

## **Corporate Governance Update: Corporate “Clawback” Provisions And Executive Compensation**

An increasing number of companies have adopted provisions allowing them to recover executive pay that has been awarded based upon financial statements that are subsequently restated. A recent study found that 246 of 2,121 companies reviewed incorporated this type of recoupment (“clawback”) policy as part of their executive compensation programs.<sup>1</sup> This is a large increase over the 2003 figures, which indicated only fourteen of 1,800 companies had such provisions.<sup>2</sup>

This recent trend has been attributed to the Sarbanes-Oxley Act of 2002<sup>3</sup> and to pressure from shareholders seeking the implementation of such provisions to promote better corporate governance policies.<sup>4</sup>

The two most common types of financial restatement recoupment policies are misconduct-based provisions and performance-based provisions. The study found that forty-four percent of recoupment policies were misconduct-based and thirty-nine percent were performance-based.<sup>5</sup>

A clawback provision is misconduct-based if it applies only to those executives who have engaged in misconduct that has caused a restatement. There must be a finding of misconduct by a particular executive that caused the restatement before recouping that executive’s performance-based pay. For example, Caterpillar Inc. has a misconduct-based policy<sup>6</sup> that provides that the board will require an executive to reimburse his incentive compensation, or will cancel his unvested stock awards if it finds that each of the following exist: (1) that incentive compensation was calculated based on incorrect financial statements, (2) the executive was engaged in intentional misconduct that caused or partially caused the restatement and (3) the incentive compensation would have been lower if the financial results were based on the correct financial information.

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<sup>1</sup> Paul Hodgson, *Clawback Policies*, 2006 Proxy Season Foresights #11 (The Corp. Lib, Jun 4, 2008). The Corporate Library conducted its survey by reviewing the most recent proxy statements of the surveyed companies. This study also found 49 companies that had clawback provisions related to the enforcement of restrictive covenants. For example, executives and officers may be required to forfeit equity awards in the event of a breach of an employment contract.

<sup>2</sup> *Id.*

<sup>3</sup> Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7243 (2002). Section 304 requires CEO’s and CFO’s to reimburse bonuses or equity compensation paid by an issuer during the twelve month period following the filing or public issuance of a financial statement, as well as any profits made from the sale of securities of the issuer during such period, if an accounting restatement is required to be made due to material non-compliance of the issuer as a result of misconduct.

<sup>4</sup> Companies are encouraged to disclose clawback policies, if any, in the Compensation Discussion and Analysis section of their annual proxy statements. *See* Regulation S-K Item 402(b)(2)(viii).

<sup>5</sup> *Clawback Policies*, at 1. Perhaps because clawback provisions are a recent trend within corporate compensation programs, there are very few reports of actual clawbacks occurring. The only publicly reported example is Warnaco Group Inc. In March, 2007 Warnaco announced it reduced the 2006 annual incentive compensation awards for the CEO, CFO and Group President as a result of a financial restatement. The Warnaco clawback provision is a performance-based provision; thus no showing of misconduct was required.

<sup>6</sup> *See* Schedule 1.

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Performance-based policies generally apply to all executives who received some form of incentive compensation based on incorrect financial statements. In this category, there need not be a finding of misconduct. Under such policies recoupment is triggered if the company is required to file a restatement even where the particular executive or manager did not commit any misconduct, or where the restatement was caused by an error involving no misconduct. International Paper Co. has a performance-based clawback policy<sup>7</sup> that provides the Compensation Committee with the discretion to direct the company to recover any portion of or all award-based pay from one or more executives with respect to any fiscal year in which the company's financial results are negatively affected by a restatement caused by errors, omissions or fraud. Additionally, the Committee has the authority to reduce future incentive payments.

There are many variations of clawback policies that a company can adopt within the two main categories of clawback policies. For example, a board may be given discretion to require reimbursement of past payments, or can have express authority to reduce future awards. Also, a clawback policy could be adopted as a statement of intent, a corporate governance policy or an agreement with executives. In addition, incorporating the policy adopted in incentive plans, award forms and employment agreements, or having executives covered by the policy acknowledge it in writing, may enhance its enforceability.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or [cgilman@cahill.com](mailto:cgilman@cahill.com); Mike Macris at 212.701.3409 or [mmacris@cahill.com](mailto:mmacris@cahill.com); Jon Mark at 212.701.3100 or [jmark@cahill.com](mailto:jmark@cahill.com); John Schuster at 212.701.3323 or [jschuster@cahill.com](mailto:jschuster@cahill.com); or Glenn Waldrip, Jr. at 212.701.3110 or [gwaldrip@cahill.com](mailto:gwaldrip@cahill.com).

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<sup>7</sup> See Schedule 2.

## **Caterpillar Inc.’s Clawback Provision<sup>8</sup>:**

If the board learns of any misconduct by an officer who contributed to the company restating all or a portion of its financial statements, it will do what is required to correct the misconduct and prevent it from occurring again and, if appropriate, take necessary remedial action. To determine the corrective action, the board will review the situation to identify whether the restatement was the result of negligence, gross negligence or intentional misconduct. The board will require reimbursement of any bonus or incentive compensation awarded to an officer or cancel unvested restricted or deferred stock awards previously granted to the executive officer if all of the following apply:

- The amount of the bonus or incentive compensation was calculated based on the achievement of certain financial results that were subsequently the subject of a restatement.
- The executive engaged in intentional misconduct that caused or partially caused the need for the restatement.
- The amount of the bonus or incentive compensation that would have been awarded to the executive had the financial results been properly reported would have been lower than the amount actually awarded.

Additionally, at the board’s discretion, it may dismiss the officer, authorize legal action for breach of fiduciary duty or take other action to enforce the executive’s obligations to the company. In determining appropriate remedial action, the board may take into account penalties or punishments imposed by third parties, such as law enforcement agencies, regulators or other authorities. The board’s power to determine the appropriate punishment for the wrongdoer is in addition to, and not in replacement of, third-party actions.

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<sup>8</sup> Caterpillar Inc. Guidelines on Corporate Governance Issue” Section XVIII “Clawback Provision” at 9, *available at* <http://www.cat.com/cda/layout?m=37474&x=7>; also as disclosed in Caterpillar Inc. Proxy Statement dated May 2, 2008 “Compensation Discussion and Analysis Compensation Recoupment Policy” at 40, *available at* [http://www.sec.gov/Archives/edgar/data/18230/000001823008000159/def14a\\_2008.htm#cda](http://www.sec.gov/Archives/edgar/data/18230/000001823008000159/def14a_2008.htm#cda)

## **International Paper Company's Clawback Provision<sup>9</sup>:**

Our Long-Term Incentive Compensation Plan contains a claw back provision relating to our long-term equity awards: stock options, service-based restricted stock awards, and performance-based restricted stock awards. Under this claw back provision, if our financial statements are required to be restated as a result of errors, omission, or fraud, the Committee may, in its discretion, based on the facts and circumstances surrounding the restatement, direct that we recover all or a portion of an equity award from one or more executives with respect to any fiscal year in which our financial results are negatively affected by such restatement. To do this, we may pursue various ways to recover from one or more executives: (i) seek repayment from the executive; (ii) reduce the amount that would otherwise be payable to the executive under another Company benefit plan; (iii) withhold future equity grants, bonus awards, or salary increases; or (iv) take any combination of these actions.

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<sup>9</sup> International Paper Company Long-term Incentive Compensation Plan, Amended and Restated as of February 7, 2007, Section 12 "Impact of Restatement of Financial Statements upon Previous Awards," *available at* <http://www.sec.gov/Archives/edgar/data/51434/000095011705000597/ex99-1.txt> ; and as disclosed in International Paper Company Proxy Statement dated April 8, 2008 "Other Compensation-Related Matters -- Claw Back of Equity Awards" at 62, *available at* [http://www.sec.gov/Archives/edgar/data/51434/000119312508076980/ddef14a.htm#toc75389\\_90](http://www.sec.gov/Archives/edgar/data/51434/000119312508076980/ddef14a.htm#toc75389_90)