Clawbacks: Trends and Developments in Executive Compensation

Katherine Blostein
Outten & Golden LLP
3 Park Avenue, 29th Floor
New York, NY 10016
kblostein@outtengolden.com

Executive Compensation Subcommittee
ERR Midwinter Meeting
Coronado, California
March 25, 2010

Clawbacks on executive compensation have been around in various forms for years. However, with recent developments in the regulation of financial institutions and the current focus on excessive pay, many companies, especially public financial institutions are implementing these provisions in their compensation plans.[1]

A clawback is a contractual provision that requires an employee to repay compensation following a specific event. These provisions are usually triggered upon employee's termination under certain circumstances, including employee's misconduct, or upon an employee's departure and subsequent work for a competitor. This paper will describe various types of clawback provisions that may be imposed on executives by virtue of law or contract. It will discuss recent developments in the area of executive compensation and provide an employee side perspective on negotiating employment agreements and compensation arrangements that may include a clawback provision.

A. Non-Compete and Restrictive Covenant Clawbacks in Employment Agreements and Compensation Plans

It is not uncommon for clawback provisions to be included in employment agreements and compensation plans to enforce restrictive covenants, such as non-competes and non-solicitation clauses. In addition, such provisions may be used to enforce restrictions on employee conduct that are sometimes referred to as "bad-boy" provisions. These provisions can potentially allow the company to recoup cash or equity compensation from the employee during his or her employment.

"Bad boy" provisions may include prohibitions against disclosing the employer's confidential information, conviction of a crime, violation of the employer's rules or policies, or disparaging the employer. While restrictive covenant clawbacks are generally applicable after the employee's relationship with the company has been terminated, the

[1] According to the executive compensation research firm, Equilar, Inc., use of clawbacks by Fortune 100 companies increased from roughly 18 percent in 2006 to 73 percent in 2009. *See* Stephen Gandel, *Can Financial Firms Get Executives to Give Back Pay?*, TIME (January 27, 2010).

"bad boy" provisions could apply to conduct that occurs during the employment relationship.

The theory of these clawback provisions has been addressed by courts in some states. For example, courts in New York have considered and enforced the "employee choice doctrine."[2] The "employee choice doctrine" provides that an employee who receives benefits conditioned on not competing with his or her former employer can choose between keeping the rights to the benefits or risking forfeiture by competing.[3] Although a court will not consider the reasonableness of a restrictive covenant if an employee left his or her employment voluntarily, a court must determine whether forfeiture is reasonable if the employee was terminated involuntarily and without cause.[4] In regard to voluntary resignation, the employee choice doctrine also applies to situations where a former employee already reaped the benefits of a compensation plan. The employee would have to pay the money back if he or she chose to compete with the former employer.[5] Where applicable, the employee choice doctrine will apply only if the departing employee makes a voluntary informed choice on whether to compete and forgo the benefits or keep the benefits and forgo competition.[6]

On the other hand, enforcement of clawback provisions connected to restrictive covenants may be problematic in some states where restrictive covenants are disfavored or unenforceable. Recovery of funds from the employee may not be possible in a state where the underlying restrictive covenant would not be enforceable. For example, in California, where non-compete agreements are not enforceable,[7] an employer would have difficulties arguing that it should be entitled to a payment on a clawback for breaching a non-compete. Even if the employer drafted the employment agreement or compensation plan to be governed by another state law, the employee's counsel could successfully argue that California law, where the employee worked, should apply.[8]

---

[2] *See Lucente v. International Bus. Machs. Corp.*, 310 F.3d 243 (2d Cir. 2002).
[3] *Id.* at 245.
[4] *See Morris v. Schroder Capital Mgmt. Int'l*, 481 F.3d 86 (2d Cir. 2007) (*citing Post v. Merrill Lynch, Pierce, Fenner & Smith, Inc*., 48 N.Y.2d 84 (1979)).
[5] *See Tasciyan v. Marsh USA, Inc*., No. 07-99, 2007 U.S. Dist. LEXIS 23001 at *8 (S.D.N.Y. Mar. 28, 2007).
[6] *Id.* In *Tasciyan*, in the absence of the forfeiture provision, the court gave the former employee a choice of either keeping the benefits and not competing or paying back the benefits and having the freedom to compete.
[7] California Business & Professions Code section 16600 provides that "[e]xcept as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void." California courts have followed this provision in employment related non-compete cases and have routinely invalidated post-employment non-competes. *See, e.g., Application Group, Inc. v. Hunter Group, Inc.*, 61 Cal. App. 4th 881, 895 (Cal. Ct. App. 1998); *Metro. Traffic Control, Inc. v. Shadow Traffic Network*, 22 Cal. App. 4th 853, 859-60 (Cal. Ct. App. 1994); *Scott v. Snelling & Snelling, Inc.*, 732 F. Supp. 1034, 1042-43 (N.D. Cal. 1990).
[8] "California will apply the substantive law designated by the contract unless the transaction falls into either of two exceptions: (1) the chosen state has no substantial relationship to the parties or the transaction, or (2) application of the law of the chosen state would be contrary to a fundamental policy of the state." *S.A. Empressa v. Boeng Co.,* 641 F.2d 746, 749 (9th Cir. 1981). *See also Sarlot-Kantarjian v. First Pennsylvania Mortgage Trust*, 599 F.2d 915 (9th Cir. 1979); *Gamer v. duPont Walston, Inc*., 65

B. Clawbacks in Enforcement of Sarbanes-Oxley Act of 2002

Under Section 304 of the Sarbanes-Oxley Act of 2002 (the "Act"), certain compensation previously paid to a chief executive officer (CEO) or a chief financial officer (CFO) of a public company can be repaid in the event the company "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."[9] Under the Act, bonus and other incentive based or equity-based compensation received by executives during the 12-months period following the first to occur of public issuance or filing with the Securities Exchange Commission (the "SEC" or the "Commission") of the financial document that contained the misstatement in question can be recovered by the SEC.[10] Profits from the sale of securities of the issuer following that 12-months period could be recouped as well.[11] Only the SEC can enforce this provision and there is no right of private action against the CEO or the CFO.[12] However, in addition to clawing back compensation, the SEC can seek civil money penalties and a host of equitable non-monetary remedies against the executives.

Since the adoption of the Act, the SEC typically enforced the clawback provision in cases where the CEO or CFO was personally involved in the misconduct at issue. However, after the financial crisis, the government's focus on excessive executive pay has resulted in surprising SEC enforcement of Section 304, with the Commission trying to recoup compensation from executives who were not found to be personally responsible for the misconduct or involved in the misconduct.[13] The first such case brought against an executive in this context was *SEC v. Jenkins*.[14] In this case, the SEC sought to claw back incentive-based compensation from Maynard L. Jenkings, the former chief executive of a public company that the SEC had previously charged with fraud in their financial statements.[15] In the case against the company or against the executive, there were no facts alleging that Jenkins had any involvement in or knowledge of the corporate misconduct (before Jenkins, the cases always involved some level of involvement in the illegal activity, either some participation or *scienter*). In *Jenkins*, the SEC took the

---

Cal.App.3d 280, 286, (1976); *Windsor Mills, Inc. v. Collins & Aikman Corp.,* 25 Cal.App.3d 987, 995 n.6 (1972). "Under the second exception, where application of a choice-of-law provision would result in the contravention of California's public policy, the provision will be ignored to the extent necessary to preserve public policy." *S.A. Empressa v. Boeng Co.,* 641 F.2d 746, 750 (9th Cir. 1981); *see also Frame v. Merrill Lynch, Pierce, Fenner & Smith, Inc*., 20 Cal.App.3d 668, 673 (1971); *Foreman v. George Foreman Associates, Ltd.,* 517 F.2d 354, 357 (9th Cir. 1975) (dictum).

[9] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, July 30, 2002 § 304, 15 U.S.C.A. § 7243 (a).

[10] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, July 30, 2002 § 304 (a).

[11] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, July 30, 2002 § 304 (b).

[12] *See e.g. In re Digimarc Corp. Derivative Litigation*, 549 F. 3d 1223, 1230-33 (9th Cir. 2008); *Pirelli Armstrong Tire Corp. Retiree Medical Benefits Trust ex rel. Federal Nat. Mortg. Ass'n v. Raines*, 534 F. 3d 779 (D.C. Cir. 2008).

[13] Esme E. Deprez, *Payback Time? The SEC Launches a Second 'Clawback' Case*, BUSINESSWEEK (November 17, 2009).

[14] *Securities and Exchange Comm'n v. Jenkins*, Case No. CV 09-1510-PHX-JWS (D. Ariz)(Litigation Release No. 21149A, July 23, 2009, http://www.sec.gov/litigation/litreleases/2009/lr21149a.htm).

[15] *Id*; Deprez *supra* 13.

position that misconduct does not need to be alleged in order to pursue an action against an executive under Section 304 of the Act.

Following the SEC's reasoning in *Jenkins*, on November 13, 2009, Beazer Homes disclosed that the SEC issued a notice to the Company's CEO, Ian J. McCarthy, stating that the Commission is planning to bring a civil action against McCarthy under the clawback provision of Section 304. Beazer Homes noted that SEC's did not allege any misconduct by McCarthy in connection with the company's financial statements or other disclosures.[16] Clearly, with the pressure from the government, the Commission will probably continue to pursue these "clawback" cases, seeking return of compensation from executives who were not involved in the misconduct.

C. Clawback Provisions under the American Recovery and Reinvestment Act

On Feb. 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (ARRA)[17] which, among other things, amends Section 111 of the Emergency Economic Stabilization Act of 2008 (EESA) and relates to executive compensation limitations for financial institutions receiving funding under the Troubled Asset Relief Program (TARP). The limitations on executive compensation imposed by ARRA upon public companies are important to be aware of. Under the original terms of EESA, only the five most highly paid executives of a public company receiving assistance under TARP were subject to compensation limitations and restrictions. ARRA significantly expanded these limitations and restrictions to apply to as many as the next 20 most highly compensated employees, or to such higher number as the U.S. Department of the Treasury (Treasury) may determine is in the 'public interest.' ARRA even goes so far as to revisit compensation determinations made before its enactment to confirm that such prior compensation determinations were consistent with TARP and not contrary to the 'public interest.'[18]

ARRA requires all recipients of TARP funds to establish certain executive compensation and corporate governance standards.[19] As part of the standards, the companies who received the funds must establish a mechanism to claw back any bonus, retention award or incentive compensation paid to senior executive officers[20] and any of the next 20 most highly compensated employees if their compensation was based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate.[21]

---

[16] Securities Exchange Commission*, Beazer Homes Discloses Wells Notice to CEO; SEC May Pursue "Clawback"* (November 13, 2009), http://www.securitiesdocket.com/2009/11/16/beazer-homes-discloses-well-notice-to-ceo/.

[17] 12 U.S.C. 5221; American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115.

[18] *Id*; *see also* Wendi S. Lazar & Katherine Blostein, *Changing Economy Impacts Executive Pay*, 172 PENS. & BEN. DAILY (BNA) 9/9/09.

[19] 12 U.S.C. 5221(b).

[20] Senior executive officers are defined as the five most highly compensated executives and those whose compensation is required to be reported. 12 U.S.C. 5221(a)(1).

[21] 12 U.S.C. 5221(b)(3)(B).

The application of the clawback requirements under ARRA is broader than those under the Sarbanes Oxley Act. The provision applies to a wider range of employees, the recovery period is not limited and it could be enforced against both public and private companies that received TARP funds. Further, the provision may be attributed to material inaccuracies relating to financial reporting and other performance metrics used to calculate bonus payments. Section 111 of EESA does not require misconduct to be present in order to trigger the clawback.[22] The Treasury Department's interim final rules also allow for a private right of action, where the TARP recipient must enforce the clawback provisions against the executive, unless the company can show that it would be unreasonable to pursue the clawback.[23]

D. New Trends in Compensation and Clawback Provisions

As discussed above, the focus on excessive pay from shareholders and the public resulted in federal regulations that limited executive pay for top executives at companies that received TARP funds. However, since many of those companies have paid TARP funds back, the government continues to work on proposals to limit excessive pay, align executive compensation closer to the companies' performance and reduce risk taking by executives. In June 2009, President Obama appointed Kenneth Feinberg as an "executive compensation czar" to set salary and bonus levels for top executives at companies that have not paid back TARP funds, and to help design a pay structure for many other firms.

In keeping with the government's recommendations, numerous companies (especially financial institutions) are changing their compensation structures in various ways. These include but are not limited to changing compensation rules to include broader and stricter clawbacks that will apply to a wider scope of employees, adjusting bases compensation, and revising annual bonus and equity compensation plans to include longer time vesting and performance vesting requirements.

- **Clawbacks:**

    - The new clawbacks included in 2009 compensation plans of major financial companies introduced the following triggers: bad risk analysis (JP Morgan Chase), profit projections falling short and detrimental activity (Bank of America), and taking excessive risks (Goldman Sachs), among others. [24]

    - JP Morgan Chase recently announced that clawback provisions that used to apply only to top executives would now apply to any employee who gets JP Morgan Stock as part of their compensation. The clawback, however, is only limited to the company's stock granted to the employee under the company's equity compensation plan.

- **Adjusting Base Compensation**:

[22] 74 Federal Register 28399.
[23] 74 Federal Register 28394.
[24] Robin Sidel, *Wall Street Toughens Rules on Clawbacks*, WALL ST. J. (January 27, 2010).

- A number of financial institutions recently increased employees' base compensation across the board.

- Still, because of economic stress, many public and non-public companies were forced to decrease their employees' base compensation in an effort to keep their staff employed. Many executives in non-financial companies also took voluntary cuts in compensation in order to avoid lay-offs of lower level employees.

- **Revising Annual Bonus Plans and Equity Compensation Plans:**

  - Companies changed the ratio of cash to equity granted to employees. The cash bonuses granted to executives were severely reduced and instead, employees were granted up to 60 or 70 percent (or even more) in equity depending on their annual bonus amounts.

  - Companies instituted longer vesting requirements on equity compensation (i.e. restricted stock or stock options) with some extending a typical 3 year vesting period to 5 years.

  - Companies instituted performance vesting on restricted stock or stock options granted to employees. In this regard, in order for the employee's equity to vest, the line of business he or she is in or even the entire company has to remain profitable in order for the employee to vest in or receive his equity.

While some of these changes are a direct response to regulators' and shareholders' concerns about excessive executive pay, others are instituted to benefit the companies as well. In this regard, an increase in base compensation may incentivize retention of talent, but could potentially result in less risk taking by employees whose bonuses are based on production alone. In the end, employees' bonuses may not be as significant as they were in previous years, but with increased salaries their total compensation may still remain comparable to what they earned before the financial crisis.

E. What Does this Mean for Employees?

Aside from the regulatory clawbacks that protect shareholders and U.S. taxpayers, most provisions in an employment agreement or a compensation plan create a contractual obligation to pay back compensation upon their termination, departure or misconduct. Because of the current economic environment, it is difficult for an employee to negotiate these provisions, particularly with public companies. If negotiating the provision is not an option, it is prudent for the employee to try and negotiate provisions that will narrow and limit the clawback's application. In these circumstances, the employee should try to make the language of the restrictive covenants, the "cause" definition, or the "detrimental activity/conduct" definition tied to the clawback as narrow as possible and limit the scope and time of the clawback's application to the employee. The alternative is having an onerous provision that can cost the employee handsomely down the line.

The contractual obligations to repay incentive or other compensation triggered by a clawback may themselves present legal issues for the employee or the company. The following are some examples:

- **<u>Wage Laws:</u>**

  - Clawing back "wages" or "earned compensation" from employees may not be allowed under some state laws, making the clawback provision unenforceable. Wage laws in some states may limit the employer's ability to recover amounts paid or owed in connection with performance of services. Even some unpaid "discretionary" bonus amounts may be considered "wages" that are owed to the employee.

- **<u>Application of Tax Claws to Clawbacks:</u>**

  - In the event the employee is forced to pay money back to the employer or former employer, the manner and timing of the payment should be carefully planned considering the possible consequences of Section 409A of the Internal Revenue Code and standard tax provisions.

  - Section 409A provides that unless a "nonqualified deferred compensation plan" complies with various rules regarding the timing of deferrals and distributions, all vested amounts deferred under the plan for the current year and all previous years become immediately taxable (including a 20 percent penalty tax) to the employee.[25]

  - If a repayment obligation under a clawback provision does not comply with the requirements of Section 409A, it could lead to a violation of the Section's offset rules. The rules allow for employee to pay up to $5,000 per year in debt to employer with a future offset against deferred compensation, these payment arrangements have to be established in the compensation plan containing the clawback.[26]

  - Since the Internal Revenue Service has not confirmed that a clawback arrangement would fit under the application of the offset provision, a repayment of the clawback provision may result in a violation Section 409A.

- **<u>Paying the Money Back</u>**

  - The company usually has considerable discretion in application and enforcement of the clawback provisions and, depending on the circumstances, may be willing to negotiate the terms and conditions of the payments.

[25] I.R.C. § 409A(a)(1)(B)(i)(II).
[26] Reg. § 1.409A-3(j)(4)(xiii).

- In the event the employee is unable to pay back the funds required by the clawback, instead of ensuring that he or she will end up in a lawsuit with the company, the employee should try to negotiate to be able to repay the funds over an extended period of time or negotiate to reduce the amount.

Conclusion

While the use of clawbacks in executive compensation has spread since the financial crisis, there is no way to predict whether this is a trend that will soon fade. Interestingly, Kenneth Feinberg recently said that he was reluctant to impose "clawbacks" on executives when their company's financial performance "faltered." He further said that he "ha[d] an assumption in [his] mind that it's not a great idea to recover money already paid and maybe already spent and already taxed" and "[he is] wary of exercising that authority in too many cases."[27] In the end, the broad use of clawbacks instituted by financial companies in 2009 may not be the policy the U.S. government supports in its efforts to regulate executive pay.

[27] Whitney McFerron, *Feinberg States Clawbacks Are 'Not a Great Idea'*, BLOOMBERG LAW REPORTS, EXECUTIVE COMPENSATION, Vol. 2, No. 10 at 4.

DIGGING INTO THE POT OF GOLD:
Executive Compensation Cutbacks and Take-Aways

Presented by The Executive Compensation Subcommittee
Thursday, March 25, 2010
Coronado, California

Panelists

Katherine Blostein
Outten & Golden LLP
3 Park Avenue, 29th Floor
New York, NY 10016
212.245.1000
KB@outtengolden.com

Jeffrey Heller
Associate General Counsel
BP Legal
BP America, Inc.
501 Westlake Park Blvd.
Houston, TX 77079
281.366.1412
Jeffrey.Heller@bp.com

Michael L. Rosen
Foley Hoag LLP
Seaport West
155 Seaport Blvd.
Boston, MA 02210
617.832.1231
mrosen@foleyhoag.com

Moderator

Darlene A. Vorachek
Abrahamson Vorachek & Levinson
120 North LaSalle Street, Suite 1050
Chicago, Illinois 60602
312.263.2698
attorneys@avmlaw.com

Jonathan Coronado is the Vice President of Operations at Enterprise Bank, a regional bank in the Midwest, where he has worked for 25 years. In early 2010, he was approached to fill the Vice President-Operations position at Energy Inc. In anticipation of this move, Jonathan is presented with an Employment Agreement from Energy Inc. The 2010 bonus provision in Jonathan's proposed Employment Agreement reads as follows:

"Employee will not be eligible to receive any of the compensation detailed in this Agreement if he engages in "Detrimental Activity." In addition, if it is determined at any time that Employee has engaged in Detrimental Activity, the Company will be entitled to recover from the Employee the 2010 guaranteed annual bonus.

Detrimental Activity means (a) any conduct that would constitute "Cause" (as defined in the Agreement) or (b) any one of the following: (i) any act or omission by Employee resulting or intended to result in personal gain at the expense of the Company; (ii) improper conduct by Employee, including, but not limited to, fraud, unethical conduct, falsification of Company records, unauthorized removal of Company property or information; or (iii) the performance by Employee of his employment duties in a manner deemed by the Company to be grossly negligent.

While employed as Vice President of Operations at Enterprise Bank, Jonathan’s compensation consisted of base salary and annual bonuses (delivered part in cash and part in stock options of the employer).

The stock option agreement contains a restrictive covenant that prohibits Jonathan from going to work for a direct competitor for one year after the end of his employment with Enterprise Bank in order for him to be able to keep his vested stock options. If the restrictive covenant is breached, Jonathan would forfeit all unexercised vested stock options, would be subject to a repurchase option enabling the Bank to repurchase shares he holds at the price he paid for them, and could be subject to an injunction.

In addition to the Energy Inc. offer, Jonathan receives an employment offer from Farmers Bank. Farmers has long sought to hire Jonathan given his operations experience.

Energy Inc. has an Oklahoma facility that lost money during 2009. As a result, the management executives at the Oklahoma facility did not receive any raises. Union members at the facility, on the other hand, received pay increases in accordance with the CBA. Bonuses are now due to be awarded. Given this background, a plan to award bonuses only to management, but not to union members, is suggested.

Unfortunately, Jonathan dies somewhat precipitously. His family is stunned, but the monetary impact of their loss is lessened when a $1.5 million check arrives in the mail from an insurance company that had issued a life insurance policy on Jonathan.

It turns out that the hefty check was misdelivered. Instead, Enterprise Bank reaches out and claws back the insurance proceeds.