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Memorandum

Clawbacks — Effective Deterrent or Effective Remedy?

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During the past eight years, Congress has statutorily created three federally mandated clawback provisions affecting executive compensation.[3] These clawback provisions are intended to provide a mechanism by which to create an environment of corporate accountability and deterrence by enhancing responsibility for financial reporting, establishing meaningful internal controls and otherwise encouraging sound executive management oversight. Experience shows, however, that clawback provisions are ineffective without proper implementation and enforcement.

A clear example of the failure to actively enforce a clawback provision is evident by the SEC's limited enforcement actions under §304 of the Sarbanes-Oxley Act of 2002 (''Sarbanes-Oxley Act''), where the Securities and Exchange Commission (SEC) failed to actively enforce this law for almost five years following its enactment.[4] Notwithstanding, Congress recently reaffirmed its commitment to clawback provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act (''Dodd-Frank Act'') by requiring that all exchange-listed companies adopt a clawback policy with respect to executive compensation. Whether these policies achieve the goal of enhancing corporate accountability and deterrence will depend not merely on whether the policies are implemented, but ultimately on whether they are vigorously enforced.

Even prior to the adoption of the Dodd-Frank Act, clawback and recoupment provisions have been gaining popularity in publicly held corporations.[5] The majority of these clawback provisions fall short of the requirements of the Dodd-Frank Act in terms of imposing liability without regard to misconduct, but far exceed the requirements of the Dodd-Frank Act with respect to the breadth and scope of activities giving rise to a clawback. As we await the development and issuance of the SEC's rules governing the implemen-

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[3] *See* §304 of the Sarbanes-Oxley Act of 2002, §111 of the Emergency Economic Stabilization Act of 2008, as amended by the American Recovery and Reinvestment Tax Act of 2009, and §954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

[4] Speech by SEC Commissioner: *Financial Regulatory Reform: The SEC Moving Forward* (Commissioner Luis A. Aguilar, Sept. 21, 2010). *See* http://www.sec.gov/news/speech/2010/spch092110laa.htm.

[5] *Current Recapture Policies and the Dodd-Frank Act*, Fred W. Cook & Co., Inc., Aug. 17, 2010 (77 of the 100 largest U.S. companies in the Standard & Poor's 500 Index have recapture policies). *See* http://www.fwcook.com/alert_letters/08-17-10_Current_Recapture_Policies_and_the_Dodd-Frank_Act.pdf.

tation of clawback policies by exchange-listed companies, employers will be well-advised to evaluate their existing employment agreements, compensatory arrangements and clawback policies, if any, and begin to formulate an action plan to address the myriad of issues that will be implicated by the implementation of the clawback policy required by the Dodd-Frank Act, particularly if the policy is designed to reach further than the statutorily mandated clawback provisions of the Sarbanes-Oxley Act and the Dodd-Frank Act.

FIDUCIARY DUTY OF LOYALTY — FAITHLESS SERVANT DOCTRINE

Even in the absence of applicable statutory authority or established policies for recouping bonuses or other compensation from corporate officers and directors, corporate employers and shareholders have been able to claw back compensation from officers and directors who breach their fiduciary duty of loyalty. Based on the common law principles of agency, the duty of loyalty applies to corporate officers and directors as agents of a corporation and requires such individuals to refrain from self-dealing and usurping corporate opportunities. As agents of the corporation, officers and directors are required to subordinate their interests to the interests of the corporation and place the corporation's interests first in matters related to the agency relationship.[6]

When the duty of loyalty is breached, the rules of agency provide that the breaching agent is not entitled to and must forfeit any compensation for services rendered during the period of his breach, even if a portion of the services may have been properly performed.[7] Compensation subject to recoupment not only includes compensation already paid to the breaching agent, but also includes compensation yet to be paid to the agent.[8] In some cases, all salary and other compensation paid or payable to the fiduciary from the time of the breach and after can be recovered. In other cases, courts have offset recovery by the amount of reasonable compensation for services legitimately performed, thereby limiting recovery to the improper gains resulting from the breach. In either case, recovery through restoration or forfeiture of compensation is generally allowed regardless of whether the fiduciary's breach causes any actual or specific damages.[9]

The application of the duty of loyalty and the remedies for a breach thereof vary by jurisdiction. In applying New York law, the Second Circuit has relied upon a "faithless servant doctrine" under which an employer may refuse to pay an employee from the time the employee was disloyal in performing his duties and has held that employees must forfeit all compensation paid or payable during the entire period of their disloyalty.[10] This application of the duty of loyalty presumes that a fiduciary's disloyal conduct affects his entire performance from the time of the initial breach and thereafter. New York law has been applied to require the forfeiture of $7 million of salary and bonuses paid to a former corporate officer whose employment was terminated for sexual harassment and misappropriation of corporate assets.[11] In reaching its determination, the court found it irrelevant whether the corporation suffered any specific harm as a result of the breach and reasoned that the harshness of the forfeiture was precisely the point of the remedy.[12] Similarly, in applying Oklahoma law, the Tenth Circuit has held that a corporate officer who participated in the business of a competitor must forfeit all of his compensation from the date of the breach through the date of his termination.[13]

Other jurisdictions have adopted less strict applications of the duty of loyalty with respect to recouping compensation from corporate officers and directors. Under Delaware law, the duty of loyalty requires an undivided and unselfish loyalty to the corporation and demands that there be no conflict between a fiduciary's duty and self-interest.[14] In 2009, the Delaware Supreme Court explicitly held that the fiduciary duties of care and loyalty that apply to corporate directors

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[6] RESTATEMENT (THIRD) OF AGENCY §8.01 cmt. b (2006).

[7] *Enstar Group, Inc. v. Grassgreen*, 812 F. Supp. 1562 (M.D. Ala. 1993) ("A corporate officer is not entitled to compensation for services during a period in which that officer engages in activities constituting a breach of the officer's duty of loyalty to the corporation. Accordingly, an officer who is found to have engaged in such conduct may be required to forfeit all compensation which he received during such time, including salary and bonuses.").

[8] RESTATEMENT (THIRD) OF AGENCY §8.01 cmt. d(2).

[9] *Id.*

[10] *Phansalkar v. Anderson Weinroth & Co., L.P.*, 344 F.3d 184 (2d Cir. 2003). *See also Riggs Inv. Mgmt. Corp. v. Columbia Partners, L.L.C.*, 966 F. Supp 1250, 1266 (D.D.C. 1997) (holding that "no compensation is owed an employee who has breached his duty of loyalty to his employer," and that the employee must return to his employer compensation he earned following the disloyal act).

[11] *Astra USA, Inc. v. Bildman*, 914 N.E.2d 36 (Mass. 2009).

[12] *Id.* ("Nor does it make any difference that the services were beneficial to the principal, or that the principal suffered no provable damage as a result of the breach of fidelity by the agent.").

[13] *Wilshire Oil Company of Texas v. Riffe*, 406 F.2d 1061 (10th Cir.), *cert. denied*, 396 U.S. 843 (1969) ("[A]n agent, who, without the acquiescence of his principal, acts for his own benefit or for the benefit of another in antagonism to or in competition with the principal in a transaction is not entitled to compensation which otherwise may be due him.").

[14] *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939)

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also apply to corporate officers and possibly even key managerial personnel.[15]

The Delaware Court of Chancery recently found, in a case where an employee worked part-time for a competitor of his employer for approximately 22 months during his period of employment, that such direct competition was a breach of the employee's duty of loyalty to his employer.[16] The court held that Delaware law prohibits an agent from putting himself in a position antagonistic to his principal and that direct competition by an agent without disclosure to his principal constitutes such an antagonistic relationship.[17] In determining the appropriate remedy for the employee's breach, the court rejected the employer's claim to recover all compensation paid by the employer to the disloyal employee during the 22-month period in which the employee was providing services to the employer's competitor.[18] Instead, in holding that fiduciaries are prohibited from profiting personally from disloyal acts that constitute fiduciary breaches and that all profits obtained from a breach of the duty of loyalty should be disgorged, the court limited the employer's recovery to the compensation received by the employee from the employer's competitor during the period of the employee's disloyalty.[19] In requiring that all improper gains be recoverable, even if no specific injury can be measured, Delaware law discourages disloyalty and prevents an unjust windfall by stripping the profits gained from disloyal acts.[20]

In another Delaware case, in which corporate fiduciaries misappropriated $28.5 million of corporate assets over an 11-year period for personal benefit, the court similarly offset the corporation's recovery by an amount representing reasonable compensation to the breaching fiduciaries for the services legitimately performed for the corporation.[21] According to the court, even where a fiduciary who breaches his duty of loyalty must forfeit all of the profits resulting from such breach, such an offset for reasonable compensation is appropriate so as to avoid the corporation and its shareholders being unjustly enriched.[22] The court, however, held that such an offset is a matter of equitable discretion to be exercised by the courts.[23]

Regardless of the harshness of the remedies that have been applied by some courts for a breach of the duty of loyalty, recoupment of compensation paid or payable based on claims of a breach of the duty of loyalty may not be an extremely practical or successful method of clawing back compensation. As an initial matter, choice of law issues may not be easily determined or resolved. Some courts have applied an ''internal affairs doctrine'' under which questions arising out of the fiduciary duties owed by an employee to his employer are considered part of the employer's internal affairs and are resolved according to the laws of the employer's state of incorporation.[24] Other courts apply traditional choice of law principles in order to determine which state has a paramount interest in resolving the disputed issues.[25] Moreover, any judgment for recovery will likely require litigation and involve significant litigation costs and, in the event a favorable outcome is obtained, additional costs will likely be required to enforce the judgment.

THE SARBANES-OXLEY ACT OF 2002

The Sarbanes-Oxley Act,[26] enacted on July 30, 2002, was designed to prevent deceptive management and accounting practices and to enhance financial reporting and disclosure. The Sarbanes-Oxley Act was adopted to restore investor confidence in the United States securities markets by protecting benefit plan participants from corporate abuses, increasing transparency as to the methods used by issuers [27] to compensate insiders (e.g., executive officers and directors

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[15] *Gantler v. Stephens*, 965 A.2d 695, 708–709 (Del. 2009); *See also Triton Constr. Co., Inc. v. E. Shore Elec. Services, Inc.*, 2009 WL 1387115 (Del. Ch. 2009).

[16] *Triton*, 2009 WL 1387155 at 18.

[17] *Id.*

[18] *Id.* at 32 (the employer was not entitled to relief based on a claim for unjust enrichment because the employee's salary and benefits received from the employer constituted fair compensation earned by the employee for his efforts).

[19] *Id.* at 37.

[20] *Id.*

[21] *Technicorp Int'l II, Inc. v. Johnston*, 2000 WL 713750 (Del. Ch. 2000).

[22] *Id.* 52 (''To avoid such unjust enrichment, courts of equity, applying Delaware law, have implicitly recognized that even where a corporate fiduciary's breach of the duty of loyalty results in his being stripped of all profit flowing from the breach, it is appropriate to offset against the corporation's recovery an amount that represents reasonable compensation to the fiduciary for services legitimately performed'').

[23] *Id.* 53 (''the [c]ourt's determination not to deprive the defendants of reasonable compensation does not rest upon any positive rule of law, but is purely and solely a matter of equitable discretion, i.e., grace.'').

[24] *BBS Norwalk One, Inc. v. Raccolta, Inc.*, 60 F. Supp.2d 123, 129 (S.D.N.Y. 1999).

[25] *Koury v. Xcellence, Inc.*, 649 F. Supp.2d 127 (S.D.N.Y. 2009).

[26] P.L. 107-204, 2002 H.R. 3763 (July 30, 2002), 15 U.S.C.A. §7201, et al.

[27] For purposes of the Sarbanes-Oxley Act, the term ''issuer'' means an issuer, the securities of which are registered under §12 of the Securities Exchange Act of 1934, as amended (the ''Exchange Act''), or that is required to file reports under §15(d) of the Exchange Act, or that files or has filed a registration statement

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of an issuer), preventing deceptive practices in management, and accelerating disclosure to the marketplace of transactions engaged in by insiders.

The Sarbanes-Oxley Act also requires an issuer's CEO and CFO to certify the accuracy of the issuer's financial statements. Section 304 of the Sarbanes-Oxley Act provides that if an issuer, as a result of misconduct, is required to restate its financial statements due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the CEO and CFO will be required to reimburse the issuer for (i) any bonus or other incentive-based or equity-based compensation received by that person during the 12-month period following the initial publication of the noncompliant financial statements, and (ii) any profits realized from the sale of securities of the issuer during the same 12-month period.[28]

The statutory clawback provisions under §304 of the Sarbanes-Oxley Act are intended to be self-executing and if a CEO or CFO does not reimburse the issuer as required, the SEC can bring an enforcement action against the CEO or CFO. The first action under §304 by the SEC seeking reimbursement from an individual who was not alleged to have personally engaged in misconduct occurred in 2009, eight years after the enactment of the Sarbanes-Oxley Act.[29] In this enforcement action involving Maynard L. Jenkins, the CEO of CSK Auto Corporation, the SEC was successful in convincing a court that §304 only requires a finding of misconduct on the part of the issuer and that it does not require specific misconduct on the part of the CEO and CFO for purposes of enforcing the reimbursement obligations.[30]

The decision in *Securities and Exchange Commission v. Jenkins* highlights that the clawback provisions in §304 of the Sarbanes-Oxley Act are not designed to punish the wrongdoer, but rather intended to incentivize CEOs and CFOs to create an effective environment of corporate accountability and oversight responsibility for financial reporting. Unfortunately, despite the fact that reimbursement under §304 is required to happen as a matter of law, it is "virtually unheard of for CEOs or CFOs to volitionally reimburse issuers." [31] Accordingly, while the clawback provisions of §304 are sound in principle, the practical reality is that an SEC enforcement action will be necessary in virtually every instance to ensure compliance, as §304 does not provide a private right of action.[32]

THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

On July 21, 2010, President Obama signed into law the Dodd-Frank Act. While the Dodd-Frank Act primarily regulates financial institutions and their products, it also contains numerous provisions relating to corporate governance and executive compensation, including, among others, the right of shareholders to have a non-binding "say on pay" vote on executive compensation and golden parachutes, additional pay vs. performance executive compensation disclosures, and a new statutorily mandated clawback of erroneously awarded executive compensation.

Section 954 of the Dodd-Frank Act creates a new §10D of the Exchange Act that requires the SEC to develop rules that direct national securities exchanges/associations to prohibit the listing of any issuer security unless the issuer develops and implements a clawback policy.[33] The policy must apply in the event the issuer is required to prepare an accounting restatement due to material non-compliance with any financial reporting requirements under the securities law, and must apply to any current and former executive officers who received incentive-based compensation (including stock options) during the three years preceding the date the issuer is required to prepare the accounting restatement due to erroneous data. More importantly, the policy must provide that the issuer will recover any incentive-based compensation *in*

that has not yet become effective under the Securities Act of 1933, as amended (the "Securities Act"), and that it has not withdrawn.

[28] In addition to the clawback provisions under §304, §1103 of the Sarbanes-Oxley Act authorizes the SEC to petition any federal court to freeze any extraordinary payments made by a public company to any of its officers, directors, and other affiliated parties during the course of an investigation for possible securities law violations. The Sarbanes-Oxley Act does not contain a definition of "extraordinary payments" other than to indicate that it includes compensation. In *Securities and Exchange Commission v. Gemstar-TV Guide International, Inc.*, 367 F.3d 1087 (9th Cir. 2002), the Ninth Circuit, in a matter of first impression, vacated the District Court's finding that termination payments to Gemstar's former CEO and CFO were "extraordinary payments" within the meaning of §1103 of the Sarbanes-Oxley Act. The case highlights that Congress, in its haste to enact legislation to stem the rising tide of corporate abuses, may not fully achieve its goals due to its failure to define key terms within the Sarbanes-Oxley Act, and the delay by the SEC in adopting regulations implementing the Sarbanes-Oxley Act.

[29] *See www.sec.gov/news/press/2009/2009-167.htm*.

[30] *See Securities and Exchange Commission v. Jenkins*, 2010 WL 2347020 (D. Ariz., 6/9/10).

[31] *See* comments of Commissioner Luis A. Aguilar, above, note 4.

[32] *See, e.g., In re Digimarc Corp. Derivative Litigation*, 549 F.3d 1223 (9th Cir. 2008).

[33] In addition, the SEC is directed to develop rules requiring each exchange-listed issuer to develop a policy providing for the disclosure of its policy on incentive-based compensation that is based on financial information that is required to be reported under securities laws.

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excess of what the officers would have received under the restated financial statements.

The Dodd-Frank Act does not specify the date by which the SEC must develop these new clawback rules or the date such rules must become effective. Currently, the SEC has tentatively planned to propose rules on the recovery of executive compensation under §954 of the Dodd-Frank Act within the April–July 2011 timeframe.[34]

The clawback provisions under §954 of the Dodd-Frank Act are a significant expansion of the clawback provisions contained in §304 of the Sarbanes-Oxley Act. Several significant differences include:

- The policy must apply to any current or former executive officer (not just the CEO or CFO).[35]
- The clawback provisions are triggered solely by an accounting restatement due to material non-compliance *without regard to misconduct*. The clawback provision under the Sarbanes-Oxley Act specifically requires a finding that the material non-compliance giving rise to the accounting restatement result from misconduct (even if the misconduct was not engaged in by the CEO or CFO).
- The policy must cover excess compensation received during the three-year period preceding the date on which the issuer is required to prepare the accounting restatement. The clawback under the Sarbanes-Oxley Act is limited to compensation received during the 12-month period following the initial publication of the noncompliant financial statements. Notably, §304 of the Sarbanes-Oxley Act does not limit the clawback to incentive-based compensation *in excess* of what would have been received under the restated financial statements.
- The policy must be adopted and implemented by the issuer, and, presumably, the issuer will be responsible for enforcement. The clawback under the Sarbanes-Oxley Act, while intending to be self-executing, can be enforced only by the SEC.

Employers and practitioners have raised numerous questions regarding the scope and breadth of these new clawback provisions, and the answers to these questions will have to wait until the SEC weighs in by issuing its proposed rules. Notwithstanding, employers must begin to undertake a review of their existing compensatory arrangements and clawback policies, if any, to determine whether changes will be necessary to comply with these new rules. While there are various issues that employers and compensation committees will likely struggle with in implementing the required clawback policy, all exchange-listed companies and compensation committees must also be prepared to address: (i) the identification of the person or committee who will enforce the policy; and (ii) internal pressure to review and revise the compensation structure applicable to executive officers.

Under §952 of the Dodd-Frank Act, a compensation committee must have the authority to retain and obtain advice from independent compensation consultants, legal counsel, and other advisers and be directly responsible for their appointment, compensation, and oversight. Additionally, issuers must provide for appropriate funding as determined by the compensation committee for payment of reasonable compensation to the independent compensation consultants, legal counsel, and other advisers. Recent studies show that clawback policies are more commonly enforced by the full board, although the compensation committee is a close second.[36] Unlike the Sarbanes-Oxley Act, the clawback provisions in the Dodd-Frank Act require enforcement by the employer and, more importantly, will require enforcement against incumbent executive officers.[37] Enforcement issues, which are guaranteed to arise in light of the fact that the clawback provisions apply without regard to personal misconduct, will almost certainly be more appropriately addressed by independent legal counsel than by internal counsel. Accordingly, while many employers are contemplating avoiding the use of independent counsel by the compensation committee, the use of independent counsel may be necessary as a practical matter to ensure a meaningful and harmonious working relationship between internal counsel and the employer's executive officers.

Compensation committees will also likely face pressure to revise the compensation structure and matrix applicable to executive officers. Under §954 of the Dodd-Frank Act, executive officers are required to

[34] http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml#04-07-11.

[35] Rule 3b-7 of the Exchange Act provides that the term "executive officer," when used with reference to a registrant, means its president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy making functions for the registrant. Until the SEC issues its proposed rules under compensation under §954 of the Dodd-Frank Act, it is not clear whether they will attempt to expand or narrow the definition of executive officer.

[36] *Current Recapture Policies and the Dodd-Frank Act*, above, note 5.

[37] The Dodd-Frank Act does not address whether the SEC can enforce the clawback policies adopted under §954 of the Dodd-Frank Act, or whether a private right of action exists.

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repay excess compensation received during the three-year period preceding an accounting restatement *without regard to misconduct*. Since the enactment of §162(m) of the Internal Revenue Code (the ''Code''), a substantial portion of the compensation paid to executive officers has been structured as performance-based compensation to ensure deductibility by the employer. While the underpinnings of §162(m) of the Code are based on pay-for-performance, the strict liability provisions of the Dodd-Frank Act place executive officers at risk of forfeiting significant compensation *without regard to fault* and, in the case of a former executive officer, due to actions occurring during periods in which they may not have had an opportunity to influence the decisions of incumbent executive officers. For example, unexercised stock options are typically retained for years following an executive officer's termination. In light of this additional risk, compensation committees are likely to receive pressure to increase non-performance based compensation, and otherwise increase the overall levels of compensation. Ultimately, the SEC guidance on the definition of incentive-based compensation (including stock options) will potentially have a major influence on future executive compensation structures.

DESIGNING AND IMPLEMENTING AN EFFECTIVE CLAWBACK POLICY

The statutorily mandated clawback provisions of the Sarbanes-Oxley Act and the Dodd-Frank Act are much more limited in scope, and the underlying objectives are much narrower in nature, than the clawback policies typically adopted by employers. Both Congress and shareholder advocates desire to deter company policies and practices that encourage excess risk-taking by executives. In this regard, it is proffered that rigorous clawback policies and robust stock ownership/holding guidelines are factors that potentially mitigate incentive arrangements that encourage excess risk-taking.[38] Employers adopting clawback policies, however, are not focused solely on limiting risk, but also on achieving the company's strategic goals and plans, protecting confidential trade secrets and practices, and maintaining competitive advantages. Accordingly, clawback and recoupment policies are commonly drafted to cover perceived detrimental conduct that far exceeds the reach of the statutorily mandated clawback provisions.

In drafting an effective and enforceable clawback policy, employers must evaluate and take into account various considerations. The list of factors that the employer must ultimately consider will be affected by the intended goals of the policy, its scope and breadth, and the types of compensatory arrangements maintained by the employer. The following list illustrates the potential decisions facing employers:

- *Who should be subject to the clawback policy?* Employers must consider whether the application of their policy will be limited to executive officers and/or senior management or, alternatively, whether to broaden the scope of their policy to cover all performance-based compensation.

- *What events will trigger the clawback policy?* Employers must determine the particular conduct or events that will trigger an employee's repayment obligations under the policy (e.g., restatement of financial statements; fraud or misconduct; violations of non-compete covenants; failure to sustain performance in the future; material errors in performance calculations; and/or conduct detrimental to the employer, including the employer's reputation). Each of these factors are intended to encourage or discourage different behavior and therefore a clear understanding of the employer's objectives must be established. Additionally, many courts analyze forfeiture-for-competition provisions under a traditional non-compete analysis and therefore enforcement issues can be heightened depending on the scope of the policy.

- *Will the policy require misconduct?* Employers will also need to decide whether to adopt a no-fault approach for all or any part of the triggering events. Most policies typically require some form of fraud, misconduct or malfeasance by the employee, but such an approach is not warranted where excess compensation has been paid due to errors in performance calculations (even if such errors do not give rise to a financial restatement).

- *One policy or more than one policy?* In many instances, it may be desirable to limit certain provisions of a policy to specific groups of employees. Similarly, it may be desirable to designate and charge a different person or committee with enforcing the clawback (e.g., the CEO for non-executive officers and the Compensation Committee for executive officers). While it certainly possible to draft a single policy covering all of the employer's clawback scenarios, there is no prohibition against having more than one policy. Similarly, employers must consider whether their policy should be included in a shareholder approved plan. Including the policy in a shareholder approved plan can give rise to unintended consequences, including potential claims if the employer fails to act or, alternatively, acts in contravention of the specific terms of the policy.

[38] *See U.S. Corporate Governance Policy*, 2010 Update (RiskMetrics Group).

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- *What compensation is covered by the clawback policy?* In determining the types of compensation to be covered under the policy, employers should consider whether the policy will apply to both cash and equity compensation and whether to limit recovery to specifically identified bonuses, incentive payments, equity compensation awards and/or severance pay. In addition, employers must determine the length of time compensation remains subject to the policy (e.g., 12 months, 3 years, etc.) and whether amounts to be repaid under the clawback policy will be limited to future compensation awards and/or extended to cover existing awards and previously paid compensation. Attempts to apply the policy retroactively will like face significant resistance and challenges absent an enforceable contractual amendment (and consideration).
- *How is the repayment amount calculated?* Clawback policies should also clearly address whether employees will be required to repay the gross amount of compensation paid/payable (gross or net of taxes) or only excess amounts. The repayment obligations, however, should and very likely will differ based on the nature of the triggering event.
- *How will the repayment obligation be implemented?* Will the employee be required to pay cash? Will the employer be permitted to offset current or future compensation? Will outstanding awards be forfeited? The final regulations under §409A of the Code contain various limitations on the ability to offset or substitute deferred compensation. In light of the fact that §409A of the Code has the potential to apply to essentially all form and manner of compensation (e.g., equity awards, annual incentive bonuses, long-term incentive pay, deferred incentive pay, severance pay, tax-gross ups, etc.), employers must be very careful in designing repayment obligations, particularly if the policy is intended to amend and/or override an existing employment agreement or compensatory arrangement. In the context of §280G cutbacks, IRS officials appear to disagree as to whether an election by the employee and/or employer over the manner in which a cutback is applied is a ''late election'' under §409A of the Code or whether it is merely a forfeiture. Until definitive guidance is provided, many practitioners have begun to hard-wire the manner in which the cutback will be applied. Accordingly, the exercise of employer discretion or an employee election as to the manner in which a clawback is enforced should be thoroughly vetted to address potential issues under §409A of the Code.
- *How will the clawback policy be enforced?* Clawback policies are essentially meaningless without an effective enforcement mechanism. In developing appropriate policies and procedures for enforcing the policy, employers must consider how determinations under the policy will be made and by whom, and how the policy will be enforced in the event an employee is unable or unwilling to make required repayments. To the extent the compensation committee (or the full board) is charged with enforcing the policy, the compensation committee's governing charter should be reviewed and amended as necessary, and the employer should be required to provide adequate financial resources for the compensation committee to retain independent legal counsel (where desirable). The issue of discretion in the enforcement of the policy must also be addressed, as good business judgment may warrant refraining from enforcement, particularly where the recovery would be small or the litigation costs would outweigh the benefits.
- *What state law limitations may apply to the clawback policy?* Employers must be mindful of potential limits to their ability to recover compensation from employees. For example, state wage laws could prevent recovery of certain compensation if such compensation is considered ''wages'' of the employee. While federally mandated clawback provisions will preempt state wage laws, broad-based clawback policies can potentially implicate state wage payment laws. Similarly, non-compete restrictions continue to be difficult to enforce in certain jurisdictions and forfeiture-for-competition provisions are not likely to be viewed in a more favorable light.
- *Other issues to consider?* Employers typically require terminated employees to execute releases to secure severance and separation pay. To avoid any unintentional limitation of the employer's right to enforce a clawback policy against a former employee, employers must review the terms of their release agreements to determine whether explicit protective language is needed to ensure that the employer's clawback rights are not waived. Additionally, in preparing a clawback policy, employers would be well advised to address and consider choice of law provisions, venue and recovery of attorneys' fees.

CONCLUSION

Employers have significant latitude in crafting clawback policies. While the policies will potentially deter excess risk-taking and other detrimental con-

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duct, enforcement of such policies has the potential to be costly and time consuming. Employers should consider alternative tools to enhance the effectiveness of the policies, including the use of mandatory deferral arrangements, secular trusts and stock ownership guidelines. A thorough understanding of both the benefits and limitations of clawbacks will be essential to crafting a policy that successfully defers undesirable conduct while providing an effective remedy to the employer.

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