Compensation Recovery ("Clawback") Provisions – Becoming Familiar with the Looming Requirement

Sometime, in the not too distant future, the Securities and Exchange Commission will finally begin the process of adopting rules to implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 954, which added new Section 10D to the Securities Exchange Act of 1934, requires every public company listed on a national securities exchange to adopt, maintain, and disclose its policy for the recovery of incentive compensation from any current or former executive officer in the event the company is required to restate its financial statements because of material non-compliance with applicable financial reporting requirements.

While the Dodd-Frank Act recently celebrated the second anniversary of its enactment into law, the SEC, under the daunting weight of an overwhelming number of rulemaking projects, has yet to take the necessary steps to implement Section 954. Thus, companies without a current compensation recovery policy and companies with existing policies that don't satisfy the stringent standards of Section 954 have been caught in an increasingly untenable position – whether to:

- continue to wait and see how the SEC ultimately interprets the scope and operation of Section 954 before adopting a policy, and incur the wrath of impatient shareholders (and the corporate governance "watchdog" groups that monitor compliance in this area); or
- adopt an "interim" policy, recognizing that it will inevitably need to be modified once the SEC specifies the parameters of the statutory requirement.

Moreover, in an environment which is putting increased emphasis on effective management of compensation-related risks, companies without a compensation recovery policy are missing one of the key risk mitigation tools at their disposal.

With imminent SEC action unlikely (the Commission's own Dodd-Frank Act rulemaking schedule simply states that rulemaking under Section 954 is "pending") and companies without compensation recovery policies being penalized by the major proxy advisory firms when reviewing their executive compensation programs, companies and their boards of directors will be faced with a critical decision this fall – maintain the status quo or install an interim policy.

With this task in mind, this Thoughtful Pay Alert summarizes the recent history of compensation recovery policies and identifies and analyses the principal issues that a technology or life sciences company should consider in designing an effective policy.

Clawbacks – A Short History

A compensation recovery (or so-called "clawback") policy is a contractual arrangement that permits a company to recover, or "take back," compensation previously paid or owed to an employee (typically, an executive officer) in the event that the employee engages in certain prescribed behavior (whether illegal or simply unethical) or a specified event occurs (for example, a financial restatement that renders a previously-earned or paid amount of compensation to be erroneous). Compensation recovery policies are not a recent phenomenon. For years, companies have used clawbacks as a potential remedy to enforce post-employment covenants, including covenants not to compete, covenants not to recruit employees, and other perceived acts of corporate malfeasance.

The Sarbanes-Oxley Act of 2002 was the first initiative to codify clawback policies in the case of executive compensation, with Section 304 of the Act requiring the chief executive officer and the chief financial officer of any public reporting company to forfeit any bonus or incentive compensation, as well as any profits realized from the sale of

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the company's securities, in the event that the company is required to restate its financial statements due to the material noncompliance, as a result of misconduct, with any financial reporting requirement. Although the provision is self-executing, over the past decade it has prompted most large public companies to review their internal practices and adopt a formal clawback policy. In fact, Equilar's most recent survey of compensation recovery policies indicated that, as of the end of 2011, 86% of the companies in the Fortune 100 maintain and disclose a compensation recovery policy (up from 20% in 2006).

Section 954 – the Requirements

As part of Congress' efforts to reform corporate governance and executive compensation practices, the Dodd-Frank Act, which was signed into law in July 2010, included Section 954. This statute actually requires exchange-listed companies to adopt and maintain two separate policies (although, until the SEC issues implementing rules, the practical import of the first required policy is presently unclear):

- A policy for the disclosure of the company's policy on incentive-based compensation that is based on financial information which is required to be reported under the securities laws; and
- A policy for the recovery of:
  - any incentive-based compensation (including stock options)
  - from any current or former executive officer
  - in the event of an accounting restatement resulting from the company's "material noncompliance" with any financial reporting requirement under the securities laws
  - in the amount of the excess over what would have been paid under the accounting restatement, with a three-year look-back

A table comparing the statutory requirements of Section 304 of the Sarbanes-Oxley Act and Section 954 of the Dodd-Frank Act (as well as Section 111 of the American Recovery and Reinvestment Act of 2009 which imposes a compensation recovery requirement on financial institutions participating in the federal government's Troubled Asset Relief Program.) is attached to this Thoughtful Pay Alert.

Timetable for SEC Action Uncertain

As previously noted, in the two years since the Dodd-Frank Act was signed into law the SEC has yet to indicate when it intends to propose rules to implement Section 954. Perhaps even more importantly, even if the SEC were to act in the near future, given that the statute contemplates that Section 954 is to be enforced through the listing standards of the national securities exchanges, SEC action is only the first step of a potentially lengthy implementation process. At this point, it is unclear whether the SEC intends to stipulate the parameters of the rules that must be reflected in the listing standards or let the national securities exchanges develop their own standards. Once the SEC has settled on its approach and finalized its rules, the national securities exchanges will then need to propose listing standards that respond to the SEC's dictates and have those standards approved – a process that could take several months.

Thus, companies without a current compensation recovery policy should consider taking action to address this situation on an interim basis until such time as the scope and operation of Section 954 has been determined by the SEC (and, as necessary, the national securities exchanges) to both minimize potential criticism from institutional shareholders and their advisors and to bolster their compensation-related risk management practices.

Designing an Effective Compensation Recovery Policy

While, on its face, articulating a compensation recovery policy appears straight-forward, there are a number of key design considerations, some of which are quite nuanced, that must be addressed. In addition, in view of the looming shadow of Section 954, any policy adopted today will have to take into account the express (and likely) parameters of Section 954 to avoid a policy that will impede a smooth transition to the eventual requirement.

Note that, necessarily, any such new policy will be less detailed than what is eventually required by Section 954 because there are so many uncertainties in the statute that will require regulatory interpretation. For example, while Section 954 expressly states that the policy is to cover stock options, it is silent about the treatment of other types of equity awards. Moreover, in the case of stock options (and, possibly, other equity awards), it is unclear how the amount

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of compensation "in excess" of what would have been paid under the accounting restatement is to be determined.

Nonetheless, even with these caveats, it is possible to develop an effective policy consistent with the company's compensation philosophy and existing corporate governance structure. In drafting a policy, the following key questions will need to be answered.

Who Should be Covered by the Policy?

Section 304 applies to a public company's chief executive officer and chief financial officer, while Section 954 applies to a listed company's executive officers (both current and former). Although the statute does not identify who is an "executive officer," it is reasonable to assume that this group will consist of a listed company's executive officers as defined in the Exchange Act (which, essentially, covers the individuals who are subject to the reporting requirement and "short-swing profits" recovery provision of Section 16 of the Exchange Act).

Thus, at a minimum, a clawback policy should cover a company's executive officers. While one approach is to limit the policy to the "named executive officers" as defined for purposes of reporting compensation in the proxy statement, since this group may change from year-to-year, such a designation can create administrative challenges involving the tracking of different executives for different time periods. Other possible groups that may be covered by the policy include:

- Executive officers and key employees
- All employees working within the company's financial function
- All employees

Observations

In view of the overriding focus of Section 954 on executive compensation, we believe that a compensation recovery policy should cover all current executive officers and, by extension, former executive officers who served in such capacity during the recovery period (see below). Extending the policy beyond this group will depend on each company's individual situation (involving factors such as work force composition, compensation structure, and likely trigger events). Potential candidates for coverage should include other key, highly-compensated employees who, through their role and responsibilities within the organization, have the capacity to harm the company through their performance (or failure to perform) or to create risks that may have a material adverse effect on the company.

What Compensation Should be Covered by the Policy?

Section 304 covers incentive-based and equity compensation, as well as profits realized from the sale of company stock, while Section 954 covers annual and long-term incentive compensation (including compensatory stock options). While silent on other types of equity awards, it is reasonable to assume that the SEC will extend the provision to cover these arrangements to avoid creating a means for avoiding the application of the policy.

Thus, there are a wide range of compensatory vehicles that may be encompassed by a clawback policy, including:

- Variable cash incentives (both annual and long-term)
- Variable equity incentives (both annual and long-term)
- Unvested stock options
- Vested (but unexercised) stock options
- Restricted stock awards and restricted stock units
- Performance shares and performance units

Observations

We believe that, at a minimum, a compensation recovery policy should cover variable annual and long-term cash incentives. Not only are these compensatory arrangements consistent with Section 954, they also represent the types of compensation that are most likely to be earned on the basis of financial measures that may potentially be affected by a financial restatement, which is probably the most common triggering event. If the company also grants performance-based equity awards, it should consider including these vehicles under the policy as well.

Note that, since most technology and life sciences companies use stock options extensively (or exclusively), excluding them from coverage may be problematic – particularly in view of the pervasive contention that service-based options are inherently "performance-based." Nonetheless, at this point expressly including stock options under the policy may be challenging given the numerous issues asso-

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ciated with the mechanics of the clawback (the most critical of which is how to value the "excess" amount that is recoverable compensation).

What Events Should Trigger Recovery Under the Policy?

Recovery under Section 304 is triggered only upon a financial restatement resulting from material noncompliance with the financial reporting standards due to misconduct. Section 954 is triggered by a similar financial restatement, but does not include a "misconduct" prerequisite.

It should be noted that, in addition to a financial restatement, many existing clawback policies can be triggered for different or additional occurrences, including:

- Intentional misconduct or unethical behavior
- Violation of a restrictive covenant (such as a post-employment non-compete provision)
- Identification of an erroneous calculation of incentive compensation
- Termination of employment for "cause"

Although many clawback policies are silent on the subject, typically compensation recovery will not be triggered in the event of a financial restatement required because of changes in the applicable financial reporting standards. In this instance, the absence of any misconduct on the part of the covered employees, as well as the perceived unfairness, tends to outweigh any issue of unjust enrichment.

Observations

At this time, use of a financial restatement as the recovery trigger is the clearest approach. Not only does this conform to Section 954, but it is also largely responsive to shareholder concerns about erroneously-paid compensation. While several commentators have aggressively advocated for a broader standard, potentially covering any number of types of malfeasance, it may be prudent to wait until Section 954 has been implemented before tackling this subject. An obvious area for expansion involves recovery in the event of any erroneous calculation resulting in the payment of compensation in excess of what should have been paid. While an easy standard to articulate, its administration can be tricky. A standard based on a financial restatement is more objective and alleviates the possibility of the company getting bogged down by situations that are more ambiguous.

Another threshold question is whether the individual from whom recovery is being sought has to have been culpable in the financial restatement. This, of course, means defining the appropriate standard of conduct – negligence, recklessness, or intention misconduct. While such a requirement is wholly compatible with Section 954 for purposes of an interim policy (that is, adopting a policy now with a misconduct condition that is later broadened to encompass any financial restatement when compliance with Section 954 is required), it will require a careful balancing of two competing pressure points – whether it is appropriate to seek recovery from someone who is not at fault, but would otherwise be the beneficiary of unjust enrichment and an executive's quite reasonable expectation that, at some point, his or her entitlement to compensation will be subject to some certainty.

For What Period of Time Should Compensation Be Subject to Recovery?

Section 304 contains a 12-month recovery period (measured from the filing date of the erroneous financial statements), while Section 954 contains a three-year recovery period (measured from the date the company is required to prepare an accounting restatement).

Most commentators agree that the clawback recovery period should not be open-ended (even though, as was seen in the stock option backdating scandal, some misconduct may go undiscovered for several years). Unless a company is prepared to withhold a portion of the incentive compensation that is awarded to covered employees for a specified period of time, it is simply not practical to expect employees (especially executives) to accept having what may be a significant portion of their compensation "at risk" for an extended period.

Observations

We believe that, at this time, a one-year recovery period may be the best interim solution. In addition to being well within the timeframe contemplated by Section 954, it also largely alleviates the challenges associated with recovering covered compensation from former executives. The ultimate length of the recovery period will have to be structured to make sense in the context of the trigger events selected and the compensation covered by the policy. Ulti-

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mately, a company is looking for a balance between these three items that promotes an appearance of fairness and ensures the enforceability of the policy.

How Should the Policy be Enforced?

While neither Section 304 nor Section 954 address how the statutes are to be enforced, the SEC has asserted (and, so far, the courts have confirmed) that it has sole authority to pursue recovery under Section 304. While enforcement of Section 954 is vested in the company, it's not clear whether shareholders will have the right to seek recovery derivatively on the company's behalf. That's a matter that will have to be addressed by the SEC.

Although most discussions of clawbacks speak in terms of a "policy," as a practical matter, simply adopting a policy statement is probably the least desirable approach because of issues of enforceability. Instead, the authority of the company to clawback compensation should be expressly addressed in any agreement relating to a covered employee's employment (typically, this will involve an executive) or in a formal agreement concerning participation in an incentive compensation plan or receipt of an incentive award. Further, when a covered employee (such as an executive) leaves the company, any severance payments or benefits or any release of claims should be expressly conditioned on agreement to a clawback provision.

Observations

Once a company has identified the types of compensation that will be covered by the compensation recovery policy, it should review and modify the documentation associated with that compensation to include a clawback provision. While, in most instances, the policy will be applied on a prospective basis, thereby only requiring modifications of the documentation to be used going forward, there may be situations where it is appropriate to consider whether pre-existing arrangements should also be covered. Further, the policy should probably stipulate how disputes will be resolved. We believe that, given the sensitivity of the subject matter, this is a subject best handled in arbitration.

Finally, implementation of a new policy may be an appropriate time to inventory pre-existing plans and arrangements to identify outstanding clawback provisions. This will not only ensure better oversight of these arrangements, but also facilitate the eventual transition to the requirements of Section 954.

Should the Decision-Maker have Discretion in Seeking Recovery?

Both Sections 304 and 954 provide for mandatory recovery of covered compensation; the primary difference between the two provisions is the amount recoverable – Section 304 contemplates recovery of all eligible compensation, while Section 954 only requires recovery of the amounts in excess of what otherwise would have been paid under the accounting restatement.

Even where a clawback policy is "self-executing," it will need to identify a "decision-maker" (such as the board of directors or the board compensation committee) to initiate recovery. In addition, as a practical matter, no policy is going to work perfectly in all situations. Inevitably, scenarios will arise that the policy may not address adequately – if at all. Consequently, to handle these situations, it may be appropriate for the policy to afford some discretion to the decision-maker. Also, there may be situations where the cost of recovery does not outweigh the benefits to the company (for example, the amount to be recovered). Interestingly, the compensation recovery provision for TARP participants includes a cost-benefit threshold that has to be satisfied before recovery is required. Section 954, however, does not.

Observations

We believe that the compensation recovery policy should give the decision-maker the discretion to both investigate the facts underlying the trigger event and fashion an appropriate remedy for the situation at hand (which may involve a clawback or, possibly, a "holdback" of future compensation). This discretion can also be exercised to set the appropriate amount of compensation that should be recovered. Companies should be careful in drafting this latter provision, however. It should not give the decision-maker the latitude to forego any recovery whatsoever (except where the amount is de minimis or a cost-benefit analysis concludes that the costs of recovery will exceed the amount to be recovered). Shareholders may question the company's commitment to good governance if it adopts a policy that makes it too easy for the decision-maker to simply decline to pursue recovery absent a compelling reason.

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Other Important Issues

Design considerations are not the only issues that a company must address in developing a compensation recovery policy. As the spotlight on clawback policies grows, it is becoming apparent that a number of additional matters – largely arising where compensation recovery is triggered – must be evaluated and planned for. One of the most important of these involves the income and other tax issues that may arise, for both the covered employee and the company, when compensation is recovered. As we have learned, several complex tax issues may need to be addressed where compensation is paid in one tax year and then recovered by the company in a subsequent tax year.

In addition, some companies may face enforceability issues in states with wage and hour laws that limit or prohibit the forfeiture of compensation that is considered "wages." For example, in California, equity compensation is considered "wages" when earned (that is, when the employee satisfies the award's service-based vesting requirements), and cash bonuses are considered "wages" when the employee fulfills all of the agreed-to conditions. Consequently, the recovery of these amounts may be subject to legal impediments that may be difficult to overcome.

Where a covered employee is a foreign national, consideration will need to be given to the impact of the laws of his or her home country on the operation and enforceability of the policy. Needless to say, each of these matters will have to be carefully evaluated as part of the policy implementation process.

Sample Policies

The following represent the public disclosures of just two of the many policies that companies have adopted to address the issue of compensation recovery in this uncertain environment. The first is from Express Scripts Holding Co.:

> In 2011, the Compensation Committee adopted a formal clawback policy that will be applicable for fiscal year 2012 reporting and beyond. Our policy applies to all current and former named executive officers and certain other executives (including the chief accounting officer) who received incentive based compensation following the effectiveness of the policy, and allows for recovery of incentive compensation payments based on restated financial results, regardless of whether misconduct was the cause of the restatement. The Compensation Committee retains discretion regarding the application of the policy. Once final rules are released regarding clawback requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act, we intend to review our policies and plans and, if necessary, amend them to comply with the new mandates.

The second is from Cintas Corporation, which also has been drafted with the looming requirements of Section 954 in mind:

> The Committee has adopted a claw-back policy, which provides that in the event of an accounting restatement due to material noncompliance with financial reporting requirement under the U.S. federal securities laws, the Committee has the right to use reasonable efforts to recover from any of our current or former officers who received incentive based compensation (including annual cash incentives, non-qualified stock options or restricted stock) during the three-year period preceding the date on which Cintas is required to prepare an accounting restatement any excess incentive based compensation awarded as a result of the misstatement. This policy applies to incentive based compensation granted after June 1, 2011. This claw-back policy is intended to be interpreted in a manner consistent with any applicable rules or regulations adopted by the SEC or the NASDAQ Stock Market as contemplated by Section 10D of the Securities Exchange Act of 1934 and any other applicable law and shall otherwise be interpreted in the best business judgment of the Committee.

Final Thoughts

While there will be a tendency to become enmeshed in the details once a decision has been made to develop a policy, we have found that there are more basic questions that first must be addressed. First, it is important to identify how compensation recovery fits within the context of your approach to corporate governance. It's also worthwhile to review your executive compensation philosophy – both as stated and as reflected in actual practice. The answers to these questions will serve as useful guideposts in working through the various design alternatives that are presented for each feature of your compensation recovery policy.

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Compensation Recovery ("Clawback") Provisions – Becoming Familiar with the Looming Requirement (continued)

It's also important to remain mindful of the numerous ambiguities in Section 954 that will have to be clarified by the SEC and/or the national securities exchanges. Since many of these ambiguities involve the mechanics of the recovery process itself, they may not need to be fully resolved to simply adopt a clawback policy. In fact, some companies have indicated that these matters will be addressed in a manner that is consistent with the requirements of Section 954. For now, it may be sufficient to simply reserve discretion to the board of directors (or board compensation committee) to deal with these matters if, and when, they arise.

Ultimately, the development of a clawback policy should not be simply a formalistic response to the latest regulatory requirement. In today's environment of increased transparency and heightened sensitivity to compensation-related risk, your compensation recovery policy should be a strong statement of your commitment to sound corporate governance; holding your employees accountable for actions that run counter to the company's objectives and strengthening your efforts around proper risk management.

Need Additional Assistance?

Compensia has had significant experience in helping technology and life sciences companies develop compensation recovery ("clawback") policies. If you have any questions on the subjects addressed in this Thoughtful Pay Alert or would like assistance in evaluating your recovery provisions, please contact Mark A. Borges at 415.462.2995 or mborges@compensia.com. ■

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

Silicon Valley

1731 Technology Drive
Suite 810
San Jose, CA 95110
408.876.4025

Timothy J. Sparks, President
tsparks@compensia.com
408.876.4024

Thomas G. Brown
tbrown@compensia.com
408.876.4023

Susan Gellen
sgellen@compensia.com
408.907.4302

Tom LaWer
tlawer@compensia.com
408.907.4309

San Francisco

1550 Bryant Street
Suite 740
San Francisco, California 94103
415.462.2990

Mark H. Edwards, Chairman
medwards@compensia.com
415.462.2985

Mark A. Borges
mborges@compensia.com
415.462.2995

Southern California

Ralph Barry
rbarry@compensia.com
858.603.2288

Anna-Lisa Espinoza
alespinoza@compensia.com
858.509.1179

Mathew T. Quarles
mquarles@compensia.com
323.919.7338

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Compensation Recovery ("Clawback") Provisions – Becoming Familiar with the Looming Requirement (continued)

Comparison of Statutory Compensation Recovery Provisions

	Section 304 of the Sarbanes-Oxley Act	Section 111 of the American Recovery and Reinvestment Act	Section 954 of the Dodd-Frank Act
Companies Covered	Companies subject to the reporting requirements of the Securities Exchange Act of 1934	Companies that are participants in the federal government's Troubled Asset Relief Program	Companies listed on a national securities exchange
Individuals Covered	Chief executive officer and chief financial officer	Five senior executive officers and next 20 most highly-compensated employees	Any current or former executive officer
Arrangements Subject to Clawback	Compensation earned and profits realized from the sale of company securities during the 12-month period following the first non-compliant filing	Bonus payments based on materially inaccurate financial statements or if employee knowingly engaged in providing inaccurate information	Incentive compensation (including stock options) during the three-year period preceding the restatement in excess of what would have been paid without the restatement
Triggering Event	Accounting restatement due to material noncompliance, as a result of misconduct, with any financial reporting requirement under the securities laws	Accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws	Statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate
Misconduct Required?	Yes; restatement arising from issuer misconduct (without regard to chief executive officer/chief financial officer's individual conduct)	No; although if Financial statements considered materially inaccurate in the case of an employee who knowingly engaged in providing inaccurate information	No
Compensation Recoverable	Any bonus and other incentive-based or equity-based compensation, and any profits realized from the sale of securities of the company	Incentive-based compensation (including stock options awarded as compensation)	Any bonus, retention award, or incentive compensation
Recovery Period	The 12-month period following the first public issuance or filing of financial document with the SEC	Period of TARP participation	The three-year period preceding the date on which the company is required to prepare the accounting restatement
Who May Enforce	Securities and Exchange Commission; no express private right of action		Company; appears that shareholder derivative actions will be allowed; no express private right of action

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