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Reply: Clawback to the Future

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In *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes* (the "Article"), we undertook the task of proposing a doctrine of clawbacks that would not only furnish a framework for analyzing the term more systematically, but would also describe the ways the doctrine would relate to established rules of contract law.[1] With his response, *In the Shadow of the Omnipresent Claw: In Response to Professors Cherry & Wong* (the "Response"),[2] Michael Macchiarola has provided us with an opportunity to articulate these thoughts on the doctrine of clawbacks further, and for that opportunity and his careful reading of the Article, we thank him.

In essence, the Response takes issue with the Article in three respects;[3] first, with what it terms the "newer" application of clawbacks to "the recoupment of corporate executive compensation"[4]; second, with the purported "latent subjectivity" of clawbacks generally;[5] and third, with the apparent operational difficulties of implementing prospective clawbacks, in-

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1. *See generally* Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368 (2009).

2. Michael C. Macchiarola, *In the Shadow of the Omnipresent Claw: In Response to Professors Cherry & Wong*, 95 MINN. L. REV. HEADNOTES 1 (2010).

3. While the Response has other quibbles with the Article, we believe the three concerns we identified represent its core, and we accordingly limit this space-constrained Reply to addressing the same.

4. Macchiarola, *supra* note 2, at 10.

5. *Id.* at 3.

cluding those relating to measurement and enforcement.[6] As for the first critique questioning the application of clawbacks to executive compensation, recent events, including the passage of the Dodd-Frank Act blunts the extent of the criticism. The Dodd-Frank Act, which establishes mandatory clawback policies in the event of an accounting restatement, ensures that clawbacks will be a significant part of the executive compensation landscape for the foreseeable future.

As to the second critique, we agree to some extent with the Response that clawbacks and the concept of unfair enrichment that we described may increase the overall complexity of contracts. However, the additional complexity that the Response complains of arises in many instances in which an equitable remedy exists. In this way, the clawback doctrine operates no differently from many existing equitable doctrines, including, for example, its close cousin, the doctrine of unjust enrichment. Moreover, like these other doctrines, the parameters of the doctrine can and will only be more precisely delineated with time. Further, many of the Response's fundamental objections to clawbacks on account of their "subjectivity" apply only to retroactive clawbacks, and not to prospective clawbacks. It bears noting, therefore, that the Article draws and, indeed, emphasizes the critical distinction between the two. We not only identify and explain the difficulties associated with the retroactive imposition of clawbacks, but affirmatively recommend writing clawback provisions into contracts prospectively.

On the final critique, we believe that many of the potential operational difficulties the Response would associate with prospective clawbacks will be minimized because their contractual nature requires parties to agree upon, and thus direct their attention to the content and operability of, such clawbacks. And again, in the course of time and practice, any such difficulties will be addressed and ameliorated. We address all three critiques in more detail below.

I. THE DODD-FRANK ACT: CLAWBACKS AND THE FUTURE OF EXECUTIVE COMPENSATION

The Response notes that "[i]ncreasingly, politicians, commentators and regulators are embracing some recoupment method to correct perceived past wrongs" in regard to executive

6. *See id.* at 12–17.

compensation,[7] and that some of this is attributable to "political posturing."[8] The Response goes on to question whether certain executive compensation scenarios should be subject to clawbacks at all.[9] In its view, "the current crop of examples [involving clawbacks in the area of executive compensation] derives from shakier statutory footing and suffers from far less robust precedent upon which to rely."[10] In other words, the Response appears to suggest that executive compensation does not raise the kind of legitimate concerns that should be addressed by clawbacks.

However, the outcry over bonuses, and subsequent events, have since shown that the Response holds a minority view. Recently, even Judge Richard Posner has (albeit reluctantly) come to the view that executive overcompensation is problematic.[11] Further, events have moved quickly, and rather than speculation about the actions of future politicians or regulators, we have recently enacted legislation to look to for guidance on these matters that affirms the "newer," if not prescient, views expressed in the Article. Indeed, the Dodd-Frank Act,[12] passed in the summer of 2010, writes clawbacks into law, providing them a firm grip on the law of executive compensation.

7. *Id.* at 12. We would respectfully submit that the events that transpired were actual wrongs, not a mere perception.

8. *Id.* at 3.

9. For example, the Response states that "not all will agree with the authors' assertion that . . . 'payment of the bonus [to an otherwise blameless AIG executive] is unfair because bonuses should not be decoupled from a company's performance, particularly where taxpayer money is involved.'" *Id.* at 7 n.21. The Response notes that there are certain scenarios, for example involving a compliance officer or in-house attorney, where AIG might become "more valuable as the company's performance beg[ins] to wane" and it would therefore be appropriate to decouple that individual's bonus from a company's performance. *Id.* at 6. This assertion, however, fails to account for or even address the fact that funding by the taxpayer may nonetheless render this situation unfair.

10. *Id.* at 10–11.

11. *See* Richard A. Posner, *Are American CEOs Overpaid, and, if So, What if Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1020 (2009) (describing larger pay packages received by American CEOs when compared with their foreign counterparts). This discrepancy may perhaps be a result of the comparatively larger role of labor in foreign corporate governance process. Statistics, circa 2003, put the gap at 500 times that of the average worker at the company. *CEOs and Their Indian Rope Trick*, ECONOMIST, Dec. 11, 2004, at 61, *available at* 2004 WLNR 14012834.

12. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376.

Specifically, section 954 of the Dodd-Frank Act provides, as a requirement for listing on a public exchange, that issuers must have a specific type of clawback in place:

> [I]n the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.[13]

Titled "Recovery of Erroneously Awarded Compensation,"[14] the provision is wide-ranging, applying to both current and former executive officers. Although the executive need not forfeit all of the compensation over the last three years, he or she must return the incentive pay that was based on faulty accounting.[15] This is a major step forward and one that we applaud.

On the other hand, this provision certainly could be stronger. There is no procedural mechanism in the Dodd-Frank Act for enforcement, which means that shareholders would have to bring a derivative suit, an action that is potentially procedurally difficult for shareholders.[16] The Securities and Exchange Commission (SEC) could also bring an enforcement action, but given the dearth of actions brought under the (significantly weaker) Sarbanes-Oxley clawbacks, one wonders if the SEC will be more proactive with this enhanced directive. Nonetheless, the passing of the Dodd-Frank Act reaffirms the position that executive overcompensation is a continuing, current problem.

Additionally, as the Response notes, many companies have already established clawback policies for executives on their own, as part of best practices. As we noted in the Appendix to the Article, there is a wide variation of clawback provisions. Some are much more harsh than others; others place a good deal of discretion in the board to determine whether any recoupment should apply; still others are only triggered by mis-

13. *Id.* § 954(b)(2).

14. *Id.*

15. *See* John C. Coffee, Jr., *Hidden Impacts of the Dodd-Frank Act*, N.Y. L.J., July 15, 2010, at 5, *available at* 7/15/2010 N.Y.L.J. 5, (col. 2).

16. *See id.* ("[P]laintiffs will probably have to rely on the traditional derivative suit.").

conduct or criminal action against an executive. Others are triggered by the requirement of "bad faith," which again invests a great deal of discretion in the board of directors to determine. The SEC's requirement that an accounting restatement trigger the clawback provides an objective benchmark. Companies, of course, are free to impose stricter clawback provisions, but they cannot fall below the mark set by the clawback required in the Dodd-Frank Act if they are to be listed.

The future has arrived, and new or not, clawbacks in executive compensation are here to stay.

II. THE FUTURE FORWARD: TIME HEALS ALL WOUNDS (EVEN THOSE OF SUBJECTIVITY)

In the Article, we proposed that clawbacks be defined as "a right to, or action for, the restitution of unfair enrichment that is otherwise justified or permitted under prevailing applicable law."[17] As we view it, "unfair enrichment" is enrichment that results in "inequities that cannot easily be resolved by existing remedies under the law because of countervailing legal rights independently supporting such inequities."[18] For example, while "it seems unfair that an executive at AIG could walk away with a bonus when the company he had a responsibility to assist is failing[,] . . . under existing law, making an equitable claim under these circumstances is problematic as it must tackle the executive's original contractual claim to the bonus."[19]

The Response complains that this concept of "'unfair enrichment' . . . introduces unwelcomed subjectivity to decisions of whether and to what extent a person's monies might be subject to return at some future date."[20] It is true of course that the application of clawbacks will require a determination of whether and to what extent any enrichment is "unfair," and further, that this may be a fact-intensive inquiry that may yield different answers close to the margin. However, "[t]hat there are differences among the conclusions reached by various models when different input values are used in those models does not render a theory or technique unreliable."[21] The clawback is a relatively new phenomenon, or at least, hitherto, it

17. Cherry & Wong, *supra* note 1, at 412.

18. *Id.* at 414.

19. *Id.* at 413.

20. Macchiarola, *supra* note 2, at 6–7.

21. Aero-Motive Co. v. Becker, No. 1:99-CV-384, 2001 WL 1698998, at *3 (W.D. Mich. Dec. 6, 2001).

"'has been subject to neither rigorous analytical scrutiny nor definition and exposition.'"[22] Courts are still coming to grips with clawbacks and will no doubt hone and explicate the theory in the years to come. Indeed, even its long-established close cousin, unjust enrichment, is still seen today as an evolving "flexible broad-based theory"[23] with such "unanticipated potential"[24] that "many scholars advocate a narrow and more predictable reach for restitution."[25] More to the point, it remains the case that "the framework of restitution is not agreed upon by scholars or courts."[26] It is therefore instructive to note that the Response itself makes the same point with respect to the concept of fraudulent transfer that will apply *a fortiori* to that of unfair enrichment: "While the requirements of fraudulent conveyance might introduce a certain layer of subjectivity, such concerns are diminishing over time, as precedent and case law establish its parameters with increasing detail."[27]

Moreover, many of the Response's fundamental concerns regarding subjectivity are relevant only to retroactive clawbacks, and greatly diminish when one invokes prospective contractual clawbacks. The latter requires that parties agree upon the very terms and nature of the clawbacks at the inception of the contracts—whether, for example, we are talking about clawback provisions in investment or employment contracts. This means that insofar as prospective clawbacks are concerned, all parties are literally on the same page regarding "whether and to what extent [the individual's] monies might be subject to return at some future date."[28] Having themselves defined the triggers for clawbacks, the parties will not have to

22. Macchiarola, *supra* note 2, at 2 (quoting Cherry & Wong, *supra* note 1, at 411).

23. Debra L. Greenfield, Greenberg v. Miami Children's Hospital*: Unjust Enrichment and the Patenting of Human Genetic Material*, 15 ANNALS HEALTH L. 213, 214 (2006).

24. Candace Saari Kovacic-Fleischer, *Restitution in Public Concern Cases*, 36 LOY. L.A. L. REV. 901, 904 (2003).

25. *Id.* at 903.

26. *Id.* at 905. Another instance of a doctrine that is well established, but not entirely predictable, is that of unconscionability. *See, e.g.*, Paul Bennett Marrow, *Squeezing Subjectivity from the Doctrine of Unconscionability*, 53 CLEV. ST. L. REV. 187, 187 (2005–2006) ("Determinations about unconscionability are subjective. To date no one has been able to articulate an objective standard. Statutes that empower the judiciary to make findings of unconscionability almost uniformly fail to define what qualifies. Judges are left to fashion solutions that they, and they alone, believe address their charge.").

27. Macchiarola, *supra* note 2, at 9.

28. *Id.* at 7.

contend with the "troubling" prospect of a lack of "the predictive value of the rule of law."[29] Similarly, to the charge by the Response that "[m]ost basically, the authors fail to answer why the contractual risk bargained for by two arms-length parties should be subject to the later assessment of an interloping arbiter,"[30] it again bears observing that in relation to prospective clawback provisions, there is no interloping arbiter for it is the parties themselves who will have agreed on when and how the underlying contractual bargain is modified.

A central pillar of the Article is the critical distinction it draws between "*retroactive* clawbacks—those that . . . are imposed after the contractual right to the bonuses has arisen and the benefits have been conferred—and *prospective* clawbacks that are introduced into contracts before the claim of right to the benefits has arisen."[31] Precisely because "any efforts to cure the inequity *retroactively* have to confront the particular legal rights that make the inequity possible"[32] and lead to considerable difficulties of implementation (including potential problems of subjectivity), we have "argued that prospective clawbacks will be a far more effective way of addressing the various [issues] that arise in executive compensation and Ponzi schemes."[33]

III. THE IMPLEMENTATION OF CLAWBACKS

The Response also fusses over the technical details of implementing clawbacks.[34] One particular concern is what the Response refers to as "measurement problems" associated with defining triggers for clawbacks in a meaningful fashion, say, for recovering executive overcompensation.[35] This enterprise will of course not be full grown at its inception, but the contractual nature of prospective clawbacks will mean that the parties will generally negotiate and therefore focus explicitly on the scope and content of such clawbacks. The conflicting incentives of the parties provide further cause for optimism that their triggers will be carefully described. Accordingly, any "measurement problems" will be significantly reduced over time.

29. *Id.* at 7.
30. *Id.*
31. Cherry & Wong, *supra* note 1, at 372 (emphasis in original).
32. *Id.* at 415 (emphasis in original).
33. *Id.* at 416.
34. *See* Macchiarola, *supra* note 2, at 12–17.
35. *Id.* at 15.

The Response also worries about certain practicalities of collection. For example, the Response mentions the "practical difficulties of getting employees to return paychecks that they have already cashed, spent, and paid taxes on," and notes that these are "likely to represent a significant burden to effective implementation."[36] However, these problems are far from insurmountable, as these are precisely the issues that payroll processors and forensic accountants deal with on a daily basis. While any such collection should be monitored for accuracy, for example, to ensure that the clawback amount takes into account the amount of applicable tax that has been paid, this is not that difficult of a calculation to perform.

As an illustration, we offer our own (perhaps ironic) example. After winning our school's Sprankling Award for Faculty Scholarship based in part on the Article, we were accidentally given two bonuses—one via check at the award ceremony, and one via direct deposit through payroll. When the matter came to our attention, we agreed that one of the transactions would need to be unwound. Such was the case even though one of us had in the interim cashed the check in addition to receiving the bonus through direct deposit, and had bills automatically and electronically paid from those deposited funds. Although there was initially some confusion about the amount to be paid back (i.e., whether it was net or gross after tax), the matter was resolved with a few emails to the payroll department and the money was returned. While there was perhaps some fifteen to twenty minutes' worth of administrative energy expended on the exercise, it was far from an insurmountable or impracticable task.[37]

Another concern raised by the Response is that of enforceability.[38] The Response questions "whether (and to what extent) privately negotiated provisions, whether in the investment agreement or executive compensation context, will be respected by a regulator or a court."[39] But prospective clawbacks, like any other privately negotiated provision, are binding on the parties and there is no reason to think that they will

36. *Id.*

37. We recognize of course that our situation involves neither a prospective clawback nor unfair enrichment. The point here, however, is that the collection issues raised by the Response (and which are equally applicable to our situation) are not as insuperable as the Response makes them out to be.

38. Macchiarola, *supra* note 2, at 16.

39. *Id.*

not be similarly enforced as a straightforward matter of contract law. That they may be challenged by resort to "appeals and legislative influence"[40] speaks only to how our legal system functions as a whole, and does not begin to differentiate a dispute over prospective clawbacks from any other legal dispute. As things stand, there is a distinct policy in favor of clawbacks that will encourage if not ensure their enforcement. In the realm of executive compensation, as discussed above, the Dodd-Frank Act explicitly requires clawbacks,[41] whereas in the area of Ponzi schemes, the rationale articulated by courts in favor of applying the netting rule—that is, to narrow the gap between winning and losing investors—would extend readily to the application of prospective clawbacks.[42]

The Response additionally suggests, however, that even if there was no dispute over their scope, clawbacks may not be enforced because, for example, a company may decide to "waive the repayment requirement of an employee unable to return the required amount without undue hardship."[43] That an individual company or investor may choose not to enforce a contractual right to monies says nothing about whether there should be such a right. Instead, it says everything about the executory nature of contract law enforcement mechanisms. In short, enforcing prospective clawbacks is, in general, no more problematic than enforcing a(ny) contractual obligation.

CONCLUSION

"Buzz Lightyear: Who is in charge here? Alien Toys (in tone of reverence): The Claw . . . The Claw chooses who will go and who will stay."

–Toy Story.[44]

The Response suggests that "employees or investors will come to fear that their monies are forever doomed to the fate of the stuffed animal in the arcade game—never free to relax in the shadow of the omnipresent claw."[45] Yet, in *Toy Story*, a movie narrated from the perspective of sentient toys, the alien toys who lived in the arcade game actually celebrated, rather than feared, the omnipresent (omnipotent?) claw.

40. *Id.*
41. *See supra* Part I.
42. Cherry & Wong, *supra* note 1, at 402–06.
43. Macchiarola, *supra* note 2, at 16.
44. TOY STORY (Walt Disney Pictures/Pixar Animation Studio 1995).
45. Macchiarola, *supra* note 2, at 7–8.

In truth, only those who hide inside and look back from the shame of having unfairly collected monies need cower in the shadow of the claw. Others who look forward to a bright future outside the box, much like the sentient toys in *Toy Story*, may well embrace what the claw represents.