *materially inaccurate*
 - Applicable to senior executive officers (“SEOs”) (*i.e.*, CEO, CFO and next 3 most highly-compensated executives)
 - Scope of compensation to be recovered:
 - Bonuses
 - Incentive compensation

TARP Clawback (continued)

- Treasury Press Release (2/4/09) requires institutions receiving TARP assistance to mandate (**status of guidance is uncertain*):
 - CEOs repay compensation if awards are based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate
 - Next 20 executives repay bonuses and incentive compensation if they *knowingly engaged* in providing inaccurate information relating to financial statements or performance metrics used to calculate their incentive pay

TARP Clawback (continued)

- Capital Purchase Program (“CPP”) requires (**status of guidance is uncertain*):
 - Compensation is subject to clawback if payments were based on materially inaccurate financial statements or *any other materially inaccurate performance metric criteria*
 - Clawback covers compensation that individual obtains a *legally binding right to payment* regardless of when compensation is paid
 - Institution not required to recover compensation based on financial statements that become materially inaccurate solely because of revisions to GAAP

TARP Clawback (continued)

- American Recovery and Reinvestment Act of 2009 (“ARRA”) (2/17/09) amends EESA (**effective date of ARRA executive compensation restrictions is uncertain*)
 - Requires institutions receiving TARP funds to establish executive compensation standards (e.g., clawbacks) applicable during period financial assistance remains outstanding
 - Trigger: If bonus, *retention award*, or incentive compensation paid is based on statements of earnings, *revenues*, gains or *other criteria* that are later found to be *materially inaccurate*
 - Applicable to CEOs and expands subject individuals to include *next 20 most highly-compensated employees*
 - Scope of compensation to be recovered:
 - Bonuses
 - Retention awards
 - Incentive compensation

Comparison of Clawbacks Under SOX and TARP

	SOX	TARP-ARRA
Subject Institutions:	Public	Institutions receiving TARP funds
Subject Individuals:	CEO and CFO	5 CEOs and next 20 most highly-compensated
Trigger:	Accounting restatement, as a result of misconduct	Award paid is based on statements of earnings, revenues, gains or other criteria that are materially inaccurate <i>(note: misconduct not required; accounting restatement not required)</i>
Duration:	Limited to compensation and profits received during 12-month period	Clawback applicable during period financial assistance remains outstanding

Trends and Best Practices

Trends

- Non-TARP Adoption of Clawback Policies
 - Responding to public backlash to executive compensation
 - RiskMetrics 2009 Voting Guidelines
 - Proposals to recoup unearned incentive bonuses or other incentive payments where fraud, misconduct, or negligence significantly contributed to a restatement of financial results that led to the awarding of unearned incentive compensation

Trends and Best Practices

- Wage and hour law issues
 - Noncompete provisions
 - Arguably, state laws against restraints on lawful competition wouldn't apply to the extent that the clawback policy is to promote a public policy unrelated to the noncompete
 - Discourage perceived manipulation or opportunity to manipulate data for payment of incentives
 - Discourage other identified “bad boy” behavior

Trends and Best Practices

- Anti-forfeiture Provisions
 - Clawback policy as a “condition subsequent” versus a “condition precedent”
 - Does this make a difference?
 - Is compensation that has been earned subject to anti-forfeiture provisions?
 - Does it help to obtain consent in writing up front to a forfeiture provision?

Trends and Best Practices

Best Practices

- If not subject to TARP, policy should:
 - Start from existing statutory standard
 - Modify to address specific issue(s)
 - Consider what you are trying to achieve
 - Perception by shareholders
 - Perception by employees
 - Draft narrowly to meet intention
 - Applicable to appropriate group of employees
 - Consider appropriate time limit

Trends and Best Practices

- Best Practices, continued
 - How much discretion to be retained
 - Make sure policy is enforceable/coordinate with grant terms
 - Think about who will be administering the clawback (e.g., after a change in control)
 - Get consent of affected executives in writing up front

Tax Treatment of Clawback

- Generally, income to employee in year of actual or constructive receipt
 - Should be no income if payment and clawback occur in the same tax year of employee
- Employee can take a loss deduction under Section 165(a) for tax year of clawback
 - Subject to 2% of AGI restriction
- May be eligible for tax credit under Claim of Right (Section 1341)

Tax Treatment of Clawback

- Generally, employer takes deduction for year of payment
- Income for year of repayment
- No deduction/income if clawback occurs in same year as payment

Case Study

- Chairman of the Board of Company XYZ, a California corporation, wishes to adopt a clawback policy that would apply to all officers of the company and would require the return of all bonuses, equity grants and option gains if the policy is breached by an officer while employed by Company XYZ
- With these goals, Chairman drafts a policy that reads as follows:

Case Study

“To the extent any officer of Company XYZ or one of its subsidiaries engages in any action that is determined by the Compensation Committee of the Board of Directors, in its sole discretion, to be materially detrimental to the interests of Company XYZ or any of its subsidiaries, such officer shall be required to:

Case Study

- Repay to Company XYZ all incentive bonuses paid to such officer within the last 5 years
- Forfeit all equity awards held by the officer which was granted to the officer within the last 5 years (including all vested and unvested awards)
- If the officer sold equity that was granted to him/her within the last 5 years, the officer must pay to Company XYZ the profit from such sale, and
- to the extent any options were exercised by the officer within the past 5 years, officer must pay to Company XYZ any profit from such exercise and return any shares held by officer as a result of such exercise

Case Study

- For purposes of this policy, the officer engaging in actions that are materially detrimental to the Company, includes, but is not limited to, any actions that result in a restatement of the financial records of the Company, any actions that are determined to be unnecessarily risky or creates unnecessary risk, any breach of a non-competition, non-solicitation and confidentiality agreement, and any other action that is determined by Compensation Committee to not be in the best interests of Company XYZ and its shareholders."

Case Study

- Is the policy too broad?
- Would the policy be enforceable?
- Is it better to have each officer specifically agree to the terms of the policy?
- Consider what power/responsibility is placed in the hands of the Compensation Committee

Case Study

- Is the clawback lookback period appropriate?
- What happens if the policy is determined to be breached after an officer terminates employment?
- Should this policy be published in public filings?
- Is this appropriate for a private company?

Questions?

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