SOUTHLEA
A GECN GROUP COMPANY

WILL YOUR CLAWBACK WORK?

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Imagine a major crisis event at your company- serious misconduct by a senior executive, material violations of law, discovery of massive fraud, major deficiencies in publicly disclosed financial statements.

Emergency board meetings are held. Armies of lawyers, accountants, forensic experts, consultants of every type (obviously the top Canadian executive compensation firm!), communication, government relations and PR firms engaged.

You have a clawback policy which your company adopted several years ago providing for the recoupment of already paid incentive compensation in the event of triggering events like executive misconduct, which you have publicly disclosed to your shareholders annually as indicia of your stellar corporate governance.

And then your lawyers advise you, the clawback policy is not enforceable against those responsible for the debacle....

Approximately 190 Canadian public companies out of the 200 plus companies in the S & P/TSX Composite Index (based on public disclosure) have adopted a clawback policy- almost 90 per cent. So, will these policies actually work when the crisis occurs?

Simply stated, a clawback is a mechanism to recoup already paid or awarded compensation from executives in the event of a triggering event or events – such as a restatement of financial statements, fraud or in some cases breaches of company policies, sometimes in conjunction with other events or sometimes as a single trigger.

Companies listed on US stock exchanges are required (under the Dodd-Frank legislation) to adopt a clawback policy addressing the recovery of compensation arising from restatements of financial statements due to material noncompliance with financial reporting requirements. (This requirement applies to Canadian public companies who are dual listed on Canadian and US stock exchanges.)

In Canada (other than such dual-listed companies), the adoption of clawback policies is not required. However, Canadian banks are “strongly encouraged” by their regulator OSFI to have clawback policies. Other public companies follow the voting policies of proxy advisory firms like ISS and Glass-Lewis which effectively mandate the adoption of such policies to obtain favourable voting recommendations for HR committee members and say on pay votes. (The only relevant Canadian law requires disclosure of such policies but does not mandate their adoption.)

As clawbacks in Canada are both “voluntary” and contractual, their terms vary- there is no prescribed content.

The issue of enforceability of such policies, however, is not always considered. As noted, Canadian clawbacks are contractual in nature – no legislation renders them enforceable. Accordingly, the policies are subject to all the issues associated with contract enforceability.

The first threshold is that, as a contract, their terms must be agreed to by the affected parties. Simply adopting a clawback policy at a board meeting (or simply describing a policy in the annual circular) does not implement a clawback – the employees affected by it must agree to be bound by it. This might be done by having executives sign the policy. However, this may not be the best approach for a number of reasons, including that the policy contains provisions which apply to the company but not the executive and this will be subject to concerns about adequate consideration discussed below.

The fact that executives must agree to the policy may affect the acceptance and terms of such policies, as executives may not wish to agree to draconian policies –such as ones that put at risk already paid compensation years after the fact , and allow claims to be brought against their families after retirement and death, even if brought by a new set of directors after, for example, an acquisition.

However, obtaining the executives' signature or click agreeing to a clawback policy may not be sufficient for enforceability. Another aspect of contractual enforceability is providing “consideration” in exchange for the agreement by the executives that their compensation will be subject to recoupment under the policy. If embedded in an employment contract, such consideration may be found to exist by virtue of the mutual rights and obligations contained in the employment contract (such as the compensation to be paid). Another way of establishing consideration might be to explicitly agree to a clawback provision in acceptance of the grant of an incentive award such as options.

Even those steps may not assure the enforceability of the clawback policy, however. It is a principle of contract law that pre-agreed damages for breach of contract are not enforceable if they are in the nature of a penalty- damages which are completely disproportionate to the damages suffered because of the contract breach. For example, a breach of company policy may not result in damages to the company which are proportionate to the entire loss of all incentive compensation and rendered unenforceable for that reason (even if the company only seeks a proportionate number of damages in the case). While there are legal doctrines which can be applied to the development of clawback provisions in such a way to render them more likely to be enforced, which are supported by Canadian court decisions, these require appropriate crafting with considered application of such doctrines.

There are other constraints which may hamper the enforceability of clawbacks because of their contractual nature. Clear and unambiguous drafting is necessary for the application of clawbacks as it is for other contacts. Likewise, limitation periods may apply to the enforcement of clawbacks (e.g. in Ontario the limitation period of two years may apply).

Having suffered the ignominy of a major crisis, a board of directors may suffer even more reputational harm when it is discovered their publicly disclosed clawback policy is not enforceable. However, the downside of a non-enforceable clawback policy may be more than reputational harm. Depending on the amounts involved, if the company has publicly disclosed its clawback policy (with a necessary implication to the public that it “works’), they are potentially subject to claims of misrepresentation in the event the policy turns out in fact to be not enforceable.

The adoption of a clawback policy must be a considered, thoughtful exercise, with expert compensation and legal advice, and not a “check the box “exercise,” to avoid an unwelcome surprise if and when it comes time to activate it.

This communication is provided for informational purposes only and does not constitute legal advice.

John Tuzyk is a Senior Advisor at Southlea Group. He has broad experience in the development of Canadian clawback policies and their enforcement, including the successful application of a clawback provision upheld by an Ontario court decision. John Tuzyk's extensive background in law and his practice in areas overlapping with Southlea's core services will significantly enhance the firm's capabilities. His focus is on providing expert advice in critical legal and governance areas, ensuring that Southlea continues to deliver comprehensive and tailored solutions to its clients.

Key Areas of Focus for John Tuzyk:

- Corporate Governance and Disclosure Matters: Including the review of board/committee mandates, preparation of the Compensation Discussion and Analysis (CD&A), and development of policies such as clawbacks and share ownership requirements.
- Employment Contracts and Incentive Plan Documents: Covering change of control and termination conditions to ensure robust and compliant agreements.
- Equity Plan Governance: Managing share reserve requests and navigating the various TSX/CSA requirements to maintain effective equity plan administration.
- Shareholder Engagement: Addressing say on pay considerations and fostering constructive dialogue with shareholders.

ABOUT US

Southlea Group is a national independent compensation consulting firm that provides global perspectives as a GECN Group company working with over 150 compensation professionals in fifteen countries. We are headquartered in Toronto with offices in Montreal and Vancouver and clients across Canada, representing all industries and organization structures. Our team of advisors is multi-disciplined with diverse backgrounds and experiences. We are proud to be a certified Women's Business Enterprise by WBE Canada and to be Rainbow Registered as an LGBT+ friendly organization.

We would be pleased to address any questions and/or explore how we can support your challenging compensation needs. Please email us at hello@southlea.com and we will follow up to set-up a time to discuss further.