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CLIENT ALERT

Navigating Compensation Governance in Uncertain Times

Early Learnings on Mandatory Clawback Policies

Not all Clawback Policies are Created Equal

Compensation Committees are in the midst of reviewing Dodd-Frank compliant mandatory clawback policies, with a looming adoption deadline of December 1, 2023. The terms of a mandatory clawback policy are dictated by rules adopted by the New York Stock Exchange and Nasdaq and approved by the Securities and Exchange Commission (“Exchange Rules”). Meridian reviewed over 100 mandatory clawback policies drafted by leading national law firms (or internal counsel) and found that, in general, they faithfully reflect these rules.

Key Observations

Many reviewed clawback policies go beyond the strict requirements of the Exchange Rules and include volitional provisions worthy of consideration. We have observed the following:

- **Committee (administrator) indemnification.** The Exchange Rules do not address the inclusion of Committee (administrator) indemnification provisions in clawback policies. Nonetheless, a minority of reviewed clawback policies include a Committee (administrator) indemnification provision, similar to the following:

Any members of the Committee, and any other members of the Board who assist in the administration of this Policy, shall not be personally liable for any action, determination or interpretation made with respect to this Policy and shall be fully indemnified by the Company to the fullest extent under applicable law and Company policy with respect to any such action, determination or interpretation. The foregoing sentence shall not limit any other rights to indemnification of the members of the Board under applicable law or Company policy.

Generally, corporate bylaws include indemnification clauses that cover director and officer conduct (in addition, public companies typically cover directors and officers under D&O insurance). The fact that some companies are also including an indemnification provision in their clawback policy indicates that they perceive it to provide some incremental protection, even if only to reaffirm the coverage of existing indemnity clauses.

- **Prohibition on indemnification of executive officers.** Nearly all reviewed clawback policies expressly prohibit indemnifying a covered executive against any amounts recouped under the policy, which is consistent with the requirements of the Exchange Rules. However, some reviewed clawback policies also prohibit (i) the reimbursement or payment of premiums for insurance that covers recouped compensation and/or (ii) an increase in an affected officer’s compensation to cover recouped compensation.

These prohibitions are consistent with the Exchange Rules, including SEC commentary that “indemnification or reimbursement would also be prohibited through modification to current compensation arrangements or other means that would amount to de facto indemnification, such as, for example, by providing an executive a new cash award which the issuer would then ‘cancel’ to effect recovery of outstanding recoverable amounts.”

Though not required, expressly restating these requirements in the policy reinforces the strict prohibition on indemnification of officers against the “loss” of erroneously awarded compensation.

- **Reimbursement of costs incurred in recovery of compensation.** Some mandatory clawback policies expressly allow for a company to seek reimbursement of costs (including legal fees) incurred in connection with the recovery of excess incentive-based compensation. Generally, these policies mandate the recovery of such costs. The inclusion of a cost recovery provision may act as an incentive for covered executive officers (particularly former executive officers) to repay excess incentive compensation upon demand.
- **Methods of recovery of excess incentive-based compensation.** The Exchange Rules do not prescribe a method or methods of recovery of excess incentive-based compensation. Rather, companies have the discretion to determine the appropriate means by which to make such recovery. However, some reviewed clawback policies include a non-exhaustive list of potential recovery methods, such as the following:

The Board shall determine, in its sole discretion, the timing and method for promptly recouping Erroneously Awarded Compensation hereunder, which may include without limitation:

- a) seeking reimbursement of all or part of any cash or equity-based award,*
- b) cancelling prior cash or equity-based awards, whether vested or unvested or paid or unpaid,*
- c) cancelling or offsetting against any planned future cash or equity-based awards,*
- d) forfeiture of deferred compensation, subject to compliance with Section 409A of the Internal Revenue Code and the regulations promulgated thereunder and*
- e) any other method authorized by applicable law or contract.*

Subject to compliance with any applicable law, the Board may affect recovery under this Policy from any amount otherwise payable to the Executive Officer, including amounts payable to such individual under any otherwise applicable Company plan or program, including base salary, bonuses or commissions and compensation previously deferred by the Covered Executive.

Provisions similar to this example (i) should facilitate the administration of a mandatory clawback policy and (ii) would place covered executives on notice as to potential methods of recovery.

- **Administrative process for determining excess incentive-based compensation.** The Exchange Rules do not require clawback policies to specify internal administrative procedures used to determine excess incentive-based compensation and the vast majority of reviewed clawback policies do not include such administrative procedures. However, a handful of reviewed policies include administrative procedures similar to the following:

The following procedures shall be followed in the event the Company is required to prepare an Accounting Restatement:

- a) The Chief Financial Officer or Chief Accounting Officer of the Company shall promptly report to the Audit Committee any instance in which the Company is required to prepare an Accounting Restatement.*
- b) Upon learning of a required Accounting Restatement, the Audit Committee shall determine the Accounting Restatement Date and shall promptly report to the Compensation Committee such determination.*
- c) The Chief Financial Officer or Chief Accounting Officer (or another appropriate officer or third party designated by the Compensation Committee) shall promptly (but in any event within ninety (90) days following the Accounting Restatement) calculate the Erroneously Awarded Compensation for each affected individual, which calculation shall be subject to Compensation Committee approval.*
- d) Promptly following the Compensation Committee’s approval of the Erroneously Awarded Compensation calculated by the Chief Financial Officer or Chief Accounting Officer (or another*

appropriate officer or third party designated by the Compensation Committee), the Company shall notify in writing each individual who received Erroneously Awarded Compensation of the amount of Erroneously Awarded Compensation received by such individual and shall demand payment or return, as applicable, of such Erroneously Awarded Compensation.

In preparing to implement a Dodd-Frank compliant clawback policy, companies should clearly delineate the process workflow, responsibilities and timing for the various tasks, which will naturally fall on different departments and individuals. These requirements may be contained within the clawback policy itself or set forth in a separate internal document. Whether to incorporate the administrative procedures into the clawback policy is a decision that should be considered from both a management and legal perspective.

- **Acknowledgment of clawback policy.** The Exchange Rules do not require covered executive officers to execute an acknowledgement of a company's adopted mandatory clawback policy. Nonetheless, roughly half of reviewed clawback policies require covered executives to sign an acknowledgement. Many of these policies note that the clawback policy remains enforceable regardless of whether a covered executive signs the acknowledgment. That begs the question as to the utility of the acknowledgement.

We are aware of a divergence of opinion among legal counsel on whether the use of an acknowledgement aids (or may aid) in the enforceability of a clawback policy.

Companies should confirm with their legal counsel regarding whether to require covered executive officers to execute an acknowledgment of their clawback policies and the benefit of such requirement.

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The **Client Update** is prepared by Meridian Compensation Partners' Governance and Regulatory Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.

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