Executive Compensation: Recovery After a Restatement

By Lee E. Miller and Steven Darien

"The most important thing we do is to meet our numbers. It's more important than any individual product; it's more important than any individual philosophy."

That was according to a former chairman of a major corporation from whom the SEC is currently seeking to recover over two hundred million dollars in salary, bonuses, and stock profits earned during a period of time when he was allegedly involved in manipulating the company's earnings. Fortunately, despite a few high-profile exceptions, this approach to management is the exception in corporate America.

Most board members and corporate executives are honest, hardworking, and try their best to serve their companies and shareholders. Whether or not the courts ultimately determine that this individual will have to return that money, in the future boards of directors can expect increasing court and regulatory scrutiny of their decisions as to whether or not to attempt to recover payments made to executives in the event of a subsequent restatement of corporate earnings. Unfortunately, they will have to exercise judgment at a time when standards are still evolving.

In recent years, hundreds of companies have had to restate prior year's earnings, including Bristol Myers Squibb, Fannie Mae, Computer Associates, AIG, Qwest, CNA, Time Warner, and Delphi; over 400 companies in 2004 alone. The vast majority of accounting overstatements have been unintentional. They may have simply been the result of unclear accounting standards, changes in accounting standards, unanticipated write-offs, etc. In cases where earnings have had to be restated, some executives may have reaped significant rewards that they would not otherwise have received. Conversely, in cases where results were understated, executives might not have received rewards they actually earned. There are, however, those few instances where executives manipulate corporate earnings in order to reap huge bonuses and stock option profits.

This raises a number of questions about the appropriate role of the board of directors in dealing with incentive compensation based on incorrect financial reporting. It also raises the question as to how far down in the organization the board should go to recoup inappropriate gains. In making those decisions, boards need to exercise sound discretion as to what is in the overall best interest of the corporation, taking into consideration questions such as:

- Was the incorrect information the result of an honest mistake or was proper accounting affected by unforeseen events?
- Was there intentional falsification or manipulation of financial data?
- What is the risk/reward philosophy of the board?

Role of the Board

The board has a clear obligation to oversee the financial reporting and to take steps to prevent inaccurate and improper financial reporting. Most boards are aggressively seeking to ensure proper financial reporting. Notwithstanding the best efforts of boards, restatements of earning will continue to occur. When improper or inaccurate reporting occurs requiring a restatement of earnings, and it results in improper payments to executives, the board has a responsibility to consider whether or not to seek to recover all or a portion of those payments.

The Sarbanes-Oxley Act requires that certain executives pay back bonuses and other incentive-based compensation that result from

Director Summary: Recent restatements should make directors more conscious of whether their current compensation plans allow for recovery of compensation gained as a result of financial malfeasance. Review your plan frequently and revise it to ensure that monies specifically tied to malfeasance may be recovered.

incorrect financial reporting. However, that provision of the Act is extremely limited in scope. It only applies to the CEO and the CFO. Even then, it only comes into play if there is an accounting restatement that is the result of misconduct.

Boards have the right, and arguably the responsibility, to seek to recover compensation that has been paid based on erroneous financial reporting not only from the CEO and CFO, but from all executives, and not merely when there is misconduct involved. Under certain circumstances the board should do so and may, in fact, have a legal obligation to its shareholders to do so. As said earlier, the standards of when a board should seek to recoup compensation based on erroneous reporting are still evolving.

In the future boards can expect increasing court and regulatory scrutiny of their decisions as to whether or not to attempt to recover payments made to executives in the event of a restatement.

In order to help the board think through the appropriate action, it is worth taking a step back to consider your overall approach to incentive awards and what understandings your board has with executives. For purposes of simplicity, we will divide reward environments into two board categories: "high risk" and "low risk."

• In a high-risk environment, executives understand they are responsible for results. No excuses are accepted. If exchange rates swing in the wrong direction, if terrorists blow up a factory, if a foreign government imposes new restrictions on pricing, or a tsunami destroys the infrastructure of a country in which the company markets, executives understand they will be held to their original agreed-upon objectives. No matter what external factors hurt their profitability they are expected to find a way to attain the promised results. After all, that is the basis on which investors invest in a company. Conversely, if exchange rates swing in a favorable direction or other external factors produce a "windfall," executives share in that windfall.

• In a low-risk environment, all manner of external factors may be used to adjust objectives or incentive compensation. Thus, if a foreign government imposes new and highly restrictive pricing policies, targets can be lowered, or the board can use its discretion to adjust awards up or down due to "uncontrollable" external factors. In theory at least, unplanned positive events would be used to lower bonuses that have been inflated by external events, although in reality this rarely happens.

Align Incentives with Shareholder Interests

While the appropriate compensation philosophy for any particular company at a given point in time depends on numerous factors, generally the high-risk approach better aligns the executives' incentive payouts with the results stockholders actually see. Additionally, many of the so-called "uncontrollables" can and should be anticipated. Contingency plans can be developed to deal with them and executives can be expected to adjust their business strategies to respond to them. Managements can partially insulate themselves and stockholders from external events by using insurance, currency hedging, or other such techniques. Today's highly paid executives should be expected to deal with the unexpected.

At the very least, executives who knowingly participate in or fail to take steps to prevent improper reporting should not benefit from their misconduct. However, the board's obligation may extend beyond just punishing wrongdoers. The purpose of incentive compensation is not simply to find a way to pay executives more money. "Pay for performance" means executives are rewarded for meeting certain preset financial and/or other goals with the ultimate goal being to increase shareholder value. When it turns out that those goals, in fact, were not met, there's little justification for the executives, whether or not they have personal responsibility for the misreporting, to reap a windfall which they would not have received had the numbers been properly reported.

Looked at in that light, directors could be held liable for breach of their fiduciary obligation to their shareholders if they fail to make efforts to recoup compensation paid as a result of improper financial reporting—monies these executives are not entitled to. At the very least, boards need to carefully consider what action they should take in the event a restatement of earnings becomes necessary. A distinction may need to be made between restatements due to changes in interpretations of accounting standards, regulatory changes, unanticipated write-downs and such that were not contemplated in the design of the executive compensation plans and situations where, for example, management may have benefited from aggressive, but subsequently determined to be inappropriate, accounting practices, even if there is no intentional wrongdoing involved.

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Not Many Returns

To date, however, while a handful of top executives have voluntarily returned bonuses following financial restatements, few companies have actually taken action to recover compensation paid to executives based on improper financial reporting. Some of the reasons given for not attempting to recoup such payments are the cost of litigation, the impact on employee morale and, frequently, the lack of a clear legal right to actually recover the compensation. The last reason, to the extent it exists, often results from actions, or omissions, in the design and drafting of the incentive compensation plans. Typically, the compensation plans under which these payments are made provide for compensation to be paid based on the figures that are reported, and do not have specific provisions dealing with what happens if those numbers are subsequently revised. Moreover, executive employment contracts frequently prohibit the recovery of compensation after it is paid, at least in the absence of specific misconduct by the executive involved. As a result, due to a lack of foresight in the way their compensation plans have been drafted, even if a board wanted to recover improper payments it might not be able to do so.

That, however, may be changing. There have been numerous shareholder resolutions seeking to require boards to recoup executive compensation paid as a result of financial reporting which subsequently has been restated. Those resolutions have typically been defeated, in part, because they were overly mechanical in their approach and deprived the board of its ability to use their discretion in the best interest of the company and its shareholders. Unless boards address this issue themselves, they may find their ability to exercise that judgment restricted by shareholder actions, future regulation, or the risk of litigation. Some companies, in fact, have begun to specifically include in their compensation plans the right to recoup payments resulting from erroneous financial reporting. International Paper, for example, has recently added a provision to its long-term incentive compensation plans that specifically gives it the right to "recover compensation paid to a participant in cases of a restatement of the company's financial statements, due to errors, omissions, or fraud."

Review Your Plans

Both as a matter of sound compensation policy and to avoid potential liability, we would suggest that boards follow International Paper's lead and include in compensation plans and employment contracts a provision giving them the right, in their discretion, not only to recover compensation paid based on erroneous reporting, but to offset such overpayments against other compensation owed to the executives. Doing that removes any incentive for executives to "make the numbers any way they have to" and sends a clear message to both the executives and the shareholders that "pay for performance" means exactly that.

Determining when to seek to recover such payments, which payments and what portion of them to seek to recover (i.e., long term incentive plans, SERPs, stock awards, and bonuses based on a variety of factors, only some of which are affected by a restatement) continues to require the exercise of sound and reasoned judgment of directors knowledgeable about compensation issues. Complicating the task is the lack of any clear standards as to when it is appropriate to recoup compensation paid to executives following a restatement and the likelihood that standards for doing so will continue to evolve. As a result, boards need to constantly review compensation plans, anticipate the possibility that a restatement of earnings may occur, seek appropriate advice, and be able to articulate the reasons for the actions they take, or choose not to take, in the event that a restatement becomes necessary.

Conclusion

In summary, boards have been put in the position of having to make very difficult judgments about recovering financial rewards that were based on erroneous financial information. These judgments are difficult enough without having to be made in an ever-changing regulatory environment. It would be advisable for boards to spell out in advance, in as much detail as practical, the criteria they will use in making these judgments, and to ensure that their compensation plans and employment agreements allow for such recovery. ■

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