Operating Clawback in a Global Context

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WHAT DO WE MEAN BY CLAWBACK?

- **Basic definition**
  Reducing, cancelling, or seeking repayment of incentive compensation based on employee misconduct, poor individual or business performance, error or other triggers

- **Key factors to consider**
  - Who is subject to clawback?
  - What compensation is subject to “clawback”?
  - When does it apply?
  - Why have a clawback—what are the triggers?
  - Where will it be enforceable (or not)?
  - How do you administer a clawback provision?
<table>
<thead>
<tr>
<th>When we say . . .</th>
<th>We mean . . .</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Recoupment” or “disgorgement”</td>
<td>Action by an employer (or regulatory authority) to compel an employee or former employee to repay an incentive award; a post-vesting “true clawback”</td>
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<tr>
<td>“Cancellation, “reduction” or “forfeiture”</td>
<td>Withholding by an employer of some or all amounts otherwise due to be paid to an employee or former employee because of the failure of a condition precedent to the employer’s obligation to pay; a pre-vesting clawback</td>
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<tr>
<td>“Malus”</td>
<td>Opposite of “bonus”—refers to the rationale for reduction, cancellation or forfeiture of an award, and generally applies in the pre-vesting context of deferred incentives</td>
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<tr>
<td>“Clawback”</td>
<td>Any or all of the above</td>
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# BRIEF HISTORY OF CLAWBACK

“Clawback” is not necessarily a new concept...

<table>
<thead>
<tr>
<th>19th - 20th Centuries</th>
<th>“Clawback” Mechanism / Impetus</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. common law doctrines</td>
<td>Employee who breaches “duty of loyalty” to employer forfeits right to compensation</td>
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<tr>
<td>“Faithless Servant”—Murray v. Beard (NY, 1886)</td>
<td>Good conscience requires restitution of amounts received unfairly by one party at expense of another</td>
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<td>“Unjust enrichment”</td>
<td>Bonus payments may be invalid if so large as to be a waste of corporate assets</td>
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<tr>
<td>“Corporate Waste”—Rogers v. Hill (U.S. Supreme Court, 1933)</td>
<td>To promote employee retention and discourage “bad boy” behavior</td>
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<td>Contractual terms and conditions</td>
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<tr>
<td>Employment agreements</td>
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<tr>
<td>Incentive plans</td>
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<td>Separation pay</td>
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<tr>
<td><strong>“Clawback” Mechanism / Impetus</strong></td>
<td><strong>Rationale</strong></td>
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<td><strong>21st Century 2002</strong></td>
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<tr>
<td>Legislation/regulation</td>
<td>Response to Enron and WorldCom scandals</td>
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<td>• Sarbanes-Oxley (“SOX”)</td>
<td>CEO and CFO should forfeit/repay awards in case of financial restatement due to material noncompliance</td>
<td></td>
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<tr>
<td>o Section 304</td>
<td>SEC may order freeze of “extraordinary payments” while investigating securities law violations</td>
<td></td>
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<tr>
<td>o Section 1103</td>
<td></td>
<td></td>
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<tr>
<td><strong>2008</strong></td>
<td>As a condition to receiving government assistance—recovery of incentive compensation based on inaccurate financials or if executive knowingly provided inaccurate information</td>
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<tr>
<td>• Emergency Economic Stabilization Act (“EESA”)/Troubled Asset Relief Program (“TARP”)</td>
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<tr>
<td><strong>June 2010</strong></td>
<td>Risk balancing of incentive pay to promote safety and soundness of banking institutions, including through use of “malus”</td>
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<tr>
<td>• Interagency Guidance on Sound Incentive Compensation Policies (U.S.)</td>
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<td><strong>July 2010</strong></td>
<td>Regulators acknowledge true clawback may be problematic so focus is on minimum deferral requirements and vesting conditions tied to fault and no-fault triggers</td>
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<tr>
<td>• CRD3 (European Parliament approves amendments to Capital Requirements Directive)</td>
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</tr>
<tr>
<td>Date</td>
<td>“Clawback” Mechanism / Impetus</td>
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<td>July 2010</td>
<td>• Dodd-Frank Wall Street Reform and Consumer Protection Act Section 954 (subject to implementing regulations not yet issued by SEC)</td>
<td>Public companies should provide for recovery of excess compensation received during the three-year period preceding an accounting restatement (misconduct not required)</td>
</tr>
<tr>
<td>June 2012</td>
<td>• U.K. Financial Reporting Council</td>
<td>Existing clawback provisions in U.K. Corporate Governance Code should be extended</td>
</tr>
<tr>
<td>April 2013</td>
<td>• CRD4</td>
<td>More risk-balancing of incentive pay for bankers, now coupled with strict limits on variable pay (not more than 100% of base pay, or not more than 200%, if approved by shareholders)</td>
</tr>
<tr>
<td>April 2013</td>
<td>Principal Elements of a Leading Recoupment Policy</td>
<td>Major companies in Health Care industry agree with stockholders that employee misconduct resulting in fines is bad for business</td>
</tr>
</tbody>
</table>

Since the early 20th century, public/investor anger over executive compensation has followed in the wake of scandals and crises. “Say-on-pay”—beginning with a mandatory non-binding provision adopted in the U.K. in 2002—is likely a major factor in the proliferation of clawback” policies outside the financial services sector. Binding “say-on-pay” is now a reality in Denmark, Norway, The Netherlands, Sweden and Switzerland.
<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pre-vesting clawback</strong></td>
<td>Australia Belgium China Finland France Germany Hong Kong India Italy Luxembourg</td>
<td>Netherlands Norway Poland Portugal South Korea Spain Sweden Switzerland U.K. U.S. Brazil, Japan, Malaysia, Philippines, Russia, Singapore, Thailand, DIFC, Vietnam</td>
</tr>
<tr>
<td><strong>Post-vesting clawback</strong></td>
<td>China, India, Luxembourg, Netherlands, Portugal, South Korea, U.S.</td>
<td>Australia Belgium Brazil Finland France Germany Hong Kong Italy Japan Malaysia Norway Philippines Poland Russia Singapore Spain Sweden Switzerland Thailand DIFC, U.K. Vietnam</td>
</tr>
</tbody>
</table>
WHAT ARE COMPANIES DOING TODAY?

  - 86% of Fortune 100 companies have a clawback policy (20% in 2006)
  - Most clawback triggers appear to be based on misconduct or are a blend of misconduct and financial restatement triggers

- **Mercer (2011 Financial Services Compensation Survey)**
  - 44% of banks had clawback provisions prior to 2011 (mostly in North America)
  - An additional 18% of banks have introduced clawbacks since 2011
  - Most clawback triggers are based on misconduct of some sort - e.g., Code of Conduct violation (73%) or non-compliance, exceeding authority or ethical violations (63%)
  - 80% of banks and 60% of insurance companies have “malus” provisions
  - 17% of global banking firms clawed back pay, or attempted to, in 2011
WHAT ARE COMPANIES DOING TODAY? (cont’d)

- New Bridge Street Survey (2012)
  - Over 60% of FTSE 100 companies (and 50% of FTSE 350) have clawback provisions
  - 40% of FTSE 100 companies (and 25% of FTSE 350) have clawback in both bonus plans and LTIPs
  - 30% of clawback triggers in FTSE 100 bonus plans are for misconduct; 40% for misstatement, less than 5% for fraud
  - 30% of clawback triggers in FTSE 100 LTIPs are for misconduct; 35% for misstatement; 10% for fraud

(Note: the above figures are approximations, derived from information complied by New Bridge Street from the latest report and accounts of FTSE 350 companies as at 31 October 2012)
### CLAWBACK TRIGGERS - Examples

<table>
<thead>
<tr>
<th>Fault-based</th>
<th>No-fault</th>
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<tbody>
<tr>
<td>Financial restatement (caused by clawback target)</td>
<td>Financial restatement</td>
</tr>
<tr>
<td>Erroneous financial/performance metrics (caused by clawback target)</td>
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</tr>
<tr>
<td>Gross misconduct; for Cause termination</td>
<td>Material downturn in performance (corporate or business level)</td>
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<tr>
<td>Reputational damage; material adverse outcome</td>
<td>Malus (formulaic reduction for subsequent loss)</td>
</tr>
<tr>
<td>Code of Conduct violation</td>
<td>Failure of business to achieve performance targets</td>
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<tr>
<td>Material violation of risk limits</td>
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<tr>
<td>Compliance violation; regulatory investigation</td>
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<tr>
<td>Failure to supervise</td>
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<tr>
<td>Breach of post-employment covenant (e.g., non-compete, other “detrimental conduct”)</td>
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<td>Failure to pay taxes on awards</td>
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</tbody>
</table>
CLAWBACK DESIGN

- No standard provision!
- Choice of fault and/or no-fault and discretionary or formulaic/automatic triggers should be based on goals
  - Consider: global strategy / internal culture / reward policy / approach to risk
  - Keep in mind enforcement challenges and accounting treatment
- Clawback period
  - U.S. - potential clawback of all incentive compensation awarded in the 3 years before the accounting restatement (Dodd-Frank requirement)
  - U.K. - market trend appears to be 2 years from vesting (or, if later, the completion of 2 audit cycles from the time of payment) for LTIPs and 3 years for bonuses
CLAWBACK DESIGN (cont’d)

- Health Care industry
  - Focus on promoting compliance and deterring conduct that could lead to financial harm (e.g., penalties)
  - Emphasis on discretion

- Financial Services industry
  - Responding to regulators’ concerns re excessive risk taking, in addition to deterring fraud and other harmful conduct
  - Multi-year deferrals and formulaic and discretionary triggers
CLAWBACK DESIGN (cont’d)

<table>
<thead>
<tr>
<th>Why have a clawback policy or provision?</th>
<th>What should it look like?</th>
<th>Do you really need one?</th>
</tr>
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<tbody>
<tr>
<td>“To say we have a clawback . . .”</td>
<td>“Policy” to recover inflated awards due to erroneous financial statements substantially caused by clawback target’s knowing or intentional fraudulent or illegal conduct</td>
<td>Probably not - CEO and CFO already at risk under SOX 304 (even if they did not commit misconduct); fraud should be grounds for termination for Cause, and there are other legal bases for recovery</td>
</tr>
<tr>
<td>“To prevent former employees from harming our company . . .”</td>
<td>Post-employment vesting conditions in award agreements that specify the potentially detrimental conduct to be discouraged (e.g., competition)</td>
<td>It might help</td>
</tr>
<tr>
<td>“To ensure pay is risk balanced and based on sustainable performance . . .”</td>
<td>Performance-vesting provisions, and/or malus and risk triggers</td>
<td>Maybe</td>
</tr>
<tr>
<td>“To promote a compliance culture . . .” or “to prevent reputational damage . . .”</td>
<td>Discretionary triggers backed by robust governance process</td>
<td>Maybe</td>
</tr>
<tr>
<td>“To comply with the law . . .”</td>
<td>Depends on jurisdiction/industry • U.S. - financial restatement trigger (Dodd-Frank) • EU/financial services - misconduct, material error, risk management failure, malus triggers</td>
<td>Yes</td>
</tr>
</tbody>
</table>
KEY DESIGN CONSIDERATIONS

Several variables may make it more (or less) likely a clawback will be enforceable at law, e.g.,

- **How clawback policy is implemented**
  - Policy pronouncement by Board of Directors
  - Plan provision (including choice of law)
  - Express conditions in signed agreement (including choice of law)

- **Compensation at risk of being clawed back**
  - Vested (paid or unpaid) incentive awards (cash or equity)
  - Gains made on exercise of options or sale of shares
  - Awards outstanding when clawback policy is adopted
  - Awards granted after adoption of clawback policy
  - Unvested incentive awards
KEY DESIGN CONSIDERATIONS (cont’d)

- Trigger event / conduct
  - Financial restatement
  - Corporate or business unit performance
  - Personal misconduct (during or after employment)

- Other plan / agreement provisions
  - Non-forfeiture
  - Right to setoff
ARE CLAWBACK PROVISIONS ENFORCEABLE?

- Clawbacks are not universally enforceable!
- Global incentive plans tend to reflect the law of the parent company’s country of incorporation and may be expressly governed by it.
- However, participants’ employment rights are usually determined by the place where they work.
- An agreement under an incentive plan may well be considered to be an employment contract.
- A choice of law clause may help but is not guaranteed to work – local law may override it!
ENFORCEABILITY - U.S. Law

- State “wage and hour” laws are most significant obstacle
  - Deductions from “wages” prohibited—only narrow exceptions are allowed (e.g., for benefit of employee and by written consent on government-approved form)

- Broad and different definitions / judicial interpretations of “wages” may make clawback problematic
  - Failure to pay “wages” can lead to damages / penalties / reputational harm

- When does incentive compensation constitute “wages”?
  - Under New York law, focus is on direct link to personal productivity:
    - Incentive pay = “wages” once earned and vested
    - Discretionary bonus based on employer’s financial performance ≠ “wages”
    - Equity-based compensation ≠ “wages”
ENFORCEABILITY - U.S. Law (cont’d)

- Generally, U.S. courts consider unvested equity awards and other bonuses not to be “wages”
- However, incentive plans take many forms, and the Devil is in the details . . .
  - Does plan formula constitute an illegal deduction from “wages” . . .
    - *Ralphs Grocery v. Superior Court* (California, 2003)
  - Or does it not?
    - *Prachasaisoradej v. Ralphs Grocery* (California Supreme Court, 2007) (4-3)
- Litigation can lead to years of uncertainty
- A *condition precedent* to obligation to pay (rather than *condition subsequent*) can make a big difference (substantively and procedurally) . . . but “wages” must be paid . . .
ENFORCEABILITY - U.S. Law (cont’d)

In New York, **“faithless servant” doctrine** allows for recovery of *all compensation* (even “wages”) paid after first disloyal act (*Phansalkar v. Andersen Weinroth & Co. L.P.*) (U.S. Court of Appeals, 2d Cir. 2003)

- Applies regardless of damages, or benefits from services rendered
- Some compensation may be exempt from recovery if paid for specific tasks performed without misconduct and untainted by the disloyal acts
- Doctrine is followed by many states, to varying degrees, but not all
  - No forfeiture of earned compensation for loyalty breach in Connecticut
- Applies only to breaches of employee’s fiduciary duty loyalty / good faith
- Available even absent a formal clawback policy or contractual condition

Other federal courts have recognized an implied right of forfeiture for disloyal acts (*Foley v. American Electric Power, S.D. Ohio 2006*)

- If plan does not have express provisions against forfeiture / setoff
ENFORCEABILITY - U.S. Law (cont’d)

“Employee choice” doctrine *(Lucente v. IBM)(2d Circuit 2002)*

- Under New York law, award terms providing for forfeiture upon resignation or for post-employment competition are enforceable
- Employee makes an informed choice to remain employed and continue being paid or to leave / compete and forfeit benefits
- Based on contract—
  - Forfeiture triggers not necessarily limited to competition
  - Target compensation not necessarily limited to unvested awards
  - Award terms should clearly outline conduct to be discouraged
- Not applicable in cases of involuntary termination not for “cause”
  - Post-employment restrictions must be reasonable and necessary to protect a valid business interest
- Followed by other states
ENFORCEABILITY - U.S. Law (cont’d)

SOX Section 304

- Financial restatement trigger (due to material non-compliance with reporting requirements as a result of misconduct)
  - Misconduct of issuer, not clawback target
- Applies only to CEOs and CFOs of companies subject to reporting requirements of the Securities Exchange Act of 1934
- Covers bonus and incentive compensation, including equity awards (and any profits from sales of company stock) received during the 12 months following publication/filing of financial statement that is restated
- Formal company policy or award provisions not required
- Right of action by SEC - not employer
- Preempts state labor laws
ENFORCEABILITY - U.S. Law (cont’d)

- **Dodd-Frank Section 954 - Recovery of Erroneously Awarded Compensation** *(pending implementing regulations by SEC)*
  - National securities exchanges must not list companies that do not:
    - Disclose policies on incentive compensation based on financial information required to be reported under securities laws
    - Provide for recovery of incentive compensation received by current or former executive officers if company is required to prepare a financial restatement due to material noncompliance with reporting requirement under the securities laws
      - Targets incentive compensation (including stock options) received during 3-year period preceding date restatement is required
      - Amount subject to recover is excess over what would have been paid under the accounting restatement
    - Misconduct not required
ENFORCEABILITY - U.S. Law (cont’d)

- Dodd-Frank issues
  - Definition of “executive officer” - who is covered?
  - When is a restatement required due to “material noncompliance”?
  - How do you determine the amount of incentive compensation that would have been paid?
  - How do you enforce clawback -
    - If covered compensation was awarded before Dodd-Frank clawback provisions were implemented?
    - If covered executive officer is outside of the U.S.?
    - If covered executive has left company and there has been a mutual release of claims?
  - Is enforcement required?
  - What if covered executive is indemnified against claims not based on misconduct?
ENFORCEABILITY – U.K.  🇬🇧

 Penalty doctrine

- Applies to specified sums payable upon a breach of contract
- A provision which constitutes a penalty is unenforceable
- What makes a provision a penalty? Modern test asks:
  - Is there a commercial justification for the provision?
  - Is the provision extravagant or oppressive?
  - Is the predominant purpose to deter breach?
  - Was the provision negotiated on a level playing field?
- Structure pre-vesting clawback as a condition of receipt
  - Imam-Sadeque v BlueBay Asset Management (Services) Ltd (2012)
ENFORCEABILITY – U.K. (cont’d)

- Post-vesting clawback is more problematic
- Reduce the risk of the clawback being a penalty
  - Agreed sum of liquidated damages
  - Based on an assessment of the company’s losses from the breach
  - Simply recovering shares or money which would not have been paid out had the breach been known at the time
  - Not linked to any particular conduct by the participant – e.g. linked to restatement of accounts (harder to say purpose is to deter breach)
- Unlikely a court will use public policy to strike down clawback where it is required by an industry regulator (e.g. financial services)
ENFORCEABILITY – U.K. (cont’d)

- Restraint of trade doctrine
  - Clawback triggered by breach of a restrictive covenant (e.g. a non-compete or non-solicitation provision) might be unenforceable
  - Particular issue for “good leavers” with delayed vesting of awards
  - Exception to the doctrine: allowed to the extent necessary to protect a legitimate business interest
    - Depends on the exact terms of the clawback and if sufficiently limited in duration and geographical scope
  - Open question whether pre-vesting clawback (as opposed to an absolute prohibition on competing or soliciting) can be challenged at all on the basis that it is a restraint of trade
ENFORCEABILITY – U.K. (cont’d)

- **Unlawful deduction from wages**
  - Employment Rights Act 1996 – employee must consent to a deduction from wages

- **Doctrine of mutual trust and confidence**
  - Employer should demonstrate rational behaviour
  - Discretion should not be exercised capriciously or in a discriminatory way
  - Advisable to have a clear process and group policy relating to clawback to show consistent application
ENFORCEABILITY – GERMANY

Effect of a foreign choice of law clause

- German law will apply if the incentive plan is deemed part of the employment contract
- Mandatory Employment Provisions cannot be excluded
- German courts will not enforce any foreign law which is contrary to German principles of public policy
ENFORCEABILITY – GERMANY (cont’d)

- Statutory law
  - German Law on the Adequacy of Remuneration of Executive Board Members (VorstAG)
    - Board members only
  - Remuneration Ordinance for Institutions (Instituts-Vergütungsverordnung)
    - Board members and risk-taking employees
  - Ordinance on the Supervisory Requirements for Remuneration Systems in the Insurance Sector (Versicherungsvergütungsverordnung)
    - Board members and risk-taking employees
ENFORCEABILITY – GERMANY (cont’d)

- General principles of law
  - Concept of clawing back previously earned and already paid-out remuneration is generally contrary to German employment law principles
    - Regular employees affected

- Case law
  - Does not exist regarding questions of statutory law and bonus clawback
ENFORCEABILITY – GERMANY (cont’d)

- Pre-vesting phase
  - Clawback permissible if
    - Vesting period is reasonable
    - Awards are not major part of remuneration
    - Reason: termination of employment
  - Clawback permissible with restrictions
    - Reason: “Cause” => contractual penalty rules need to be observed
ENFORCEABILITY – GERMANY (cont’d)

Post-vesting phase

- Depends on type of award
  - Purely based on individual performance
    - Clawback impossible since the employee has already delivered performance
  - Purely based on company loyalty
    - Clawback possible when employment contract is terminated
  - Mixture of individual performance and company loyalty
    - Clawback possible but with time restriction depending on the amount of bonus (e.g. bonus of more than one’s month salary -> period up to 6 months)
ENFORCEABILITY – GERMANY (cont’d)

- Permissible clawback reasons
  - Violation of policies/law during the relevant assessment period
    - Well defined regarding the prerequisites of the award
    - Explanation of the clawback procedure
  - Future business developments
    - Well defined and transparent
    - Not too excessive
  - Violations of policies/law during the years following the relevant assessment period
    - Well defined and transparent
    - Not too excessive
  - Activities of major financial risk or financial losses
ENFORCEABILITY – GERMANY (cont’d)

- Inadmissible clawback reasons
  - Post contractual non-compete
    - Subject to § 74 of the German Commercial Code
    - Employer has to pay the employee non-compete compensation of at least 50% of last remuneration
    - Maximum of two years
  - Termination of contract of employment, early retirement, agreement on termination agreement
    - Encroaches on the employee’s right of termination
    - Violation of Article 12 of the German Constitution (freedom of occupational choice)
ENFORCEABILITY – GERMANY (cont’d)

Drafting of clawback clause

- Principles for standard terms and conditions (Allgemeine Geschäftsbedingungen) applicable
  - Wording needs to be very specific => every single reason for which clawback might apply needs to be stated
  - Set out the position in the plan or contract => no surprises

- For regular employees (other than Board members and risk takers)
  - Total annual remuneration may not be reduced by more than 25-30%

- Under statutory law (VorstAG, InstitutsVergV)
  - Malus mechanisms as a means to implement remuneration structures taking into account the full range of current and potential risks are proposed; up to 60% to be deferred for 3-5 years
ENFORCEABILITY – OTHER COUNTRIES

 France
   Prohibition on financial sanctions which may lead to salary deductions, even if arising from employee’s misconduct / breach
   High risk of awards / bonuses (vested or unvested) being salary
   A general discretion re: clawback is unlikely to be enforceable
   Clawback cannot be applied outside the period to which the award / bonus relates
   Clawback linked to restrictive covenants are unlikely to be enforceable (restriction on the employee’s freedom to work)
ENFORCEABILITY – OTHER COUNTRIES (cont’d)

- **Canada**
  - Non-compete covenants may be a restraint of trade and therefore not enforceable
  - But the clawback does not prohibit the employee from competing – so it may be enforceable, provided it is not a penalty

- **India**
  - Post-vesting clawback of shares can only be done by sale under exchange control regulations
  - So company will need to buy them back from employee (e.g. for nominal value)
ENFORCEABILITY – OTHER COUNTRIES (cont’d)

- Russia

  - Reduction or cancellation of “salary” payments is prohibited unless a few limited exemptions apply
  - Clawback triggers linked to circumstances beyond the employee’s control may be invalid
  - Clawback triggers linked to misconduct are unlikely to be enforceable
### NOTABLE CLAWBACK ACTIONS

<table>
<thead>
<tr>
<th>Case / Situation</th>
<th>Legal Mechanism/Theory</th>
<th>Compensation Targeted</th>
<th>Outcome</th>
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<tbody>
<tr>
<td>SEC v. Gemstar – T.V. Guide (2005)</td>
<td>SOX 1103—to freeze “extraordinary payments” pending investigation of securities fraud</td>
<td>Severance payments to CEO and CFO equal to 5X base pay (US$ 37 million)</td>
<td>U.S. Court of Appeals (9th Cir.) upholds escrow order</td>
</tr>
<tr>
<td>Scrushy v. Tucker (HealthSouth) (2006)</td>
<td>Derivative action against CEO (unjust enrichment; waste)</td>
<td>US$ 47 million</td>
<td>Recoupment order upheld</td>
</tr>
<tr>
<td>J.P. Morgan v. Pierce (2007)</td>
<td>Violation of non-compete covenant in stock plan</td>
<td>Vested shares valued at US$ 376,000</td>
<td>Former employee ordered to repay</td>
</tr>
<tr>
<td>AIG (2009)</td>
<td>Public anger over contractual retention payments made after government bailout</td>
<td>US$ 165 million paid to senior executives</td>
<td>Legislative push to increase tax on awards up to 100% fails</td>
</tr>
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### NOTABLE CLAWBACK ACTIONS (cont’d)

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<tr>
<td>SEC v. Jenkins (2009)</td>
<td>SOX 304 (against CEO not charged with misconduct)</td>
<td>US$ 4 million (bonuses + stock sale profits)</td>
<td>Agreement to repay $2 million</td>
</tr>
<tr>
<td>Global bank X (2012)</td>
<td>Clawback policy (malus / business loss)</td>
<td>50% of 2010 bonuses that exceeded CHF/USD 2 million</td>
<td>Unvested awards (and 2011 bonus pools) reduced</td>
</tr>
<tr>
<td>Global bank Y (2012)</td>
<td>Clawback policy (erroneous awards in light of subsequent bad results)</td>
<td>Up to 40% of 2010 bonuses to former CEO and 13 other executives</td>
<td>Unvested awards reduced</td>
</tr>
<tr>
<td>Global bank Z (2012)</td>
<td>Clawback policy (bad risk outcomes)</td>
<td>Incentive comp, including shares and options</td>
<td>Maximum permitted clawback effected, including voluntarily from senior executive</td>
</tr>
</tbody>
</table>
DEVELOPING A GLOBAL APPROACH TO CLAWBACK

- Investigate the likelihood of enforceability in each country
- Can it be increased by tailoring the plan to local criteria?
  - Reluctance to treat employees differently under a global plan depending on where they are located
- Take a commercial / HR decision to apply clawback generally across all countries and bear the risk that it may not be enforceable against some participants?
- Does it matter that clawback may not be enforceable?
ADMINISTERING CLAWBACK PROVISIONS

- Communication is vital - policy will not be effective if not known and understood (effectiveness vs. enforceability)
- Award documentation - are your clawback provisions clear and unambiguous? Are they formally agreed to by participants? Are they too narrowly drafted to cover unforeseen events (or too broad)?
- Exercise of discretion - who is authorized to act and how?
  - Board compensation committee / local remuneration committees?
  - Management by delegated authority?
  - Pursuant to written procedures/guidelines?
  - When and how to investigate?
  - How much to clawback?
  - Right to appeal?
HOW MUCH SHOULD YOU CLAWBACK?

- Degree of fault
- Any tax paid
- Amount of loss suffered
- Impact on reputation
- Level of responsibility

It's a judgement!
TAX CONSIDERATIONS – U.S.

- Generally: no vesting = no tax; so tax issues should arise only if clawback occurs post-vesting
- If post-vesting clawback is in same year as vesting, generally there should be no major issues
  - Clawed back amount is not reported as income to employee (earnings statement should report net compensation paid that year)
  - Employer takes no deduction for compensation paid and recouped in same year
  - Income and FICA taxes paid in same year as vesting / repayment can be recovered
TAX CONSIDERATIONS – U.S. (cont’d)

- If post-vesting clawback occurs in year after payment
  - Employer recognizes income in year of recovery equal to deduction taken in year of payment
  - No reduction of current-year compensation paid to employee (earnings statement should not be net of amount recovered)
  - Employee should be able to claim a deduction in year of repayment / setoff for trade or business expenses or losses under IRC § 162(a) or IRC § 165(c)(1)
    - Employee’s deduction is limited (only aggregate miscellaneous deductions that exceed 2% of AGI are deductible) or may be disregarded under AMT
    - Additional relief may be available under IRC § 1341 (“claim of right”) . . . depending on facts and circumstances
TAX CONSIDERATIONS – U.S. (cont’d)

- Income tax withholdings are not refundable after calendar year in which they were withheld from wages
- But FICA tax withholdings may be claimed up to 3 years after filing date of relevant tax return
- Beware of potential IRC § 409A issues if clawback is effected by setoff against other “nonqualified deferred compensation”
  - Don’t reduce compensation not yet payable
  - Report “gross” compensation (not net of amount recovered) in year of setoff
TAX CONSIDERATIONS – U.S. (cont’d)

Caveat!

- The above analysis may not apply fully in all cases and other issues may arise
- Be sure to review all details carefully -
  - Retroactive or prospective clawback policy?
  - Clawback triggering event?
  - Cash or equity compensation?
  - Direct repayment or holdback (setoff) from other compensation?
TAX CONSIDERATIONS – U.K.

- Can an employee claim a tax refund (or tax loss) for any post-vesting clawback?

- **Julian Martin v HMRC (2012)**
  - S.11(3) ITEPA 2003 - relief may be available under section 128 ITA 2007 where “taxable earnings is negative” – but no definition / calculation
  - Tribunal decided that the amount of signing-on bonus that Mr Martin had to repay his employer under a clawback provision was “negative taxable earnings”
  - Means a "contractual reversal, under the terms of employment, of what had constituted taxable earnings”
  - S. 128 ITA 2007 limits the "carrying back" of any employment loss to the tax year before the loss-making year
But … Finance Bill 2013 caps S.128 ITA 2007 relief to greater of £50,000 or 25% of income

National insurance contributions – HMRC: adjustments would be made in practice

Adjustment of corporation tax deduction?

Practical implications - will companies clawback the gross rather than net-of-tax amount?
OTHER ISSUES

➤ Accounting
  ➤ U.S. GAAP - discretionary provisions may subject awards to variable accounting
  ➤ UK (IRFS 2) – adjust expense to take account of clawback? Evolving area!

➤ Disclosure of policies and actions
  ➤ U.S. - S-K 402(b), if clawback affects NEOs; also per Dodd-Frank
  ➤ U.K. – BIS proposals (remuneration reporting regulations)
  ➤ Voluntary disclosure?

➤ Consultation / Works Councils

➤ Regulators and public perception
TIPS FOR EFFECTIVE CLAWBACK

✓ Structure clawback as a vesting condition precedent
✓ Make sure you have a binding contract
✓ Check local regulation
✓ Communicate clearly to employees
✓ Have a fair process for applying discretionary provisions
Questions?

Thank you for your participation
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