

The Impact of Dodd-Frank Clawback Policies on NQDC Plans

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SYNOPSIS: Dodd-Frank clawback policies require covered companies to promptly recover any “erroneously awarded compensation” received by certain current or former “executive officers.” “Erroneously awarded compensation” refers to incentive-based compensation received by the executive that would have been less if recalculated after certain financial restatements. Recovery of erroneously awarded compensation is mandatory, with only limited exceptions, although companies retain discretion as to the means of recovery. Companies with nonqualified deferred compensation (NQDC) plans should consider whether erroneously awarded compensation can be recovered from plan benefits, and if so, what NQDC plan amendments would be required to authorize such recoveries. Any such amendments should be crafted after considering potential compliance issues under Internal Revenue Code Section 409A. This article explores the ways in which NQDC plans may be impacted by these Dodd-Frank clawback policy requirements and the related Section 409A compliance considerations.

Overview of Dodd-Frank Clawback Policy Requirements

In 2023, companies with securities listed on Nasdaq or New York Stock Exchange (NYSE) were required to adopt a policy mandating the recovery of certain “erroneously awarded compensation” from current or former “executive officers.”^[1] We often refer to these as “Dodd-Frank clawback policies.” The rules apply to any company with securities listed on Nasdaq or NYSE, including companies with publicly listed debt and foreign private issuers. No exceptions apply for emerging growth or other smaller reporting companies. Covered companies also must publicly disclose their written Dodd-Frank clawback policy and provide future disclosures if the policy is ever triggered. The rules required that covered companies adopt their Dodd-Frank clawback policy by no later than December 1, 2023, to be effective for any incentive-based compensation received on or after October 2, 2023.

A potential obligation to recoup incentive-based compensation under a Dodd-Frank clawback policy is triggered if the company determines that it must restate its financial statements due to material noncompliance with any financial reporting requirement under the securities laws. The trigger event includes the relatively uncommon “Big R” restatement, which corrects a material error in a previously issued financial statement, and which the company must publicly announce through a Form 8-K filing. The trigger event also includes the more common “little r” restatement, which corrects prior-year errors that were not material in previously issued financial statements, but which would be material in the current year financial statement if not corrected. An 8-K disclosure is not required for a “little r” restatement. In its final rulemaking release, the Securities and Exchange Commission (SEC) estimated that “little r” restatements outnumbered “Big R” restatements three-to-one.^[2]

If a triggering financial restatement occurs, the company must look back to the three fiscal years ending immediately before the year the restatement determination is made and identify any “incentive-based compensation” that was “received” in any of those three years by any of the company’s current or former “executive officers.” The company must determine whether any of that incentive-based compensation would have been less, based on the restated financial results. Any excess incentive-based compensation that was received over what should have been received based on the correct financial statement results — referred to as “erroneously awarded compensation” — must be repaid by the current or former executive officer. No fault or misconduct on the part of the executive officer is required.

The rules broadly define “incentive-based compensation” for this purpose to include any compensation granted, earned, or vested based wholly or in part on the attainment of a financial reporting measure, including non-GAAP measures and stock price or total shareholder return. Common examples include most annual incentive awards, many performance-vesting stock awards, and stock awards granted based on achievement of financial performance goals. Conversely, base salary or discretionary grants of time-vesting stock awards would typically not constitute incentive-based compensation. Incentive-based compensation is considered “received” when the relevant performance period ends, not when the amount is calculated and paid. The covered “executive officers” are the company’s Section 16 reporting officers (or the equivalent of those positions in covered companies that are not otherwise subject to Section 16 reporting, such as companies with publicly listed debt). (See the chart attached at the end of this article with an overview of the Dodd-Frank clawback policy requirements.)

Covered companies should now be planning on how to enforce their Dodd-Frank clawback policies if a triggering financial restatement occurs. The rules mandate prompt recovery of erroneously awarded compensation with only limited exceptions. However, the rules include broad discretion for companies as to how the recovery will be accomplished. For example, if \$100,000 of an executive’s previously paid annual incentive bonus was subject to clawback, the company does not necessarily need to require the executive to repay this amount in cash. Rather, the executive’s fulfillment of the clawback “debt” might be accomplished through the forfeiture or cancellation of other compensation worth \$100,000, such as an outstanding equity award. Companies with NQDC plans should consider whether benefits under the plan could be considered erroneously awarded compensation, or whether those benefits could otherwise be a source of recovery of erroneously awarded compensation owed by a current or former executive officer.

Potential Clawback Impacts on NQDC Plans

Benefits under NQDC plans for current or former executive officers could be impacted by a required recovery under a Dodd-Frank clawback policy in two ways.

First, some portion of the NQDC plan benefits could themselves be considered erroneously awarded compensation.^[3]

Example 1 (Erroneously Awarded Compensation in a NQDC Plan). An executive defers 100% of the executive’s annual cash bonus for 2024 into a NQDC plan and receives a related matching contribution on those deferrals. In 2026, the company determines that it is required to restate its 2024 financial statements and determines based on those restated results that the 2024 bonus should have been 50% less. As a result, 50% of the 2024 bonus deferred into the NQDC plan by the executive, and 50% of the related matching contributions, is erroneously

awarded compensation that is required to be recovered by the company, as are any earnings credited on those amounts under the NQDC plan.

Second, an executive or former executive might owe a payment of erroneously awarded compensation to the company unrelated to NQDC plan benefits. However, the executive or former executive may have a balance under a NQDC plan that represents a convenient source to implement the required recovery.

Example 2 (Erroneously Awarded Compensation Not in a NQDC Plan). In 2026, a company determines that 50% of a former executive's 2024 bonus was erroneously awarded compensation based on a required restatement of the company's 2024 financial statements. The former executive did not defer that bonus, but the former executive does still have a large balance in the company's NQDC plan. The company would like to implement the required recovery by reducing the former executive's NQDC plan account by the amount of the erroneously awarded compensation.

Absent a specific plan provision permitting such actions, implementing the recoveries in those examples may not be permitted. But before companies amend their NQDC plans to allow for recoveries under their Dodd-Frank clawback policy, compliance with Section 409A of the Internal Revenue Code of 1986, as amended (Section 409A) should be considered.

Section 409A Considerations and Open Issues

NQDC plans must comply with the requirements of Section 409A. Section 409A generally requires that amounts can be paid only on one of six specified permitted payment events (*i.e.*, death, disability, separation from service, a fixed date/schedule, change in control, or unforeseeable emergency) established at the time of initial deferral. Once the payment rule is established, payments generally cannot be accelerated or further deferred, with limited exceptions. Failure to comply with Section 409A may lead to significant adverse tax consequences to employees, including accelerated income recognition, a 20% additional tax, and potential "penalty interest" additional taxes.

The Section 409A regulations include a provision, often called the "substitution rule," that should be considered before adding a provision to a NQDC plan implementing a Dodd-Frank clawback policy recovery.^[4] The substitution rule is often viewed as an anti-abuse provision and is meant to block an employee from agreeing to voluntarily relinquish a NQDC payment due in a later year in exchange for a new payment currently. The regulation states as its general rule:

Except as otherwise provided under these regulations, the payment of an amount as a substitute for a payment of deferred compensation will be treated as a payment of the deferred compensation.^[5]

The regulation notes, however, that a forfeiture or relinquishment of deferred compensation, not in exchange for another payment, is permitted:

A forfeiture or voluntary relinquishment of an amount of deferred compensation will not be treated as a payment of the compensation, but there is no forfeiture or voluntary relinquishment for this purpose if an amount is paid, or a legally binding right to a payment is created, that acts as a substitute for the forfeited or voluntarily relinquished amount.^[6]

Under the first example above in which an amount credited to a NQDC plan is determined to have been erroneously awarded compensation, a strong argument can be made that a NQDC plan provision resulting in a forfeiture of those amounts complies with Section 409A. That is because the employee was never entitled to that compensation; it was paid based on erroneous financial results. Removing the contribution (and related matching contributions and earnings) from the NQDC plan account through a forfeiture simply puts the employee and the NQDC plan in the position they would have been in had the compensation been correctly determined in the first instance. This action should be viewed as a permitted, nonpaired forfeiture of deferred compensation under the substitution rule.

The second example above, however, may lead to a different answer. In that example, the executive has a personal obligation to repay erroneously awarded compensation to the company under the Dodd-Frank clawback policy that is unrelated to the NQDC plan. The company wants to use NQDC plan benefits to satisfy that personal obligation. In this case, the forfeiture of a NQDC plan benefit that would otherwise have been paid at a later date in satisfaction of an executive's unrelated payment obligation to the company might be viewed under the substitution rule as an accelerated payment of the NQDC benefit. The substitution rule includes the following provision, treating offsets from a NQDC plan in satisfaction of a loan to an employee as an impermissible substitution:

[W]here the payment of an amount results in an actual or potential reduction of, or current or future offset to, an amount of deferred compensation, or if the service provider receives a loan the repayment of which is secured by or may be accomplished through an offset of or a reduction in an amount deferred under a nonqualified deferred compensation plan, the payment or loan is a substitute for the deferred compensation.^[7]

If the erroneously awarded compensation received by the employee is treated like a loan from the company that the employee is required to repay, then use of the unrelated NQDC plan benefits to satisfy the repayment obligation could be considered an accelerated payment under the substitution rule. If so, the NQDC plan would fail to comply with Section 409A, triggering Section 409A's adverse tax consequences for the executive.

The Dodd-Frank Act clawback rules implement a public policy intending to prevent windfalls to executives when financial restatements are required. Those rules also mandate that companies promptly recover all erroneously awarded compensation, with very few exceptions. There is a compelling argument that public policy should allow for the substitution rule to be read in a way that permits forfeiture of NQDC balances as a means for a company to promptly recover erroneously awarded compensation, even if the erroneously awarded compensation is unrelated to the NQDC plan benefits, in order to help facilitate compliance with the clawback rules. In our view, this could be particularly helpful in a scenario in which the only outstanding compensatory interest a former executive has in the company is a NQDC account. However, until Treasury or the Internal Revenue Service (IRS) clarifies the application of the substitution rule in this context, care should be taken when amending a NQDC plan to allow for such a recovery from the plan.

What Employers Should Do Now

Employers with Dodd-Frank clawback policies should currently be developing action plans to implement the policy if a triggering financial restatement occurs. Part of the action plan should include reviewing any NQDC plans sponsored by the company and considering whether:

- Plan benefits could include erroneously awarded compensation (either by elective deferrals, a plan benefit formula that considers incentive compensation awards, etc.);
- The plan already includes any provisions that subject plan benefits to any company clawback policies, including the Dodd-Frank clawback policy; and
- It would be advisable to adopt any additional amendments to the NQDC plan regarding recovery of erroneously awarded compensation in the event the Dodd-Frank clawback policy is triggered.

Any amendments to NQDC plans should be closely reviewed with legal counsel, especially to consider potential Section 409A compliance issues. Companies should also continue to monitor for additional clarifications from Treasury or the IRS regarding those Section 409A considerations.

There may also be strategies to improve enforceability of the Dodd-Frank clawback policy against NQDC plan benefits, short of amending the NQDC plan. For example, the Dodd-Frank clawback policy itself might include a broad range of recovery methods that include forfeiture or other recovery from NQDC plans (to the extent permitted by Section 409A), and many companies will require covered executives to formally acknowledge and agree to the policy. A company could also consider adding language to annual deferral election forms to clarify that any portion of the deferred compensation later determined to be erroneously awarded compensation under the company's Dodd-Frank clawback policy (and any related matching contributions and earnings) will be forfeited.

The point of these strategies is to make enforcement of the Dodd-Frank clawback policy, if triggered, more efficient and less costly to the company. Companies should carefully consider how recoveries of erroneously awarded compensation can be most easily implemented. The rules mandate prompt recovery with few exceptions. For companies that do not act to create contractually enforceable rights to recover amounts due under their Dodd-Frank clawback policy, the company may someday become stuck between a rock and hard place. The company may have a nondiscretionary obligation to promptly recover erroneously awarded compensation, but high enforcement costs to do so. The recovery actions taken must be disclosed when a triggering event occurs. Shareholders may react negatively to those disclosures if the company could have acted to create more easily enforceable recovery rights but failed to do so.

Attachment: Dodd-Frank Clawback Policy Summary Chart

Feature	Description
Covered Individuals	Current and former “executive officers” (similar to Section 16 “officers”), including the issuer’s principal accounting officer.

	<p>any compensation granted, earned, or vested based wholly or in part on attainment of a financial reporting measure, including non-GAAP measures and stock price or total shareholder return.</p> <p>Does not include compensation awarded on a purely discretionary basis or time-based equity awards (if not granted based wholly or in part on attainment of a financial reporting measure).</p>
<p>Delayed Compensation</p>	<p>Accounting restatement is required to correct an error in previously issued financial statements that is material to the previously issued financial statements (a so-called “Big R” restatement) and (2) when an accounting restatement is required that is not material to previously issued financial statements, but would result in a material misstatement if the error was corrected or left uncorrected in the current period (a so-called “little r” restatement).</p> <p>Recovery is based on material noncompliance with financial reporting requirements and is on a “no fault” basis. Executive misconduct or responsibility for the error is not required.</p> <p>The triggering event occurs when the board determines (or reasonably should have determined) that a restatement is required or when a legally authorized body directs the issuer to prepare a restatement, whichever is earlier.</p>
<p>Look-Back Period</p>	<p>The policy must require recalculation of any incentive-based compensation “received” during the three completed fiscal years preceding the triggering event. Incentive compensation is deemed received in the fiscal period during which the performance measure specified in the incentive compensation award is attained, which is not necessarily when the incentive-based compensation is granted, vested, or paid.</p> <p>Does not apply to incentive-based compensation “received” before the individual was an executive officer.</p>

	<p>three-year look-back period and seek repayment of the amount received by the executive officer, in excess of the amount that would have been received if the calculation was based on the restated results — the “erroneously awarded compensation.”</p> <p>Indemnification of recovered amounts is prohibited.</p>
Enforcement	<p>The issuer’s policy generally cannot permit discretion regarding base compensation received, unless the direct costs of enforcement would clearly exceed the amount to be recovered, where enforcement would be prohibited by law of another jurisdiction, or where enforcement would alter the tax-qualified status of a retirement plan. An issuer’s reliance on any exceptions must be publicly disclosed.</p>
Form of Policy	<p>The policy must be memorialized in a stand-alone document that is publicly filed.</p> <p>Certain disclosures are also required in annual reports/proxy statements.</p>

[1] The requirements come from Section 954 of the Dodd-Frank Act and implementing rules adopted by the SEC, Nasdaq, and NYSE.

[2] See *Listing Standards For Recovery Of Erroneously Awarded Compensation*, SEC, Final Rule, Release Nos. 33-11126, 34-96159, IC-34732, File No. S7-12-15, , RIN No. RIN 3235-AK99 (10/26/2022), Section IV.A.

[3] The SEC, Nasdaq, and NYSE rules implementing the Dodd-Frank Act clawback requirements do not require recovery of erroneously awarded compensation that is in a tax-qualified retirement plan, such as a 401(k) plan. The SEC acknowledged that the anti-alienation rules that apply to tax-qualified retirement plan benefits should trump the Dodd-Frank Act clawback rules, and in any event such amounts should be relatively small given various limits on the amount on tax-qualified retirement plan benefits. No such exception was included for NQDC plans.

[4] See Treas. Reg. §1.409A-3(f).

[5] *Id.*

[6] *Id.*

[7] *Id.*

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