The Dodd-Frank Clawback And The Problem Of Excess Pay

by Jesse M. Fried and Nitzan Shilon

The Dodd-Frank Act requires firms to adopt clawback policies for recovering certain types of excess pay—overpayments resulting from errors in performance measures (such as reported earnings). The authors discuss the costs of excess pay to investors and explain why most firms' existing arrangements fall far short of what the Dodd-Frank Act is likely to require. The authors also offer guidance to boards seeking to eliminate the types of excess pay not reached by Dodd-Frank.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires publicly traded firms to adopt policies that compel the recovery of certain types of overpayments made to executives on the basis of financial results that turn out to be false and require a restatement. The Securities and Exchange Commission (SEC) is currently developing regulations to implement this new clawback policy requirement.

In a recent study, we found that most firms lack a robust "excess-pay" clawback policy—one that *requires* firms to recover extra pay received by executives as a result of errors in performance measures. The absence of such a policy is likely to reduce firm value by leading to the systematic overpayment of executives and, more important, by weakening and distorting executives' incentives. Dodd-Frank's clawback-policy requirement can thus be expected to improve compensation arrangements at public firms.

However, in our view, Dodd-Frank's clawback requirement does not go far enough. In particular, it does not appear to require firms to recoup excess pay arising from executives' sale of company stock at prices inflated by errors in earnings or other metrics. Permitting executives to keep these forms of excess pay is likely to be detrimental to firms and their shareholders. We recommend that boards seeking to improve executives' incentives implement arrangements beyond those required by Dodd-Frank to address this limitation.

The mismeasurement of performance metrics can lead to erroneously high payouts, or "excess pay."

☐ *Excess pay and its costs to investors.* Executives receive a substantial amount of their pay in the form of incentive compensation—equity and bonuses. Much of this incentive compensation is directly or indirectly tied to quantifiable performance measures. For example, bonuses are often directly linked to a company's annual earnings. In addition, the payoff from executives' sale of equity is indirectly tied to current earnings to the extent that these earnings affect the stock price.

The mismeasurement of these performance metrics can lead to erroneously high payouts, or "excess pay." In many cases, excess pay results from misconduct, such as when executives deliberately inflate earnings or other metrics to boost their own payouts. For example, Gary Winnick, the CEO of Global Crossing, sold more than $700 million worth of stock in the year before the firm filed for bankruptcy, while the company was allegedly inflating sales revenues. Similarly, Qwest insiders sold more than $2 billion of stock while they were overstating revenues as the firm's stock price dropped by over 90 percent from its peak. Unfortunately, these are not isolated cases. Empirical studies consistently report a systematic link between inflated earnings and executive stock sales.

It is not difficult to find examples of executives who have misreported financial results to boost their

Jesse M. Fried *is a Professor of Law at Harvard Law School.* **Nitzan Shilon** *is an S.J.D. candidate at Harvard Law School. [E-mail: jfried@law.harvard.edu]*

bonuses. During the period 2001 to 2004, Fannie Mae executives received millions of extra dollars in earnings-based bonuses and option grants while overstating firm earnings by at least $10 billion. Similarly, during the years 2000 to 2004, Nortel Networks executives engaged in accounting manipulation that triggered tens of millions of dollars in "return to profitability" bonus payments. The secret backdating of executive option grants and nonexecutive employee option grants also boosted reported earnings in affected firms by billions of dollars, thereby increasing executives' bonus payouts.

Excess pay can also arise in the absence of misconduct. For example, a number of firms appeared to engage openly in the backdating of employees' option grants because of an innocent misunderstanding of the relevant accounting rules. Such option-grant backdating erroneously boosted reported earnings and thereby inflated any bonuses based on these earnings. To the extent that the higher reported earnings inflated the stock price, executives were also able to sell their own shares for a higher price. Even executives in these firms who were acting in good faith may well have received substantial amounts of excess pay.

Even if a firm is not substantially weakened or destroyed by financial reporting manipulation, the out-of-pocket costs of such manipulation can be substantial.

Excess pay imposes three types of costs on investors. First, whether or not executives' receipt of excess pay results from misconduct, excess pay reduces the amount of value available to shareholders. For example, an executive who is paid $1 million based on misstated earnings, but who should have been paid $500,000 based on actual earnings, receives $500,000 that otherwise could have been distributed to shareholders or invested in the firm on their behalf.

Second, the possibility of overpayment can hurt shareholders by undermining the desirable effects of incentive-based compensation arrangements. Large incentive payments are justified as necessary to motivate managers to generate firm value. Permitting executives to keep pay that is not merited by actual performance reduces the payoff differential between good and poor performance, thereby weakening pay-performance sensitivity and executives' incentives to increase firm value. Again, this problem arises whether or not the excess pay is the result of misconduct.

Third, the ability to reap excess pay via manipulation can lead executives to take steps that impose direct costs on the firm. For example, Enron executives' manipulation of earnings destroyed a business with an estimated $30 billion of firm value. Even if a firm is not substantially weakened or destroyed by financial reporting manipulation, the out-of-pocket costs of such manipulation can be substantial. For instance, firms that restated their financial results following SEC allegations of accounting fraud during the period 1996 to 2002 collectively paid an extra $320 million in taxes while overstating their earnings by $3.36 billion, which may well have enabled managers to sell their shares at higher prices. Fannie Mae alone incurred more than $1 billion in expenses cleaning up its books when its executives, who had been given high-powered incentives to boost earnings, overstated earnings by $10 billion. In each of these cases, the amount of firm value lost to the government and outside accountants far exceeded the excess pay received by the executives.

The likelihood that an executive of any particular firm would be required by the SEC to return pay has been quite small.

☐ *The inadequacy of the SOX clawback.* Section 304 of the Sarbanes-Oxley Act (SOX) gives the SEC the ability to recoup certain payments made to executives. It can be applied when a firm is required to prepare an accounting restatement due to material noncompliance as a result of misconduct with any financial reporting requirement. In such a case, Section 304 enables the SEC to require the CEO and CFO of the firm to return to the firm any bonus or other incentive- or equity-based compensation received within 12 months of the misleading financial statement, as well as any profits realized from the sale of stock during that period.

Notably, in the event of a required restatement and a finding of misconduct, the SEC could recover not only excess pay but *all* of the incentive pay received in the 12-month period following the misleading statement. Relative to a clawback targeted solely at *excess* pay, the SOX recovery provision appears quite punitive. However, the SOX clawback is very unlikely to be deployed, substantially reducing its deterrence (and recovery) effects. To begin with, the SOX clawback can only be deployed if there has been misconduct. As previously discussed, excess pay can impose substantial costs on investors even if there is no misconduct by diverting value from investors and undermining payperformance sensitivity. The SOX clawback cannot do anything to mitigate these costs.

Moreover, even if there has been misconduct at a particular firm, significant resource constraints make it difficult for the SEC to determine that misconduct has occurred and prosecute a Section 304 clawback action. As a result, the likelihood that an executive of any particular firm would be required by the SEC to return pay has been quite small. Indeed, the SEC has deployed the SOX clawback very infrequently during the last decade and, in most of the cases, the targeted executives had first been convicted of criminal fraud.

Our study of S&P 500 firms indicates that, unfortunately, most firms have failed to put in place clawback policies that require them to recover excess pay resulting from errors in performance measures.

While we found many gaps in the clawback policies of the firms studied, we focus on the two defects that most undermine the effectiveness of these policies. First, the overwhelming majority of S&P 500 firms gave directors discretion not to recoup excess pay. Second, most firms with clawback policies barred directors from recouping excess pay unless the executive had engaged in misconduct.

More than 90 percent of S&P 500 firms gave directors discretion whether to recoup excess pay. To begin, nearly 50 percent of S&P 500 firms did not have any excess-pay clawback policy. Firms that lacked such a clawback policy ranged from companies with market capitalizations in the hundreds of billions of dollars, like Apple and AT&T, to smaller, less well-known firms. Directors of those firms are, of course, free to decide whether to recoup excess pay.

Too Few Clawback Policies?

Excess Pay Clawback Policies In S&P 500 Firms (Mid-2010)

Market capitalization (as of August 2010)	Number of firms with policy	Percent of firms with policy
> \$100B (21 firms)	16	76%
\$10B–\$100B (214 firms)	126	59%
\$1B–\$10B (250 firms)	109	44%
Total 485 firms*	251 firms	52%

* Sample of 485 S&P 500 firms; excludes 15 companies subject to special TARP clawback restrictions at time of study.

Source: Jesse Fried and Nitzan Shilon, "Excess-Pay Clawbacks," Journal of Corporation Law, *36, pp. 722–751, 2011*

Among the remaining S&P 500 firms that had fully disclosed excess-pay clawback policies, 81 percent gave boards discretion to let an executive keep the excess pay even if the board found that the executive had committed misconduct. Consider, for example, Procter & Gamble's 2010 clawback policy, which states: "The committee has adopted the Senior Executive Officer Recoupment Policy that *permits the company to recoup or 'claw back'* [certain bonus and incentive] payments made to executives in the event of a significant restatement of financial results for any reason." The policy fails to require the board to seek recovery of excess pay; it merely gives directors the ability to seek recovery, allowing the board to decline to recover all or any excess pay.

Unfortunately, directors seldom use their discretion to recover excess pay from executives. As *The New*

York Times reported in 2005, "[C]ompanies very, very rarely—as in almost never—get that money back."

Forcing an executive to return pay would embarrass and financially hurt the executive.

The reason for this reticence is simple: Directors incur significant personal costs when they seek to recover excess pay from current or departed executives. Forcing a current executive to return excess pay would obviously impose a financial cost on the executive and be embarrassing, especially if the executive was responsible for the error that gave rise to the excess pay. If directors feel loyal to the executive or otherwise care about their relationships with the executive, they are likely to find it awkward to seek to recover excess pay.

The board of Las Vegas Sands Corporation found itself in this position several years ago. Directors accidentally gave chairman and CEO Sheldon Adelson an extra $1 million in 2005 as a result of what the company termed an "improper interpretation" of his employment contract. The compensation committee voted 3 to 1 to allow Adelson to keep the $1 million, even though Sands' stock had declined 18 percent during the year. The committee justified its decision based on the "outstanding performance of the company in 2005." Of the three compensation committee members who voted to allow Adelson to keep the excess pay, two were or had been affiliated with another of Adelson's businesses, suggesting that loyalty to Adelson may have influenced their decision.

A departing CEO is more likely to be a friend if directors do not aggressively pursue the recovery of the CEO's excess pay.

It may be somewhat less costly for directors to recover excess pay from a departing or departed executive, who has much less influence over directors after leaving the firm. However, directors will still incur substantial personal costs in seeking to recoup excess pay from departed executives. First, an executive will typically litigate rather than turn over the money sought by the board. Litigation is not merely unpleasant for directors; it could also reveal potentially embarrassing facts about their service on the board. Second, directors seeking recovery will forfeit the value of their relationships with the executive. Directors tend to be interested in maintaining good relationships with departing or departed executives because these executives can perform favors for them in the future. As one corporate lawyer put it, "It's quite normal for a board to want the departing CEO to be a friend, not an adversary." A departing CEO is more likely to be a friend if directors do not aggressively pursue the recovery of any excess pay that the CEO received.

Given these considerations, directors are likely to let executives departing the firm keep any excess pay. Indeed, this is precisely what happened at Fannie Mae. CEO Franklin Raines departed the firm in late 2004 following an earnings-manipulation scandal after he had reaped millions of dollars in excess pay from bonuses based on inflated earnings. Not only did Fannie Mae's directors allow Raines to keep the excess pay, but they also gratuitously boosted his pension on the way out.

Some might argue that giving directors discretion not to recoup excess pay could benefit shareholders by allowing boards to forgo recovery in cases where the costs of a clawback are greater than the amount of excess pay. We find this argument unpersuasive for two reasons.

First, giving boards discretion is likely to drive up the cost of recovery. If an executive knows that the firm will pursue him until the excess pay is recovered, he has little incentive to resist recoupment. Thus, the cost of recovery will be low. If, on the other hand, the executive knows that directors have discretion over the recovery of excess pay, he has a strong incentive to drive up the cost of the process to deter directors. A policy requiring directors to recoup excess pay could therefore actually lower the cost of recovery.

Second, even if the cost of recovery always exceeds the excess pay recouped, there are likely to be desirable deterrence effects associated with a policy requiring recoupment. Suppose, for example, that by manipulating a compensation metric, Executive A will generate excess pay of $5 million. Suppose further that the cost of recovering that excess pay is $10 million. If Executive A knows that the firm will not seek to recover the $5 million because it will cost the firm $10 million, Executive A has an incentive to manipulate the compensation metric and reap an extra $5 million at shareholders' expense. If, on the other hand, the firm commits in advance to recover the money (even though it will impose a net cost on the firm of $5 million), Executive A has no incentive to manipulate the compensation metric, and the firm will not incur any recovery costs. The firm's shareholders are $5 million better off by having committed to spend $10 million to recover $5 million of excess pay. Requiring boards to recover excess pay, even if it is costly to do so, is thus likely to lower recovery costs by reducing both executives' resistance to returning excess pay and the likelihood that such excess pay will arise in the first instance.

A second major problem with firms' clawback policies is that they frequently bar recoupment in the absence of misconduct. Our study found that more than two-thirds of S&P 500 firms with clawback policies indicate that directors cannot recoup excess pay unless there is a finding of executive misconduct. In other words, an executive can keep excess pay—no matter how much—unless the company determines that the executive has committed misconduct. Consider, for example, IBM's 2010 clawback policy:

> "To the extent permitted by governing law, the company will seek to recoup any bonus or incentive paid to any executive officer if (i) the amount of such payment was based on the achievement of certain financial results that were subsequently the subject of a restatement, (ii) the board determines that such officer engaged in misconduct that resulted in the obligation to restate, and (iii) a lower payment would have been made to the officer based upon the restated financial results."

The policy commits the company to recoup an inflated bonus from an executive only if the misstatement giving rise to the excess pay was due to the executive's misconduct. If there is no misconduct, the executive would be free to pocket the excess pay.

When a clawback cannot occur absent a finding of misconduct, directors may use their discretion to wrongly conclude there was no misconduct.

The costs of permitting an executive to keep excess pay absent misconduct are substantial. Allowing an executive to pocket excess pay even in the absence of misconduct confers an undeserved windfall on the executive at shareholders' expense. It also reduces the performance sensitivity of the executive's compensation, thereby undermining incentives to increase firm value.

A misconduct hurdle also reduces the likelihood of recovery even if there was, in fact, misconduct. Directors may use their discretion to wrongly determine that there has not been misconduct for the same reasons that they are reluctant to recoup excess pay more generally: the personal costs of recouping pay from an executive far exceed the benefits. In other words, a misconduct requirement may give boards an excuse not to demand repayment. Additionally, when misconduct has in fact occurred, even directors acting in good faith may have difficulty detecting it. In either case, the executive will be permitted to keep excess pay despite having committed misconduct. This, in turn, will systematically transfer additional value from shareholders to executives and further undermine the deterrent effect of the clawback policy.

In short, a "misconduct" requirement enriches undeserving executives, undermines pay-performance sensitivity, and reduces deterrence against misconduct without any significant offsetting benefits. The apparent culpability or innocence of an executive should not affect the executive's ability to keep pay that was unearned.

☐ *Benefits of the Dodd-Frank clawback requirement.* The Dodd-Frank Act instructs the SEC to create a clawback policy requirement. Under the Act, the SEC must direct each national securities exchange to require every listed company to put in

Beyond Dodd-Frank
Limiting Excess Pay From Stock Sales

To minimize excess pay arising from sales of stock by executives, boards should consider one or more of the following steps:

☐ To reduce executives' ability to reap large profits from prices temporarily inflated by erroneous earnings or other metrics, equity payoffs should not depend on a single day's stock price. Instead, the payoff should be based on the average stock price over a significant period of time, perhaps six months or a year.

☐ To reduce executives' ability to profit from selling on inside information, require their intended sales to be disclosed in advance. Disclosures of large or unusual sales would intensify scrutiny of the firm's accounting results and prospects, lowering the stock price and executives' trading profits when such scrutiny leads investors to believe that the stock is overpriced.

☐ To eliminate (not just lessen) executives' ability to trade on inside information and substantially reduce their incentive to manipulate the stock price, adopt a "hands-off" arrangement under which restricted stock and stock options are cashed out according to a fixed, gradual, and preannounced schedule set when the equity is granted.

place a clawback policy to recover certain incentive compensation paid to executives when the firm is required to prepare an accounting restatement. The clawback policy must provide that if a firm is required to restate its financial statements due to "material noncompliance" with financial reporting requirements under the securities laws, the company will recover from current and former "executive officers" any "incentive-based compensation" (including any stock option award) that is based on "erroneous data," received during the "three-year period preceding the date on which the company becomes required to prepare an accounting restatement," and in excess of what would have been paid if calculated under the restatement.

Section 954 of Dodd-Frank differs from the SOX recovery provision in a number of important ways.

▫ Dodd-Frank requires firms to recover excess pay; the SOX clawback can only be invoked by the SEC.

▫ The SOX clawback can be triggered only if the restatement is the result of "misconduct," while Dodd-Frank requires recovery of excess pay even absent misconduct.

▫ SOX allows the recovery of all incentive pay, while Dodd-Frank requires the clawback of only certain types of excess pay.

The SEC is currently developing regulations for implementing Dodd-Frank's clawback policy requirement. The exact contours of this clawback requirement have not yet been determined. While the devil will be in the details, it nevertheless appears that Dodd-Frank will have significant effects on compensation arrangements. Prior to Dodd-Frank, fewer than 2 percent of S&P 500 firms had policies requiring the clawback of excess pay whether or not there had been misconduct on the part of the targeted executive. After Dodd-Frank, all publicly traded firms must have such a clawback policy, substantially increasing the likelihood that excess pay will be recouped.

Requiring publicly traded firms to put in place robust clawback policies will generate three important benefits for shareholders. First, it will reduce the diversion of value from shareholders to executives via excess pay. Second, it will improve the performance sensitivity of executives' compensation arrangements by more closely tying payouts to actual performance; this, in turn, will increase executives' incentive to generate value for shareholders. Third, it will reduce executives' incentive to manipulate earnings and other compensation-affecting metrics.

☐ *Beyond Dodd-Frank: minimizing excess pay from stock sales.* Although Dodd-Frank's clawback requirement will substantially improve clawback arrangements at public firms, it does have a number of limitations. Most important, Dodd-Frank does not seem to require a policy to claw back the excess proceeds from sales of stock made while the firm was inflating earnings or other metrics.

Dodd-Frank requires firms to adopt a policy that will recover from an executive "who received incentive-based compensation" in "excess of what would have been paid to the executive" in the event that certain conditions are met. Because the proceeds of a stock sale are not "paid" by the firm, the SEC may interpret

Dodd-Frank as not requiring firms to adopt a policy to recover the extra proceeds an executive receives by unwinding equity incentives at a stock price inflated by errors in performance metrics.

Such an omission would be problematic even if other elements of an executive's compensation arrangement are subject to recovery under a Dodd-Frank-compliant clawback policy. Executives will still have an incentive to manipulate earnings before they dispose of large amounts of stock. Indeed, earnings manipulation prior to stock sales has been quite common.

Firms should structure executives' equity plans to make it harder for them to profit from selling stock when the price is inflated by erroneous earnings.

We do not suggest trying to remedy this problem by expanding clawbacks to reach excess stock-sale proceeds (the difference between what the executive actually received selling stock and the amount that he would have received absent the metric errors). The reason is simple: it would be complicated for firms to calculate what the stock price would have been absent the errors and thereby determine the amount of excess stock-sale proceeds.

Instead, we suggest structuring executives' equity arrangements to make it difficult for executives to profit heavily from selling stock when the price is inflated by erroneous earnings or other metrics. To begin with, firms should limit the extent to which the payoff from stock sales depends on a single day's price. Rather, an executive's equity payoff should be based on the average stock price over a significant period of time. For example, the payoff from the liquidation of equity incentives could be based on the average stock price over the preceding year. If the executive's payoff is not based on the stock price over a short period, the incentive to manipulate the short-term stock price prior to unwinding the equity would be substantially diminished.

One or two additional steps should also be taken. First, executives could be subject to a "hands-off" arrangement that leaves them no discretion over when their equity is cashed out. Under this arrangement, restricted stock and stock options would be cashed out according to a fixed, gradual, and pre-announced schedule set when the equity is granted. Because each sale would involve only a small amount of stock and the executive would have no control over the timing of the sale, the executive would have much less incentive to manipulate the stock price around the sale.

Second, to the extent that executives have any discretion over when they cash out their equity, they should be required to disclose their intended unwinding in advance. Such advance disclosure would notify the market that executives might be manipulating the short-term stock price or be aware of bad news, thereby intensifying scrutiny of the firm's accounting results and prospects. This would lead to a downward adjustment in the stock price to the extent that investors believe the firm is "hiding something." Coupled with average-price payoffs, advance disclosure would further reduce executives' ability to profit from manipulating a firm's stock price.

In short, Dodd-Frank appears to allow executives to keep windfalls from stock sales made when earnings or other price-affecting metrics are erroneous, even if these deviations result from deliberate manipulation. This deficiency cannot easily be fixed through an excess-pay clawback policy because of the difficulty of determining the extent of excess stock-sale proceeds reaped by an executive. Instead, it can be mitigated by structuring executives' equity incentives so as to reduce their motivation and ability to manipulate earnings and other metrics before they unload shares.

In conclusion, executives' receipt of excess pay imposes substantial costs on shareholders. By requiring firms to adopt policies mandating the recovery of certain types of excess pay, the Dodd-Frank Act is likely to improve compensation arrangements at public firms. However, Dodd-Frank does not reach all types of excess pay, and directors should thus take additional steps to minimize excess pay and its costs. ■