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SEC's Final "Clawback" Rule May Pose Code Section 409A Issues for Nonqualified Plan Sponsors

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In 2015, the Securities and Exchange Commission ("SEC") proposed under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("the Dodd-Frank Act") a requirement for publicly-traded companies to adopt clawback policies for recovering erroneously awarded compensation from its executive officers. On October 26, 2022, the SEC adopted the long-awaited final rules, and NYSE and Nasdaq-listed companies are required to adopt compliant clawback policies by December 1, 2023.

Under the final SEC rule, public companies and certain other companies must adopt clawback policies that provide for recovery of "incentive-based compensation," defined as "any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure." The rule raises a number of corporate governance issues for publicly traded companies. However, nonqualified plan administrators should also pay attention, particularly if there is discussion to recover incentive-based compensation from nonqualified plan benefits. As in so many other areas, employers must beware of the pitfalls in Code section 409A.

The Clawback Rule in Brief

Generally, the clawback rule requires executives of public companies to repay (pre-tax) certain incentive-based compensation based on financial metrics later found to be wrong. Incentive-based compensation for this purpose is defined as compensation (including stock options) that is granted, earned, or vested based wholly or in part upon attainment of any financial reporting measure, including GAAP and non-GAAP reporting measures.

A public company's clawback policy must require certain executives to repay incentive-based compensation that was overpaid within the three fiscal years prior to the date the company is required to prepare a restated financial statement due to material noncompliance with reporting requirements (without regard to fault or misconduct). This rule applies to such amounts overpaid to current or former executive officers, which are broadly defined for this purpose similar to Section 16 officers under the Securities Exchange Act of 1934.

Clawback Policies and Code Section 409A

At first glance, an executive's nonqualified plan benefit may seem like a tempting source of funds to satisfy his or her clawback obligation. Unlike qualified retirement plans, nonqualified plans are generally exempt from ERISA's strict rules regarding benefit forfeiture. In fact, an executive may even prefer to use unpaid nonqualified plan benefits to satisfy a clawback obligation instead of paying the clawback out of his or her bank account.

However, in the world of nonqualified plans, if something seems too good to be true, it usually is – and Code section 409A is usually the cause of the trouble. Under Code section 409A, if an executive's right to deferred compensation is reduced (or otherwise is assigned or pledged) to satisfy a debt to the employer, then the deferred compensation is treated as paid to the executive. While Code section 409A provides a limited exception where the amount of the offset is no more than $5,000, in general these offset arrangements are viewed as an impermissible "acceleration" of payment in violation of Code section 409A. The consequences of such violation include immediate income inclusion, a 20 percent additional tax, and premium interest. As a result, companies should proceed with caution before attempting to satisfy a clawback obligation by deducting the amount from an executive's nonqualified plan benefit (or any other amount subject to Code section 409A).

However, there are situations where such a clawback is permissible. For example, if the deferred amount is attributable to excess incentive-based compensation (*e.g.*, a deferred portion of the executive's annual bonus), it may be appropriate to "clawback" a portion of the deferred incentive-based compensation. Even in this scenario, it is unclear how much of the deferred amount can be used to satisfy the clawback obligation. For example, suppose an executive deferred $100,000 of a $500,000 bonus under a nonqualified plan, and is later required by a clawback policy to repay 10% of the bonus, or $50,000. It may be reasonable in such a situation to reduce the executive's nonqualified plan benefit by $10,000, or 10% of the $100,000 deferral. However, an argument that the entire $50,000 required to be repaid can be recouped from the $100,000 deferral seems more aggressive in the absence of additional guidance.

Conclusion

While the final clawback rules certainly impact the corporate governance and disclosure practices of publicly-traded companies, such policies could also create significant administrative issues for nonqualified plan sponsors. In drafting clawback policies by the December 1, 2023 deadline, nonqualified plan sponsors must beware of the pitfalls in using deferred compensation to satisfy an executive's clawback obligation. Please contact any of our experienced Groom attorneys for assistance in this area.