Agenda

(1) Why adopt a clawback policy?
(2) Who should be subject to the clawback policy?
(3) What types of pay should be subject to the risk of clawback?
(4) How long should that compensation be at risk?
(5) What are the clawback triggers?
(6) What are the tax implications on an employee whose pay is clawed back?
(7) Beware wage and hour issues.
(8) Should you address the coordination between the clawback policy and indemnification rights?
What is a clawback policy?

• Also called “recoupment” policies
• Requires a current and/or former employee to repay compensation previously paid to him under specified circumstances
  — May also require disgorgement of profits realized in connection with that compensation
Why adopt a clawback policy?

- Publicly-traded companies are required to adopt a clawback policy
  - Section 304 of the Sarbanes-Oxley Act of 202
    - Only applies to the CEO and CFO
    - Requires disgorgement of any incentive-based pay and related profits received during the 12 month period preceding a financial restatement resulting from “material noncompliance” and “misconduct”
  - Section 10D of the Securities Exchange Act (as added by Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010)
    - Applies to all current and former executive officers
    - Requires disgorgement of any incentive-based pay based on restated financial statements during the prior 3 year period
    - Misconduct not required
Why adopt a broader clawback policy?

• Provide a mechanism to deflect bad press and recoup corporate losses caused by employee malfeasance
  — #MeToo
  — Steve Easterbrook firing by McDonald’s

• Strong clawback policies are recommended by the proxy advisory firms
  — Improve ISS Equity Plan Scorecard

• Act as a reasonable retention tool by requiring repayment of certain compensation (like hiring bonuses, expense reimbursements for relocation and tuition expenses) if the employee terminates before a specified period of time
Who should be subject to the clawback policy?

• Alternatives
  • Executive officers (Section 16)
  • Other officers and/or employees
  • All employees
  • Non-Employee Directors
• Should policy apply to all employees?
• Former individuals (e.g., must individual be employed at the time of the trigger)
• SOX and Dodd Frank

CEO & CFO versus all Section 16 officers
What types of pay should be subject to the risk of clawback?

<table>
<thead>
<tr>
<th>Types of compensation can be recouped:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Cash (bonuses, cash LTIPs)</td>
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<tr>
<td>• Equity (full value and appreciation - stock, options, RSUs)</td>
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<td>• Gains from equity-based compensation</td>
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<td>• Severance that has been previously paid</td>
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<tr>
<td>• Deferred compensation</td>
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<tr>
<td>• Signing bonuses, relocation expense reimbursements</td>
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<th>Consider enforcability?</th>
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<tbody>
<tr>
<td>• Drafting considerations in award agreements and bonus opportunities</td>
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<tr>
<td>• What about former employees?</td>
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<td>• Stock ownership requirements?</td>
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</tbody>
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<table>
<thead>
<tr>
<th>Lookback: For how long is covered compensation at-risk?</th>
<th>Amount At Risk: what amount of the compensation is subject to recoupment and how will it be valued?</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Limited, tied to discovery (typically amounts paid or granted during 12 to 48 months preceding the restatement or discovery of misconduct)</td>
<td>• Entire amount paid/earned</td>
</tr>
<tr>
<td>• Limited, tied to misconduct or restatement (amounts paid or granted during the period in which the misconduct occurred or to which the restatement applies)</td>
<td>• If financial statement triggers are used, difference between the amount that should have been paid (with accurate financial results) and the amount that was actually paid (with inaccurate financial results)</td>
</tr>
<tr>
<td>• SOX – 12 month period following disclosure of financial document</td>
<td>• What about pre-tax vs. post-tax compensation payments</td>
</tr>
<tr>
<td>• Dodd Frank – 3 year period before date of accounting restatement</td>
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</tbody>
</table>
What are the clawback triggers?

- Financial misconduct
- Financial restatement due to the employee’s actions
- Other financial restatements without malfeasance
- Individual fraud, criminal activity
- Violation of non-compete
- Material violation of a company policy
- Reputational harm/adverse publicity
- Termination before a specified date
- Mandatory/discretionary enforcement
What are the tax implications on an employee whose pay is clawed back?

• Federal income tax treatment depends on the amount of time that has elapsed between the date that the compensation was originally paid and the date of the clawback.

• Same tax year
  — Treat as if the original payment had never occurred (See IRS Rev. Rul. 79-311)
Tax implications for clawback of prior year pay

- FICA tax - If repayment within 3 years, can claim a refund
- Federal income tax
  - Recouped pay remains taxable in the year originally paid. NO AMENDED W-2
  - Employee deducts the repayment under:
    - Code Section 162(a) (suspended)
    - Code Section 165(c)(1) (suspended)
    - Code Section 1341 claim of right (requires the amount to exceed $3k)
  - Old authority for the position that the clawed-back amount is excluded from the reportable wages for the year of the offset. See, e.g., Moorman v. Commissioner, 26 TC 666 (1966), acq. 1956-2 CB 7. No guidance has been issued implementing this interpretation since the Code Section 162 deductions were suspended.
Beware wage and hour issues

• Exempt Employees
  — DOL opinion letters issued under the Federal Fair Labor Standards Act (FLSA 2006-7 and FLSA 2001-7):
    • repayment agreements violate the salaried employee exemption rule
    • contingent repayment deduction causes the employee to cease to qualify as an exempt employee – whether or not the repayment obligation is triggered
Beware wage and hour issues

• Nonexempt Employees
  — Need to ensure that the employee receives minimum wage plus all overtime to avoid any claim that the FLSA rules have been violated by any recoupment

• Local laws
  — For example, California has strong labor laws that prohibit recoupment of most wages and an active plaintiffs bar that regularly litigates
Coordination between the clawback policy and indemnification rights

• Hertz Case (Allegations are based on “Defendants' wrongful ‘tone at the top’ was a form of misconduct and gross negligence.”)

• Executives requested “advancement of fees” in DE court and Hertz seeking judgment denying this request.
  — Advancement versus Indemnification

• Hertz’s articles of incorporation and by-laws include a typical formulation to describe the scope of indemnification coverage:
  — The Corporation shall indemnify, to the fullest extent permitted by the DGCL and other applicable law, any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (each, a “proceeding”), by reason of the fact that he or she is or was or has agreed to become a Director or officer of the Corporation . . . or by reason of any action alleged to have been taken or omitted in such capacity, against expenses (including attorneys’ fees), judgments, fines and amounts paid in settlement. . . .

• The Hertz Global Holdings, Inc. by-laws also include the following unusual language:
  
  [N]o indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the Corporation unless and only to the extent that the Delaware Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Delaware Court of Chancery or such other court shall deem proper.

• **Key Consideration**: Review clawback policy and bylaws to ensure they properly reflect Company’s intent.
Sample Clawback Policy

• Revised: September 14, 2010
• This policy covers Microsoft’s executive officers, principal accounting officer, and other executives who have been designated as participants in Microsoft’s Executive Incentive Plan (collectively referred to as "covered officers").

Microsoft will seek to recover, at the direction of the Compensation Committee after it has considered the costs and benefits of doing so, incentive compensation awarded or paid to a covered officer for a fiscal period if the result of a performance measure upon which the award was based or paid is subsequently restated or otherwise adjusted in a manner that would reduce the size of the award or payment. Where the result of a performance measure was considered in determining the compensation awarded or paid, but the incentive compensation is not awarded or paid on a formulaic basis, the Compensation Committee will determine in its discretion the amount, if any, by which the payment or award should be reduced. In addition, if a covered officer engaged in intentional misconduct that contributed to award or payment of incentive compensation to him or her that is greater than would have been paid or awarded in the absence of the misconduct, Microsoft may take other remedial and recovery action, as determined by the Compensation Committee.
# Sample Clawback Policy

## Proxy Disclosure

Wells Fargo (2019 Proxy)

<table>
<thead>
<tr>
<th>Policy/Provision</th>
<th>Trigger for Clawback or Forfeiture</th>
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<tbody>
<tr>
<td><strong>Unearned Compensation Recoupment Policy</strong></td>
<td>Misconduct by an executive that contributes to our Company having to restate all or a significant portion of its financial statements</td>
</tr>
<tr>
<td><strong>Extended Clawback Policy</strong></td>
<td>Incentive compensation was based on materially inaccurate financial information or other materially inaccurate performance metric criteria, whether or not the executive was responsible</td>
</tr>
<tr>
<td><strong>Equity Award Clawback Provisions</strong></td>
<td>Our equity award agreements and our LTICP provide that all awards are subject to the terms of any applicable clawback policy maintained by or required by law</td>
</tr>
</tbody>
</table>
| **Equity Award Forfeiture Provisions**        | • Misconduct that has or might reasonably be expected to cause reputation or other harm to our Company or any conduct that constitutes “cause,”  
  • Misconduct or commission of a material error that causes or might be reasonably expected to cause significant financial or reputation harm to our Company or the executive’s business group,  
  • Improper or grossly negligent failure, including in a supervisory capacity, to identify, escalate, monitor or manage, in a timely manner and as reasonably expected, risks material to our Company or the executive’s business group,  
  • An award was based on materially inaccurate performance metrics, whether or not the executive was responsible for the inaccuracy, or  
  • Our Company or the executive’s business group suffers a material downturn in financial performance or suffers a material failure of risk management |