



Annual Meeting 2011
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Executive Compensation Clawbacks

Policy and Practical Considerations



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- Program Overview
 - TARP, Other Clawback Arrangements
 - SOX § 304
 - Prevalence of Clawbacks
 - Dodd-Frank § 954
 - Policy Design



- TARP
 - EESA § 111(b)(3)
 - Materially inaccurate statements
 - Senior executive officer and next 20 most highly compensated
 - No reference to time period
 - See TARP Q&A at: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&tpl=/ecfrbrowse/Title31/31cfr30_main_02.tpl



- Other Clawbacks

- IBM v Bajorek

- Clawback provision in stock option award invoked by IBM after Bajorek joins a competitor of IBM
 - Applying New York law to allow employer to condition employee's stock options on not working for a competitor for six months after exercising options would not violate California law
 - 191 F.3d 1033 (9th Cir., 1999)



- Other Clawbacks (cont'd)
 - Guidry v. Sheet Metal Workers Nat. Pension Fund
 - Union official convicted of embezzling union funds brought action to recover retirement benefits
 - remedial provisions of Labor-Management Reporting and Disclosure Act did not override ERISA's prohibition on pension benefit alienation; constructive trust on benefits not allowed
 - 493 U.S. 365 (1990)



- **SOX § 304**

- **Additional Compensation Prior to Noncompliance With Commission Financial Reporting Requirements.** If an issuer 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, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for--
 - any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and
 - any profits realized from the sale of securities of the issuer during that 12-month period.



- SOX § 304, Caselaw
 - In re Digimarc Corporation Derivative Litigation
 - no private right of action
 - 549 F.3d 1223 (9th Cir., 2008)
 - See also Neer v. Pelino, 389 F. Supp. 2d. 648 (E.D. Pa. 2005)
 - In re DHB Industries, Inc. Derivative Litigation
 - cannot indemnify for § 304 clawback
 - Settlement agreement provision; wider applicability?
 - 622 F.3d 188 (2nd Cir., 2010)



- SOX § 304, SEC Enforcement
 - McGuire – settlement, first § 304 recovery
 - All incentive and equity-based compensation from 2003 through 2006, > \$400 million
 - Under SOX § 304, **SEC doesn't need to establish a causal link between violation of securities law and amount to disgorge, increasing amount it can seek to disgorge.** Rachael E. Schwartz, The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean, *The Business Lawyer*, Vol. 64, November 2008.
 - Securities and Exchange Commission v. William W. McGuire, M.D., Civil Action No. 07-CV-4779-JMR/FLN (D. Minn. 2007)



- SOX § 304, SEC Enforcement
 - Jenkins – litigation, no charge § 304 recovery
 - 718 F. Supp. 2d 1070 (D. Ariz. 2010)
 - Effort to settle the case for less than half of amount originally sought was rejected by the Commission
 - http://www.washingtonpost.com/business/economy/sec-rejects-proposal-by-its-enforcement-staff-to-settle-landmark-clawback-suit/2011/07/19/gIQAZujzPI_print.html



- SOX § 304, SEC Enforcement (cont'd)
 - McCarthy – settlement, no charge § 304 recovery
 - SEC v. McCarthy, No. 1:11-CV-667-CAP (N.D. Ga. March 3, 2011)

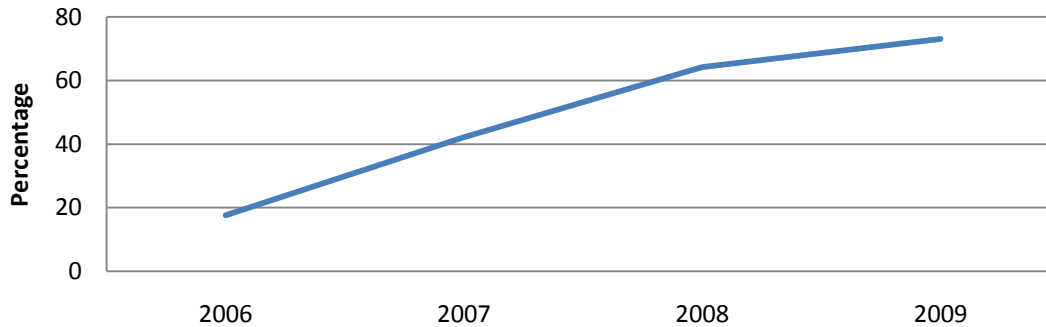


- SOX § 304, SEC Enforcement (cont'd)
 - Little SEC guidance regarding
 - pursuit of no-fault reimbursement
 - calculating amounts
 - Large Number of Restatements post-SOX, Very Few Enforcement Actions
 - 2006 – 2009: 4,609 Restatements
 - “Excess Pay Clawbacks,” Jesse Fried and Nitzan Shilon, March 2011, <http://ssrn.com/abstract=1798185>, citing Heffers et al, 2009 Financial Restatements: A Nine Year Comparison, Audit Analytics Trend Reports (2010).



- **Prevalence of Clawback Arrangements**

Fortune 100 Firms with Disclosed Clawback Policies, Equilar Study, Fall 2009



– Equilar now estimates this number at >80%



- Prevalence of Clawback Arrangements (cont'd)

Market Capitalization	# of Firms with a Policy	% of Firms with a Policy
Mega Cap (21 firms)	16	76%
Large Cap (214 firms)	126	59%
Mid Cap (250 Firms)	109	44%

- “Excess Pay Clawbacks,” Jesse Fried and Nitzan Shilon, March 2011, <http://ssrn.com/abstract=1798185>

– So, on the rise, but not everywhere – yet



- Prevalence of Clawback Arrangements (cont'd)
 - Common Features of Existing Arrangements
 - Discretionary, Limited Scope (Executives)
 - Finding of Misconduct Required
 - Distinction between misconduct generally, intentional misconduct and fraud
 - Of 20% of S&P 500 firms requiring recovery of excess pay, 86% prevent Board from recovering pay absent a determination of misconduct.
 - » “Excess Pay Clawbacks,” Jesse Fried and Nitzan Shilon, March 2011, <http://ssrn.com/abstract=1798185>



- **Dodd-Frank § 954**
 - **SEC. 10D. Recovery of Erroneously Awarded Compensation Policy**
 - **(a) Listing Standards.** The Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not comply with the requirements of this section.



- **Dodd-Frank § 954 (cont'd)**
 - **SEC. 10D. Recovery of Erroneously Awarded Compensation Policy**
 - **(b) Recovery of Funds. The rules of the Commission under subsection (a) shall require each issuer to develop and implement a policy providing—**
 - **(1) for disclosure of the policy of the issuer on incentive based compensation that is based on financial information required to be reported under the securities laws; and**



- **Dodd-Frank § 954 (cont'd)**
 - **SEC. 10D. Recovery of Erroneously Awarded Compensation Policy**
 - **(b) Recovery of Funds.—**
 - **(2) that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.**



Comparison of Key Provisions

	Sarbanes Oxley Section 304	Dodd Frank Section 954
Clawback Triggered when -	Issuer 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.	Issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws.
Compensation Subject to Clawback	Applies only to CEO and CFO	Applies to any current or former executive officer
Time Period	The 12-month period following the first public issuance or filing with the SEC of the financial document embodying such financial reporting requirement.	The 3-year period preceding the date on which the issuer is required to prepare an accounting restatement based on erroneous data.
What Compensation is Subject to Clawback?	(1) Any bonus or other incentive compensation received by that person from the issuer and (2) any profits realized from the sale of securities of the issuer.	Incentive compensation (including stock options awarded as compensation) - the amount "in excess of what would have been paid to the executive officer under the accounting restatement."
Private Cause of Action?	No - SEC enforcement action	No - Securities Exchanges (delisting)
Disclosure	No specific disclosure requirement	Listed companies must disclose



- **What Neither SOX nor Dodd-Frank Covers**
 - No recovery in absence of restatement
 - Consider SEC v. Shanahan: SEC required to prove company was required to prepare a restatement before CEO could be required to repay bonuses
 - 624 F. Supp. 2d 1072 (E.D. Mo., 2008)
 - No recovery of proceeds of stock sales at prices (alleged to have been) driven up (allegedly) inflated earnings



- **Dodd-Frank Proposed Regulations**
 - Not available at press time



- Clawback Policy Design
 - Baseline Question: *Trying to Meet, or Exceed, the Regulatory Requirements?*
 - *Align with Overall Compensation Philosophy*
 - Unintended Consequences
 - Smaller proportion of pay “at risk” as incentive pay
 - Comp tied to non-financial performance objectives
 - Accounting consequences for modifying awards



- Clawback Policy Design (cont'd)
 - Note: SOX and Dodd-Frank co-exist; Dodd-Frank doesn't trump SOX
 - Individuals to be Covered (more than execs?)
 - Executive Officers
 - Rule 3b-7 under the Securities Exchange Act?
 - Section 16 filers?
 - What about individuals who become execs after the grant/award but before the restatement?



- **Clawback Policy Design (cont'd)**
 - Compensation to be Covered
 - Comp not tied to specific performance metrics?
 - Clawback Period
 - Question: is Dodd-Frank Retroactive?
 - Only the Required Period? Or Longer?
 - Dodd-Frank 3-year period - covers grants, vesting and exercises?



- Clawback Policy Design (cont'd)
 - When Will a Clawback Be Required?
 - SOX
 - Dodd-Frank
 - Is “the date” the same as the Form 8-K, Item 4.02 date?
 - » Determination that the financial statements should no longer be relied upon
 - Other Triggers



- **Clawback Policy Design (cont'd)**
 - Issuer Discretion Whether to Recover?
 - Dodd-Frank: no discretion
 - Who Acts for the Issuer?
 - Board
 - Committee
 - CEO
 - Forum for Resolving Disputes



- **Clawback Policy Implementation**
 - Stand Alone Policy
 - Employment Agreements
 - Incentive Plans (Cash, Equity Award Agreements)
 - Severance Agreements (Release of Claims?)
 - ERISA
 - Corporate Governance Guidelines
 - Code of Conduct



- **How to Effect a Clawback**
 - Immediate Reimbursement
 - Reimbursement Over Time
 - Offsets



- Clawbacks and Tax Issues
 - Same Year
 - Later Year
 - Revenue Ruling 79-311
 - § 1341 (Inconsistent IRS Rulings, Case Law)
 - § 409A
 - § 83 Property
 - Recovering FICA



- **Clawbacks/Accounting Considerations**
 - Accounted for when a triggering event takes place
 - Recognize the value returned by the individual
 - Return of shares – treasury stock
 - Income to the extent of compensation expense previously recognized for the award clawed back
 - Excess value would be increase to APIC (additional paid-in capital)



- Clawbacks/Accounting Considerations (cont'd)
 - Assumption: need mutual understanding of how the clawback would work when the award is made
 - Subjectivity or discretion – may mean there is no grant date for accounting purposes
 - Variable accounting for the fair value of the award until a grant date is established
 - Clawback mechanism should be based on objective factors to have a grant date at award



- Clawbacks and Insurance and Indemnification Considerations
 - Typical trigger: “wrongful act”
 - Consider the *Jenkins* scenario
 - Claim precluded by a “profit or advantage” exclusion
 - D&O Market Reaction



- Clawbacks and International Considerations
 - Treatment by country varies widely
 - China: may be enforceable, more likely if U.S. law and with a U.S. parent company
 - France: likely not enforceable
 - U.K.: likely enforceable
 - *See International Implications of Clawbacks in Equity Compensation, Baker & McKenzie, Global Equity Services, March 2011 (in the course materials)*



- **Clawback Policies and Proxy Advisory Firms**
 - ISS (2011 US Proxy Voting Guidelines)
 - Case-by-case voting recommendation
 - Considerations
 - Adoption of a formal recoupment policy
 - Chronic restatement history/material financial problems
 - Policy substantially addresses shareholder concerns