Clawbacks and Other Termination Provisions

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Overview

• Introduction
• Design and operation
• Enforcement obstacles
• Global strategies
• Conclusion
Introduction

• **What is a clawback provision?**
  – A provision that requires an award recipient to repay plan benefits in the event of wrongdoing

• **What do we mean by ‘other termination provisions’?**
  – Provisions governing the rights of participants with respect to plan benefits in the event of termination of employment, other than clawback provisions
Introduction

- What drives design of clawbacks and other termination provisions?
  - Punishment for bad behavior: clawback
  - Incentives to encourage loyalty to the Company
  - Rewards for good behavior: long service
  - Fairness for no-fault: layoff, redundancy
  - Compassion for natural events: death, disability
Clawback Operation – Penalties

- Forfeiture of award
- Recapture of shares
- Claw back of profits
- Set-off against other pay
- Pre-tax versus after tax
Clawback Operation – Triggers

- Competition with the employer
- Financial malfeasance
  - Sarbanes-Oxley section 304
- “For cause” termination
- Other conduct “against the Company’s interest”
Clawback Operation – Other Features

• Length of reach-back:
  – 12 months most common; longer periods also used
  – Options exercised post termination
• Types of benefits reached
  – Option spread, shares, sale proceeds
• Early discovery requirement
• Notice and chance to cure
Other Termination Provisions – Features

<table>
<thead>
<tr>
<th>Termination of Employment Provisions</th>
<th>Treatment at Termination</th>
<th>Post-Termination Exercise Period (Predominant Approaches)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Voluntary Termination</td>
<td>• All options forfeited</td>
<td>Most common practice – lesser of 90 days and remaining term to exercise vested options</td>
</tr>
<tr>
<td></td>
<td>• Unvested options forfeited</td>
<td>Significant minority – lesser of one year and remaining term to exercise vested options</td>
</tr>
<tr>
<td>Normal Retirement</td>
<td>• All unvested options vest</td>
<td>• Full term to exercise vested options</td>
</tr>
<tr>
<td></td>
<td>• Unvested options are forfeited</td>
<td>• Lesser of three years and remaining term to exercise vested options</td>
</tr>
<tr>
<td></td>
<td>• Partial vesting of unvested options</td>
<td>• Lesser of five years and remaining time to exercise vested options</td>
</tr>
<tr>
<td></td>
<td>• Continued vesting of unvested options</td>
<td></td>
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<tr>
<td></td>
<td>Market practice is fairly evenly divided as to whether to vest unvested options or not vest unvested options (38% and 41% respectively)</td>
<td></td>
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<tr>
<td>Early Retirement</td>
<td>• Treat same as voluntary termination (i.e., no special provision covers early retirement; retirement provisions are limited to normal retirement)</td>
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## Other Termination Provisions – Features (Cont.)

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<td>By the Company for Cause</td>
<td>All options forfeited (vested and unvested)</td>
<td>N/A</td>
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</table>
| By the Company without Cause        | Unvested options forfeited | • Lesser of 90 days and remaining term to exercise vested options  
                                         |                                         | • Lesser of one year and remaining term to exercise vested options  |
| By the Executive (voluntary termination) | • All options forfeited  
                                         | • Unvested options forfeited | • Lesser of 90 days and remaining term to exercise vested options  
                                         |                                         | • Lesser of 30 days and remaining term to exercise vested options  |
| Death                               | • All unvested options vest  
                                         | • Unvested options forfeited  
                                         | • Partial vesting of unvested options  
                                         | • Continued vesting of unvested options | • Full term to exercise vested options  
                                         |                                         | • Lesser of three years and remaining term to exercise vested options  
                                         |                                         | • Lesser of five years and remaining time to exercise vested options  |
| Disability                          | Same as death             | Same as death                                            |
| Work-force reduction                | Unless company has a history of work-force reductions, most common market practice is for the Committee to deal with it when the reduction occurs – frequently treated more generously than a regular termination without cause. | Not typically described. |
Enforcement – US

- Termination provisions governed by contract law
  - Employment at will doctrine
  - Litigation claims based on fraud, etc.
  - Non-compete clauses unenforceable or limited enforceability in some states, elsewhere must be reasonable
  - *IBM v. Bajorak* upheld clawback in 1999
Obstacles to Enforcement Outside US

- Statutory option termination provisions, e.g., Denmark \( \geq \) July 1, 2004
- Court decisions that override forfeiture, post-term exercise provisions, e.g., Denmark \(<\) July 1, 2004
- Required contract of employment with Works Council consultation (Netherlands)
- Rules against set-off (Hungary, Thailand)
- Non-compete clauses unenforceable (e.g., Mexico) or limited (e.g., Luxembourg)
- Inclusion may trigger termination pay
- Special rules, e.g., France 6 months for death
Obstacles to Enforcement Outside US (Cont.)

• Failure to translate (e.g., Belgium, Finland, Poland, Italy) or recommend independent counsel (Australia)
• Not signed by employee: e.g., Luxembourg, Russia, Thailand
• Electronic signatures problematic: e.g., Argentina, Australia, Bermuda, Brazil, Germany
• Movement between jurisdictions
• Clawback: not much authority
• Set-off: illegal in some countries
Clawback Provisions – Global Strategies

• Eliminate all clawbacks outside U.S.
• Retain unless clearly unenforceable
  – Maximum protection of the Company
  – May still require modification for local law
• Reasons to retain even if enforcement is unlikely
  – *In terrorem* effect
  – Parity of treatment
  – Might work if the employee moves
  – The law may change
• Modify or eliminate to avoid exposure to criminal sanctions
Other Termination Provisions – Global Strategies

- Strategic design
  - Address treatment of “good leavers,” e.g., Spain
    - Most US plans do not distinguish between voluntary termination and termination other than for cause
    - Enforceability of termination for cause impacted by local definitions of ‘cause’
    - Exposure for wrongful termination
  - Definitions of early/normal retirement age, disability:
    - Provide a uniform definition
      - Could be based on HQ country
      - Definition should be clear and HR and easy to administer
    - Tie to definitions in local programs, statutory benefits
Other Termination Provisions – Global Strategies (Cont.)

- Check country-specific requirements, e.g.:
  - Denmark, France
  - Qualified plan requirements, e.g., UK, France
- Avoid cliff vesting in certain countries
- Consider implications for performance plans
- Allow employee to keep tax amounts, e.g., Netherlands, Poland
  - Don’t overlook employment contract provisions!
Other Termination Provisions – Global Strategies (Cont.)

- Drafting strategies
  - Select US law as governing law
  - Statement that plan not granted for past services
  - Statement that plan does not constitute compensation for services to local employer
  - Separate agreement to contain doubtful provisions (China-PRC)
  - Define termination as last day of actual work to avoid notice provisions (caveat: France)
  - Characterize clawback as “liquidated damages” (Hong Kong)
Other Termination Provisions – Global Strategies (Cont.)

• Operational strategy: exclude involvement of local employer, e.g., Luxembourg
Conclusion

- Decide on core termination provisions
- Decide on global strategy (design/drafting/operational)
- Follow through with testing against local rules and definitions
- Review employment contracts
- Expect uncertainties and inconsistencies
Questions?

Thank you for your participation