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Financial Reform Bill Has Bad News for Executive Compensation

by Rick Firestone, Michael Ungar, Andrew Liazos and Eugene Goldman

Board members will be interested in understanding the implications of Section 954 of the current version of the Senate financial reform bill. This provision would require companies that need to prepare a restatement to recover incentive-based compensation from executive officers, even if no one engaged in any misconduct.

If enacted, Section 954 could have adverse consequences for public companies, their officers and their shareholders. Boards would face challenging decisions regarding compensation practices.

Currently, Section 304 of the Sarbanes-Oxley Act (SOX) requires the chief executive officer (CEO) and chief financial officer (CFO) to reimburse a company for amounts received as incentive-based compensation and profits realized from stock sales during the 12-month period following the issuance of a financial statement that requires an accounting restatement due to material non-compliance with securities laws. This requirement does not apply to other executive officers, and is only triggered “as a result of misconduct.” Unlike the framework envisioned by Section 954, an action under Section 304 can only be brought by the SEC.

Section 954, if enacted, would require public companies to develop and implement compensation recovery policies as a condition of having securities listed on national securities exchanges and associations. Unlike Section 304, Section 954 would require public companies to adopt policies to recover from all current or former executive officers (not just CEOs and CFOs) incentive-based compensation in “excess” of the amount that the executives would have received had there been no error in the financial reports.

Under Section 954, a company’s clawback policy would be triggered by a restatement due to material noncompliance with financial reporting requirements under the securities laws. The policies envisioned by Section 954 would force companies to seek reimbursement of amounts received by executives during the three years prior to the date on which the company was required to prepare a restatement. As a practical matter, the proposed legislation would likely force public companies to file legal actions against current or former executives who refused to return amounts claimed as excess compensation.

Also, Section 954 does not appear to envision a clawback policy that would give the board discretion to determine whether recovering “excess” incentive-based compensation is appropriate under the particular circumstances. For example, Section 954 does not appear to allow a company to provide an exception to its clawback policy for situations when a board determines that the amount that the company could reasonably expect to recover in any litigation would be less than the anticipated cost of pursuing such action.

Another potential problem with Section 954 is that it does not address whether it would create a private right of action for shareholders. As a result, shareholders may be able to file derivative actions on behalf of companies that do not take any action to recover excess compensation. Dealing with any shareholder lawsuits could become quite complicated due to disagreements over what can be recovered under the policy (i.e., what is the “excess” compensation), particularly with respect to incentive compensation plans that allow the compensation committee to exercise discretion in awarding amounts or that use performance goals that are based on non-GAAP financial criteria.

Section 954, if enacted, would raise other complex issues for companies and their boards. For example, it would create uncertainty as to whether an executive who was awarded compensation would have to return those benefits to the company, if the clawback provision was subsequently triggered as a result of a restatement. Given the constant uncertainty that would exist, boards would face challenging decisions in trying to negotiate new compensation packages with executives, or in determining the appropriate amount of incentive-based compensation to award to executives. To mitigate these uncertainties, executives may insist upon receiving significant increases in base compensation. This would result in reducing one of the benefits of performance-based compensation—alignment of the interests of executives with the interests of shareholders.

In addition, most existing clawback policies would not meet the requirements of Section 954 due to the proposed legislations’ (a) lack of a misconduct requirement, (b) three-year look-back period, and (c) lack of a provision for board discretion. As a consequence, if Section 954 is enacted, companies may need to revise their existing clawback policies.

The House bill does not contain a comparable provision to Section 954. McDermott Will & Emery will be monitoring the situation to determine whether Section 954 is incorporated into the final conference report.

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