Executive Compensation

Prepping Your Clawback Policy for Prime Time

By Annette Leckie and Jessica Page

In the wake of corporate scandals and high-profile executive misconduct, compensation committees are reviewing the adequacy of their clawback and forfeiture policies. Board members want to be assured they have the tools needed if they find themselves in the headlines.

The original clawback provision under Sarbanes-Oxley requires only the CEO and chief financial officer (CFO) to disgorge incentive payments if misconduct leads to a restatement. A more stringent statutory clawback requirement was proposed as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. This mandatory clawback requirement, which has not yet been finalized, extends beyond the CEO and CFO and is triggered upon a financial restatement, without regard to fault.

For years, most corporate clawback policies have been guided in part by these proposed rules in anticipation of the Dodd-Frank measures becoming final. These policies often cover top executives; are triggered by a financial restatement due to the misconduct of a covered executive; and allow for, but do not require, recoupment of "excess" incentive compensation. Policies extending well beyond restatements are still a minority practice (outside of financial services). Now, however, compensation committees are asking, What tools will we need in the event of a scandal, particularly one causing reputational or financial harm short of a restatement? The answers are driving more fulsome discussions and policies.

Expanding Triggers

The primary area of change is the expansion of what triggers a clawback or forfeiture. Examples include:

■ Moving from a "fault" to a "no-fault" policy following a restatement, under the theory of preventing unjust enrichment rather than simply punishing misconduct. This change may also include holding executives accountable for all inaccurate calculations, not just those requiring a restatement. (Proposed Dodd-Frank regulations would require a no-fault policy with respect to restatements.)

■ Separating misconduct from a restatement, allowing misconduct alone to trigger recoupment or forfeiture of compensation.

■ Clarifying the definition of "misconduct" beyond criminal business offenses to include misconduct that led to, or could lead to, significant reputational or financial harm; failure to supervise; termination for cause; breaching code of conduct, ethics, or risk policies; or violation of restrictive covenants.

Other Considerations

As committees review their clawback policies, other considerations should include:

■ **Compensation subject to clawback.** Most policies will cover cash and equity incentive pay, but many will also cover non-performance-based elements (restricted shares/options, for instance).

■ **Forfeiture versus clawback.** Forfeiture provisions apply to compensation that has not yet vested or been earned and paid, while clawback policies cover compensation that has already been paid out. Forfeiture provisions are easier to execute and often found embedded in equity award agreements. Clawbacks, being harder to execute and more punitive, may require a higher level misconduct or criminal infraction than might be required to trigger forfeitures, which might be triggered by material violation of company policies, for instance.

■ **Coverage period.** How far back can the committee look for triggering events? Most policies cover a lookback period between one and three years. However, forfeiture policies not tied to a financial restatement often include look-forward periods from the date of the misconduct through the remaining vesting schedule.

■ **Covered employees.** Some policies cover all incentive plan participants, while others focus solely on executives. Others may bifurcate their structure with forfeiture provisions covering all equity recipients and clawbacks applying only to top executives. Many companies also include former participants and executives through retirement and severance policy provisions.

■ **Discretion.** Most policies allow for committee discretion in determining whether to recoup or cause forfeiture of compensation.

When the unthinkable happens, shareholders and other stakeholders expect boards to act. Robust clawback and forfeiture provisions provide the compensation committee with valuable tools needed to address difficult situations. And while most companies may never use them, the best time to implement or expand a policy is well before it may be needed.

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