

Executive Compensation Clawbacks: A Robust Analysis of Design Features

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Executive Compensation Webinar Series
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Presentation by:
Anthony Eppert
AnthonyEppert@HuntonAK.com
512.542.5013

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 - A purpose of the webinar series is to provide FREE CE credits
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About Anthony “Tony” Eppert



Anthony Eppert , Partner
Hunton Andrews Kurth LLP

Tel: +1.713.220.4276

Email: AnthonyEppert@HuntonAK.com

- Tony practices in the areas of executive compensation and employee benefits

- Before entering private practice, Tony:
 - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
 - Obtained his LL.M. (Taxation) from New York University
 - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
 - Editor-in-Chief, Journal of Medicine and Law
 - President, Tax and Estate Planning Society

Upcoming 2021 Webinars

- 2021 webinars:
 - Finding Value: How to Negotiate Compensatory Economic Drivers in a Change in Control Transaction (4/8/21)
 - Is a Global Employment Company the Solution to Help Manage Internationally Mobile Employees? (5/13/21)
 - Training Course on Designing an Equity Incentive Plan (6/10/21)
 - Training Course on Stock Option Awards and Stock Appreciation Rights (7/8/21)
 - Training Course on Restricted Stock and Restricted Stock Unit Awards (8/12/21)
 - Preparing for Proxy Season: Start Now (Annual Program) (9/9/21)
 - How to Properly Hire and Fire an Executive Officer (10/14/21)
 - A Review of Unique Non-Employee Director Compensation Arrangements (11/11/21)
 - Thoughts on Maximizing the Deductibility of Compensatory Arrangements (12/9/21)

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Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded issuers, and involve substantive areas of:
 - Tax,
 - Securities,
 - Accounting,
 - Governance,
 - Surveys, and
 - Human Resources

- Historically, compensation issues were addressed using multiple service providers, including:
 - Tax lawyers,
 - Securities/corporate lawyers,
 - Labor & employment lawyers,
 - Accountants, and
 - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



Our Compensation Practice – What Sets Us Apart (cont.)

- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement “best practices”
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Purpose of Presentation

- The purpose of this presentation is to discuss clawback policies sponsored by publicly-traded issuers
- To that end, this presentation covers:
 - Rationale of clawback policies,
 - Upcoming requirements under the Dodd-Frank Act,
 - Overview of current approaches to clawback policies,
 - Design features of clawback policies,
 - Disclosure and shareholder proposals,
 - Indemnification and advancement of expenses issues, and
 - Various action items to consider

Rationale for Clawback Policies

- Reduce potential motivation for inappropriate actions or decisions by reducing financial gain to be realized
- Prevent unjust enrichment
- Concept of clawback has its roots in Sarbanes-Oxley Act ("**SOX**")
 - Section 304 of SOX was intended to address the public policy goal of holding corporate executives accountable when there is misconduct with respect to a public company's financial statements
- Anticipation of final rulemaking from the Securities and Exchange Commission that is required under Section 954 of the Dodd-Frank Act
- Institutional investors and shareholder advocates are encouraging boards to adopt clawback policies that go beyond the statutory requirements
- Recent corporate scandals and associated calls for executive accountability

Drawbacks to Clawback Policies

- Covered individuals may become overly cautious and risk averse
- Clawbacks might chill performance-based compensation and result in a move toward more fixed pay (*i.e.*, higher base salary)
- The potential application of a clawback to incentive compensation could result in the perception by the covered individual that the value of the incentive compensation is reduced
- Covered individuals might be less willing to identify situations that might trigger a restatement or a recalculation of performance metrics or other criteria
- Most clawback provisions that are currently in place at issuers are untested
- Could have a negative effect on board management relationships, executive team morale, and on broader issues of talent development and retention

Dodd-Frank Requirements

- As a quick review, the current requirements of the Dodd-Frank Act clawback (that has not yet been effectuated, but would require that exchanges require listed companies to have such policies) include:
 - Compensation clawback policy must apply at least to current and former executive officers
 - In contrast, Section 304 of SOX applies only to the CEO and CFO
 - The clawback policy must be triggered any time the company is required to prepare an accounting restatement resulting from “material” noncompliance with any financial reporting requirement under the securities laws
 - In contrast, Section 304 of SOX applies only when a restatement of financial statements is “required” and is the result of “misconduct”
 - Thus, Section 304 of SOX contains a fault requirement and Dodd-Frank does not
 - Once the clawback is triggered, it would apply to all “incentive-based” compensation that is based on financial information required to be reported under the securities laws
 - The look back period for which incentive-based compensation is subject to clawback is the 3-year period preceding the date on which the restatement is required
 - In contrast, the look back period under Section 304 of SOX is 12 months
 - The amount subject to the clawback is the difference between the amount paid and the amount that should have been paid under the accounting restatement
 - No discretion

What Are Companies Doing?

- To date, companies have been applying a variety of approaches while they await finalization of the clawback requirements under the Dodd-Frank Act. These approaches include:
 - Do nothing and wait
 - Adopt a “loose” policy that is expected to be amended in a more robust way once final rules are issued
 - Have executive officers sign a contractual arrangement whereby each such executive agrees to comply with the Dodd-Frank Act clawback requirements (when effective) and any clawback policy adopted by the company, as such is amended from time to time
 - Adopt a very formal and robust clawback policy
 - Encompass other “triggers” (e.g., violations of corporate ethics codes, “fitness to serve” standards, and restrictive covenants)
 - Increase the risk of forfeiture of certain benefits should an executive be terminated for ethical or compliance lapses

Covered Executives

- Section 954 of the Dodd-Frank Act applies to “any current or former executive officer of the issuer who received incentive-based compensation”
- The group of covered individuals should be broad enough to cover at least those individuals who influence decision-making with respect to critical business issues. Currently, issuers who have adopted clawback policies generally cover one or more of the following groups:
 - Named executive officers
 - Current key executive officers (e.g., Section 16 officers)
 - Current and former key executive officers (e.g., Section 16 officers)
 - Incentive pay recipients (annual and/or equity plan participants)

Compensation Components Covered

- Clawback policies can cover several forms of compensation paid to an individual, but is usually limited to incentive compensation, which may include:
 - Annual cash bonuses
 - Long-term cash incentive awards
 - Equity awards (both full-value awards, such as restricted stock or restricted stock units, and appreciation-only awards, such as stock options and stock appreciation rights)
 - Gains from the sale or exercise of equity-based compensation
 - Nonqualified deferred compensation

- Typically fixed pay is not included (e.g., salary, retention bonuses, etc.)

- In general, policies will cover only compensation that is attributable to a specified period prior to the triggering event (typically 1 – 3 years)

Triggering Events

- Recoupment triggered by errors in financial performance measures or reporting (regardless of whether any individual engaged in fraud or misconduct), for example, when incentive compensation was paid based on:
 - A misstatement (a lesser standard than a restatement) of the company's financial statements
 - Materially inaccurate performance metrics or other criteria
- Recoupment triggered if the individual engaged in fraud or misconduct (regardless of whether there is a financial restatement or a material error in calculating the compensation paid). Typically, this would include one or more of the following:
 - Fraudulent or intentional misconduct
 - Engaging in conduct detrimental to the company
 - Gross negligence
 - Violation of company policies
 - Failure to supervise
- Recoupment only if both of the above triggers are satisfied
- Proposed rules under the Dodd-Frank Act would apply regardless of the fault of the executive officer and without regard to an executive officer's responsibility for preparing the issuer's financial statements

Developments in Clawback Triggers

- Should traditional clawback triggers be expanded to include a broader set of bad behavior such as sexual harassment, data breaches, and reputational harm?
 - If yes, then issuers should consider revisiting “cause” definitions in executive contracts, equity incentive plans, etc.
 - Alternatively, executive contracts, equity plans, etc., could be drafted to be subject to the clawback policy, and then for purposes of the clawback policy a more rigid or loose definition of cause could be inserted into such policy

- Institutional investors and proxy advisors have moved to supporting policies that can recoup compensation from behavior that causes direct financial harm to shareholders, reputational risk to the company or results in criminal investigation, even if such actions do not result in a material restatement

Amount of Compensation Eligible for Recovery

- The amount to be recouped may depend on the clawback trigger
- Clawback policies typically provide that, in the event of a financial restatement or a recalculation of performance metrics or other criteria, the amount recoverable is the difference between:
 - The payment actually made to the covered individual (or the number of shares granted or that became vested under an equity award grant to the covered individual), and
 - The payment that would have been made (or number of shares that would have been granted or become vested) based on the restated financial results or the recalculated or adjusted performance metrics or other criteria
- In cases of fraud or misconduct, clawback policies could provide that the amount recoverable is greater, such as:
 - The additional amount paid, granted, or vested during the period relating to the fraud or misconduct
 - Any equity award that vested or was exercised after the act of fraud or misconduct, including the gain on the award if the shares have been sold
- Alternatively, in cases of fraud or misconduct, the clawback could provide that all compensation paid under certain plans or programs are subject to clawback

Discretionary vs. Nondiscretionary Enforcement

- Alternatives for enforcement discretion include:
 - The clawback will automatically trigger when a triggering event occurs
 - As a modification to an automatic trigger, the clawback policy could instead provide that the trigger is applied automatically unless the amount to be recovered would be less than the anticipated cost of recovery or a specified threshold amount
 - The clawback may be designed such that the board of directors (or another body) has discretion to determine whether to apply the clawback. If discretion is provided, the limits of that discretion should be addressed in the policy

- A clawback policy should address which body determines whether a clawback is triggered and is generally responsible for making determinations under the policy

How to Exercise Discretion

- Create a process in advance for applying the discretion
- When, whether, and how discretion to trigger a clawback should be exercised
 - Did the company or its stakeholders suffer harm (*e.g.*, financial, reputational, or employee morale)
 - Was there culpability by an executive, or the employees for whom the executive is responsible to supervise
 - Nature of behavior
 - Company policies and procedures
 - Was risk anticipated in company's risk assessment

Actions to Facilitate Clawback Enforcement

- Consideration should be given to establishing a claims procedure in the event that a negatively-impacted individual challenges any determinations under the clawback policy
- Amend compensation programs to explicitly incorporate the clawback policy
- Obtain consent of covered individuals if the goal is to extend the policy to covered compensation previously paid and equity grants previously awarded
- Require the deferral of incentive compensation to allow for cancellation or forfeiture in the event a clawback is triggered
- Require retention of a significant portion of shares acquired through equity compensation programs
- Explicitly retain the discretion to withhold future incentive compensation awards and equity awards
- Options may be limited after a termination of employment

Disclosure and Shareholder Proposals

- The SEC lists clawback policies as an example of an item that should be described in a company's CD&A
- Companies should disclose in their annual reports any account restatement cases requiring recovery from past fiscal year(s) so that investors are well informed
- Information about any outstanding excess pay from prior restatements should be reported with appropriate explanations
- Shareholder proposals relating to clawback policies tend to seek:
 - Disclosure of recouped or forfeited amounts of executive compensation
 - Reasons why recoupment or forfeiture occurred
 - Disclosure of decisions not to pursue recoupment
 - Expansion of the circumstances in which clawback will occur, to include misconduct that results in violation of a company policy that causes significant financial or reputational harm to the company, or, in some cases, where an executive failed to manage or monitor conduct or risks
- These shareholder proposals have, however, generally been unsuccessful

Indemnification/Advancement of Expenses Issues

- Case Study: In early 2019, a publicly traded company filed a complaint against several former executives citing gross negligence and misconduct and asking to claw back compensation
 - The Company argued that the executives were not entitled to indemnification or, advancement of expenses because the Company was compelled to bring the action
 - The Court upheld the advancement of expenses because the clawback suits arose from the defendants' work as officers of the Company and were covered by the advancement rights outlined in the Company's bylaws
 - Delaware courts have recognized indemnification and advancement as distinct principles and have found that an executive need not prove he or she will ultimately be indemnified in order to receive advancement
 - Delaware courts have upheld advancement of expenses even where executives were accused of fraud or other misconduct

- Companies should review their indemnification and advancement obligations and determine whether they need to be modified to reflect their intentions

Action Items

- Clawbacks should be reviewed by the compensation and compliance committees at least annually as part of the company's analysis of material risks
- Review plans that are currently in place and key design choices
- Consider whether it makes sense to expand or revise existing policies to take the following into account:
 - Definition of "cause" used in forfeiture provisions in severance and employment agreements and equity plans
 - Expand triggering events for clawbacks to include fraud-based governmental or internal investigations, material ethical misconduct, and damage to the corporate reputation and adverse publicity to the employer
 - Indemnification and mandatory arbitration clauses for clawback litigation issues
 - Incorporate any final rules under the Dodd-Frank Act
 - Set forth a process to determine how discretionary clawbacks will be determined

Don't Forget Next Month's Webinar

- Title:
 - Finding Value: How to Negotiate Compensatory Drivers in a Change in Control Transaction

- When:
 - 10:00 am to 11:00 am Central
 - April 8, 2021