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## Making “Clawbacks” More Palatable in Bank Incentive Compensation Arrangements

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The term “clawback” has been repeatedly bubbling to the surface in recent regulatory pronouncements on bank executive compensation. The newly enacted [Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (the “Dodd-Frank Act”) provides for national securities exchanges to adopt listing standards requiring listed companies to develop and implement clawback policies in the event of a financial restatement. Banks that participated in the U.S. Treasury’s Capital Purchase Program (the “CPP”) are required to subject any bonus payment made to senior executives and the next twenty most highly compensated employees to a recovery or “clawback” provision. The recently issued joint agency [Final Guidance on Sound Incentive Compensation Policies](#) (“Guidance”), which is applicable to *all* federally insured financial institutions, also emphasizes risk-management in compensation arrangements and repeatedly refers to the use of clawbacks as a potential risk-management tool. The clear writing on the wall is that clawback provisions will be required, or at a minimum will be considered a best practice, for all insured financial institutions.

So what exactly is a “clawback”? In the context of incentive compensation, a clawback is a contractual provision whereby the employee receiving an incentive bonus or similar benefit agrees to repay all or a portion of that compensation upon specially arising circumstances. Such circumstances typically involve some later determination that the compensation was based upon inaccurate information, or that it was based upon activities that created an unacceptable amount of risk for the financial institution.

Many of our clients who are CPP participants have expressed frustration surrounding the CPP clawback requirements, and it is likely that non-CPP participants will run into similar problems as they attempt to comply with the recommendations of the Guidance. As banks attempt to implement clawbacks, they are having a

difficult time obtaining the necessary buy-in from employees. Essentially, the employees are reluctant to take a bonus payment knowing that there is a possibility, however remote, that they may be required to repay it. In working with these clients, we have come up with a number of observations and recommendations for making clawback provisions more palatable for bank employees. Each of these is discussed below.

### **Tie the contractual obligation to repay directly to the actions of the employee**

Consider the situation where an incentive bonus for all employees is based upon some percentage of the bank's profits or revenues. In that situation, an employee who has nothing to do with the bank's accounting and reporting function might justifiably be anxious about signing a clawback agreement requiring them to repay the bonus if it is later determined that someone else made a mistake in accounting for or reporting the bank's annual earnings. To alleviate these concerns, we recommend that banks carefully draft clawback provisions so that the triggering event is tied directly to that employee's actions (or inaction).

This approach is permissible for CPP participants, and will also work for other financial institutions that are seeking to comply with the Guidance. Under Treasury's CPP compensation regulations, the clawback provision must be triggered if it is later determined that a bonus was based upon any materially inaccurate financial statements or any other materially inaccurate performance metric criteria. For this purpose, a financial statement or performance metric criteria would be treated as "materially inaccurate" with respect to any employee who knowingly engaged in providing inaccurate information (or who knowingly failed to timely correct inaccurate information) relating to those financial statements or performance metrics.

By tying the clawback provision to the employees own action (or inaction), it clarifies that an employee will only be required to repay a bonus when that employee is individually culpable. Essentially, the message changes from, "You are agreeing to repay your bonus if someone else committed misconduct or made a mistake," to "You will only have to repay your bonus if you committed knowing misconduct." In general, employees are more willing to agree to the clawback provision when the trigger is under their own control.

### **Limit the time that the clawback will be applicable**

Bank employees have also been reluctant to agree to clawback provisions of infinite duration. Again, these employees are probably justified in their concern. An infinite clawback provision is like a threatened lawsuit with no statute of limitations -- you can never quit looking over your shoulder. The solution here is to incorporate a clear expiration date, after which time the clawback cannot be triggered, and the employee will no longer have any contingent obligation to repay. Where such an expiration exists, employees who are overly concerned about a potential

clawback can simply invest the incentive payment and earn interest on those funds until the clawback had expired. After that time, they can be at ease in spending the bonus without worry that their employer will come asking for a recovery.

For CPP participants, the clawback duration must extend for the entire time that the CPP funds are outstanding. For other banks, a duration of three years will probably pass regulatory scrutiny. Three years is the required look-back time for clawbacks of listed companies under the new Dodd-Frank Act.

### **Use a planned message and strategic timing when proposing a clawback to employees**

The phrase, “It’s all in the delivery,” is applicable to more than baseball and bowling. The timing and message surrounding a bank’s presentation of clawback provisions to its employees can be critical to obtaining their consent. It is important to be strategic about the timing. Some banks have had success in using the incentive payment as the proverbial “carrot”—strategically timing the proposal of the clawback to coincide the presentation of a bonus or other incentive payment. It is understandably easier to get an employee to agree to a clawback provision when a very tangible bonus check is sitting right there on the table.

Some banks have also found it helpful to “hide behind the regulators.” That is, to change the message from, “We would like for you to agree to this clawback provision,” to something more like, “Our regulators are requiring (for CPP recipients), or expect for us to obtain (for banks subject to the Guidance), your agreement to this clawback arrangement in connection with your incentive compensation.” This is a completely true message, and it may help the employee to understand that the clawback is simply a necessary measure for the Bank to achieve regulatory compliance.

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