What You Need To Know About How Executive Compensation Is Affected By The Dodd-Frank Act

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Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") contains many provisions which affect the governance of publicly-traded companies. Section 954 of the Act requires the Securities Exchange Commission ("SEC") to direct stock exchanges to prohibit the listing of securities of companies that have not developed and implemented compensation clawback policies. A clawback policy involves the recovery by a company of incentive compensation in excess of what would have been paid or awarded had the determination for such incentive compensation been based on restated financial statements.

This provision was a reaction to the many earnings restatements that preceded and followed the financial crisis of 2007-2009, resulting in overpayments of incentive compensation plan awards which were calculated according to inflated earnings statements and stock values. The overpayments were reflected in annual bonuses, stock appreciation rights, stock options, restricted stock, restricted stock units, performance cycle awards, etc.

Most publicly-traded companies provide such incentives as a means of attracting and retaining key executives while at the same time providing incentives to build and maintain long-term shareholder value by providing incentives designed to motivate executives to achieve those goals. In addition, the $1 million cap on deductions for executive pay under 162(m) of the Internal Revenue Code of 1986, as amended (the "Code"), has an exception for bona fide incentive arrangements, thereby prodding companies to provide substantial incentive-based compensation to key executives to attract and retain them on a tax-deductible basis.

The SEC has yet to issue any rules to implement the requirements of Section 954, so public companies are not yet required to adopt a clawback policy. However, in a study of clawback use during 2014 at 100 large publicly traded US companies, PricewaterhouseCoopers gathered data on clawback provisions and on the differences in clawback use among various industries (*Executive Compensation: Clawbacks,* January 2015). Among the findings for all companies:

- 90% of the companies have policies to claw back compensation if a restatement of financial results must be made. 73% require evidence that the employee caused or contributed to false or incorrect financial reporting; 27% do not require any personal connection.

- 83% claw back compensation in cases of misconduct. These may include breaking the company's code of conduct, being convicted of a crime, and other transgressions, including financial wrongdoing.

- 76% reserve the right to determine on a case-by-case basis whether to enforce clawbacks.

- 84% may recover both cash and stock awards, while 7% recover only cash incentives, and 9% recover only equity awards.

- 89% may recover awards regardless of whether they have vested, and 11% recover only fully vested awards.

- 62% apply clawbacks to executives and senior management, 28% extend them to the broad employee population, and 9% apply clawbacks only to NEOs.

Clawbacks and stock ownership guidelines are two reasons companies have been considering the imposition of post-vesting holding periods. Adding this additional holding period to already vested shares makes it easier to enforce the provisions and reduces the earnings charge.

Section 954 Specifics

Section 954 requires the SEC to adopt rules requiring all publicly-traded companies to adopt a clawback policy that:

- is triggered by an accounting restatement due to material non-compliance with financial reporting under the federal securities laws,

- covers any current or former executive officers who have received incentive compensation for the affected year(s), and

- requires the recovery of incentive compensation (including stock option awards) in excess of what would have been paid or awarded (had the determination for such incentive compensation been based on the restated financial statements) during the three-year period preceding the date the company is required to prepare the restatement.

It is important to note that Section 954 does not require misconduct by the covered executive officers to trigger the clawback obligation and that all key officers are subject to the clawback. If the clawback is triggered, all key officers will be subject to repayment of overpayments. Companies must disclose their clawback policies in their public filings.

Where a company decides to adopt a clawback policy in advance of mandatory SEC rules, it will typically try to preserve as much flexibility as possible and avoid overly detailed rules that may have unintended consequences. In particular, the company's board (or compensation committee) will often preserve the discretion in seeking recovery.

Other Issues

Some companies may decide to impose mandatory deferrals on at least a portion of the annual bonuses (and other incentive compensation) for the three-year period following the date the compensation is earned (*i.e.*, the same period over which the clawback may be improved under the Act). This would be done because of potential state law and international law hurdles

that could be involved in pursuing employees and former employees to recover overpayments, and the potential large cost of doing so.

This could apply to the value of equity gains already earned and option value gains (even if not yet monetized). Trying to recoup any of these forms of compensation may also create practical and legal hurdles. Complications will be involved, particularly when executives sell shares to pay taxes and/or option exercise prices. Other executives immediately sell shares and reinvest the after-tax proceeds in other investments, some of which may be illiquid. Because amounts would be taxed in a different taxable year than the year of repayment to the company, uncertain tax results face executives.

These situations might cause some companies to adopt mandatory bonus deferrals that could be used as an offset against other compensation elements. This would provide security of recovery to the company and not force executives to undo financial planning strategies by liquidating their holdings to repay overpayments.

To avoid potential federal income tax problems under Code Section 409A, a company might impose a 3-year vesting subject to forfeiture if the executive leaves before the vesting date. Nonvested benefits are not subject to the complicated deferred compensation rules of Section 409A and, thus, that section's nonacceleration rules would not apply. Such a vesting schedule, however, would likely be unattractive to executives.

The Impact of Clawbacks on Divorcing Couples

A clawback of income earned prior to and even after a divorce could have a significant and far reaching impact on the asset and debt allocation between the parties, the tax consequences of property allocation and support, as well as the calculation of income for the purposes of spousal and child support.

Given the rapid proliferation of such clawback provisions in executive compensation plans, family law practitioners must be aware of their existence and address how the impact of a clawback will impact each of the parties in the judgment for divorce.

To follow is a summary of potential issues and consequences to be considered and addressed in light of the law in your particular jurisdiction.

A. Allocating responsibility for payment of clawback of income (or property) already divided between divorced spouses.

Assume parties were divorced on June 30, 2012 after a 20 year marriage. The divorce judgment awards to both parties assets comprised of salary and bonus earned by the wife through June 30, 2012. In addition, both vested and unvested stock options awarded to the wife throughout the marriage and through June 30 of 2012 were also divided between the parties. On June 30, 2013 wife's company, of which she is the CFO, announces a major restatement of its 2011 earnings. All of wife's incentive compensation for the three years prior to the restatement, including income she earned after the marriage, is now subject to clawback pursuant to the company's compensation clawback policy. All told, the wife must repay the company $1 million due to the overpayment of 2011 bonus income and stock option grants.

Assuming the responsibility for this liability is not addressed in the parties judgment for dissolution of marriage, the likely outcome in many jurisdictions would be that this liability would be the sole responsibility of the wife and the husband would have no obligation to contribute from his share of the marital assets to the payment of this debt.

However, to the extent that the divorce practitioner is aware that a clawback provision exists in their client's compensation plan at the time of the divorce, best practices would dictate that to the extent that assets awarded to parties under the judgment are later clawed back, that both parties share in the repayment of that clawback liability in some equitable proportion.

B. The potential impact of clawbacks on previously filed income tax returns.

While much remains unsettled as it relates to the tax impact of incentive compensation clawbacks, it is clear that if a taxpayer repays compensation first paid in a prior year, he may not amend the prior year's return to exclude the payment from that year's income. Rather than excluding the repaid compensation from gross income in the year it was originally earned, the IRS takes the position that the repaid income should be taken as an itemized deduction in the year in which the repayment is made. What is unclear is how the scenario will be treated in which the clawback repayment is actually withheld from a taxpayer's income in a year that has not yet been taxed (i.e., the current year). For a good overview and discussion to the tax impact of clawbacks, see: Tax Notes; "Taxing Clawbacks: Theory and Practice" Barker and O'Brien, October 25, 2010 at page 423. To the extent as suggested above, an obligation for the repayment of clawed back income would be allocated between divorcing spouses, equity would require that any tax benefit received as a result of the repayment of clawed-back income should also be equitably allocated. However, given the fact that joint tax returns filed by parties during the year in which the income was originally earned cannot be amended, another mechanism will have to be employed to equitably allocate the tax benefit to both parties. For example, the amount to be contributed to the clawback payment by the nontaxpayer spouse could be reduced for an amount equivalent to the tax benefit to the taxpayer spouse of the itemized deduction which will be deducted in the year in which the call that payment is made.

C. The impact of delayed or deferred incentive compensation.

As referenced above, companies may begin deferring additional bonus or incentive compensation for employees during the three-year clawbacks as part of their clawback policies. To the extent that this income is deferred solely for the purposes of securing assets in the event of a clawback and to the extent that the only risk of loss of the income would be the triggering of the clawback provision (as opposed to the employees termination or departure from the company) this will raise issues in jurisdictions that treat vested and unvested deferred compensation differently under their marital property rules.

For example, some jurisdictions have adopted "bright line" rules that mandate that all assets acquired during the marriage, whether vested or unvested, are treated as marital property. Other jurisdictions have a different approach, in which a court is to consider the amount of work or service post marriage that will be required in order for assets to vest inequitably allocating the

assets. In Illinois for example, our law essentially provides for the application of a coverture fraction in determining what portion of unvested deferred compensation should be considered divisible at the time of divorce. (If a spouse has deferred compensation vesting in a three year schedule and only the first year occurs during the marriage, one-third of the compensation award would be treated as marital property, if and when the compensation is paid). For an overview of varying approaches to the division of deferred compensation, see: Durst, Robert J., II. "Stock Options: A Significant but Unsettled Issue on the Distribution of Marital Assets." AAML 17 (2001): 295-305. However, compensation holdbacks solely for the purposes of securing assets in the event of a clawback, are very different from typical deferred compensation that requires an employee to continue to work at the company in order for it to vest. To the extent that the only event that could trigger the loss of this compensation would be a clawback, there really isn't any additional work that needs to be performed by the employees spouse in order to "earn" that income. Practitioners in jurisdiction that apply coverture rules, will need to distinguish holdbacks to secure clawback payments from traditional deferred compensation vesting schedules.

D. Adjustments to income for support purposes.

Both spousal support and child support are generally based on historic income and may even be calculated as a percentage of income each year the support is paid. A compensation clawback which occurs after the support has been paid on the overstated (and ultimately claimed back) income, could result in a windfall to the support recipient if not addressed in the body of a judgment. Furthermore, a substantial itemized deduction resulting from a compensation clawback could have an unintended effect on the calculation of support in the relevant year - and for years to come if future support is based upon an income averaging approach. To the extent that a support payor is subject to a clawback provision, even outside of the period during which it could impact a marital property division, giving a Court guidance about what to do in the event of a compensation clawback as it relates to support is also a much safer approach than not addressing the issue.

Conclusion

Given the large number of companies that are now implementing clawback policies and given the significant impact they could have on divorcing parties, family law attorneys need to be aware of their existence and stay current on what will inevitably be a developing body of law addressing their impact.

Provided with this paper are several sample policy outlines and clawback provision clauses.