
How Effective Is Your Clawback?

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Clawback provisions in employment agreements and compensation plans, which permit a company to recoup bonus or other compensation paid or owed to an employee, are on the rise. Shareholder groups, legislators and compensation reform advocates endorse clawbacks as an effective tool to prevent executives and other employees from retaining undeserved windfalls and to enhance pay-for-performance initiatives. Their use is receiving particular attention in the banking sector, where incentive-based pay often comprises a large portion of overall compensation, but clawback provisions are proliferating across all industries among private and public companies. Equilar reports that the number of Fortune 100 companies having clawbacks increased from 17% to over 70% since 2006.

A company's clawback policy may bear little resemblance to the similar statutory measures found in the Sarbanes-Oxley Act and Troubled Asset Relief Program ("TARP") legislation. Those provisions are limited in scope, applying only to the CEO and CFO of public companies under Sarbanes-Oxley and to a certain number of top executives and highly paid employees of TARP participants. Only a financial restatement arising due to misconduct gives rise to the Sarbanes-Oxley clawback, which may be enforced solely by and at the discretion of the SEC. TARP clawbacks may be triggered by any material mistakes in financial statements or performance criteria related to the compensation subject to recovery, and companies are required to enforce the measures unless doing so is demonstrably unreasonable.

Compensation committees considering such measures have great flexibility in fashioning a clawback policy to strengthen the company's existing compensation structure and strategic goals. Among the considerations that should be taken into account when developing a clawback policy are:

- What type of compensation should be subject to recovery (e.g., should the provision apply only to particular bonuses or more broadly; should it apply to both cash and equity compensation)? Will the company attempt to recoup paid amounts in addition to deferred and/or unvested compensation? Should the employee be required to return the gross amount paid or an amount net of taxes?

- Which employees should be subject to the rule (e.g., senior executives only, all employees with incentive-based compensation or other particular groups of employees)?
- What triggering event(s) should be employed?
 - Will fraud or wrongdoing be required, or is a “no-fault” approach more appropriate where any mistake in the applicable financial statements or performance criteria may invoke the provision? And for triggers requiring wrongdoing, will the repayment obligation be limited only to those who perpetrated or had knowledge of the wrongful acts or be applied more broadly? For example, should a division leader’s performance bonus be subject to recovery if a member of the unit misstates (deliberately or unintentionally) financial data relating to the bonus?
 - Should events unrelated to erroneous or fraudulent financial data trigger a clawback? A number of companies permit forfeiture or recovery of compensation from certain employees who cause significant financial losses or reputational harm to the company. Some financial institutions have adopted provisions allowing them to clawback bonuses based on the long-term results of the employee’s activities over the applicable performance period.
 - Consideration should be given to procedural issues when deciding upon the appropriate trigger, such as the process to be used to determine whether wrongdoing has occurred and by whom, or whether a mistake is “material,” for purpose of the clawback.
- How long should compensation earned by an employee be subject to the clawback? For example, a provision might apply to any unpaid amount and amounts paid over the previous one, three or five year period, or there may be no formal limit. The appropriate term may be affected by the type of compensation, logistical constraints on recoupment, and the applicable enforcement mechanisms.
- What discretion should the board of directors (or other enforcement body) have in administering the clawback measure? Should there be circumstances where enforcement is mandatory to the extent practicable?
- How should these design elements interact? For example, notwithstanding the general policy, should a clawback triggered by fraud apply to compensation whenever earned or require repayment of the gross amount rather than net of taxes?

The answers to the questions posed above will depend on the reasons underlying adoption of the policy and the circumstances surrounding the company’s compensation scheme. Clawbacks can be employed for myriad purposes. They have long been used as an enforcement mechanism for restrictive covenants, such as non-competition, non-solicitation or confidentiality clauses. Today, companies may be more interested in ensuring that incentive pay is based on appropriate time horizons; and clawbacks can offer a backstop against payment of bonuses based on fleeting or illusory gains in performance metrics. Many clawback provisions are also drafted to be triggered by violations of company policy or ethical misconduct.

Legal and Enforcement Considerations

Regardless of the reasons for adopting a clawback policy, certain legal issues must be addressed at the outset of its implementation. A failure to take into account the legal context may undermine the company’s ability to recoup payments.

Wage laws in some states may limit the ability to recover amounts paid or owed in connection with the performance of services. Even some bonus compensation that has not yet been paid may not be forfeitable if the amount is considered “wages” that are owed to the employee. Often, the degree of employer discretion in awarding the bonus will be determinative as to whether the compensation is considered non-forfeitable. Once paid, however, even a discretionary bonus may be deemed to be wages not subject to forfeiture.

In the U.S., applicable state law may also limit the utility of clawbacks triggered by the breach of a restrictive covenant. Restrictive covenants may be wholly or partially unenforceable in some states. Recovery under such a clawback provision in these jurisdictions may not be possible. Multinational companies must consider applicable foreign law as well.

Relevant jurisdictions should be identified not only to determine the legal limitations to recovery, but also to ensure that appropriate steps are taken as soon as a policy is agreed upon to facilitate enforcement. At a minimum, this should include comprehensive documentation of employee communications, including acknowledgments and/or consents from the individuals subject to the clawback. The simplest enforcement mechanism, of course, is the forfeiture of prospective payments, but even these straightforward designs may be problematic if the employee may be construed as having a legal right to the compensation.

Another enforcement issue concerns the treatment of an employee who is financially unable to repay the required amount or who would suffer undue hardship by doing so. Both business and legal considerations may be implicated by the company's actions. For example, agreeing to accept payment over an extended period of time could implicate the Sarbanes-Oxley Act's prohibition against issuing companies granting loans or extending credit to executive officers and directors. A clawback policy that provides the company considerable discretion in application and enforcement will generally leave it with more options in such cases. Nevertheless, it may be desirable to determine default procedures to be followed in order to ensure consistent and fair implementation of the clawback.

Tax Issues

Section 409A of the Internal Revenue Code of 1986, as amended (the “Code”), imposes penalty taxes on employees whose deferred compensation is paid at a time or in a manner that does not comply with certain requirements of that section. A repayment obligation triggered by a clawback provision could lead to a violation of Code Section 409A offset rules. This can occur when negotiating severance payments, which may be considered deferred compensation for purposes of Code Section 409A. For example, a non-compliant payment may arise if a clawback repayment is offset against future payments of the employee's deferred compensation. Although the Code Section 409A regulations permit an employee to repay up to \$5,000 per year of a debt to an employer with a future offset of deferred compensation payments, such arrangements must be provided for in the applicable plan and the debt must be incurred in the ordinary course of the service relationship between the employer and employee. It is not clear that a repayment obligation under a clawback provision would constitute such a debt.

Other tax issues include the proper accounting and tax treatment of amounts that were paid and employment taxes withheld in a prior tax year and related repayments of such amounts in a subsequent year due to the clawback. (If repayment occurs in the same year as the original payment, no portion of the amount that is repaid is considered income.) The employer usually takes a deduction in the year payment is made and recognizes income in the amount of any repayment occurring in a later tax year.

Generally, an employee may take a loss deduction under Code Section 165(a) in the tax year a clawback repayment is made and may be eligible for a tax credit as a “claim of right” under Code Section 1341. The purpose of the “claim of right” credit is to compensate an employee when the tax burden arising from including the compensation in the year it was paid exceeds the tax benefit of deducting the amount repaid to the employer in a subsequent tax year. The availability of Code Section 1341 relief may be limited in certain circumstances, including when an employee makes a Code Section 83(b) election to immediately include in income compensation in the form of property (e.g., restricted stock) that is subject to a substantial risk of forfeiture. The threat of a clawback provision could therefore affect the decision to make a Code Section 83(b) election.

Conclusion

A well-crafted clawback policy can enhance the company’s overall compensation strategy by establishing a viable disincentive against fraud and excessively risky or other harmful activities. Adopting such measures can signal to investors that the company is taking a proactive approach to improve pay-for-performance principles. However, it is essential that compensation committees implementing clawbacks understand both the benefits and the limitations of clawback provisions and carefully integrate them with existing compensation plans and agreements.

If you have any questions about the content of this advisory, please contact the Pillsbury attorney with whom you regularly work or any of the members of the Executive Compensation & Benefits group.

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