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How Public Companies Can Prepare for the Executive Compensation Clawback Regime

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Many public companies have not waited for the Securities Exchange Commission (SEC) to mandate executive compensation recovery policies, as required by the Dodd-Frank Act. Shareholder and peer pressure has resulted in the adoption of a range of clawback policies. However, virtually all of these policies must – as a condition to stock exchange listing – be tightened substantially to comply with the rule recently proposed by the SEC.[1] Companies that have not yet adopted such policies will need to do so once the exchange listing standards are adopted.

Under Rule 10D-1, a public company would be required to adopt, disclose and enforce a policy providing that, if it is required to restate financial statements due to material noncompliance with financial reporting requirements, it will recover from any of its current or former executive officers who became entitled to receive incentive-based compensation during the preceding three fiscal years so much of that compensation as exceeds what would have been paid absent the error.

The rule is subject to comment and may be revised before it is final, and will then need to be translated to listing standards by the stock exchanges, so any actual recoupment of compensation will not be required for some time. But public companies should not wait to prepare.

First, to the extent any company needs an additional incentive to ensure that its financial statements comply with financial reporting requirements, the initial compliance date – as of which a clawback could be triggered by material error – will be when the SEC rule is finalized: potentially as early as September 30 of this year, but more likely December 31.

Second, even though some details of the rule may change before final adoption, there are a number of issues and processes that companies can and should address in advance to ensure a smooth transition to the new regime.

Updating Existing Clawback Policies

Most existing clawback policies will need to be tightened to comply with Rule 10D-1. In particular:

- Existing policies typically allow the Board complete or substantial discretion in deciding whether to seek recovery and on what basis. The proposed rule allows no discretion, and permits the company to cease recovery efforts only if they would cost more than the amount of the proposed recovery (or, for foreign private issuers, in some circumstances where recovery would violate home country law).
    - *Note that the lack of discretion seems to resolve concerns over whether a company's equity grants might be subject to variable accounting treatment, requiring potentially uncapped mark-to-market charges during the clawback period.*
- Existing policies typically provide for recovery in the event the financial statements were misstated due to misconduct, and then only from the persons responsible (sometimes only fraudulently) for the misconduct. The proposed rule provides for recovery on a no fault basis; i.e., (i) irrespective of the reason for the misstatement and (ii) from all persons who were executive officers and received incentive-based compensation the amount of which was increased by the misstatement.
    - *Most companies' policies include additional triggers for a clawback, such as breach of corporate policies, breach of noncompetition covenant, and other actions constituting "cause." These would not be affected by Rule 10D-1.*
- Existing policies may limit the type of compensation that is recoverable, or give the Board discretion to decide which compensation is recoverable. Some companies now limit recovery to vested equity. The proposed rule requires clawback of all excess "incentive-based compensation," whether cash or equity and whether vested or not.
    - *"Incentive-based compensation" would include any compensation that is granted, earned or vested based upon (a) the attainment of financial reporting measures used in preparing the company's financial statements or any measures that are derived from such measures (i.e., non-GAAP financial measures), (b) the company's stock price, or (c) total shareholder return (TSR).*

   - *The "excess" recoverable amount in the case of compensation based on stock price or TSR may be based on "a reasonable estimate."*
- Existing policies may limit the look-back period for identifying compensation that is potentially subject to recovery to less than the three years required by the proposed rule.
- A minority of existing policies only apply to a handful of senior executives (e.g., the "named executive officers"); these will need to be broadened to cover all "executive officers" (the Section 16 reporting persons). However, subject to the following point, most policies already apply either to all executives or to an even broader group of employees than the rule requires.
   - *Current policies, however, typically do not also cover former executives, who will be included under the proposed rule.*

Note also that:

- Companies would be barred from either indemnifying executives against clawback liability or paying premiums for insurance policies providing such indemnification.
- Extensive disclosures will be required if a clawback is triggered.

The proposed rule does not give companies much leeway, but some aspects – such as the manner in which a company would calculate the "excess amount" where compensation had initially been based on stock price or shareholder return – are controversial, and the SEC has requested comment on dozens of questions.

In addition, many companies have not, in their compensation plans and executive employment agreements, been reserving their right to recover compensation under such plans and agreements if required by the SEC rule. This may complicate future clawback actions. It also remains to be seen how companies will be able to enforce a recovery in the face of an inconsistent state wage law. The SEC's release proposing Rule 10D-1 simply asserts that companies may amend inconsistent contracts and says nothing at all about federal preemption of state laws. These topics will undoubtedly garner more attention.

Planning for Implementation

Topics companies should begin addressing now include:

- Review existing clawback policies to determine what must be revised.
- Review existing compensation plans and policies to determine what forms of compensation would be recoverable.
- Review existing executive employment, retention and indemnification agreements to (a) evaluate the company's right to recover compensation without provoking a breach and (b) ensure that they do not provide indemnification for clawed back amounts. Don't make the situation worse by entering into new agreements that don't incorporate the company's policy.
- Consider what amendments should be made to existing plans, grants and agreements to facilitate any recovery that becomes necessary. Whether and how an employment agreement may or should be amended requires attention to the language of the agreement, other applicable law and governance and personnel considerations.
- Review and, if necessary amend, the charter and bylaws to ensure they do not provide indemnification for clawed back amounts.
- Consider adding or beefing up stock ownership guidelines and post-vesting holding periods for equity grants. This is in the nature of self-help, enhancing the likelihood that incentive compensation is not dissipated during the lookback period. However, see the next point.
- Consider how to limit the adverse tax impact of any recovery that may be required. Tax planning is necessary. For example, if a clawback policy requires a holdback of compensation to be paid in the future, Section 409A of the Internal Revenue Code may impose a penalty if that compensation is clawed back early. Another Section 409A problem may arise if the clawback is enforced by offsetting amounts from severance or other compensation owed to the executive.
- Consider which board committee should have responsibility for implementing the policy. Since all executives who received incentive-based compensation will be subject to any given clawback action, this responsibility is unavoidably one for the directors. The relevant committee charter should be reviewed with the new requirement in mind.
- Consider whether the Side A coverage in the company's D&O policy would – or should – cover an executive's costs of defending against the company's clawback claim. This should at least be considered for executives who were not at fault in connection with the restatement. Although insurance covering an executive's defense costs is apparently permissible under the proposed rule, the board may not like the shareholder optics. Whichever the conclusion, the company should make sure that its D&O policy works as desired. Among other points, if coverage for defense costs is desired, the D&O policy may need to be endorsed in order to waive any insured v. insured exclusion solely with respect to the defense of the company's clawback claim.
- Consider – with the compensation consultants – whether, and the extent to which, the company might move away from incentive-based compensation to reduce the clawback risk. This also carries shareholder optics risks, especially given the pressure in recent years to increase the proportion of performance-based compensation in the mix, but it should not be ignored.

- Consider ancillary steps, such as adopting an exclusive forum by-law if not already in place. It is to be expected that some shareholders will seek to capitalize on the new rule by bringing derivative lawsuits on the basis that the board of directors did not obtain an adequate recovery, so companies should consider other steps to reduce the expense of such actions.
- Finally, begin to socialize executives (and the board of directors) to the new environment. This may be the most important activity of all.

The proposed rule will probably be revised before it is finally adopted. However, companies should not wait until then to plan for implementation. For more information on the matters discussed in this Locke Lord article, or if you would like to discuss submitting a comment to the SEC on the proposed rule, please contact the Locke Lord lawyer who handles your affairs or any of the lawyers listed below.

Endnote

1 http://www.sec.gov/rules/proposed/2015/33-9861.pdf (July 1, 2015). The rule itself begins on page 178.

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