CFO

Clawbacks Revisited

How Dodd-Frank might have an impact on the design of executive-compensation plans.

By Andrew Liazos - May 12, 2011

MM Much attention has been paid to Dodd-Frank-mandated changes in public-company compensation programs and proxy disclosure that are designed to influence say-on-pay voting this proxy season. Obtaining a favorable vote is clearly not a certainty. As of early May, there were at least 16 public companies that failed to secure a majority thumbs-up, and that number will surely climb during the height of the proxy system during the coming weeks.

But there's another aspect of the Dodd-Frank legislation with significant potential ramifications that has largely flown under the radar screen. It's a subject that deserves attention by CFOs.

Section 954 of Dodd-Frank requires the Securities and Exchange Commission to direct the national exchanges (such as the NYSE and Nasdaq) to impose new listing standards. The forthcoming standards will require public companies to develop and implement compensation-recovery arrangements — so-called clawback policies. The SEC plans to propose and adopt the rules sometime between August and year-end. While it will take some time for the listing standards to be amended, new or revised clawback policies may need to be established and disclosed during the 2012 proxy season.

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The rules, when implemented, will require significant changes to existing clawback policies. Section 954 states that when noncompliance with a financial-reporting requirement leads to an accounting restatement, the issuer will recover from any current or former executive officer all incentive-based compensation paid during the preceding three-year period that was above what would have been paid under the restatement. Unlike existing clawback policies, Section 954 does not require that there be misconduct by anyone — being an executive officer is enough. In addition, boards apparently will have no leeway to factor in special facts and circumstances in determining the appropriate action.

The potential scope of Section 954 is quite broad. What is "incentive-based compensation"? Dodd-Frank states that it "includes stock options awarded as compensation,"

but the impact of the provision is likely to be far more sweeping than that. Many public companies recently have introduced performance shares and other types of equity awards that are based on achieving EBITDA, earnings per share, return on equity, and other performance criteria that are based directly on results shown in the financial statements.

Such awards would presumably be subject to the new clawback rules. The same goes for traditional types of short-term and long-term cash incentives based on similar performance criteria that are designed to qualify as "performance-based compensation" and are thus exempt from the $1 million tax-deduction limit under Internal Revenue Code Section 162(m).

What's more alarming is the ambiguity regarding the amount that should be recovered. How does one determine precisely when a public company "is required to prepare the accounting restatement"? Is it the date when the facts requiring the restatement are first known by management? When the work to do the restatement is done? When the restatement is actually filed? Worse, how does one determine the amount of excess incentive-based compensation that would not have been paid under the accounting restatement? What if an executive received a stock option that vested solely upon continued employment — will the officer forfeit stock options granted during the three-year lookback period regardless of the amount of the misstatement?

Making matters still worse is that the SEC could require the clawback amount to be based on the pretax benefit, leaving the officer in a position where he may not necessarily be able to recover previously paid taxes on such compensation. Clearly, the SEC and the national exchanges have many issues to sort out.

Starting Over

As you might imagine, the potential far-reaching impact of these rules is being considered by directors, compensation consultants, and human-resources professionals. It is reasonable to anticipate that these rules, in combination with other factors, may result in serious reconsideration of how incentive-compensation plans are designed.

For example, if an annual cash incentive is based on a designated level of EBITDA, the incentive might be changed to a performance goal based on an operational measure that is not part of the financial statements. Another alternative might be to have, in effect, a discretionary bonus that is structured with a relatively low financial hurdle that is virtually immune to an accounting restatement and yet still qualifies as performance-based compensation that is tax deductible. Other possibilities might include non-GAAP financial measures.

On the other end of the spectrum, shareholder groups might exert pressure to require deferred payment of incentive compensation that's potentially subject to a clawback under the new rules. Sorting out these issues and the potential accounting ramifications of the new rules will not be simple or quick, and it's important for a CFO to have a role in this process earlier rather than later.

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