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Day 1
Clawbacks- What to Do Now
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Speaker1: Welcome back everyone. I want to remind you if you haven't already, for staff to reserve a seat for a roundtable this afternoon because those are filling up quickly. And now I'll get right to it. We now have a 35-minute panel to cover the latest developments in clawbacks. I want to welcome and thank for participating, Mike Melbinger of Winston & Strawn and compensationstandards.com. Scott Spector of Fenwick & West, Kyoko Takahashi Lin of Davis Polk & Wardwell, and Ron Mueller of Gibson Dunn. And I am going to turn it over to Scott to frame the discussion here.

Scott Spector: Thank you, Liz and we won't waste a lot of time with any general comments and will turn it right over to Kyoko who will start talking about company policies generally and how they relate to executive agreements with respect to clawbacks. Kyoko…

Kyoko Takahashi Lin: Sure. So, I think, you know, most people know what clawbacks are just to level set, they are really about when executives are asked to or really required to turn over compensation that has already been paid as opposed to compensation that might be paid down the road, can be distinguished from a forfeiture in that way and that's one of the things to just note at the outset, only because it can impact a lot of things like the drafting. Later on, we will get to topics like enforceability and things like that. Originally, clawbacks were really associated with instances where companies either had a financial accounting restatements or if they erroneously or fraudulently calculated their incentive compensation metrics, such that essentially executors were being overpaid for compensation that they thought that they were owed.

Nowadays, companies are adding, and this is the point about reputational harm. Nowadays, companies are adding more aspects, more things that can trigger a clawback. It can include a lot of fraud-like situations. I'm sorry, a lot of cause-like situations. It can also include violations of restrictive covenants. It can even pick up things that are amorphous in nature but that could cause reputational harm to the company.

For companies in certain industries, it can also pick up lapses of supervision by senior people that could result in a regulatory or similar kind of failure and so this is just to say that clawbacks, the purpose and scope of clawbacks have generally been expanding

and so, I think that the first issue to think about there from a drafting perspective is really to be very thoughtful and to be clear about what the scope of the clawback is, what are the events that actually trigger it, what is the process the board actually has to go through. Is the clawback required; is it mandated or does the board have some kind of discretion to exercise clawbacks. In the context of the situation where a company is asking executives to pay back gross amounts that were already paid, be clear that it's really a gross clawback as opposed to an after tax clawback.

And so, the more you can be specific about what the clawback really entails, the greater the chance, first of all, everyone will be on notice on exactly what it means but also we'll see actually that it has an impact on enforceability issues down the road. It also has an impact on, as the scope of clawbacks become more expansive, there has been a concern raised by some that the clawback looks a lot more discretionary, could be a lot more discretionary, ultimately especially on the impact on equity compensation and so when that happens, then the accounting treatment of equity compensation, which is typically equity accounting or fixed accounting can change in a way that makes it more susceptible to variable accounting and that would be for most companies that is not a good place to be and so, again if you can be more specific and leave it less open to discretion then chances that your compensation, your equity compensation in particular might be adversely impacted become less. So, for a variety of reasons those are just some things to think about from a drafting perspective. Ron, I know you had some insights on this point as well.

Ron Mueller: Sure. Thank you. I was really just picking up on the points you just made. I think as clawbacks are being pushed into greater service that there is a tendency for some to kind of say, well let's add this to our existing clawback and particularly that, you know, depending on how you're addressing it, that may not work. I think it's very pretty straight forward when someone is doing a clawback based on a financial restatement, for example, to say "Well, this financial performance measure was one of the ones that affected the payout under the annual bonus and so, if we had to restate those results, what would the bonus have been?"

That's a very different calculation than what you're doing by saying, for example, "Well, depending on how you're working in the reputational issues, well, gee this annual bonus had a individual discretionary element for it and if we had known this executive was behaving this way, we obviously wouldn't have done that piece of it," or whether you even want to be able to say "No,", you know, kinda "The grant of these equity awards was based on the assumption that you were a good player and acting appropriately and now that we've learned you were doing something that could harm the company in one way or another, how do you want to calculate that back?" So, we've actually been, when we are drafting them, kind of drafting separate **____, that are drafts, (06:15)** whether it's a, you know, **_____ (06:21)** clawback **how we thought it should work _____(06:23),** depending on what the **_____ (06:27)** is.

Scott Spector: Let's shift to a slightly different topic and just add on to what the two of you have been talking about and Mike, why don't you talk about the impact of clawback arrangements on executive recruitment retention and on their perspective on being subject to these kinds of policies.

Mike Melbinger: Sure, thanks Scott. I think a better way to title that might even be to discuss the impact on negotiations. Because compensation clawbacks have become so ubiquitous and so clearly a matter of best practices and governance that nearly every company in America has them and I'm just not sure a compensation committee or board would be in its right mind not to demand some form of clawback forfeiture, etcetera. So, the question then becomes, what, in our negotiations, what form of clawback or forfeiture protection will the company get.

Many executives will agree to an employment agreement that simply states that all compensation paid to the executive will be subject to the company's general compensation clawsback policy as amended from time to time. Okay, that's nice and then negotiations are easy. Others will want to limit to say incentive compensation only. Others will want to limit that to the equity awards agreements only or the equity awards and annual incentive. But sometimes only equity award agreements, a separate document. And finally, some will recognize, and this segues back to where we were, sometimes the clawback will only be really a reference to the termination for cause provision. Because termination for cause provisions have been around a lot longer than clawback features and they can generally accomplish the same result. So, if properly drafted, which then segues us back into the proper drafting point. I'll just let, **anyone (08:52)** want to comment on that?

Kyoko Takahashi Lin: And one thing that I might just note there is, you know, I think one of the things is that because of the potential challenges around the enforceability of a clawback, you know, there's a real question of what documents, if any, to embody the clawback in. You know, I think originally companies were putting in, as you said, policies; you know, broad-based compensation policies and I think that while that can be helpful and also allows for flexibility from the companies perspective, especially as these governance practices evolve over time, you know, when push comes to shove and there's a real question as to whether the clawback is valid and enforceable, you know, to have something where there is real privity of contract between the individual and the company becomes quite critical. This is true of people in the United States.

It's definitely true of people outside the United States just given the labor and employment laws that apply outside but if you can put it into an employment agreement and I think Mike, this goes to your question, the point that you made about recruitment and things like that, the negotiation issues that from the companies perspective, that's great. You know, that's like your gold standard home run. But if they are really relying

on something where people are just subject to a policy, even a bonus plan that people are not signing, because most people are not signing their participation in a bonus plan, for example, and for some companies they don't even have the individuals sign an equity award agreement. They just get the document that just shows up on their website.

Scott Spector: Kyoko, let me jump in on this for a second. And first of all, a good case example of exactly what you've been talking about, there's this recent case in McDonalds and that is now certainly now a posterchild for not only potentially the definition of cause in clawback situations but also where they pointed to for the clawback right. And as I think Mike and you just said, you know, if you are trying to put something like that in an employment agreement, you will get this pushback by counsels to the executive and, you know, you're going to have a big discussion about not only cause but also, you know, whether in fact you hardwire a right to clawback something that was given to the executive.

But in the McDonalds case, they pointed to, and it's a complicated case, but they pointed to both the severance agreement and the actual option grant forms that specifically said, and they're different provisions but they accomplish the same thing and they have really great language. They specifically said that if the executive is terminated for cause or even if the executive could have been terminated or was terminated for cause and payments were made, that they have a right to clawback, not only stop paying awards but clawback any unexercised options, clawback any shares that are still out there and also clawback the proceeds of any awards that were given and then settled, etcetera. And so, they've put those in the option form and in the severance plan where presumably the executive and the executive counsel had no ability to comment on it and say "Oh, I don't want that provision in my agreement because it's a corporate document" and it's a much safer place to avoid the kind of issues that you and Mike were talking about.

Specifically, by the way, in option plans now, I put a provision in there that says that you can stop a person from exercising an option and put a hold on any option if, not only you terminate the person for cause but you could have terminated the person for cause. If you combine that with the definition of cause, that picks up some of the events we read about these days. It's pretty effective now in giving company leverage to negotiate which is, I think, what you're wanting. So, let's move on here for a second and let's talk about unintended consequences that come up when you exercise clawback rights, etcetera. Kyoko referred to one which is the impact on your accounting treatment for equity awards but there's a host of others and there's a number of issues that you've got to be thinking about and advising the boards and the comp. committee before they implement a clawback policy and certainly before they exercise one. Ron, do you want to take the lead on that?

Ron Mueller: Sure, I'll just touch briefly again on what your triggering events are and, you know, one issue that there's been some debate around is whether timed clawbacks to restatements kind of discourages management from doing a restatement and, you know, there is some graphing issues here because there are what people call bit capital, are restatements where you actually have a material error and go back and have to re-cast or re-present the financial statements. And then there are what are called Little R restatements where a company has to revise it's financial statements, its historical one's but does not go back and kind of republish those but corrects them on kind of a running basis and basically describes that revision in a footnote to the financial statements.

According to Audit Analytics, you know, last year there were fewest numbers of restatements in the past 15 years, total of 484. 80 percent of those were the Small R restatements and it's really, I think a debated issue about whether the prevalence of clawbacks is either discouraging management from restating financial statements. It certainly affects the dynamics around that, but it may also be the fact that simply clawbacks and many other things are making companies be more careful on their financial accounting to begin with. But I think it is something to focus on, on how you're drafting these and thinking through how they operate.

Scott Spector: Mike.

Mike Melbinger: Okay, so next on intended consequence, we'll talk a bit about indemnification and D&O insurance and I dare say that one of the surprises or unintended consequences of companies attempts to enforce clawback provisions on an executive or particularly a former executive is when that executive turns around and demands indemnification from the company or at least an advancement of his or her legal expenses to fight the litigation launched by the company to clawback his or her compensation.

Okay, so that's kind of a double whammy for the companies. Now, the companies in these cases have argued that it's against public policy to allow indemnification towards something maybe the executive did wrong, but so far the courts have said, well they've upheld the executives rights to advancement because the clawbacks generally are due to activities the executive undertook in his or her employment with the company. Okay, and this is, well this is up to now, and mostly financial things. When they see a different situation with the McDonalds thing, which I don't think has led to an indemnification claim yet. So, what we haven't seen, and we thought we might see is a rush by companies to revise the re-indemnification provisions to address this issue.

We haven't seen, I at least haven't seen it, I'll be interested in other panelists use on it, but maybe that's because indemnification is nearly always, always in my experience, also include a provision that would prevent indemnification or require repayment of advanced amounts if it's found that the executive did not act in good faith in a manner

that he or she believed was in the best interests of the company or the executive acted in self-interest. So, that's another way that I suppose even without an amendment of the indemnification provision, a company could perhaps be forced to advance legal fees, _____ **(18:46)** still get them back. One quick comment on D&O insurance because that's the other side of the coin here.

Again, D&O insurance typically contains an exception or an exclusion for insured against insured litigation, which by that it means litigation by the company against the executive. So, we've seen less controversy there. It also, by the way, the exclusion in most D&O policies, includes a lawsuit by the executive to recover compensation to which he or she should not have been entitled to. So, those are standard exclusions in D&O policies that, I don't want to say save the day but maybe save the day for the company. Other panelists, what's your experience on indemnification?

Scott Spector: Well, Mike, let me make a couple remarks. First, and I think this is actually the most interesting piece these days about clawbacks. I was really amazed in Hertz, if you actually look at the Hertz complaints, etcetera, to see all the Delaware law firms and other major law firms in New York and Washington that lined up to support the executives request for a clawback, for indemnification. And you've got to ask, "Why would they line up like that?" And I'm told by my litigation partners that they lined up that way because they wanted to make a point that the proper way to deal with this is through indemnification claims and that there is that right unless you've amended your bylaws or something like that.

And that's a better way to get at it. With the repayment provision, if in fact the person loses, then to have the executive try to claim against the D&O policy and you mentioned one exception but to somehow get the right to hit that D&O policy and really cause all kinds of havoc on the limits of that policy and other issues that involve D&O insurance. And I thought that was very interesting and it hadn't really been talked about. I also thought what was interesting was that boards and comp. committees, when they put in clawbacks or certainly when they exercise clawback rights, I'm not sure that they all know that in fact that executive has rights to claim indemnification or to go against policy. So, Ron, you've been kind of shaking your head. **Three of you have (21:42)** been shaking your head yes.

Ron Meuller: Yeah, I agree that I think that it's part of what needs to be checked. You can, depending, you know, many companies are hesitant to amend, as you say, their bylaws in connection with putting in a clawback and, but again, it really is the other element here and if your trying to draft the bylaws to include these claims, it can be very tricky because again that's a claim over compensation and some types of claims of overcompensation, your executives, they'll feel like they should be able to sue over. So, you know, I think it's another tricky aspect of the whole subject.

Scott Spector: Okay. Kyoko, do you want to talk about how you, as a board or comp. committee, enforce clawbacks and what you've seen and what the problems are when you actually decide you're going to exercise clawbacks?

Kyoko Takahashi Lin: So, you know Scott, it's interesting, you reference the Hertz and the McDonalds cases. I think two of the most prominent cases recently regarding clawbacks and, you know, the dollar amounts in both of those cases are pretty significant and not surprisingly, the executives have vigorously fought back in both of those cases. And so, you know, when something like this really happens, I think it really shines a spotlight on the fact that these cases can very much be challenged in court and that's why we're talking about indemnification and, you know, all that kind of thing.

It's, you know, when you're drafting the clawback and this sort of goes back to the drafting again, you know, you may have drafted it with the best of intentions, trying to make sure that it's enforceable, trying to make sure that it captures all these circumstances but it's hard to imagine every single situation that would be picked up, you know, that could be picked up by a clawback and, you know, now I think that there is a greater sense that clawback policies, at least boards should actively think about whether they should pick up other instances besides, you know, financial restatements, either with a big R or a small R as Ron noted and pick up other instances. You know, I think for a variety of reasons, although the scope of clawbacks is expanding, you know, not every company is rushing to go down that route for a variety of very understandable reasons.

And then, when something happens, they want to be able to point to their clawback policy and it turns out that their clawback policy may not have picked a particular set of circumstances up. The words are not quite there; you have to sort of stretch for the words. And given the sort of challenges around the enforcement of clawbacks anyway, even if the facts are quite sympathetic towards the company, as a legal matter, there may be a real challenge. Now, in what we've seen in a number of instances is that, you know, even if a company may not have a unambiguous ability to claw an amount back, as a matter for it's own reputation and also, you know, to deter bad behavior in the future, they may decide to exercise their claw back anyway and that, I think, is an interesting thing for companies to do.

But I think that it really, you know, this goes back to the points that we were making earlier where you really want to make sure that you go back and do a review of a clawback policy and make sure that it, you know, on it's face it's going to capture at least the basic cases that you think it's going to capture and be understanding of the fact that if there are cases that it's not going to capture it's because you have, you know, deliberately reached that view as opposed to sort of finding that afterwards in a court of law.

Scott Spector: Before we move on to stockholder proposals, let me just ask the three of you this question real quickly. How often do you see the existence or the possibility of a clawback being used as leverage to get some other result, whether it's the person, the executive to voluntarily resign, to give up other payments voluntarily or to maybe leave the board if you didn't otherwise have that right?

Ron Meuller: We see it, I can't say often fortunately but we definitely have used it.

Mike Melbinger: I mean, it would seem to be a nice tool to have in your toolbox, even if you, as Kyoko, you didn't want to take the step of enforcing it to at least threaten to clawback and be on, you know, make life miserable for the executive as a condition of getting the soft landing, etcetera on the termination of the situation. Ron, shareholder proposals and, you know, I think it's just broader than proposals but it's any request of a companies investors to either put a clawback proposal in or to beef it up and perhaps go to a reputational harm kind of clawback policy that Kyoko mentioned.

Scott Spector: Yeah, you know, so, on the investor community it's still pretty, has varying views on clawbacks. There are a couple of large institutional investors, most notably BlackRock, that does expressly address fallback policies and does expressly say that they support clawback policies that include, that address reputational injury to a company. Another institutional money manager is JP Morgan Asset Management. Last year, amended its voting guidelines to also support those. Most of the other large institutional shareholders still have kind of a case by case approach on it and address clawbacks as part of their general compensation voting policies, say they'll look at it on a case by case basis and it's really kind of hard to see, you know, what they are, where they are focusing on it.

There are, and I'll let Mike talk a little bit about, or Mike, happy to talk with you a little bit about the shareholder proposals, there is a focus by some of the members of counsel of institutional investors and other shareholders that have been arguing that clawbacks should be particularly put in place at some pharmaceutical companies and are actually looking at expanding, you know, the enforceability of those through bonus or compensation deferral programs.

Ron Meuller: Right. I'm only aware of one shareholder proposal on compensation clawbacks that went to a vote and passed this year, it's Stericycle: a Chicago-based company. But there are several other, at least a couple other key takeaway points this year. One of them, well, we still see this request, it was raised by a couple folks, that the clawback include explicit reputational harm among the reasons. Now, that's been, there's been pushback, mostly from the companies for whom it's requested, and it's been largely successful, I believe.

Of course, I don't see all these situations but by pointing out that "Well, our definition of cause or our clawback provision, one of the two, explicitly refers to a violation of our code of conduct," and that's where provisions like harassment, etcetera, are typically housed and that, plus other things too. So, the code of conduct is a nice, broad sweeping provision to get covered. And then just briefly, one other provision that I thought was very interesting and I think Scott, you may have brought this to my attention but most prominent, Eli Lilly, where they came in with a regular shareholder proposal asking for compensation clawback provisions to be stiffened but also a separate proposal asking for a greater deferral of compensation, which deferral of course would allow easier clawbacks of said compensation. Scott?

Scott Spector: Ron, let's take our final few minutes and talk about two items that really are one in the same thing and first, the SECs proposal that's still out there and where that's going to go; are we going to see anything in the near future or are we going to have to wait for the presidential elections? And if we do have to wait, what's likely and, you know, the likelihood that that's even going to happen and that's not going to get, you know, just put on the back burner, Kyoko?

Kyoko Takahashi Lin: So, you know, I think as many of you know, the SECs rule to put in a clawback provision, which actually was going to require then listing exchanges for the new listing standards that would be applicable to all public companies. You know, that was originally put in place by the Dodd-Frank Act of 2010. The SEC eventually did propose a rule in 2015, the summer of 2015, doing exactly that. It proposed a rule. It was a pretty expansive rule, they gave us probably more prescriptive than a number of people had been anticipating but, you know, it was what it was.

And then it just sat there. Never got any traction after that, you know, some companies looked at that. They sort of started, you know, thinking about ways that they might enhance their clawback policies and things like that but as a pure rule-making matter, it just sat on the books as a proposed rule and it hasn't really gone anywhere since then. It's now five years later and so far, I don't think that we have seen much SEC activity on this front. You know, once in a while they've hinted but not a whole lot. They've shown certainly a willingness to be active on other unrelated areas that don't have to do with this topic but not anything so, I don't know if any of the other three of you are hearing, you know, rumors or anything, you know, in the, you know, coming up. But that's sort of our situation right now.

Ron Meuller: I'll put a plug in for tomorrow's session and maybe Dave Lynn will get Bill Hinman to address whether it's coming up. You know, I do think that the proposed rules reflected much of what we were touching on about the difficulty of drafting and particularly, for example, because the rules were really tied to financial restatements and yet referenced stock-option clawbacks. So, you know, how do you translate that, what is

the amount that gets clawed back? So, it was really wrestling with, you know, the very drafting issues we were talking about.

My own impression is that the rules would have to be re-proposed and so I do think the commission is trying to get a lot done this year, but I don't know if that's going to hit the radar. If not, you know, I think what will be interesting would be what happens if we end up with a chair of the SEC that's a democrat. You know, that's the situation we were in with, well actually an independent, but when the rules were last proposed. But, you know, I do think that some of the vocal shareholder groups are asking for more than what Dodd-Frank would authorize so it'll be interesting to see how that's addressed.

Scott Spector: Mike, last word?

Mike Melbinger: Yes, I think, in the upcoming, or the announcement of the spring agenda, say explicitly that the new rules, well the next round is proposed regs, so…

Scott Spector: Okay, Liz, we're out of time, you've got to cut us off so we beat you to it and we appreciate the fact that we got everything done.

Markeys/pti:cr