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DOJ, SEC Focus Should Prompt Clawback Policies Review

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The fall of 2022 has been a very active period when it comes to executive compensation and regulators focusing on clawing back compensation paid to executive officers.

The U.S. Securities and Exchange Commission's recent final rule on clawbacks received considerable attention in October, when it finalized regulations implementing a mandate in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. [1]

In September, the U.S. Department of Justice fired its own shot across the bow, when Deputy Attorney General Lisa Monaco unveiled the DOJ's revised corporate crime guidance to prioritize and prosecute corporate crime. She reiterated that the number one priority for the DOJ is individual accountability.

To that end, Monaco emphasized that the DOJ will reward companies that claw back compensation from executives when misconduct occurs.

This new DOJ focus on clawbacks is intended to give general counsels and chief compliance officers the tools to implement responsible corporate behavior and to foster a corporate culture that both deters and punishes risky — and possibly criminal — behavior by top executives.

Additionally, the DOJ's revised corporate crime guidance admonishes prosecutors to consider whether a company's compensation system is structured in a manner that provides affirmative incentives for compliance-promoting behavior, such as by using compliance metrics and benchmarks for compensation calculations, and performance reviews that measure and incentivize compliance-promoting behavior.

Perhaps the DOJ was prompted to act at the time by what it viewed as an inexplicable delay by the SEC. When Monaco made her policy announcement in September, the SEC still had not implemented a final rule governing clawbacks, some 12 years after the passage of the Dodd-Frank Act.

But now that the SEC has acted, companies face the challenge of operating under two separate regimes featuring clawbacks. The SEC's civil no-fault approach, under which noncompliance could result in delisting of the public company, and the DOJ's focus on criminal culpability and clawback policies that could help avoid, or at least mitigate, criminal charges against a company.

As noted below, balancing the two approaches is likely to present interesting challenges. Some history on clawbacks provides useful context for understanding the two approaches.

Following the recession in 2008, the Dodd-Frank Act sought to promote corporate accountability by directing the SEC to require publicly listed companies to implement compensation clawback policies and thereby recover erroneously paid compensation.

Executives can face clawback of previously paid compensation under various circumstances. The difficult issue is determining the reason for clawing back compensation — i.e., was it the result of fault or criminal conduct, or was it an accounting mistake? — and determining the executive's culpability in securing unjustified compensation.

Clawbacks can arise when incentive compensation — annual bonuses or long-term equity compensation — pays out based on the achievement of financial metrics, such as earnings per share or revenue growth, where the determination that those metrics have been achieved turns out to be incorrect.

Errors like this can stem from a range of factors, some implicating an executive's actions more than others.

For example, they can result from a misapplication of complicated accounting principles, or inadequate internal controls, or, at worst, actual and intentional executive fraud, misconduct or criminal activity.

In light of this, the SEC's final rule was surprising in some ways.

In particular, the SEC final rule does not reference misconduct or fault, instead it focuses on recovering erroneously paid compensation due to inaccurate financial statements even in no fault situations.

For example, an officer's incentive-based compensation could be clawed back even if there was no misconduct on the part of anyone at the company and/or the officer bore no responsibility for the inaccuracies in the financial statements.

The final rule also imposes various disclosure and reporting obligations on public companies when clawback situations arise.

It also generally mandates recovery unless independent directors determine recovery is impracticable and third party enforcement expenses, such as attorney fees, would exceed the amount to be recovered after reasonable efforts have been made to recover amounts, or recovery would violate home country law in the case of foreign issuers, as in effect at the time that the final rule is adopted.

Now that the SEC has adopted the final rule, and once the exchanges issue listing standards consistent with the rule — which can be as late as 12 months after the final rule is published — we can expect companies to adopt compliant clawback policies or revise existing clawback policies to be compliant.

Does the SEC's recent action devitalize the DOJ policy statement?

Put another way, once a public company adopts a clawback policy consistent with the listing standards coming out of the final SEC rule, will that serve as an adequate mitigating factor under the DOJ approach to prevent criminal charges from being filed against the company?

The answer to these questions is complicated and nuanced.

Unlike the SEC rule, which focuses on financial accountability, the DOJ focuses on criminal misconduct, which in turn implicates public policy goals of deterrence and punishment.

Accordingly, the DOJ is likely to consider but look beyond the adoption of a clawback policy consistent with the SEC rule.

If Monaco's proposals are implemented through the promulgation of formal prosecutorial guidelines, corporations that are the target of DOJ criminal investigation may succeed in avoiding prosecution or mitigating criminal penalties only if they have actually enforced clawback policies in line with Monaco's recommendation.

While the SEC's final rule would allow a company to forego clawback recovery that was impracticable — as determined by its independent directors — the DOJ approach is likely to stress actual recovery as a mitigating factor, and determinations of impracticality may receive negligible weight.

In addition, the DOJ approach is likely to reward companies who enforce clawbacks that would not be triggered by the SEC rule. The SEC rule triggers recovery generally based on a no-fault approach tied to accounting restatements due to material noncompliance with financial reporting requirements.

The DOJ approach, on the other hand, addresses criminal activity and thus transcends accounting restatements, such that even accurately determined compensation — where there has not been any accounting restatement — could require a clawback if the executive were deemed culpable or in a position to have prevented the criminal activity.

In the eyes of the DOJ, the issue may not simply be erroneously paid compensation, but rather unjustified and inequitably received compensation under circumstances involving criminal activity.

Interestingly, the DOJ's orientation appears more consistent with clawback policies previously adopted by some companies, before the SEC issued it clawback rule in October.

These earlier policies did not expressly address accounting restatements but permitted the board to claw back compensation if it determined that an executive had engaged in willful misconduct — either affirmatively or by omission — or had failed to address misconduct by others over which the executive had responsibility.

The policy announced by Monaco leaves to be determined just how much relief a company targeted by a DOJ investigation will gain by adopting and implementing clawback policies — Monaco called on the DOJ's criminal division to develop further guidance by the end of this year to "reward corporations that develop and apply compensation clawback policies."

While the precise contours of the DOJ guidance remain to be fleshed out, it is safe to assume that DOJ prosecutors will continue to enjoy considerable discretion in making charging decisions.

Now that the SEC has issued its final rule and the DOJ is focusing on executive compensation, companies should consider a multidisciplinary approach to reviewing, implementing and enforcing clawback and other compensation policies — for example policies that contain both accounting restatement and misconduct triggers.

The issues are complicated, and white collar criminal counsel need to work closely with executive compensation counsel and securities counsel to fully understand the scope and enforcement of clawback policies.

A clawback policy implicates many constituents: The senior executive team, the board of directors, the compensation committee, outside shareholders and shareholder advisory services, and D&O insurers, to name a few.

To that end, companies will need a a sound legal approach to maximize protection against DOJ criminal investigations through the adoption of clawback policies.

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[1] Michael Album, Colleen Hart, Kate Napalkova, Andrea Rattner, Seth Safra, David Teigman and Heather Monte, Long Time Coming: SEC Adopts Final Dodd-Frank Clawback Rules | Employee Benefits & Executive Compensation Blog (erisapracticecenter.com), The Employee Benefits & Executive Compensation Blog.

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