Clawbacks of Executive Compensation Today

The concept of a clawback of compensation by an employer is not new or even unique to the U.S. However, it has been in the news recently due to several instances of corporate and individual malfeasance. So we thought we would describe what we are seeing today in this still evolving world of compensation clawbacks, since there is still no consistency of practice in this arena.

Exactly what constitutes a clawback – or recoupment as it is often called – and the basis of this action can be nebulous. (Most, if not all, of us have been subject to clawbacks in a non-business setting – e.g., give that piece of candy/doll/last piece of cake or pizza to your brother/sister/father/pet or you’ll regret it). Although taking such action was typically mandated by parental or sibling authority rather than a formal family policy, it sought to achieve similar objectives as corporate compensation clawbacks – a sense of fairness and motivating better behavior in the future.

At the time that Congress enacted the Sarbanes-Oxley Act in 2002, which included one of the first formal clawback laws, almost no companies had a corporate policy requiring or authorizing the clawback of compensation. Even a decade ago, relatively few companies had a formal clawback policy. Equilar reported that less than 18% of the Fortune 100 companies disclosed a clawback policy in 2006. In contrast, over 90% reported having one in 2016.

However, only 15% of companies surveyed by Shearman & Sterling had a mandatory clawback policy.

What action results in a clawback can vary considerably. Then, what gets clawed back can also be customized to each individual circumstance. For example, in the recent Wells Fargo customer accounts scandal, the bank’s former CEO, John Stumpf, had approximately $28M of incentive compensation paid to him in 2016 clawed back. However, he did not have to return cash to the company; rather, this amount is to be deducted from future nonqualified retirement plan payments. This avoids a potential tax issue which we will highlight below. In addition, he agreed to forfeit $41M in unvested equity that was scheduled to become vested in the near future. At the same time, Carrie Tolstedt, the head of community banking at Wells Fargo, who was terminated “for cause”, forfeited all outstanding stock options valued at $47.3 million, along with $19 million of other unvested equity.

Meanwhile, the enormous data breach at Equifax has resulted in the forced “retirement” of CEO Richard F. Smith. It has been reported that the Board of Directors is considering terminating him “for cause” which could require certain compensation to be paid back to the company and other be foregone. Last month, KB Home confirmed that their CEO, Jeffrey Mezger will forfeit 25% of this year’s annual bonus as a result of his sexist and homophobic ranting against his neighbor in Los Angeles (which was recorded on a security camera). Should that be considered a compensation clawback or similar to a penalty assessed on professional athletes for inappropriate behavior?
The term clawback really should be separated from compensation forfeiture clauses which may result in the non-payment of future compensation. In contrast, a clawback seeks to recover compensation already earned or paid. The basic premise of a clawback is that it voids unjust enrichment and discourages corporate risk taking. A corporate policy should address the circumstances under which a clawback can occur and the time period during which it could occur.

Here is a brief summary of their history and the different types of clawbacks that could impact corporate executives in the U.S.

- **History of Compensation Recovery Policies**
  Unconventional clawbacks – and they were not called clawbacks until recently – have been around for centuries. Financial penalties have been incorporated in non-compete agreements in the U.S. since the early 1800s. Compensation paybacks also have been incorporated in athletic contracts for decades. Virtually all major league baseball teams incorporate clawback language in minor league contracts for their top draftees. The MLB Commissioner’s office introduced recommended clawback language over a decade ago – and the player’s union has agreed that such clauses may be included in the contracts of minor league players, with the timeframe of any payback based on the amount of a signing bonus. It is now also fairly common to incorporate clawback clauses in the contracts of college athletic coaches. Athletic clawbacks generally are not related to bad behavior, but to not achieving goals or leaving the team before a set term.

The concept of a company requesting or requiring a repayment of an employee’s compensation had been in place well before Congress acted to require certain clawbacks in 2002. Over 50 years ago, a number of companies had policies that required an executive to pay back to the company compensation which the IRS determined to be “excessive” and therefore not deductible by the company. In the 1960s, the Flagg Grain Co. had such a provision in an executive’s employment contract. When the salary of the corporate secretary was deemed excessive by the IRS, he returned $3,600 to the company. He then sought to deduct that amount on his tax return which the IRS denied, and the Tax Court upheld its position. The same issue was litigated again in 1983 when Eugene Van Cleave voluntarily repaid to his employer the compensation that the IRS had deemed excessive as required by the company’s by-laws. The IRS denied his tax deduction for the repayment, but he fought the battle and won in federal court. (The tax treatment of amounts that are repaid remain somewhat murky and uncertain to this day – more on this below).

The largest corporate clawback in history was the recovery by United Health Group of $600M from its former CEO, William McGuire for gains realized from illegal stock option backdating from 2003-2006. Tyco recovered over $500M from its former CEO, Dennis Kozlowski in 2012 for a massive fraud that actually resulted in his going to jail. In the so-called “London Whale” scandal in 2012, J.P. Morgan Chase paid $920 million in penalties to U.S. and U.K. regulators. Several of those accused of being responsible for trading losses returned bonuses and the Chief Investment Officer also repaid two years’ worth of her salary. We have already summarized more recent actions by Wells Fargo and Equifax. Yet, compensation clawbacks are not being universally applied in all circumstances. The board at United Continental Holdings had discretion and decided not to seek a clawback from its CEO who had been terminated in connection with a federal investigation.

Within the past five years, voluntary clawback policies have become fairly common throughout Corporate America. In many cases, the board of directors or corporate decision maker has a degree of discretion as to whether to pull the trigger. Any decision could have reputational implications.

- **Foreign Country Recovery Policies**
  The United States is not the only country that requires employers to recover compensation in certain instances. Most European countries have had clawback policies for many years – although, apparently there were no compensation clawbacks by Volkswagen related to its emission fiasco, but they agreed to pay enormous penalties and terminated several executives. The Financial Conduct Authority in England issued rules in 2015 that require all banks and financial firms operating in Great Britain to adopt rules for repaying bonuses received by executives who participate in, or were responsible for, conduct which results in a significant loss to the firm. This clawback period can extend for up to ten years when a bank has been notified it is under investigation.
In Canada, clawback policies are not mandatory, but have become more common, particularly among large public companies. Canadian companies which adopt clawback policies are required to disclose them in their annual management information circulars. The Financial Stability Board, an international organization, recommends that all Canadian financial organizations adopt clawback policies as a best practice. In contrast, several other countries have labor or employment laws that prohibit any repayment of compensation.

**U.S. Legislative Activity**

**Sarbanes Oxley Act of 2002 (SOX)** - The initial clawback law passed by Congress had its genesis in the corporate scandals at Enron, Tyco and WorldCom nearly 25 years ago. SOX authorized companies to recover annual bonuses, equity-based compensation, and profit on the sale of company stock received within a 12-month period after a company is forced to restate its financials due to “misconduct”. This law applies only to the company’s CEO and CFO, and does not define misconduct or specify whether the individual must participate in the misconduct. SOX clawbacks are enforceable only by the SEC. As a result, there are relatively few SOX clawbacks on record.

CEOs/CFOs subjected to SOX-related charges include those from ArthroCare Corp., CSK Auto, Beazer Homes, United Healthcare, OCZ Technology Group, Saba Software, and Computer Sciences Corp. In 2016, a federal appeals court unanimously upheld the SEC’s power under SOX to seek clawbacks from a CEO and CFO even if neither was personally guilty of misconduct (*SEC vs. Jensen*).

The SEC on occasion has not pursued a SOX compensation clawback when a company’s CEO and CFO voluntarily reimburse the company when accounting fraud violations are found. Examples are Monsanto, Logtech and Orthofix Int’l where executive officers were not found to have any personal misconduct yet repaid cash bonus and the value of equity awards for years accounting violations occurred.

**Troubled Asset Relief Program (TARP)** - Companies which received government assistance as a result of the financial crisis of 2008-2009 were subject to compensation recovery policies substantially broader than those under SOX. TARP rules required the repayment of any bonus, retention award or other compensation paid when a financial statement was determined to be materially inaccurate. More significantly, this rule applied to the company’s five highest-paid senior executive officers, plus up to the next 20 highest paid employees, with the number varying based on the amount of TARP assistance. Unlike SOX, the TARP clawback did not require misconduct or a restated financial statement. Repayments here also were rare—although the CEO for Wilmington Trust Corp. paid back a $2M signing bonus and several executives at American International Group repaid bonus awards.

**Dodd-Frank Act of 2010** - The Dodd-Frank Wall Street Reform & Consumer Protection Act did not redefine a clawback, but instead directed the SEC to design a robust clawback policy. In July 2015, the SEC released proposed regulations significantly expanding the number of executives potentially subject to a clawback, requiring disclosure of each company’s clawback policy and reporting those individuals subject to a clawback. These rules would apply to all publicly-traded companies, including foreign private issuers.

A clawback would be triggered when a company is required to restate its financials due to any material noncompliance with a financial reporting requirement. Any incentive-based compensation received by an “executive officer” during the three fiscal years prior to the date on which the company is required to prepare an accounting restatement is subject to recovery. The amount clawed back would not be the entire incentive compensation paid, but rather the amount of such compensation paid in excess of the amount that would have been paid if the restatement applied.

Incentive compensation includes any cash or equity awards earned or vested based wholly or partially upon the attainment of any “financial reporting measure.” Examples would include most performance-based annual bonus awards and long-term incentive awards, but not salary or time-vested long-term awards. If the incentive compensation is based on stock price or total shareholder return, companies may use a reasonable estimate to determine the amount to be recovered. There is no de minimis exception although there are two limited exceptions where companies would have discretion not to seek repayment. An example is where the expense of enforcing the recovery would exceed the recoverable amount or when the recovery would violate the law in a foreign jurisdiction.
As significantly, each company’s clawback policy would have to be disclosed in annual public filings such as a proxy statement or Form 10-K. In addition, in the event of an accounting restatement that requires recovery, disclosures must be made about the clawback in the year for which the restatement occurred and also in any future year the company enforces the clawback.

However, the SEC now has delayed the issuance of its final rules, so changes in corporate policies to comply with the proposed rules currently are on hold.

**Recoveries Under Employment Contracts and Compensation Plans**

Contractual recoupments have been much more common than statutory clawbacks. In most cases, clawback provisions in plans and agreements are triggered by an executive going to work for a competitor or violating “bad behavior” clauses. In the context of stock options, these clauses might provide for a recovery of any gross profit realized upon the exercise of a stock option during a defined period of time (e.g., six months or one year prior to the alleged violation). There are a number of practical, as well as legal concerns with regard to such provisions, especially when enforcement is discretionary or when the company does not take a consistent position with regard to enforcement. In fact, the lack of enforcement guidelines is a reason we saw some companies eliminate clawback provisions from agreements prior to Dodd-Frank. In addition, it is often more difficult to enforce a clawback after an executive has left employment. However, courts have generally upheld the legality of clawback clauses within executive compensation plans and agreements.

We estimate that a substantial majority of Ayco corporate partners now have a clawback clause in their executive compensation plans/long-term incentive plans or grant agreements. These are different from benefit overpayment recoveries. Often these can be discovered as a result of plan audits. An example is an employer’s attempt to recover improper or excess pension distributions.

Forfeiture provisions are less common in nonqualified deferred compensation plans, but we have seen a few examples. Forfeiture of an executive’s voluntary elective deferrals is essentially the equivalent of a clawback of pay. A federal court upheld the legitimacy of such a forfeiture clause in a voluntary stock deferral plan at Citigroup. Forfeiture clauses often are associated with a non-compete covenant and are more common in supplemental executive retirement plans.

**State Laws**

Even in the absence of a contractual right to recover compensation, a company may be able to recover compensation based on state law. A classic example involved Richard Scrushy, the former CEO of HealthSouth Corporation. Although he was acquitted of criminal charges based on accounting fraud, the company successfully forced a repayment of $47.8M under Alabama law. In a case involving the law firm, Dewey & LeBoeuf LLP, a federal Bankruptcy Court agreed that New York law allowed a bankruptcy trustee to clawback and recover all partnership distributions made while the partnership was insolvent. Some states have laws dealing with the enforcement of non-compete agreements. When J.P. Morgan Chase sought to recover $376,000 in the value of stock awards after an executive went to work for a competitor, a court held the clawback clause to be clearly enforceable under Delaware contract law. However, non-competes are not enforceable in all states, with California being one such state that generally prohibits enforcement.

Several states have wage payment laws which prohibit employers from refusing to pay or recover wages already earned absent narrow exceptions. An Illinois court, as an example, held that a non-compete is unenforceable without adequate consideration – which it found to be two years of employment. Thus, a company could not enforce such a clause in a contract for a new hire. Under Texas law, non-competes generally will be enforced if there was consideration paid at execution of the agreement, there are reasonable geographic and activity restrictions, and the terms protect an employer’s legitimate business needs.

**Proxy Advisors & Shareholder Votes**

Shareholder advisory groups like Institutional Shareholder Services (ISS) and Glass Lewis have indicated that they take into consideration a lack of a clawback policy in evaluating a public company’s corporate governance practices. But it appears that having a mandatory clawback of equity awards is not currently a primary focus of these groups.

The Council of Institutional Investors, which represents more than 125 pension funds and other large investors, has urged the SEC to support tough clawback
provisions. While the U.S. Chamber of Commerce has called the SEC proposals “needlessly complex” by implicating too many executives, the Center on Executive Compensation commented that applying it to all executive officers was a familiar and workable group. The Center supports “no fault” clawback policies, but believes there should be flexibility in their implementation.

Even prior to Dodd-Frank, The Conference Board’s Task Force on Executive Compensation recommended that companies adopt clawback policies for misconduct which contributed to excessive or unearned payouts of executive compensation. The Board indicated a company should fully disclose any policy, as well as actions taken to recoup compensation, which the SEC rules, if ever finalized, will require.

➢ **Tax Consequences**

The income tax treatment of compensation that is clawed back or voluntarily repaid to the company isn’t always perfectly clear, particularly when the repayment occurs in a year subsequent to when the compensation was originally paid. Any federal, state, local and FICA tax withheld when the compensation was paid or made available should generally stand. The executive may be entitled to take a loss deduction under IRC §165(a) for the tax year of the clawback or may be eligible for a claim of right tax credit under §1341. There are inconsistent federal court decisions that opine in this area of tax law. The company should be entitled to a corporate tax deduction in the year the compensation was paid originally – but could have to report income in the year of repayment. The company should not issue a revised Form W-2 deleting the compensation that was paid in a prior year (although, this might be a viable option if the clawback occurs in the same year and it is determined there was never a right to the payment).

A clawback of certain compensation could create, or at least raise, potential IRC §409A penalty issues if amounts relate to deferred compensation or other elements of pay subject to §409A. The acceleration of a payment could risk a 20% tax penalty (payable by the executive), so a company should avoid satisfying a clawback obligation by deducting amounts from a deferred compensation account or accelerating the payment of amounts subject to §409A rules. The IRS had detailed alternative methods for a taxpayer to claim a tax benefit when a clawback occurs due to a Ponzi scheme. Here, the taxpayer would be entitled to claim a loss deduction or a tax credit, whichever results in a greater tax recovery amount.

➢ **Accounting Consequences**

There has been a concern raised by some in the accounting field that a discretionary clawback feature incorporated within equity awards (e.g., stock options, restricted stock, performance stock) could potentially change their accounting treatment from fixed to variable accounting. Several years ago, before the recent mandate for having a clawback policy and when clawbacks were rare, this matter appeared to be addressed directly in ASC 718-10-30-24. It states that a contingent feature in an award that might cause an employee to return either the equity award or any realized gains, such as a clawback feature, shall not be reflected in estimating the grant date value of an equity instrument. However, a few commentators have suggested that this does not address or take into account clawback policies that allow discretion, such as by the board of directors, in their application and enforcement.

➢ **Issues To Consider**

Dodd-Frank definitely has altered the landscape for corporate clawback policies. Even prior to when the SEC proposed rules were issued in 2015, most large companies already had established customized compensation recovery policies. Some of these were designed for the optics to appease shareholder and corporate governance groups. But, they can discourage “bad” behavior by executives. The threat of a clawback and a requirement to disclose names may be as powerful in preventing bad behavior as any actual recovery (as was noted in a New York Times article).

Over the past several years, a number of companies and the D & O insurance industry have explored whether it would be possible to come up with an insurance solution to cover a possible clawback situation. Legislation proposed by Rep. Frank, co-sponsor of the Dodd-Frank Act in 2012, would have prohibited such insurance. It failed to pass Congress. But the SEC’s proposed rules prohibit employers from paying premiums on an insurance policy covering an officer’s potential clawback obligation.

The Financial CHOICE Act, passed by the House earlier this year, but unlikely to become law given the current state of Congress, would repeal many aspects of Dodd-
Frank, including the clawback rules. It is more likely we will simply see a significant delay in the finalization of the SEC’s proposed rules. This would leave it up to companies to set their own policies in this arena.

Here are a number of issues that should be reviewed by companies that have or are considering the adoption of a clawback policy:

- To which current (and former) executives should a clawback apply?
- Which elements of pay should be subject to a clawback?
- What circumstances and type of conduct should trigger a clawback?
- Should the company or a committee have discretion to enforce the clawback?
- How far back and from which date (grant or payment) should the clawback reach?
- How will the company communicate the clawback to those affected?
- When will any revised policy become effective?
- Should any policy apply retroactively (after the right to the compensation has attached) or prospectively only (before a claim of right has arisen)?

The concept of a clawback has become much more common in the lexicon of compensation professionals. Whether they serve their purpose of discouraging “bad behavior” or lead to a higher non-performance-based pay for executive officers remains to be seen.

The CEO Pay Ratio Disclosure Is Upcoming

The CEO pay ratio rule was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. It requires all U.S. public companies (and issuers of public debt even if they have no publicly-traded securities) to calculate the median total annual compensation of the company’s worldwide employee population compared to the annual total compensation of the company’s CEO. It is now over two years since the SEC issued final rules regarding how this calculation is to be made. Disclosure of the pay ratio and the basis of the calculation is scheduled for fiscal years beginning on or after January 1, 2017. This would generally mean reporting in proxy statements filed in spring 2018.

Given the current Administration’s delay of many regulatory matters, many had anticipated that this calculation and disclosure might be delayed or shelved. However, last month, the SEC issued new guidance regarding the rule and confirmed that it will need to be disclosed in 2018 proxy statements, as proposed. At the same time, this recent guidance does provide some relief in the calculation of the pay of a “median employee”, which should be welcome relief to all U.S. public companies. Here is a brief outline of the modifications recently announced:

- **Reasonable Estimates Allowed** - In an Interpretive Release, the SEC stated that a company may utilize reasonable estimates, assumptions or methodologies in calculating the pay ratio. The SEC will not pursue an enforcement action against a company unless there was not a reasonable basis for the calculation or it was provided in bad faith.

  Companies may use their own internal records to identify the median employee, even if such records do not include every element of compensation. These may also be used to determine whether the 5% de minimis exemption for non-U.S. employees is available. This will be welcome by those companies which don’t provide the same types of compensation to all worldwide employees, including equity and long-term incentive awards.

- **Relaxed Independent Contractor Exclusion** - The recent guidance clarifies which workers will be considered employees for purposes of calculating the pay of the median employee. Previous guidance was retracted and the new rules now provide that whether an individual, including an independent contractor, would be considered an employee will be based on any widely recognized test a company uses to determine whether its workers are employees. This will be a welcome change by those companies whose pay is determined by unaffiliated third parties.

- **Increased Flexibility on Statistical Sampling** - Construction of the CEO pay ratio does not require companies to calculate the pay of the median employee using any and all elements of pay. (In contrast, the CEO’s pay will be calculated using data reported in the Summary Compensation Table of the company’s proxy.) Companies will be allowed to construct a pay sampling for the median employee...
Institutional Shareholder Services (ISS) released results of a survey it recently conducted among investors regarding whether they intend to use the CEO pay ratio disclosures in analyzing a company’s compensation policy. Nearly 75% of those participating in the survey indicated that they did intend to compare and use the disclosure in their analysis of compensation issues. The most significant differences are likely to receive a great deal of press once proxies are released next year. Then, the year-over-year comparison likely will begin starting in 2019. In addition, several states and cities have pending legislation that will impose a surtax or other charges on companies that report pay ratios that exceed certain thresholds.

**Cleveland Can’t Tax Your Pension (Qualified or Nonqualified)**

Last month’s *Digest* described the conundrum of state and local income tax rules. Late last month, the Supreme Court of Ohio issued an interesting opinion overturning a ruling by the city of Cleveland’s tax administrator and the Cleveland Income Tax Board of Review with regard to the right of Cleveland to tax the supplemental executive retirement plan (SERP) benefits of a corporate executive who worked in Cleveland (*MacDonald et al. vs. Cleveland Income Tax Board of Review*). Here’s what this case involved.

William MacDonald retired from National City Corp. in 2006. (National City was acquired by PNC Financial Services in 2008). He had accrued a significant benefit under the company’s SERP and elected to have it paid as a joint and survivor annuity commencing in 2006. MacDonald did not live in Cleveland but worked there for over 30 years. The city (as almost all cities and towns in Ohio) has an income tax on residents and any non-residents who work in the city. However, a Cleveland ordinance exempts “pensions” from the city income tax. National City did not withhold any city income tax when it began paying the SERP benefits. However, the city assessed $182,142 in taxes against MacDonald representing 2% of the present value of the life annuity payments, based on what had been reported on McDonald’s Form W-2 for FICA tax purposes in 2006.

MacDonald disagreed with this assessment claiming that the SERP was a pension benefit and should be exempt from city taxes. However, the Cleveland Income Tax Board of Review upheld the assessment. He then further appealed to the State of Ohio Board of Tax Appeals. It concluded that the city was wrong to tax the SERP and that determination has now been upheld by the Ohio Supreme Court.

Cleveland had argued that while pensions were exempt from city taxes, under a city ordinance, it had the right to tax nonqualified deferred compensation and that the SERP really was a nonqualified benefit. In addition, city tax administration rules defined those pensions exempt from taxation as distributions reported on Form 1099-R. Since SERP payments are reported on Form W-2, they wouldn’t meet the city’s rules to be a non-taxable pension. The city also argued that a city ordinance provided that it had the right to tax all taxable income, including wages and all other income from whatever source derived. But this ordinance was clearly in conflict with the separate ordinance which specifically excluded pension income from city tax.

The Ohio Supreme Court concluded that the SERP qualified as a pension, despite being nonqualified deferred compensation and reportable on a Form W-2. It also concluded that the pension exclusion ordinance trumped the distinct city ordinance which seemed to allow the city to tax all qualifying wages.

Ironically, or perhaps, showing a degree of consistency with associated legal expenses, the City of Shaker Heights, OH where MacDonald resided also sought to subject the present value of the SERP benefit to its local tax. This was denied, on procedural grounds, in a 2015 decision by the court of appeals for Franklin County, OH, and subsequently upheld by the Ohio Supreme Court. This case and its nearly decade for full resolution is another example of the ongoing conundrum of state and local income taxes.
Did You Know...?

- Under the recently enacted Disaster Tax Relief & Airport and Airway Extension Act of 2017, those impacted by Hurricanes Harvey, Irma or Maria with a principal residence located in the disaster area and who sustained a loss can withdraw funds from a 401(k) plan or other retirement account without the 10% tax penalty for distributions before age 59½. In addition, 401(k) plans can increase allowable loan limits to $100,000 for qualified hurricane relief, allow delayed loan repayments for up to a year, and allow for re-contribution to the plan any withdrawals for home purchases cancelled due to disaster.

- The IRS has issued guidance confirming the tax treatment of leave-based donation programs intended to benefit the victims of hurricanes Harvey & Irma (Notice 2017-52). Under these programs, employees can forego vacation, sick or personal leave in exchange for cash payments that the employer makes to qualified charitable organizations. The IRS will not assert that these cash payments constitute taxable income to the employees for income and employment tax purposes so long as the payments are made to a IRC §170(c) organization for the relief of victims of these storms and it is paid before January 1, 2019.

- The Equal Employment Opportunity Commission (EEOC) has sued Estee Lauder for providing new mothers with more paid leave for caregiving and child-bonding than new fathers. The EEOC contends the policy violates the Equal Pay Act which prohibits discrimination in pay and benefits based on sex.

- The IRS has extended through 2018 relief from nondiscrimination rules for qualified defined benefit pension plans that were frozen with respect to new hires prior to 2014. This relief has been in effect for the past several years, but was scheduled to end this year. The IRS also released the mortality table that defined benefit pension plans should use to determine minimum present value for annuity distributions in 2018 (Notice 2017-60).