

Bonus Compensation And Clawbacks: What Employers Need To Know

by **Gretchen Harders and Susan Gross Sholinsky**

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Employers recently have been exploring the use of “clawbacks” to recover bonus compensation payable to employees. Clawbacks are contractual provisions that require an employee to repay compensation received from an employer following events such as an employee’s termination of employment, to compensate the employer in the event of an employee’s misconduct, to use as a retention incentive, or upon an employee’s departure and subsequent work for a competitor. This Client Alert does not address the use of clawbacks with respect to equity-based compensation; that has long been done, particularly by companies in the financial services industry. Rather, our focus is on the clawback of cash compensation to be paid to an employee. Employers need to be aware of the special legal issues that may arise in drafting, negotiating and enforcing such clawbacks.

Background

Although some employers utilized clawbacks as a tool prior to 2002, the Sarbanes-Oxley Act of 2002 was the first federal statute to require that certain bonuses previously paid to an executive be forfeited or repaid to the issuer. This forfeiture or repayment obligation applies only to the issuer’s CEO and CFO and is triggered upon a restatement of the issuer’s financial statements due to material noncompliance or misconduct.

Under the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009, the federal bail-out program re-introduced the concept of executive repayment of bonuses related to inaccuracies of financial statements. These new rules apply to a broader group of executives and were widely viewed as critical to Congressional approval of the federal bail-out program.

On June 10, 2009, the Department of the Treasury issued an interim final rule (31 CFR Part 30, RIN 1505-AC09; scheduled for Federal Register publication on June 15, 2009) entitled “TARP Standards for Compensation and Corporate Governance,” which implements the bail-out program’s executive compensation provisions. The interim final rule provides that any bonus payment with respect to certain executives of bail-out recipients must be subject to a “recovery” or “clawback” provision, which is triggered in certain circumstances relating to

materially inaccurate financial statements or performance metric criteria. A bonus payment for this purpose is broadly defined to include retention and incentive payments and will be deemed to have been made when the employee obtains a legally binding right to the payment. A key clarification is that the TARP recipient must exercise its clawback rights, except to the extent it demonstrates that it is unreasonable to do so (for example, if the cost of enforcing the rights would exceed the amount to be recovered).

Legal Considerations

Although the recent bail-out legislation approves the use of clawbacks as a critical protection for shareholders, the use of clawbacks creates special legal issues and considerations. Typically, the obligation to repay bonus compensation is triggered upon the employee's termination of employment. Once the obligation is triggered, the employee will be required to repay the bonus compensation previously received, either in a lump-sum payment or in installments.

Potential Tax Consequences

The manner and timing of the repayment obligation should be carefully considered. Upon termination of employment, the employer and employee may want to negotiate the repayment schedule or consider the amount to be repaid as an offset to severance. Section 409A of the Internal Revenue Code of 1986, as amended (the "Code"), which imposes penalty taxes on deferred compensation, would appear to limit the ability of employers to renegotiate the terms of the bonus repayment, as well as the ability to offset severance or other compensation to the employee by the amounts owed under the bonus repayment. Final Treasury regulations under Section 409A of the Code (Reg. § 1.409A-3(j)(4)(xiii)) make clear that offsets of "deferred compensation" for an employee "debt" must be limited to \$5,000 per year and paid on the same schedule as ordinary debt payments. It is not entirely clear whether clawback rights constitute, or once triggered become, a "debt" or "loan" for tax purposes, which would more typically involve a full recourse promissory note. However, Final Treasury regulations under Section 409A of the Code (Reg. § 1.409A-3(e)) also restrict the renegotiation or offset of compensation to the extent it results in a substitution or replacement of deferred compensation. This could be an issue where the amount of severance is being reduced by the repayment obligation to the extent the severance obligation is or could be considered deferred compensation.

Another tax question that could arise is how to account for income and employment taxes that were withheld or paid in a prior tax year when the original bonus compensation was paid. Under the "claim of right" doctrine, the bonus compensation would be included in the year of receipt and the employee will be allowed to claim a deduction on the compensation repaid in the year of repayment. *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932) (XI- 1 C.B. 293); IRS Revenue Ruling 76-374 (1976– 2 C.B. 19).

Restrictive Covenants

A further legal consideration is that clawback provisions often are triggered upon an employee's violation of restrictive covenants, such as noncompetition or nonsolicitation provisions. State law will determine whether such provisions will be enforceable in the applicable jurisdiction. Further, Final Treasury regulations under Section 409A of the Code

(Reg. § 1.409A-1(d)) provide that noncompetition covenants do not extend the vesting period (*i.e.*, the period during which an employee is required to perform substantial services within the meaning of Section 409A of the Code), and, therefore, could be an issue in drafting clawback provisions triggered by restrictive covenants.

State Wage and Hour Laws

State wage and hour laws also should be considered when an employer decides to use clawback provisions. Bonus compensation promised or previously paid to an employee could be considered “wages” or “earned compensation” that may not be forfeited pursuant to applicable state wage and hour laws. The critical question under state wage and hour law is whether the compensation subject to the clawback constitutes “wages,” particularly where the bonus was “owed” to the employee pursuant to a bonus plan or policy and not clearly “discretionary” on the part of the employer.

In many states, incentive compensation and discretionary bonus compensation, the amount of which has not been fixed or determinable, are not considered “wages.” In New York State, for example, incentive compensation such as stock options is not deemed to be “wages.” *Guiry v. Goldman Sachs & Co.*, 814 N.Y.S.2d 617 (1st Dep’t 2006). Similarly, bonuses that are discretionary, based on the employer’s financial performance and not directly related to the “personal productivity” of an employee are not considered “wages” under New York State’s Labor Law. *Truelove v. Northeast Capital & Advisory, Inc.*, 715 N.Y.S.2d 366 (N.Y. 2000). However, once paid, even a discretionary bonus may be deemed to be a wage. In that case, employers may be limited in their ability to enforce the obligation, as such enforcement may be considered an impermissible deduction from, or forfeiture of, wages.

Litigation

Finally, in order for an employer to recoup payments previously made to employees or former employees, the employer may need to initiate a proceeding or lawsuit in court. This issue may be further complicated if there are other legal disputes between the parties relating to the termination of employment.

Practical Guidance for Employers

Given the potential issues in implementing and enforcing clawbacks, employers may wish to consider alternatives to a clawback provision, such as a retention bonus program requiring the performance of substantial services before the compensation is paid, or forfeiture provisions that apply to severance or other future compensation. That being said, clawbacks of bonuses can be a useful tool in retaining employees and defending compensation practices to boards and shareholders. An important factor to consider will be whether clawbacks are legally permissible and enforceable in the applicable jurisdiction.

In drafting clawback provisions, employers also should consider the following:

- The repayment obligation generally should be stated clearly in writing and signed by both parties;
- A clawback provision set forth in an agreement that is executed at the time the bonus payment subject to the clawback is made likely will be easier to enforce than a

clawback provision set forth in a separation agreement that is negotiated at the time of termination of employment;

- Applicable state wage and hour laws should be reviewed (such as New York State's Labor Law);
- The type of compensation to which the clawback relates (*i.e.*, cash, incentive, or equity-based compensation);
- If the clawback provision is set forth under a bonus plan or program applicable to a group of employees participating in the program, there should be consistency in administering and applying the repayment provisions;
- There may be an advantage in reserving to the employer the discretion to determine the manner and timing of the repayment obligation; and
- Any release of claims should exclude the repayment obligation.

For more information about this Client Alert, please contact:

Gretchen Harders
New York
212-351-3784
Gharders@ebqlaw.com

Susan Gross Sholinsky
New York
212-351-4789
Sgross@ebqlaw.com

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