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Clawbacks

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

By Jennifer Banzaca

Employee compensation clawbacks can help hedge fund managers deter bad acts, preserve reputation and demonstrate a commitment to compliance. However, compensation clawbacks are only effective if properly structured, carefully drafted and consistently enforced. This is the second article in a two-part series designed to help hedge fund managers think through the pros and cons of implementing compensation clawbacks. In particular, this article starts by exploring some of the cons, including those relating to federal employment and tax law; state wage, labor and tax law; whistleblower issues; and logistical concerns. This article then identifies four best practices for structuring and implementing clawbacks, and concludes with an appendix including three sample clawback provisions provided by sources and actually used by hedge fund managers, and one definition of "cause" used in connection with a clawback provision. The first installment in this series provided an overview of employee clawbacks at hedge fund managers; discussed the types of employees, misconduct and triggering events covered by clawbacks; and highlighted the benefits of implementing clawbacks. See "Structuring, Drafting and Enforcement Recommendations for Hedge Fund Managers Considering Employee Compensation Clawbacks (Part One of Two)," The Hedge Fund Law Report, Vol. 6, No. 31 (Aug. 7, 2013).

Potential Drawbacks of Clawbacks

There are at least four potential drawbacks of clawback arrangements. First, such arrangements could undermine a manager's efforts to attract talented employees. Henry Bregstein, a partner at Katten Muchin Rosenman LLP, observed, "Managers are going to have to be very careful in trying to use this tool more expansively because they are going to want to be able to hire talented traders and portfolio managers. If the Street perceives or even misperceives that a manager is asserting 'clawback' claims in order to reduce bonus payouts, that could hurt the manager's ability to attract talented employees."

Bruce Simonetti, a partner at Akin Gump Strauss Hauer & Feld LLP, agreed, adding, "These plans are very broad and very discretionary and can put managers at a disadvantage. If you have a portfolio manager that you are trying to attract and you tell him that you have these broad-based discretionary clawback provisions that could affect that manager's ability to earn competitive compensation, that portfolio manager may choose to go elsewhere." Alan Johnson, managing director at compensation consultant Johnson Associates Inc., similarly noted, "You do not want to make these provisions so onerous that it's negative for employees or prospective employees. If such provisions are unfair, one-sided or ambiguous, you can drive people away or be unable to attract the people you are looking for."

In light of the potential for overly burdensome clawback terms to serve as a deterrent in hiring, it is important for managers of typical bargaining power not to stray too far

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from market practice in drafting such terms. As Gibson Dunn partner Sean Feller suggested, "You do not want to be too far outside the market because it could hurt in attracting talented employees. If you have a very employee-unfavorable clawback policy, people might decide to go to a different firm with a less restrictive policy." For a discussion of other provisions that can be similarly radioactive in hedge fund manager employment agreements, see "Schulte Roth & Zabel Partners Discuss Non-Competition and Non-Solicitation Provisions and Other Restrictive Covenants in Hedge Fund Manager Employment Agreements," The Hedge Fund Law Report, Vol. 4, No. 42 (Nov. 23, 2011).

However, the playing field is not entirely level, and for managers of materially greater bargaining power, more restrictive clawbacks may be practicable. Leor Landa, a partner at Davis Polk & Wardwell LLP, observed on this point, "If you are a well-known firm with a great reputation and people are clamoring to work with you, you have some bargaining power to impose more restrictive agreements like this. If you are a smaller or lesser-known shop, it gets harder to impose very strict clawback agreements because the talent will walk away and go elsewhere."

Second, as discussed in more detail below, if not carefully conceived, a clawback provision could violate applicable employment and other laws, which could subject the firm to civil and perhaps even criminal sanctions.

Third, managers must be committed to rigorously enforcing clawbacks in a fair and equitable manner once they are implemented, or risk facing regulatory and other scrutiny for failing to do so. "I think these provisions might, at the margin, help managers demonstrate to regulators that the firm maintains a strong culture of compliance, but that is undercut if the firm waives or never exercises these provisions," said Elizabeth Fries, a partner at Goodwin Procter LLP. Therefore, managers that implement such clawbacks must be prepared to enforce such clawbacks uniformly, even with respect to "valuable" employees.

Fourth, some practitioners have doubts as to whether clawbacks are an effective means of preventing harm to a firm. "I think we'll continue to see the more traditional holdbacks being used with the addition of 'bad acts' provisions as managers try to chill bad behavior, which is really the goal," Katten's Bregstein predicted. "If an employee actually does something that threatens the viability of a firm, the clawback or holdback may be relatively meaningless compared with the damage done."

Legal and Other Considerations in Structuring Clawback Arrangements

Once a manager decides in concept to establish a clawback arrangement, the manager should consider at least the following factors in structuring the arrangement.

State Wage, Labor and Tax Laws

First, managers must understand the laws and regulations that could impact such arrangements because of the potential for civil or criminal liability.

Most notably, certain state laws prohibit a manager from collecting "wages" already paid out to employees. Simonetti explained, "Before any manager would want to institute such a clawback provision, its initial review has to be whether the

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clawback would be permissible under the state wage laws where they are operating. The manager then has to consider how they can go about mitigating the risk of being viewed as improperly clawing back wages and potentially violating state laws."

Citing an example of such a state wage law, Gibson Dunn's Feller explained, "Section 221 of the California Labor Code states that 'It shall be unlawful for any employer to collect or receive from an employee any part of wages theretofore paid by said employer to said employee.' California courts have interpreted this provision broadly to cover generally all amounts paid for services performed by an employee (including bonuses and incentive arrangements). Under this provision of the California Labor Code, clawbacks could be unenforceable if the payments to the hedge fund managers are considered wages." As a result, Feller explained, "You have to look at wage laws and employment laws in each state. Some have strong laws that say that once you pay out wages, you can't take them back. With deferred compensation that hasn't been paid out yet, that's more clearly enforceable."

Of course, the application of such state wage laws will depend in large part on how the term "wages" is defined. Explaining that "wages" could potentially include incentive-based compensation, Simonetti explained, "If, after the money has been paid out, it has been discovered that an employee has engaged in some illegal activity (perhaps insider trading) and the firm is now subject to sanctions and has to disgorge itself of certain profits, the manager may want to try to reclaim some of the profits that it paid to the employee. If you want to do this, you have to carefully examine state wage laws because once you pay compensation to an employee – even if it's incentive-based – in some states, that is still characterized as wages and you cannot try to reclaim them money. The company could be subject to civil or criminal sanctions for trying to disgorge the employee of those wages that had previously been paid."

Discussing the California law, Feller added, "Some practitioners take the view that an amount paid to an individual is only 'wages' once the amount is fully earned, which could include satisfying any applicable clawback conditions. That is why clawbacks would not be enforceable with respect to amounts paid before the individual agrees to any clawback policy since, in that case, the payments would not have been conditioned on satisfying the clawback policy. Payments after an individual agrees to a clawback policy would arguably be conditioned on meeting the requirements of the clawback policy and thus not considered wages until those conditions are satisfied."

Fries, of Goodwin Procter, described possible conditions for recouping wages paid to an employee in other jurisdictions. "A firm needs to give some thought as to how a clawback provision integrates with employment law issues such as laws relating to the payment of wages. In some jurisdictions, when employees are giving up something (for example, payment is subject to forfeiture), you also have to consider whether that person's spouse has to sign the agreement."

Other state labor and tax laws may also impact the ability of a manager to claw back compensation from an employee. Holly Weiss, a Partner at Schulte Roth & Zabel LLP, explained, "When drafting clawback and forfeiture provisions, managers should ensure that they comply with a variety of laws that may be implicated, including state labor

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laws and tax laws. For example, the New York Labor Law prohibits certain deductions from wages. Section 409A of the Internal Revenue Code governs the timing and payment of certain deferred compensation." See "IRS Issues Guidance on Compliance with Section 409A Requirements Applicable to Deferred Compensation Plans of Hedge Fund Managers," The Hedge Fund Law Report, Vol. 3, No. 3 (Jan. 20, 2010).

Whistleblower Rules

Another issue to consider is whether the clawback provision will conflict with applicable whistleblower rules, such as those adopted under the Dodd-Frank Act. See "How Can Hedge Fund Managers Incentivize Employees to Report Compliance Issues Internally in Light of the SEC's Whistleblower Bounty Program?," The Hedge Fund Law Report, Vol. 5, No. 20 (May 17, 2012). As Fries explained, "One consideration is how these clawbacks interact with whistleblower rules and requirements, especially, for example, if there is alleged insider trading and employees who are alleged to be involved implicate others. Even if someone has engaged in a 'cause' event, if they blow the whistle on the firm, the firm needs to consider whether there are any legal constraints on its ability to fire them or penalize them in some other way, including financially."

Tax Considerations

When structuring clawback provisions, managers should be attentive to tax implications associated with holdbacks and deferred compensation. According to Simonetti, "From the employee perspective, when an employee is paid money, he or she is taxed in the year in which it was paid. Where the clawback extends back for a certain number of years, the employee is effectively being required to repay pretax dollars when he or she has already paid the government its share. The employee then has to amend his or her returns or try to take a tax credit for taxes already paid, but those options can be limited. It does put a particular strain on the employee, especially if it involves a large sum of money. I think managers need to be aware of this when drafting these provisions."

Collection Concerns

Where compensation has already been paid to an employee, another concern is whether it is advisable for the manager to take action to recoup such compensation. According to Simonetti, "Just because you have this theoretical right to claw back money, if the person is no longer employed by you, how do you seriously go about getting the money back? To a certain degree, you are going after an individual and there is a cost associated with trying to collect those funds and there is an effort involved. There is a logistical concern that absent having money put aside to satisfy this potential claim, there is a collection issue. Then you have to try to chase down employees for money that may no longer be there. With all the time and effort involved, a manager has to weigh whether the amount that would be clawed back is worth those costs."

Documenting Clawback Arrangements

Clawback provisions are typically memorialized in employment agreements between the firm and the employee as well as in the firm's employee handbook. As Feller explained, the terms of any clawback provision, since it is usually applied firmwide, will be included in the firm's policies and procedures. Employees subject to the policy

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will sign a written acknowledgement that they understand that they are subject to the policy and accept such terms and conditions. Terms may also be included in employment offer letters or contracts outlining terms of the incentive compensation program.

Several samples of employee compensation clawback provisions and a sample definition of "cause" – all provided by sources and actually used by hedge fund managers – are contained in Appendix A to this article.

Best Practices When Adopting Clawback Provisions

Sources offered at least four best practices for structuring and implementing employee compensation clawback provisions.

First, managers should clearly understand the goals of their clawback provisions, including understanding what types of misconduct they are trying to deter as well as ensuring that the amount of compensation to be clawed back will effectively accomplish the desired goals. Johnson explained, "You have to have zero tolerance for this kind of behavior. You want to have really strong compliance and risk programs in place to prevent bad behavior, but if something happens you want to have real consequences."

Second, managers should ensure that any clawback provisions are clearly drafted to minimize the risk of litigation should the manager elect to enforce the provision. Michael Gray, a partner at Neal, Gerber & Eisenberg LLP, explained, "When drafting these provisions, the clearer the definition of 'cause' and what is considered a bad act, the less likely a manager is to have a dispute about enforcing these provisions."

Weiss, of Schulte, agreed that the terms of the clawback need to be very clear. "Clawback and forfeiture provisions need to be clearly and carefully documented. You do not want to have ambiguity, particularly with respect to the triggers for a clawback or forfeiture."

Third, Lance Zinman, a Katten partner, stressed the need for managers to verify that their clawback arrangements, as envisioned, will be legal and enforceable. "They have to be careful to structure them in a manner that places the firm in the best position to use them. Whether there are contingencies to the receipt of a bonus or the ability to have security for the obligation, structuring them in the most enforceable manner is important." This includes gaining an understanding of any applicable laws or regulations that could hinder enforcement of the clawback or, even worse, subject the manager to civil or criminal liability.

Fourth, managers must adopt any necessary policies and procedures designed to ensure rigorous enforcement of the clawback provision. Johnson explained, "It's just like any other firm policy you do not stick to: there could be serious issues for not doing what you say you will be doing."

Appendix A

Sample Clawback Provisions

Sample #1

A clawback of compensation will be initiated when an Employee materially breaches covenants; violates a statutory or common law duty of loyalty to the firm; engages in an intentional act of fraud, embezzlement, theft,

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misappropriation or misrepresentation; performs his or her duties in bad faith or gross negligence; becomes subject to an order of the SEC issued under Section 203(f) of the Investment Advisers Act of 1940; is convicted by a court of competent jurisdiction of any felony or misdemeanor or any substantial equivalent crime by a foreign court; is indicted or convicted by a court of competent jurisdiction of a crime that is punishable by imprisonment for one year or more, or any crime involving moral turpitude, fraud, embezzlement or misappropriation; is found by the SEC to have engaged, is convicted by a court of engaging or has admitted engaging in violations of Sections 203(e)(1), (5) or (6) of the Advisers Act; uses alcohol, drugs or other controlled substances in such as manner as to interfere materially with the performance of his or her duties, if the material interference continues for three working days or occurs for more than 10 working days in the aggregate during any 12 month period.

Sample #2

In the event the Company determines, in its sole discretion, that the fraud, willful misconduct or gross negligence of the Employee was a contributing factor to the need to restate the calculation of the Company's net income for any fiscal year, then the Company may, in its sole discretion, recalculate the Bonus. The Employee shall promptly repay to the Company the difference between the Bonus that was paid to the Employee and the reduced bonus.

Sample #3

If you resign your employment or the Company terminates your employment for Cause, you will forfeit the portion of the Bonus that is unvested at the time of such resignation or termination.

Sample Definition of "Cause"

Cause means a determination of a violation of any law, rule or regulation related to the business; indictment or conviction of a felony; commission of a fraudulent act; violations of the Code of Conduct; failure to perform duties or to follow reasonable directives; or any act that might reasonably be expected to be injurious to the firm.

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