Dodd-Frank Clawbacks: Hot Issue for 2012

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank” or the “Act”) includes a host of requirements aimed at reforming executive compensation practices at publicly traded companies. So far, most companies have been focused on the Act’s Say-on-Pay and Say-on-Frequency shareholder vote requirements, which first became effective in January 2011. Many of the Act’s other executive compensation reforms await proposed regulations, and have therefore taken a back seat to Say-on-Pay and Say-on-Frequency.

One of these reforms standing in the regulatory batter’s box is Section 954, “Recovery of Erroneously Awarded Compensation” – the Dodd-Frank “clawback.” Section 954 does not become effective until regulations have been finalized. According to the current rulemaking calendar, the Securities and Exchange Commission should propose regulations under Section 954 before the end of this year and should issue final regulations sometime during the first half of 2012. We think the adoption and implementation of clawback policies in compliance with Section 954 will become a key executive compensation issue during 2012. This article explores the requirements of Section 954 and what companies should currently be doing in anticipation of these requirements.

WHAT IS A CLAWBACK?

The term “clawback” has become a commonly used, loosely defined term of art in the world of executive compensation. In general, a clawback is the right of a company to recover from an executive previously earned and paid compensation as the result of some triggering event, such as a financial restatement, the executive’s breach of an employment policy or covenant, etc. Some companies also more broadly refer to clawbacks as conditions that would allow a reduction in compensation that has not yet vested or that has been held back for a specified deferral period. This article focuses on policies regarding the recovery of previously earned and paid compensation, as that seems to be the likely thrust of Section 954.

WHAT PURPOSE DOES A CLAWBACK SERVE?

There are at least three broad categories of purposes that a clawback policy could potentially serve:

- Limit the Risk of Manipulation. The risk of manipulation occurs when a compensation program encourages individuals to manipulate data used in determining compensation as a way to increase compensation. A clawback policy can mitigate this risk by triggering a right to the clawback if there has been executive misconduct in manipulating financial results. The clawback requirements under Section 304 of the Sarbanes-Oxley Act of 2002 (which applies to incentives paid to a company’s Chief Executive Officer and Chief Financial Officer in case of a financial restatement due to misconduct) illustrate this type of clawback policy.
• **Penalize Bad Behaviors.** As a condition to an incentive award or other payment of compensation, a company may establish a contractual right with an executive to recover previously paid compensation if the executive engages in certain detrimental conduct unrelated to a financial restatement, such as violation of company policies or breach of employment covenants.

• **Prevention of Windfall.** The broadest form of clawback policy permits recovery of compensation without regard to misconduct if there is a financial restatement or other change in financial results, and as a result more compensation was paid than would have otherwise occurred had the correct financial results been originally reported. The Act’s clawback requirements under Section 954 fall into this category.

For the first two categories above, by putting previously earned and paid compensation at risk, the clawback policy is intended to create a disincentive from engaging in the particular behavior that triggers the right to the clawback. The third category appears focused more on preventing unjust enrichment than creating a disincentive to engage in specific bad behaviors, although arguably a “no fault” clawback would also broadly reduce the risk of manipulation.

**KEY REQUIREMENTS UNDER SECTION 954**

Section 954 of the Act adds Section 10D to the Securities Exchange Act of 1934. It requires public companies to adopt a policy that:

- is triggered by a required financial restatement due to “material noncompliance” with any financial reporting requirements under the securities laws; and

- requires recovery from any current or former executive officer of any incentive-based compensation (including stock options) awarded during the three-year period preceding the date that the company is required to prepare the restatement that is in excess of what the executive would have otherwise received absent the reporting error.

Note that Section 954 does not require any executive misconduct to trigger the clawback. In this regard, it seems to be focused on preventing a windfall in addition to mitigating the risk of manipulation. Also, unlike most clawback policies currently in effect, Section 954 does not appear to permit discretion by the board of directors to choose to not pursue the clawback in a particular circumstance (e.g., if the expense of enforcing the clawback exceeds the amount recoverable). Rather, if a triggering financial restatement occurs, it appears that Section 954 requires an attempt to recover any excess compensation awarded as a result of that restatement. Section 954 also requires companies to disclose their policy in their public filings and the stock exchanges to prohibit the listing of securities by any company that fails to comply with Section 954.

**CHALLENGES WITH SECTION 954**

Like many other provisions under the Act, Section 954 includes key terms that require greater definition through the regulatory process – for example, (i) what constitutes “material noncompliance” that triggers a clawback, (ii) which officers will be defined as “executive officers” whose compensation is at risk, (iii) when is a financial restatement “required” rather than merely advisable, (iv) as of what date does the three-year lookback period commence, (v) which elements of compensation comprise “incentive-based compensation” that is potentially subject to the clawback and (vi) at what point in time are those amounts considered “awarded” and therefore within the three-year scope of the clawback.

Furthermore, Section 954 could create significant enforceability issues in several respects. First, if companies do not create enforceable contractual rights to recover previously earned and paid compensation, then a policy to seek the clawback would be effectively toothless. This enforceability disconnect could occur if the implementing rules for Section 954 require the three-year lookback to retroactively apply before the policy is required to be adopted. Second, if a former executive executed a mutual release of claims in connection with his or
her departure, that release may bar the company from seeking recovery of compensation absent an express carve-out. Finally, companies often indemnify executives for costs incurred in defending against a claim or lawsuit, provided that the executive is not found guilty of malfeasance. The Act does not require misconduct in order for the clawback provisions to apply. The company may then find itself in the troubling situation of having to indemnify an executive who is defending against a clawback claim made by the company, even if the clawback is determined to be proper.

Even more fundamentally, Section 954 seems premised on the assumption that compensation outcomes are formulaically tied to reported financial results, so that any “excess” compensation as a result of a financial restatement may be readily determined. This is simply not the case for many companies. Often, incentive-based compensation is determined based on a “scorecard” of metrics, some of which may be non-financial or subjective, without a formulaic weighting of each metric. In other cases, incentive compensation may become earned based on factors related to stock price, such as so-called “relative total stockholder return” performance measures which have become increasingly popular in recent years. How a financial restatement might have retrospectively impacted stock prices is anybody’s guess. Consequently, determining what constitutes “excess” compensation under Section 954 may prove extremely problematic.

Any clawback policy needs to balance the legitimate business and shareholder goals served by the policy against the need to provide competitive levels of compensation with some degree of certainty to the executive as to what has been earned. Financial restatements can be triggered for all sorts of reasons, many of which result from the inherent complexities in the underlying accounting rules. One recent study indicates that during 2006-2009 there were over 4,500 financial restatements reported by public companies.1 Given the inherent risks that a triggering financial restatement could occur, combined with the broad scope and “no fault” nature of Section 954, some companies may consider shifting their compensation policy towards greater proportions of fixed compensation (such as salaries) or to more subjectively based incentive compensation programs that may escape the risk of clawback under Section 954.

WHAT COMPANIES CAN DO NOW TO PREPARE FOR 2012

Much of the work on a company’s required Dodd-Frank clawback policy must, by necessity, await the rules implementing Section 954. However, companies can begin to consider certain aspects of the new requirements, including:

- What, if any, clawback policy does the company currently maintain and how do the requirements of any such current policy compare with Section 954?

- The Act provides a floor for purposes of implementing the clawback requirements. A company is certainly permitted to expand its clawback policy to cover additional individuals or additional amounts. Should the policy be limited to executive officers as required by the Act or include additional layers of management? Should the policy include triggers beyond those required by the Act? For example, should the policy be triggered by certain bad behaviors such as violation of company policies or breach of employment covenants?

- How should the policy be documented to maximize enforceability? One approach could be to have the policy included in a single “master” document and then incorporated into the operative provisions of applicable incentive plans and award agreements. Enforceability could be further enhanced by obtaining executive written consent to the policy.

- What incentive-based compensation arrangements does the company currently maintain for executive officers that might potentially be covered by the policy? Do those arrangements currently include

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provisions that might permit a Dodd-Frank clawback?

- Does the company use a mutual release of claims when an executive departs, and if so how might that release be modified to carve out any clawback claims under a required Dodd-Frank clawback?

- Should (or can) the company’s indemnification policy and procedures be amended to not apply in case of a required Dodd-Frank clawback?

- Are any executive officers based outside the U.S., and if so are there any local law considerations with respect to the policy?

- Does the company have any appetite to consider alternative compensation structures that might reduce the potential impact of the Dodd-Frank clawback policy on its executives?

CONCLUSION

Given the number of key open issues with Section 954 and the potential sensitivities around a policy that could require companies to recover previously earned and paid compensation without fault of the executive, companies will want to closely monitor the Section 954 rulemaking process. There will undoubtedly be an opportunity to comment on the proposed rules once published. Companies may want to consider offering comments depending on the details of the proposal. In any event, much attention will be required during 2012 to designing, implementing and ultimately disclosing a clawback policy that complies with Section 954.