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"CLAWBACKS" OF EXECUTIVE COMPENSATION

To Our Clients and Friends:

With the continued spotlight on executive compensation, and with companies in the mortgage and finance industries facing ongoing challenges in the months ahead, the subject of recouping, or "clawing back," executive compensation in the event of financial statement errors is likely to remain a focal point for boards of directors. Moreover, in the past several years, institutional shareholders and governance activists have focused on clawback provisions as a significant corporate governance and executive compensation issue.

The specifics of clawback provisions vary by company, but they share a common goal of enabling companies to recover performance-based compensation to the extent they later determine that performance goals were not actually achieved, whether due to a restatement of financial results or for other reasons. This client alert provides some background on clawbacks and concludes with a list of issues for companies to consider.

Background

Following the Enron- and WorldCom-era corporate scandals and enactment of the Sarbanes-Oxley Act of 2002, attention increased on the extent to which companies had the ability to recoup -- or "clawback" -- incentive compensation awarded to senior executives if it was later determined that their activities significantly contributed to a financial statement restatement, which resulted in a determination that the executives had received unearned incentive compensation as a direct result of their own misconduct.

The Sarbanes-Oxley Act of 2002 includes a clawback provision, Section 304, which generally requires public company chief executive officers (CEOs) and chief financial officers (CFOs) to disgorge bonuses, other incentive- or equity-based compensation, and profits on sales of company stock that they receive within the 12-month period following the public release of financial information if there is a restatement because of material noncompliance, due to misconduct, with financial reporting requirements under the federal securities laws. However, Section 304 has a number of limitations. Specifically:

- it governs recoupment of compensation paid only to the CEO and CFO and does not extend to other senior officers;

- it does not define "misconduct," creating an ambiguity about whether the CEO or CFO had to have participated in the misconduct in order to be subject to liability, and it does not otherwise specify whose misconduct is sufficient to trigger recoupment; and

- to date, courts have held that Section 304 is enforceable only by the SEC and does not provide private plaintiffs (such as a company or its shareholders) standing to bring a claim against a CEO or CFO.[1]

In December 2007, the SEC reached its first settlement with an individual under Section 304. In a settled enforcement action, the former Chairman and CEO of UnitedHealth Group Inc. agreed to reimburse the company for all incentive- and equity-based compensation that he received from 2003 through 2006, totaling approximately $448 million in cash bonuses, profits from the exercise and sale of UnitedHealth stock, and unexercised options.[2]

Clawback provisions can be implemented in a number of ways: through policies, compensation plans, award agreements and employment agreements. Some of these approaches provide a contractual basis for enforcing the provisions, while others do not. In the absence of a contractual right, there nevertheless is some ability to pursue recoupment of unjustly paid compensation through state-law claims, as shown by the 2006 Alabama Supreme Court ruling that former HealthSouth Corporation CEO Richard Scrushy was obligated to repay $47.8 million in bonuses that he received improperly.[3]

Company and Shareholder Initiatives

There is no requirement under the Sarbanes-Oxley Act, other SEC rules or securities market listing standards that companies take steps to provide for the clawback of executive compensation. However, the SEC's executive compensation disclosure rules adopted in 2006 provide that it may be appropriate for the Compensation Discussion & Analysis in a company's proxy statement to discuss any company "policies and decisions regarding the adjustment or recovery of awards or payments if the relevant registrant performance measures upon which they are based are restated or otherwise adjusted in a manner that would reduce the size of an award or payment."[4]

In the wake of the SEC's rule changes, there is now more information available about which companies have adopted clawback provisions and the substance of these provisions. A fall 2007 survey by Equilar, Inc. indicates that among Fortune 100 companies, the prevalence of disclosed clawback policies increased from 17.6% in 2005 to 42.1% in 2006. A survey of approximately 2,100 companies released in June 2008 by The Corporate Library found that 300 companies had clawback provisions, compared to only 14 companies that had disclosed the existence of these provisions four years ago. As of March 2008, 28 of the Dow 30 companies had implemented clawback provisions, including 23 companies that had adopted formal clawback policies aimed at recouping the incentive compensation paid or granted to executive officers and certain other employees. These policies most often provide for recoupment in the event of a restatement or a significant/material restatement of financial results due to misconduct on the part of the executive officer or other employee. The remaining five companies had incentive compensation plans that contain clawback provisions.

Clawback provisions also have been a focus of shareholder proposals in recent years. Between January 2004 and June 2008, shareholders submitted a total of 32 proposals requesting that companies adopt clawback provisions, including six proposals submitted for the 2008 proxy season. The 32 shareholder proposals were submitted to 22 different companies, with some companies receiving the proposal in more than one year. Of these 22 companies, nine previously had restated their financial results in the one to five years before receiving the proposal. The popularity of clawback shareholder proposals peaked in 2006 and 2007, when shareholders submitted ten and 11 proposals, respectively. In 2008, the proposals have averaged 10.7% of votes cast at five meetings, according to preliminary results compiled by RiskMetrics Group, Inc./ISS Governance Services (ISS), compared to 23.7% of votes cast in 2006 and 28.4% of votes cast in 2007.

Some companies have taken steps to address clawbacks in response to a shareholder proposal, and some have done so as a general governance reform or following a high-profile restatement of financial results. Other companies have argued in response to shareholder proposals that formal clawback policies unnecessarily restrict a board's discretion to determine how best to respond to accounting improprieties.

A number of companies have sought to exclude clawback shareholder proposals from their proxy statements by pointing to existing clawback provisions and arguing that these provisions "substantially implemented" a shareholder proposal under Rule 14a-8(i)(10). The SEC staff generally has taken a narrow view of the actions that are sufficient to "substantially implement" a clawback proposal and has permitted companies to exclude a proposal only in circumstances where the form and substance of a company's clawback provisions correspond closely to those sought in the proposal.[5] ISS takes a case-by-case approach in formulating voting recommendations on shareholder proposals seeking the adoption of clawback policies. It considers whether a company has adopted a "formal" clawback policy, and whether there is an absence of chronic restatement history or material financial problems. In applying these criteria, ISS generally has been supportive of companies that adopt clawback policies, and has recommended votes "against" shareholder proposals at these companies, as long as the clawback policies do not afford too much discretion to the board. As an example, during the 2008 proxy season, the SEC staff took the position that Exxon Mobil Corp.[6] could not omit a clawback shareholder proposal as substantially implemented, but ISS recommended votes "against" the proposal.

Issues for Companies to Consider in Addressing Clawbacks

There are a number of issues for boards to consider with respect to clawbacks. The primary question is whether to address clawbacks in the first place. Doing so sends a message to shareholders that the board is committed to sound executive compensation practices and effective corporate governance, and voluntary implementation of clawback provisions will reduce the likelihood that a company will receive a shareholder proposal. On the other hand, companies need to consider whether the adoption of a clawback will adversely affect their ability to attract and retain executives.

Once a board decides to adopt a clawback provision, there are a number of issues that need to be addressed in formulating the provision.

1. To whom should the clawback provisions apply?

Clawback provisions can cover the CEO and CFO, or they can apply more broadly to all executive officers or even all employees. Covering the CEO and CFO is consistent with the approach taken in Section 304 of the Sarbanes-Oxley Act. However, a clawback provision that is limited in this respect does not reach other executive officers whose compensation may be performance-based or whose job functions may impact a company's financial reporting. Proxy voting advisors ISS and Glass, Lewis & Co. generally favor clawback shareholder proposals covering executive officers and recommend that shareholders vote "for" proposals seeking recoupment both from senior executives and from employees who are potentially responsible for accounting improprieties.

2. To which awards should clawback provisions apply?

Base salary is not generally linked to specific performance targets and, therefore, is not typically covered by clawback provisions. With respect to performance-based awards, the single most popular approach that companies have taken is to adopt clawback provisions that include all performance-based awards, both short-term (*i.e.*, with a performance period of one year or less) and long-term (*i.e.*, with a performance period of more than one year, and typically two to four years). Covering only long-term incentives may be viewed as too narrow to serve as a deterrent for misconduct if executives are continuing to receive short-term incentives (usually in the form of annual cash bonuses) based on specific performance targets that were not actually achieved. Consistent with Section 304 of the Sarbanes-Oxley Act, some companies also have adopted provisions that apply to the recoupment of gains derived from selling stock when the price of the stock was affected by improper accounting, although these provisions are relatively rare.

3. What circumstances should trigger clawback provisions?

Companies with clawback provisions take a variety of approaches to the standards for determining the circumstances that trigger these provisions. Clawback provisions can apply in the event of a "significant" or "material" restatement, in the event of all restatements (other than those due to changes in accounting policy) or in the event that financial data turns out to be incorrect. Many companies have limited the application of their clawback provisions to "significant" or "material" restatements. It should be noted, however, that under applicable accounting standards, a materiality standard applies when a company determines whether accounting errors require a restatement of financial statements. A clawback provision that applies in the event of all restatements, other than those due to changes in accounting policy, addresses the argument that it is unfair to shareholders if executives are permitted to retain incentive compensation based upon performance targets that were not actually achieved. However, such a provision also would apply in circumstances where a restatement is required due to an error that was not the result of fraud or misconduct or where a restatement does not result in a significant change to a company's overall financial results. For this reason, such a provision may impact a company's ability to attract or retain executives. Finally, a "no-fault" clawback provision would require recoupment following a determination that the prior achievement of performance goals was based on incorrect data. Like clawback provisions triggered by any restatement, a "no-fault" provision addresses the argument about the unfairness to shareholders that results from allowing executives to keep compensation awarded on the basis of performance targets that were not actually met. However, a "no-fault" provision would require recoupment in circumstances where incorrect data result from an innocent mistake, not fraud or misconduct or where applicable accounting standards would not require a restatement of financial statements. Accordingly, this type of provision could have negative ramifications for a company's ability to attract and retain executives.

4. To what type of conduct should the clawback provisions apply?

Related to the issue of when clawback provisions should apply (question 3 above) is the type of conduct that triggers application of the provisions. Alternatives include requiring recoupment in the event of misconduct by the executive officer from whom recoupment is sought, in the event of misconduct by any employee, or in the event of any conduct that results in incorrect financial data. Limiting clawback provisions to misconduct by the individual executive officers from whom a company seeks recoupment is the most common alternative and provides a targeted approach that incorporates a deterrent effect. Broader provisions that rely on misconduct by any employee could be viewed as consistent with the oversight function performed by senior executives. Finally, a "no-fault" clawback provision would not require any misconduct; instead, it would mandate recoupment simply upon a restatement of financial statements or the discovery of incorrect financial data. As discussed above, a "no-fault" provision addresses the argument about the unfairness to shareholders that results from allowing executives to keep compensation awarded on the basis of performance targets that were not actually achieved. However, a clawback provision with no reference to misconduct would apply in circumstances where the incorrect data resulted from an innocent mistake, and thus may impact a company's ability to attract and retain executive officers.

5. Should the clawback provisions grant discretion to the board?

Clawback provisions may grant discretion to the board of directors to determine whether misconduct occurred and whether to recoup compensation. Provisions that grant discretion to the board offer the advantage of flexibility because the board can decide whether, and to what extent, recoupment is appropriate based on the specific facts and circumstances involved. However, if the board has too much discretion, the SEC staff is unlikely to concur that a company may exclude a clawback shareholder proposal on "substantial implementation" grounds. In addition, ISS may recommend a vote in favor of a clawback shareholder proposal where a company's clawback provisions grant what ISS views as too much discretion to the board.

6. To what extent should the clawback provisions modify employment agreements, compensation plans and award agreements?

Companies that intend to adopt clawback provisions can do so by adopting a clawback policy. However, the adoption of a policy, without more, may raise questions as to the policy's enforceability and could lead to criticism for failing to implement the provisions fully. Accordingly, companies should consider the additional step of amending existing employment agreements, compensation plans and/or award agreements to include specific reference to clawback provisions, either by adding language that provides for recoupment in specified circumstances or by incorporating an external clawback policy by reference. Unlike with a stand-alone clawback policy, this would provide a contractual basis for enforcing the clawback provisions. In cases where a company enters into individual award agreements pursuant to an incentive compensation plan, clawback provisions can be implemented by amending or revising the form of award agreement used for executives covered by the provisions; changing the plan itself may not be necessary. As a legal matter, it may not be possible to apply clawback provisions retroactively to outstanding or previously paid awards without the consent of the covered executives. Retroactive application may contravene existing employment agreements and award agreements, which generally contain language prohibiting changes that are adverse to an executive without the executive's consent. These provisions also may not be enforceable because the executive is not receiving any reciprocal rights or benefits. In addition, retroactive implementation may have a negative effect on employee morale.

7. How far back should the clawback provisions reach?

Section 304 of the Sarbanes-Oxley Act provides for recoupment of compensation received within the 12-month period following the public release of financial information that subsequently has to be restated. Consistent with this, some companies have adopted clawback provisions that reach back 12 months prior to the filing of restated financial results. However, more companies have adopted provisions that reach back for longer periods. In some cases, the relevant period covers 36 months, representing the period of time for which companies must include financial statements in their SEC filings, while other companies' provisions reach back for longer periods, such as five years, or correspond to the length of performance cycles (often three years) under compensation plans. Another, less common approach is for the policy to have unlimited reach, although executives are likely to view this as inequitable and it may impact the company's ability to attract and retain executives.

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[1] *See*, *e.g.*, *Neer v. Pelino*, 389 F. Supp.2d 648 (E.D. Pa. 2005), *In re BISYS Group Inc.*, 396 F. Supp. 2d 463 (S.D.N.Y. 2005), *Kogan v. Robinson*, 432 F. Supp. 2d 1075 (S.D. Calif. 2006).

[2] *See Securities and Exchange Commission v. William W. McGuire, M.D.*, Litigation Release No. 20387 (Dec. 6, 2007).

[3] *See Scrushy v. Tucker*, 955 So. 2d 988 (Ala. 2006) (involving state law claim for unjust enrichment).

[4] *See* Item 402(b)(2)(viii) of Regulation S-K.

[5] *See, e.g.*, Exxon Mobil Corp. (avail. Mar. 24, 2008, recon. denied).

[6] *See id*.

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Gibson, Dunn & Crutcher's Securities Regulation and Corporate Governance Practice Group and its Executive Compensation and Employee Benefits Practice Group are available to assist in addressing any questions you may have regarding these issues. Please contact the Gibson Dunn attorney with whom you work, or any of the following:

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