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Designing a "Repayment" Policy May Be Harder Than You Think: Issues that a Company Should Consider

There is increasingly widespread agreement that corporations should adopt policies concerning repayment of executive compensation when the financial criteria that led to such payment are later determined to be inaccurate. There is much less agreement, however, on the specific terms that should be contained in a repayment policy. This letter explores the key questions that a Board of Directors must address in designing a repayment policy.

Repayment policies generally require employees to repay previously received compensation in the event of a financial restatement. Sometimes repayment is conditioned on an executive's misconduct (i.e., a "clawback" policy), and in other circumstances the policy imposes a repayment obligation regardless of fault. The letter below addresses all such policies and refers to them broadly as "repayment policies."

Repayment policies have become prevalent among large companies and are rapidly expanding to others as a "best practice." For example, a 2008 study by Equilar, a proxy research firm, found that approximately 64% of the *Fortune* 100 companies had repayment policies. This was a significant increase from the 18% that disclosed such policies in 2006. We expect this trend to continue, particularly in light of the continued regulatory focus on repayment polices, as evidenced in the recently enacted American Recovery and Reinvestment Act of 2009 ("ARRA"), which expands the required repayment policies at financial institutions receiving federal assistance.

While there appears to be a consensus among institutional investors that repayment policies are desirable, relatively little time has been spent considering some of the complicated design and implementation issues that need to be addressed in developing an appropriate policy. This letter will consider some of those issues. As background, we will first review the repayment rules in the two most important federal statutes mandating such policies—the Sarbanes-Oxley Act of 2002 ("SOX") and the ARRA.

This letter does not discuss the forfeiture/repayment polices that some companies use in connection with non-compete provisions and other restrictive covenants. Those policies do not

hinge on the inaccuracy of financial statements, but are triggered by an executive's engaging in certain kinds of prohibited behavior. Instead, the focus of this letter will be on the design of repayment policies that apply when inaccurate financial statements or financial data have caused executives to receive more compensation than would otherwise have been the case.

SOX and the ARRA

While the SOX and ARRA rules differ in many respects, perhaps the fundamental difference is that between the "fault" approach of SOX and the "no fault" approach of the ARRA, as described in more detail below.

SOX rules. The SOX repayment rules only apply in certain very limited circumstances.[1]. They only apply to the CEO and the CFO of a public company and only when there is a restated financial statement "due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws." If these circumstances exist, the CEO or CFO must repay the issuer any amounts received during the 12 months following the filing of the inaccurate financial statements that fall into one of two categories: (1) "any bonus or other incentive-based or equity-based compensation" or (2) "any profits received from the sale of securities."

Several factors cause most companies to conclude that the SOX-required repayment policy is inadequate. To begin, several courts have held that no one other than the SEC can enforce the SOX rules. Moreover, (1) the policy only applies to the CEO and CFO; (2) the policy only applies when there is "misconduct," a term that is not defined in the statute; (3) the policy only applies to transactions during the 12 months following the inaccurate financial statements; and (4) the amounts subject to recapture may bear no relationship to the restatement. To illustrate this last point, suppose a CEO sold stock in 2009 and it eventually turned out the 2008 financials were inaccurate because they understated corporate profits.[2] Under these circumstances, the SEC would apparently have the authority to recapture all of the CEO's profits from the stock sales.

ARRA rules. ARRA amended the repayment rules for financial institutions receiving federal funds ("TARP recipients") originally introduced in the Emergency Economic Stabilization Act of 2008.[3] The restrictions generally apply to the five highest paid senior executive officers plus up to the next 20 highest paid employees[4] and require repayment of "any

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[1] See our letter of May 20, 2008, "Comprehensive Executive Compensation 'Reform' Bill Introduced into Senate," which describes legislation introduced last year by Senator Clinton that would have significantly expanded the SOX clawback rules. http://www.fwcook.com/alert_letters/05-20-08-Comprehensive-Executive-Compensation-Reform-Bill.pdf, which is available at our website at www.fwcook.com.

[2] This might occur, for example, if 2007 profits had been overstated by including amounts that should have been reflected in the 2008 financial statements.

[3] The ARRA changes are described in our letter dated February 18, 2009, "Congress Expands Restrictions on Executive Compensation for Financial Institutions under Troubled Asset Relief Program," http://www.fwcook.com/alert_letters/02-18-09_Congress-Expands-Restrictions-on-Executive-Compensation.pdf, which is available at our website at www.fwcook.com.

[4] The number of covered employees varies with the amount of TARP assistance, ranging from only the most highly compensated employee ($25 million or less TARP assistance) to 25 employees (TARP assistance over $500 million).

bonus, retention award or incentive compensation" that is based on "statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate."

The ARRA restrictions are substantially broader than the SOX restrictions since the repayment rules (1) cover up to 25, rather than two, employees, (2) do not require misconduct, (3) do not require a restated financial statement, and (4) are not limited to compensation paid in the 12-month window following an inaccurate financial statement. The rules are narrower in requiring a connection between the compensation being recouped and the inaccurate financial information.

Many companies conclude that neither set of rules provides a completely satisfactory basis for designing a company repayment policy.

Questions That Should Be Addressed in Designing a Repayment Policy

The following represent the most important questions that should be considered in implementing a repayment policy. In thinking through these questions, the Board of Directors (or Compensation Committee) may want to focus on what may be the common situation in which an overpayment occurs—an annual or long-term incentive plan based on financial metrics. For example, assume that the executives receive payments in March 2010 under an incentive plan based on 2009 performance. It is later discovered that 2009 performance had been inaccurately calculated. While this may coincide with a need to restate the 2009 financials, that may not always be the case.

Question 1—Who should be covered? Practices vary in the scope of coverage; however, many, if not most, policies limit coverage to executive officers. Some are extended to all employees, especially if the obligation to repay requires the employee to have engaged in behavior leading to the inaccurate financial results. Depending on the scope of the company's bonus programs, however, a company may decide that the repayment obligation should not be extended to all employees, both because of communications difficulties and the relatively small amounts that might be involved.

Question 2—Should the obligation only apply if the executive was responsible for the inaccurate data that led to the overpayment? While it appears that most policies only require repayment if the executive bears some responsibility, others provide that repayment may be extended to all executives that benefited from the restatement. While conditioning repayment on "fault" is more palatable to executives, others may argue that the overpayment was a windfall. Moreover, conditioning repayment on behavior by the executive can embroil the company in complicated disputes over whether the executive engaged in the proscribed behavior (misconduct, fraud, gross negligence, etc.). As a result, some companies prefer to make executives potentially liable for repayment in all cases, but retain the ability to use discretion in applying the repayment policy.

Question 3—What types of overpayments should be covered? Clearly, the repayment policy should apply where the amount of overpayment can be precisely calculated. A harder case arises when gains on equity compensation might have been inflated by inaccurate financial

statements. While this type of overpayment is contemplated by SOX, only a small minority of corporate policies address this situation (for example, one policy refers to seeking the return of "stock sale proceeds to the extent they had been inflated due to financial results that later had to be restated"). Given the difficulties in determining when stock profits are attributable to inaccurate financials, this type of a repayment policy will be harder to apply than the portion of the repayment policy that deals with overstated bonus or long-term performance award payments.

A related question that must be considered is whether the repayment obligation should only be triggered by inaccurate financial statements. For example, annual bonuses at some companies are based in part on safety improvements, new product developments, or other criteria that are not reflected in the financial statements. An important design issue is whether the repayment obligation is only tied to inaccurate performance metrics that are reflected in inaccurate financial statements.

Question 4—Should there be limits on the source of repayment? Repayments may be limited to future compensation payments to executives or the company may also have the right to sue for repayment. While it will be administratively easier if repayment were only enforced through reductions in future payments due the executive (including, for example, the reduction or cancellation of outstanding awards), this would leave the company without a remedy if the executive has already terminated and there are no outstanding awards.

Question 5—Should there be a time limit on seeking repayment? The answer to this question may depend on whether the repayment policy is limited to cases of misconduct. If misconduct is a precondition to an obligation to repay, there may be little sympathy for a time limit on a company's right to seek repayment. Absent misconduct, however, employee acceptance of a repayment obligation will be more likely if, after a certain period of time, restated financial data will not affect previously paid bonuses. One recent policy provided that no repayment obligation would exist with respect to bonus payments unless steps had been taken to consider restating the financials by the end of the third year following the year in question.

Question 6—Should the repayment policy be retroactive? With respect to completed payouts, the company's ability to impose a repayment policy may be limited by the relevant plan documents. Consultation with legal counsel is particularly appropriate prior to implementation of a retroactive policy in this situation. On the other hand, if a multi-year performance period is still ongoing when a policy is adopted, it appears logical to apply the repayment policy. Again, the plan documents and legal counsel should be consulted before making a decision.

Question 7—To what extent should the repayment policy be discretionary? The answer to this question may depend on the scope of the clawback policy that is being considered. For example, if the clawback policy only applies in the case of restated financials, only covers executive officers whose misconduct led to the restatement, and only applies to the extent a lower bonus or long-term incentive award would have been earned pursuant to the corrected financial statements, the company may conclude that the policy should apply without exception. At the other extreme, if the policy applies to all employees, has no time limit, and includes stock price profits attributable to inflated financial statements, the company may conclude that it is essential to have discretion to determine when to apply the policy. In considering this issue, the

company should seek input from legal counsel in order to evaluate the procedures that would need to be followed in exercising discretion—that is, if a discretionary standard is to be adopted, what types of administrative procedures will the company need to follow in order to be satisfied that its decision will withstand legal challenge?

Question 8—Who should enforce the policy? The Compensation Committee has, of course, the most experience with the benefit programs that are potentially subject to a repayment. On the other hand, a significant potential for controversy may exist with respect to some repayment decisions, particularly if enforcing the repayment policy requires litigation. Given these circumstances, the company should consider whether the Compensation Committee should have full enforcement authority or whether the repayment policy should be administered through recommendations to the Board of Directors, which will make the final decision.

Question 9—How should the clawback policy be communicated to employees? This last question refers to an issue that must not be overlooked in designing a repayment policy—are employees fully bound by the provisions in the policy? To take an extreme case, suppose the policy is adopted by a Board resolution and publicized in the CD&A, but the covered employees never receive a copy of the policy. Will the employees be able to claim that they are not bound by the policy? The opposite extreme would be a policy document that is agreed to in writing by each affected employee. The company should consult with legal counsel to determine what formalities must be followed to ensure that the policy is fully binding on affected employees.

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This letter is intended to alert compensation professionals about developments that may affect their companies and should not be relied on as providing specific company advice. General questions about this letter may be directed to David Gordon at 310-734-0111 (degordon@fwcook.com) or Michael Chavira at 310-734-0108 (mpchavira@fwcook.com). Specific questions should be referred to legal counsel. Copies of this letter and other published materials are available on our website at www.fwcook.com.