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Clawbacks

Structuring, Drafting and Enforcement Recommendations for Hedge Fund Managers Considering Employee Compensation Clawbacks (Part One of Two)

By Jennifer Banzaca

Hedge fund compensation discussions have typically focused on upside – on how structuring acumen, tax strategy and legal legerdemain can be used to maximize post-tax compensation to good performers. See "Hedge Fund Manager Compensation Survey Addresses Employee Compensation Levels and Composition Across Job Titles and Firm Characteristics, Employee Ownership of Manager Equity and Hiring Trends," The Hedge Fund Law Report, Vol. 6, No. 8 (Feb. 21, 2013). However, in the wake – or in the midst – of unprecedented insider trading and other enforcement in the hedge fund industry, there is a growing recognition among managers that compensation can also be used to mitigate downside. In particular, hedge fund managers are increasingly exploring, implementing and using employee compensation clawbacks to minimize the ex ante risk of bad acts and mitigate the ex post impact of such acts. For example, S.A.C. Capital Advisors, LLC (SAC Capital) announced in May 2013 – shortly before various SAC Capital entities were indicted for securities fraud and wire fraud – that it planned to implement a policy allowing the firm to claw back compensation from employees engaged in misconduct. See "SAC Capital Entities Indicted for Securities Fraud and Wire Fraud in Connection With Employees' Alleged Insider Trading," The Hedge Fund Law Report, Vol. 6, No. 29 (Jul. 25, 2013). In October 2012, Morgan Stanley went beyond mere implementation to actual enforcement, suing former FrontPoint Partners, LLC portfolio manager Joseph "Chip" Skowron to recoup compensation paid to Skowron. Morgan Stanley generally alleged that it had the right to claw back such compensation because of Skowron's 2011 guilty plea to insider trading and obstruction of justice charges. See "Morgan Stanley Sues Former FrontPoint Partners Portfolio Manager Joseph F. 'Chip' Skowron III for Losses Allegedly Caused by Skowron's Insider Trading and Subsequent Cover-Up," The Hedge Fund Law Report, Vol. 5, No. 44 (Nov. 21, 2012).

Employee compensation clawbacks offer powerful advantages to hedge fund managers, particularly in the current heightened enforcement climate. They can deter bad acts, preserve reputation and broadcast a manager's commitment to compliance. However, clawbacks are not without legal and practical risk, including potential civil and criminal liability for managers that do not properly structure or enforce clawbacks. To help hedge fund managers in evaluating the utility of clawbacks to their businesses, The Hedge Fund Law Report is publishing a two-part series on employee compensation clawbacks in the hedge fund industry. This article, the first installment, provides an overview of employee clawbacks at hedge fund managers; discusses the types of employees, misconduct and triggering events covered by clawbacks; and highlights the benefits of implementing clawbacks. The second installment will identify drawbacks of clawbacks; outline legal and other considerations for managers in structuring and enforcing clawbacks; describe documentation of clawbacks; enumerate best practices for structuring clawbacks; and provide sample employee clawback provisions.

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Background

Generally, a clawback gives an employer a contractual right to recover compensation paid or to be paid to an employee if specific triggering events occur; those triggering events usually refer to defined categories of employee misconduct. Implicit in the "paid or to be paid" part of this definition is the idea that clawbacks can refer to compensation that has already been paid or compensation to be paid in the future. (Used in the latter sense, "clawback" is more of a colloquialism; a more accurate term in that case, as discussed below, would be "holdback.") Holly Weiss, a Partner at Schulte Roth & Zabel LLP, explained, "In the hedge fund context, the term 'clawback' sometimes refers to an arrangement structured as a true clawback of compensation that was already paid out to an employee. Other times the term 'clawback' refers to the forfeiture of unpaid deferred compensation."

While some institutions, such as Morgan Stanley, may actually have in mind a "traditional clawback" that is designed to recoup amounts already paid out to an employee such as Chip Skowron, sources that spoke with The Hedge Fund Law Report explained that hedge fund managers typically think of a clawback as a "holdback" or the withholding of unpaid compensation that would otherwise be paid to an employee in the form of a bonus or other deferred compensation because many managers do not want to face the expense and legal ramifications associated with clawing back compensation already paid to an employee.

Henry Bregstein, a partner at Katten Muchin Rosenman LLP, explained, "From my standpoint, such clawbacks are more commonly referred to as holdbacks. A hedge fund manager would not want to say that it is taking back compensation someone has already earned. Legally, that's a much more difficult position in terms of enforceability." In fact, as will be discussed in more detail later in this series, certain state laws prohibit an employer from pursuing an employee for "wages" already paid to the employee.

Lance Zinman, also a Katten partner, explained, "Most of our clients view it as more of a holdback. The holdbacks are not meant to only cover regulatory or legal problems; they are meant as incentive compensation tools to align the interests of the employees with those of the fund and the fund investors. Typically, a holdback for compensation purposes will also include the ability to hold back for other things, such as any regulatory or legal problems."

Alan Johnson, a managing director of compensation consultant Johnson Associates Inc., explained, "It's much easier to cancel amounts that have not been paid than to actually get money back from people, where you may have to go to court or arbitration to try to get the money back. That's one of the key reasons that hedge fund managers will usually keep deferred compensation in their clawback arrangements rather than trying to recover money already paid out." For insight on compensation levels in the hedge fund industry from Johnson's firm, see "Greenwich Associates and Johnson Associates Issue Report on Asset Management Compensation Trends in 2012," The Hedge Fund Law Report, Vol. 6, No. 8 (Feb. 21, 2013). Sean Feller, a Partner at Gibson Dunn & Crutcher LLP, agreed, observing, "With deferred compensation, it's a lot easier to enforce. If you have a clawback that says that an employee will pay back compensation if something happens, you still have to go out and sue the employee to get that money. It's much easier if you have a pool of money that is sitting there."

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Nonetheless, Zinman explained that some firms wish to pursue "traditional clawbacks." "There are some managers who, in addition to the holdbacks, are instituting actual clawback provisions that would give the firm the right to go after the employee in the event that damages caused by the employee's act are not covered by the amount held back. It also protects the manager in situations where there is no knowledge of a regulatory issue at the time that the employee leaves, but such a regulatory issue comes to light thereafter. For instance, some regulatory actions are instituted years after the purported act occurred. Because holdbacks often do not extend for years, the manager may not have any recourse in connection with such regulatory actions. As a result, we are seeing some managers instituting provisions to allow them to pursue employees for such liability." Nonetheless, Zinman believes that such traditional clawbacks will rarely be pursued by managers. "If you have a holdback, it's easier to achieve your remedy," he said. "If you have a clawback, you typically have to institute a proceeding in order to obtain relief. There will likely be attempts to defend the claim, making it a more difficult process. So, this is probably something that will only be used if there is a serious issue such as insider trading." Additionally, numerous employees may balk at having their compensation subject to a clawback that can extend for an indefinite period.

Scope of Clawback Arrangements

The terms of employee compensation clawbacks can vary widely.

Which Firm Employees Are Subject to Compensation Clawbacks

Typically, where managers impose clawbacks in the first instance, all investment professionals and key employees at the manager are covered by the clawback arrangement. However, coverage may differ, depending on varying bargaining power among principals and employees when negotiating their employment arrangements. Weiss explained, "Generally, clawback and forfeiture provisions will apply across the board for all employees who receive incentive compensation that is subject to clawback or forfeiture. The provisions are not usually individually negotiated, although certain individuals may be able to obtain more favorable terms." For more on individually negotiated employment terms of a key investment management employee, see "Icahn Enterprises Employment Agreement with Top Executive Highlights Measures Hedge Fund Managers Can Take to Retain and Incentivize Top Talent," The Hedge Fund Law Report, Vol. 5, No. 25 (Jun. 21, 2012).

Michael Gray, a Partner at Neal, Gerber & Eisenberg LLP, added, "Most of these provisions are simply templates that are applied firmwide to employees that are responsible for making investment decisions, as well as the executives. They are not usually negotiated individually, but that is not to say that certain people do not have the bargaining power to negotiate these provisions to an extent."

What Types of Misconduct Would Typically Trigger a Clawback?

Typically, misconduct involving a manager's funds or business would trigger a clawback. Also, in some circumstances, personal misconduct unrelated to employment could also trigger a clawback.

Gibson's Feller explained, "It could be any misconduct or violations of company policy, although there is likely some type of materiality qualifier. It could be triggered by a government investigation of illegal activity. Depending on

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how strict you want the provisions to be, there is a range of triggers you could go with. But, such triggers are focused on misconduct, illegality and government investigations."

Elizabeth Fries, a partner at Goodwin Procter LLP, added, "When the clawback is triggered will vary, and there is a broad spectrum. Employees may suffer financial consequences for not complying with firm compliance policies and procedures. If an employee is a recidivist and has been warned about violations, another violation of company policy might be enough to trigger the forfeiture of compensation."

Often, the types of misconduct that will trigger a clawback are those actions that would typically trigger a "for cause" termination of the employee pursuant to an employment agreement or similar document. Bruce Simonetti, a Partner at Akin Gump Strauss Hauer & Feld LLP, observed, "The hallmarks of 'cause' always include acts of embezzlement, fraud, theft, dishonesty, commission of felonies or misdemeanors involving moral turpitude; acts that violate securities laws; willful misconduct; or breach of codes of conduct or codes of ethics. These are the universal provisions that are in all cause agreements and, by extension, in compensation clawback provisions."

Gray further explained, "The standard of what is considered 'cause' is where the rubber meets the road. Are you found by a court to have been grossly negligent or guilty of willful misconduct, fraud or otherwise breaking the law? How broad or narrow is the definition of cause? That is the key metric. In general, I see these definitions being pretty tight, but even-handed."

As Fries noted, "There is a huge question as to the definition of 'cause.' As a starting point, an employee always wants it to be that they are convicted of something relating to the business, while the employer wants it to be that the employee has done something that could be damaging. In between there is an indictment. Also, there is usually discussion around the nature of the problem – is it a securities-related crime, financial fraud, a crime or misdemeanor involving moral turpitude or a dishonest act? In some cases, if the test is to have committed a dishonest act, theoretically it may include a situation where someone has taken home an extra package of pencils, which seems overly broad. The employers usually write the agreement. So, unless an employee is a star recruit or there is a heavily negotiated contract, the employer typically succeeds in negotiating a cause definition that really does kick in not just when the police put someone in handcuffs, but at an earlier stage of the process."

Managers must consider not only the types of misconduct that could trigger the clawback, but also the types of events that will trigger the clawback. Most notably, managers often wrestle with the question as to whether an employee's compensation should be clawed back at any point in the legal process prior to the conviction of or guilty plea entered by an employee. Fries explained, "Overall, the firm usually has leverage, and therefore, typically, the firm will be able to claw back compensation even when an employee is arrested or indicted and not convicted. For an employee who has negotiating clout, he or she would negotiate for the clawback to be triggered when he or she has been found guilty or otherwise responsible. The ultimate provision may also depend on the firm. For example, if the firm has had its own regulatory issues in the past, it may have a greater ability to say that the firm just will not tolerate any misconduct because of the reputational issues. For firms with a more institutional client base, where there is more due diligence being done,

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there is a greater sensitivity to various issues. So, the trigger point could be sooner." On due diligence best practices, see "Deutsche Bank's Hedge Fund Consulting Group Provides a Roadmap to Hedge Fund Managers in Navigating the Operational Due Diligence Process," The Hedge Fund Law Report, Vol. 6, No. 28 (Jul. 18, 2013).

As to whether personal misconduct should trigger a clawback, Feller observed, "You will see some provisions include triggers for personal misconduct if the action is materially injurious to the firm." Gray agreed and added, "I think you can fairly say that it includes any behavior that would impact the firm. To the extent that you do something outside the firm that violates securities laws or otherwise shows you to be a dishonest person, I think that does affect the firm and would generally subject a person to a clawback provision."

Fries clarified that whether personal misconduct is covered by a clawback can be the subject of negotiation between the firm and a prospective employee. "Personal misconduct can be included in these triggers. To the extent the agreement is negotiated, that's clearly part of the negotiations. In those cases, sometimes the trigger may be only a crime involving 'moral turpitude' or a felony, for example."

Compensation Subjected to Clawbacks

As a matter of contract law, there is no restriction on the types of compensation that can be clawed back from an employee, meaning that salary, bonuses or other forms of incentive compensation can be subject to a clawback arrangement. However, as described in more detail in the second installment in this series, various state laws may restrict or flatly prohibit a manager from clawing back certain categories of compensation already paid to an employee.

Questions can also arise regarding the extent to which equity in the management company owned by an employee can be clawed back. Fries explained, "Compensation clawbacks exist in the U.K. in the regulated financial markets, but in the U.S. hedge fund industry, it's very hard to do. It's much easier for managers to keep any or all of an employee's deferred compensation. In the deferred compensation mode, an employee tends to be cut off completely. If the employee is leaving the firm and has equity that is being bought back, usually it can be cut off. But if they have paid capital into the firm, they would get that back."

One question managers often ask is how much compensation can typically be clawed back from an employee. Typically, firms do not adopt a formulaic approach to how much compensation may be clawed back. Rather, all deferred and unpaid compensation is generally clawed back – or sought to be clawed back – from the employee. As Schulte's Weiss said, "It's not usually a percentage of the amount. Rather, it is everything that is left on the table when the employee leaves the firm."

The Cost-Benefit Analysis Concerning Implementing Clawbacks

The decision whether to implement a clawback may seem deceptively easy, as the benefits seem clear while the drawbacks seem minimal. Nonetheless, the analysis may prove more difficult than it appears at first glance.

Benefits of Clawbacks

There are at least three principal advantages of clawbacks.

First, the most salient benefit of clawback arrangements is their deterrent effect, which has ex ante risk-mitigating benefits for the manager. According to Leor Landa, a

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Partner at Davis Polk & Wardwell LLP, "The basic concern is mitigating the significant institutional franchise-level risk from wrongdoing by individuals and to align individual employee incentives with longer term franchise goals. As recent headline-making cases have shown, an allegation that one person has acted badly or taken unacceptable risk, notwithstanding all the right policies and procedures, monitoring and supervision, can ruin a franchise. Hedge fund managers are looking at economic incentives to get employees to think about those risks. The idea is to further align employees economically with the notion of doing the right thing, preserve franchise value and take a longer term view."

Weiss added, "Clawback and forfeiture provisions are tools that hedge fund managers can use to incentivize good behavior and disincentivize misconduct. Clawbacks and forfeiture provisions may also help hedge fund managers avoid the distasteful prospect of having to pay employees who have engaged in misconduct."

Nonetheless, some practitioners expressed skepticism with respect to the deterrent effect of clawbacks. Fries, for example, suggested, "For the people who are going to engage in some type of misconduct, the economics of how much money they have on the table from the firm really are not going to hold them back."

Second, clawbacks can allow a manager to minimize losses associated with employee conduct by recapturing amounts that would otherwise be paid to an employee. Admittedly, however, the "value" of the reputational harm and damage to the franchise occasioned by the kind of conduct that would give rise to a clawback is – while difficult to quantify – a multiple of compensation to any employee, even the best compensated. So, clawbacks can serve a kind of insurance function, but with respect to scenarios that are largely uninsurable.

Third, clawback arrangements, as a component of a broader compliance program, can help demonstrate and communicate a manager's culture of compliance to regulators, investors and (especially post-JOBS Act rules) the public. See "A Compilation of Important Insights from Leading Law Firm Memoranda on the Implications of the JOBS Act Rulemaking for Hedge Fund Managers," The Hedge Fund Law Report, Vol. 6, No. 30 (Aug. 1, 2013). As Johnson noted, "It's something that regulators are coming to expect. If there ever is a problem, you can say that you had these measures in place to not only try and prevent the behavior, but also to take action against people who do something bad. I think it's consistent with a reasonable risk and compliance culture. It sends a signal that you are above board and you are serious about risk and compliance."

That said, some practitioners view the ability of clawbacks to demonstrate a solid compliance culture as probably necessary, but not sufficient, to cause investors to invest. As Feller noted, "These provisions show your investors that you take compliance seriously and are taking steps to ensure there are no issues – that you hold your employees to a high standard. Investors may come to demand them at some point. I do not think that these provisions have become ingrained enough for managers to know whether they are helpful in fundraising. I would imagine investors look on them favorably, but they probably are not a crucial item at this point."

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