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EXCESS-PAY CLAWBACKS

Jesse Fried
Nitzan Shilon

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Jesse Fried^{*}

Nitzan Shilon^{**}

Abstract

We explain why firms should have a clawback policy requiring directors to recover “excess pay”—extra payouts to executives resulting from errors in performance measures (such as reported earnings). We then analyze the compensation arrangements of S&P 500 firms and find that very few have voluntarily adopted such a policy. Our findings suggest that the Dodd–Frank Act, which requires firms to adopt a policy for clawing back certain types of excess pay, will improve compensation arrangements at most firms. We also suggest how firms should address the types of excess pay not reached by Dodd–Frank.

^{*}Professor of Law, Harvard Law School.

^{**}SJD Candidate, Harvard Law School. We would like to thank Joy Batra, Stephen Dee, Daniel Doktori, Edward Dumoulin, Dan Friedman, June Hwang, Leon Johnson, Steven Kochevar, Da Lin, Michael Mirochnik, and Katherine Petti for excellent research assistance, and the students of *The Journal of Corporation Law* for their valuable editing work. Joe Bachelder, Lucian Bebchuk, Ben Heineman, and Robert Jackson provided helpful comments. We would also like to thank Equilar, an executive compensation research firm, for providing complimentary use of their reports. Finally, we are grateful for financial support from Harvard Law School, the John M. Olin Center for Law, Economics, and Business, and the Harvard Law School Program on Corporate Governance.

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Jesse Fried*

Nitzan Shilon**

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I. INTRODUCTION

On July 21, 2010, President Obama signed into law the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank).¹ Among other things, Dodd–Frank requires publicly-traded firms to adopt policies that compel the recovery of certain payments made to executives on the basis of financial results that turn out to be false and require a restatement.² In particular, a firm that is required to restate its financial results must recover certain incentive-based compensation paid to an executive that exceeds the amount he would have received under the restated results.³ The Securities and Exchange Commission (SEC) is currently developing regulations to implement this new clawback policy requirement.⁴

A number of legal academics have criticized the federal government for imposing this excess-pay clawback requirement on all publicly traded firms.⁵ Mandating such clawback policies, they argue, is an unnecessary and undesirable intrusion into these firms’ compensation arrangements; private ordering will yield better results.⁶ Indeed, over 80% of Fortune 100 firms had voluntarily adopted some form of clawback policy before Dodd–Frank was enacted⁷—a pattern that appears to support these critics’ claims.

This Article explains why Dodd–Frank’s clawback-policy requirement will likely improve compensation arrangements at public firms, but does not go far enough. Part II

1. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2. This requirement is embodied in a new Section 10D to the Securities Exchange Act of 1934. *Id.* § 954.

3. *Id.*

4. See Jeffrey S. Klein & Nicholas J. Pappas, *New Clawback Requirements for Listed Public Companies*, N.Y. L.J., Oct. 4, 2010 (reporting that the SEC was planning to propose implementing rules during April–July 2011).

5. See, e.g., Stephen M. Bainbridge, *Dodd–Frank: Quack Federal Corporate Governance Round II* (UCLA Sch. Of Law, Law-Econ. Research Working Paper No. 10–12, 2010), available at <http://ssrn.com/abstract=1673575> (criticizing the Dodd–Frank clawback as unfairly penalizing executives and describing the clawback, along with the entire Act, as corporate governance quackery); Larry E. Ribstein, *Financial Reform That Isn’t*, FORBES.COM (July 8, 2010), <http://www.forbes.com/2010/07/08/financial-reform-bill-hedge-funds-opinions-columnists-larry-e-ribstein.html> (criticizing the Dodd–Frank clawback for enabling the recovery of payments to “innocent executives” and arguing that the development of such provisions should be left to states competing for corporate charters).

6. See, e.g., Ribstein, *supra* note 5 (claiming that state competition for corporate charters will lead to desirable compensation arrangements).

7. Press Release, Equilar, Clawback Prevalence Continues to Rise in Fortune 100 (Aug. 25, 2010), available at http://www.equilar.com/press_20100825.php.

discusses why 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—would be expected to boost “firm value,” the value flowing to all of the firm’s shareholders over time.⁸ We begin by showing that an executive’s ability to keep excess pay imposes costs on shareholders, even if the executive has not committed misconduct. We then explain why, absent a robust excess-pay clawback policy, executives will often be able to keep any excess pay that they receive. First, the recovery provision of the Sarbanes–Oxley Act of 2002 (SOX)⁹ is unlikely to be used to claw back an executive’s excess pay. Second, when given discretion, directors cannot be expected to choose to recoup excess pay from either current or departed executives.

Part III examines excess-pay clawback policies prior to Dodd–Frank: Did firms put in place robust policies—policies requiring boards to recoup excess pay? We find that, before Dodd–Frank, nearly 50% of S&P 500 firms had no excess-pay clawback policy whatsoever. Of those firms with clear policies, 81% did not require directors to recoup excess pay but rather gave directors discretion to allow executives to keep excess pay. Of the remaining firms, 86% did not permit directors to recoup excess pay absent a finding of “misconduct.” As a result, less than 2% of S&P 500 firms required directors to recover excess pay from executives whether or not there was misconduct. Thus, on the eve of Dodd–Frank, most S&P 500 executives were not subject to robust excess-pay clawback policies. We conclude Part III by offering two explanations for firms’ failure to voluntarily adopt adequate clawback policies before Dodd–Frank.

Part IV turns to Dodd–Frank’s clawback requirement, which mandates that publicly-traded firms adopt a policy to recover certain kinds of excess pay received by executives when a restatement is required, regardless of whether there has been misconduct. We explain why, given the inadequacy of the SOX clawback and firms’ own weak excess-pay clawback policies, Dodd–Frank is likely to substantially improve the quality of compensation arrangements at most publicly-traded firms. We also consider—and reject—the argument that Dodd–Frank will undesirably reduce the use of incentive pay in public firms.

Part IV then explains that Dodd–Frank’s requirement does not mandate the recovery of all types of excess pay. First, Dodd–Frank does not compel firms to recoup excess pay from executives unless a restatement is required. Second, Dodd–Frank 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. We discuss why permitting executives to keep these forms of excess pay is likely to be detrimental to firms and their shareholders. We also suggest how boards seeking to improve executives’ incentives should address these two limitations. Part V concludes.

Before proceeding, we wish to emphasize that a publicly-traded firm may need to be subject to other types of clawback policies besides one targeted at excess pay. For example, in a financial firm, it may be desirable for the government to recover payments to executives whose decisions put the firm at risk and necessitated a government bailout,

8. In another work, one of us has used the term “aggregate shareholder value” to describe the value flowing to all of the firm’s shareholders over time. See Jesse M. Fried, *Share Repurchases, Equity Issuances, and the Optimal Design of Executive Pay*, 89 TEX. L. REV. 1113, 1114 (2011) (defining “aggregate shareholder value”). We use the term “firm value” here to mean “aggregate shareholder value.”

9. Sarbanes–Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (2002).

whether or not there were errors in the metrics used to determine those payments.¹⁰ Such insolvency clawbacks would deter executives from taking risks at taxpayers' expense. And should the firm require a bailout, insolvency clawbacks would reduce the cost of the bailout to taxpayers. Similarly, it may be desirable to claw back the pay of executives who engage in certain types of misconduct, such as unethical behavior or violations of the duty of loyalty, even if their pay is properly calculated. Such misconduct clawbacks could deter executives from acting in certain ways that harm the corporation and its shareholders.¹¹ However, our focus in this Article is only on excess-pay clawback policies: policies designed to recover extra pay that executives receive solely because of errors in earnings or other performance metrics.

II. THE PROBLEM OF EXCESS PAY

This Part describes why excess pay can impose large costs on investors. Part II.A explains that errors in earnings or other compensation-related metrics often inflate executive pay. If such unearned pay were likely to be recovered, it would not impose substantial costs on shareholders. However, as Part II.B discusses, shareholders cannot rely upon the SEC or directors who have discretion over whether to recoup excess pay to recover such pay.

A. Excess Pay and its Costs to Investors

Executive compensation arrangements are likely to give rise to erroneously high payouts to executives. These excess payouts can impose substantial costs on shareholders when they are not recovered.

1. The Likelihood of Executives Receiving Excess Pay

Executives receive a substantial amount of their pay in the form of incentive compensation—equity and bonuses.¹² 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.¹³ In addition, the payoff from executives' sale of equity is indirectly tied to current earnings because reported earnings affect the stock price.¹⁴

10. See Jesse M. Fried, *Uncle Sam Should Claw Back Wall Street Bonuses*, S.F. CHRON., Sept. 30, 2008, at B7, available at <http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2008/09/29/ED201385J9.DTL> (arguing that the government should seek to claw back bonuses paid to Wall Street executives shortly before their firms were bailed out by the government). Cf. KENNETH R. FRENCH ET AL., *THE SQUAM LAKE REPORT: FIXING THE FINANCIAL SYSTEM* (2010) (proposing collective holdback for senior managers of financial firms that would be forfeited in the event of bankruptcy or extraordinary government assistance).

11. See Ben W. Heineman, Jr., *Making Sense of Clawbacks and Holdbacks*, BUS. WK., (Aug. 13, 2010), http://www.businessweek.com/managing/content/aug2010/ca20100813_666706.htm (explaining that acts of malfeasance other than those connected to misstatements of financial results should also trigger a clawback).

12. See Huasheng Gao et al., *A Comparison of CEO Pay in Public and Private US Firms* 31–33 (Nov., 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1572406> (reporting that equity compensation and bonuses comprised, on average, 73% of CEO pay in all public firms during the period 1999–2008).

13. See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 124–25 (2004) (describing the structure of various types of bonus plans).

14. See Jesse M. Fried, *Hands-Off Options*, 61 VAND. L. REV. 453, 458–59 (2008) (describing evidence

The mismeasurement of these performance metrics can lead to erroneously high payouts, or “excess pay.”¹⁵ As we explain below, such mismeasurement may arise with or without “misconduct” (however that term is defined) by executives or their firm.¹⁶ Thus, even an executive acting in good faith could end up receiving substantial amounts of excess pay.

Importantly, excess pay is not an inevitable outcome of executive compensation arrangements. Compensation arrangements could be structured to prevent excess pay from arising in the first instance. Firms could address the problem of excess *bonus* pay (and the need for bonus clawbacks) by keeping the bulk of bonuses in “bonus banks” that deliver value to executives only after the accuracy of the results driving the bonuses is assured.¹⁷ Alternatively, as Sanjai Bhagat and Roberta Romano have emphasized, the problem of excess pay (and the need for clawbacks) could essentially be eliminated altogether by compensating executives primarily with equity that must be held until after retirement.¹⁸ But until boards adopt such approaches—for which they currently show little appetite¹⁹—compensation arrangements will continue to generate excess pay.

a. Excess Pay without Misconduct

Excess pay is not always the result of misconduct; it can arise from the accidental mismeasurement of a compensation metric. Suppose, for example, that an executive is to be paid a bonus of \$100,000 for each \$10 million in reported earnings. The executive and the firm take all reasonable precautions to ensure the accuracy of reported earnings. However, the firm’s employees or outside accountants make a book-keeping error or innocently misinterpret the relevant accounting rules, causing the firm to erroneously

on the link between earnings manipulation and insider stock sales).

15. Of course, mismeasurement can also lead to underpayment. However, executives who have been mistakenly underpaid have a strong incentive to seek from the firm any amount they are owed, and directors can be expected to make these executives whole.

16. By “mismeasurement of performance metrics,” we mean mismeasurement according to the accounting standards in effect at the time. If accounting standards are subsequently modified so as to change the measurement of a performance metric that was correct at the time it was made, we would not consider that to be a mismeasurement leading to excess pay.

17. For example, if earnings errors were always corrected within X years, a board could withhold a bonus for X years to ensure that the executive was properly paid. See Nanette Byrnes, *Executive Pay: Bonus Banks*, BUS. WK. (Feb. 4, 2009), http://www.businessweek.com/magazine/content/09_07/b4119000477911.htm (describing several firms’ use of bonus banks where “money can be drawn down . . . provided [the firm] meets or exceeds predetermined operating targets and other benchmarks”); Alex Edmans & Xavier Gabaix, *Tractability and Detail-Neutrality in Incentive Contracting* (N.Y.U., Working Paper No. FIN-08-019, 2009), available at <http://ssrn.com/abstract=1354507> (describing bonus-bank mechanisms for aligning pay with performance).

18. See Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-term*, 26 YALE J. ON REG. 359, 367 (2009) (noting that paying executives solely with equity that could not be cashed out until after retirement would create a “natural clawback” and avoid the need for a separate clawback mechanism). See also Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1919 (2010) (explaining how long-term holding requirements should be structured to better tie pay to performance).

19. See, e.g., Joann S. Lublin, *Law Sharpens ‘Clawback’ Rules for Improper Pay*, WALL ST. J. (July 25, 2010), <http://online.wsj.com/article/SB10001424052748704249004575385500170389086.html> (quoting a compensation expert as estimating that only five percent of publicly-traded firms have bonus deferral arrangements); Nitzan Shilon, *Illusory CEO Ownership Policies* (2011) (unpublished manuscript) (on file with author) (describing the lack of robust equity holding requirements in publicly-traded firms).

report an extra \$20 million in earnings. As a result, the executive receives a bonus that is \$200,000 too high.

The inadvertent receipt of excess pay may well be quite common. For example, it likely occurred in a number of firms that appeared to engage openly and innocently in the backdating of employees' option grants because of a misunderstanding of the relevant accounting rules.²⁰ Such option-grant backdating erroneously boosted reported earnings²¹ 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. The receipt of both types of excess pay did not appear to involve a secret scheme to manipulate earnings or boost other performance metrics. Nevertheless, the executives likely received excess pay.

b. Excess Pay Resulting from Misconduct

Excess pay can also result from wrongdoing; executives may deliberately inflate earnings or other metrics (or pressure others to do so) to boost their own payouts. Unfortunately, it is not difficult to find dramatic examples of executives misreporting financial results to boost their stock-sale profits. For example, Gary Winnick, the CEO of Global Crossing, sold more than \$700 million worth of shares in the year before the firm filed for bankruptcy, while the company was allegedly inflating sales revenues.²² Similarly, Qwest insiders sold more than \$2 billion of stock while they were overstating revenues, as the firm's market capitalization dropped from \$85 billion to \$4 billion.²³

These are not isolated occurrences. A number of empirical studies have found a link between inflated earnings and executive stock sales. One study found that firms that fraudulently misstate their earnings tend to have more insider selling activity.²⁴ Another found that executives of firms that experienced accounting irregularities and were subsequently subject to SEC enforcement action were more likely to have exercised their options in the preceding period.²⁵

It has also not been difficult to find examples of executives misreporting financial

20. See Victor Fleischer, *Options Backdating, Tax Shelters, and Corporate Culture*, 26 VA. TAX REV. 1031, 1038 (2007) (describing firms that openly backdated stock option grants out of ignorance of the accounting rules). Most firms that engaged in option-grant backdating did so secretly. See Jesse M. Fried, *Option Backdating and Its Implications*, 65 WASH. & LEE L. REV. 853, 863–64 (2008) (explaining that thousands of firms engaged in the secret backdating of options).

21. See Fried, *supra* note 20, at 873–74 (explaining how the backdating of employee option grants boosted reported earnings in some firms by over a billion dollars).

22. Henny Sender & Rebecca Blumenstein, *Questioning the Books: Global Crossing Creditors Review Sales, Swaps*, WALL ST. J., Feb. 25, 2002, at A6.

23. Roger Martin, *The Fundamental Problem with Stock-Based Compensation*, ROTMAN, Winter 2003, at 9, available at www.rotman.utoronto.ca/rogermartin/fundamental_problem.pdf.

24. See Scott L. Summers & John T. Sweeney, *Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis*, 73 ACCT. REV. 131, 144 (1998) (reporting that insiders in companies where fraud is found reduce their net position in the entity's stock by engaging in significant selling activity, regardless of whether selling activity is measured by dollars of shares sold, number of shares sold, or number of selling transactions).

25. See Natasha Burns & Simi Kedia, *The Impact of Performance-Based Compensation on Misreporting*, 79 J. FIN. ECON. 35, 63 (2006) (finding that top managers of firms that experienced accounting irregularities and were subsequently subject to SEC enforcement actions had exercised their options in the preceding period at a higher rate than top managers of other firms).

results to boost their bonuses. Consider Fannie Mae. During the period 2001–2004, its executives received millions of extra dollars in earnings-based bonuses and option grants while overstating firm earnings by at least \$10 billion.²⁶ Similarly, during the years 2000–2004, Nortel Networks executives engaged in accounting manipulation that triggered tens of millions of dollars in “return-to-profitability” bonus payments.²⁷ The secret backdating of executive option grants and non-executive employee option grants also boosted reported earnings in affected firms by billions of dollars, thereby increasing executives’ bonus payouts.²⁸

2. *Excess Pay: The Costs to Investors*

Executives’ receipt of excess pay can impose two types of costs on shareholders if the pay is not expected to be—and in fact is not—subsequently recovered: (1) the systematic diversion of value from shareholders to the executives and (2) the destruction of value that is a byproduct of the manipulation aimed at generating excess payouts.

a. *Value Diversion*

Whether executives’ receipt of excess pay is accidental or results from misconduct, excess pay reduces the amount of value available to shareholders. For example, suppose an executive is paid \$1 million based on misstated earnings when he should have been paid \$500,000 based on actual earnings. As a result, the executive receives \$500,000 that otherwise could have been distributed to shareholders or invested in the firm on their behalf.

To be sure, boards could take into account the potential for receiving excess pay when they negotiate an executive’s compensation package. In principle, boards could reduce, dollar-for-dollar, an executive’s salary or pension for every expected dollar of excess pay. In such a situation, excess pay would not lead to systematic over-compensation of executives.²⁹

But compensation based on misreported metrics would be a peculiar type of pay. Excess pay either is random—in the case of accidental misreporting—or arises from misconduct. It is not, in either case, related to an executive’s contribution to firm value.

26. See Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage*, 30 J. CORP. L. 807, 807–12 (2005) (explaining how the structure of Fannie Mae’s compensation arrangements gave executives an incentive to inflate earnings); Eric Dash, *Fannie Mae to Restate Results by \$6.3 Billion Because of Accounting*, N.Y. TIMES (Dec. 7, 2006), http://www.nytimes.com/2006/12/07/business/07fannie.html?_r=1&em&ex=1165726800&en=ce14eaf69685179d&ei=5087%0A (reporting regulators’ conclusion that, of the \$90 million paid to Fannie Mae CEO Franklin Raines during the period 1998–2003, at least \$52 million—more than half—was tied to bonus targets that were reached by manipulating accounting).

27. See Press Release, SEC, SEC Charges Four Former Senior Executives of Nortel Networks Corporation in Wide-Ranging Financial Fraud Scheme (Mar. 12, 2007), available at <http://www.sec.gov/news/press/2007/2007-39.htm> (explaining how Nortel officials misstated revenue by several billion dollars).

28. See Fried, *supra* note 20, at 858–74 (examining the impact of the secret backdating of executive and non-executive option grants).

29. Some commentators have made a similar claim about insider trading profits. See, e.g., Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 881 n.80 (arguing that shareholders end up paying managers the same compensation whether or not managers are permitted to engage in insider trading).

Permitting executives to make such profits is thus an inefficient way to reward them for performance. Indeed, as we explain below, the prospect of receiving excess pay provides executives with incentives to take steps that may reduce firm value.³⁰

b. Value Destruction

When executives engage in misconduct to generate excess pay, they can destroy far more value than the amount of excess pay they ultimately receive. In particular, the possibility of over-payment can hurt shareholders by undermining, and in some cases perverting, the desirable effects of incentive-based compensation arrangements.

To begin, large incentive payments are often justified as necessary to motivate managers to generate firm value.³¹ But 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' incentive to increase firm value.³² This problem arises whether or not the excess pay results from misconduct.

Furthermore, the ability to reap excess pay from misconduct can lead executives to take steps that impose direct costs on the firm. In extreme cases, such manipulation can substantially weaken, if not destroy, the firm.³³ For example, Enron executives' manipulation of earnings destroyed a business with an estimated \$30 billion of firm value.³⁴

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 example, firms that restated their financial statements following SEC allegations of accounting fraud during the period 1996–2002 collectively paid an extra \$320 million in taxes while overstating their earnings by \$3.36 billion,³⁵ which may well have enabled managers to sell their shares at higher prices. Fannie Mae alone incurred over \$1 billion in expenses cleaning up its books after its executives, who had been given high-powered incentives to boost earnings, overstated earnings by \$10 billion.³⁶ In each of these cases, the amount of firm value lost to the government and outside accountants likely exceeded

30. Another reason to be skeptical that excess pay is part of executive compensation arrangements is that there is no evidence that directors or compensation consultants ever calculate expected excess pay when designing compensation arrangements. Absent such a calculation, there is unlikely to be a corresponding reduction in other elements of an executive's pay arrangement to offset expected excess pay.

31. See Michael Jensen & Kevin Murphy, *CEO Incentives: It's Not How Much You Pay, But How*, HARV. BUS. REV., May–June 1990, at 145 (emphasizing the importance to shareholders of giving executives large incentive-based pay packages to encourage performance).

32. See Lucian A. Bebchuk and Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 665 (2005) (noting that executives who receive large amounts of compensation even if they perform poorly will have less incentive to perform well).

33. Michael C. Jensen, *Agency Costs of Overvalued Equity*, FIN. MGMT., Spring 2005, at 5, 10–11.

34. *Id.*

35. Merle Erickson et al., *How Much Will Firms Pay for Earnings That Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings*, 79 ACCT. REV. 387, 406 (2004). Some of these taxes may have been subsequently refunded to the firms.

36. See Marcy Gordon, *Wall St. Applauds Fannie Mae Restatement*, CHI. TRIB., Dec. 7, 2006, at 3 (describing the response to Fannie Mae's 2006 earnings restatement); Bebchuk & Fried, *supra* note 26, at 809–12 (explaining how the structure of Fannie Mae's compensation arrangements gave executives an incentive to inflate earnings).

the excess pay received by the executives themselves.

B. Executives' Ability to Keep Excess Pay

The significant costs to investors associated with excess pay described in Part II.A would not arise if either the SEC or directors could be expected to force executives to return excess pay. However, neither the SEC nor directors exercising their discretion can be depended upon to recoup excess pay.³⁷

1. The SEC's Reluctance to Recoup Excess Pay

As we explain in more detail below, the Sarbanes–Oxley Act (SOX) gave the SEC the power to claw back executive pay in certain situations, but the agency has rarely used this power. The likelihood that any given executive would be subject to the SOX clawback has thus been rather small.

a. The SOX Clawback

In 2002, President Bush signed into law the Sarbanes–Oxley Act (SOX).³⁸ SOX contained a variety of measures aimed at rebuilding investors' confidence in the capital markets, including new rules increasing disclosure requirements, mandating tighter internal controls, and boosting civil and criminal penalties for misreporting.³⁹ It was widely considered to be the most important federal intervention in corporate governance since the enactment of the securities laws in the 1930s.⁴⁰

SOX also contained a clawback provision that applies to publicly-traded companies: Section 304.⁴¹ If a firm is required to prepare an accounting restatement due to material noncompliance, as a result of misconduct, with any financial reporting requirement, 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.⁴²

37. In some cases, shareholders may sue derivatively to recover excess payments. See Phred Dvorak & Serena Ng, *Check Please: Reclaiming Pay From Executives is Tough to Do*, WALL ST. J., Nov. 20, 2006, at A1 (describing shareholder suit against executives of FPL Group Inc. in which executives were forced to return \$9.75 million of \$92 million in cash bonuses for a merger that was never consummated). But such cases are rarely brought because of the costs involved and the substantial procedural hurdles that must be overcome to maintain such a suit. See BEBCHUK & FRIED, *supra* note 13, at 45–48 (describing difficulty of bringing derivative suit). Shareholder suits are thus not an effective method of recovering excess pay.

38. Sarbanes–Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (2002).

39. See Fried, *supra* note 14, at 459 (describing SOX).

40. See, e.g., Jonathan R. Macey & Maureen O'Hara, *Regulation and Scholarship: Constant Companions or Occasional Bedfellows?*, 26 YALE J. ON REG. 89, 93 (2009) (citing Roberta Romano's description of SOX as "arguably the most important federal statute in the area of corporate law and corporate governance").

41. SOX § 304.

42. *Id.* The provision does not specify whether the misconduct must be that of the officer targeted or the firm. Recently, however, a court has accepted the SEC's argument that the clawback can be applied as long as there is some misconduct associated with the false financial statement, even if the executive himself did not commit misconduct. See *SEC v. Jenkins*, 718 F. Supp. 2d 1070, 1074–77 (D. Ariz. 2010) (denying defendant CEO's motion to dismiss the case on the ground that he did not commit misconduct, and holding that misconduct by the issuer, acting through any of its officers, agents, or employees, triggers the reimbursement

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 an excess-pay clawback of the kind required by Dodd–Frank, the SOX recovery provision appears quite punitive. But, as we explain below, the SOX clawback is very unlikely to be deployed, substantially reducing its ex ante deterrent (and ex post recovery) effects.

b. The Limited Effectiveness of the SOX Clawback

As we explain below, the likelihood that the SEC would deploy the SOX clawback against any given executive has been almost zero. Thus, from an executive’s perspective, the expected recovery associated with the SOX clawback is extremely low.

To begin, the SOX clawback can only be deployed if there has been misconduct. However, as we explained earlier, excess pay can impose substantial costs on investors even if there is no misconduct.⁴³ In particular—whether or not there is misconduct—excess pay diverts value from investors ex post and undermines pay–performance sensitivity (and therefore executives’ incentive to generate value) ex ante. The SOX clawback cannot do anything to mitigate these costs.

Moreover, even if there is misconduct, the likelihood that an executive would be forced to return pay under SOX is quite small. Neither boards nor shareholders (derivatively) can use the SOX clawback to sue for a recovery; only the SEC can invoke the provision.⁴⁴ Litigating a clawback case is expensive, especially since the SEC must demonstrate misconduct. Because the SEC faces significant resource constraints,⁴⁵ it can only be expected to seek recovery in a few cases each year.

Indeed, over the last decade, the SEC deployed the clawback very few times. In most of the cases, the targeted executives had first been convicted of criminal fraud.⁴⁶

obligation of a CEO or CFO).

43. See *supra* Part II.A.2 (discussing the costs of excess pay to investors).

44. See, e.g., *Neer v. Pelino*, 389 F. Supp. 2d 648, 657 (E.D. Pa. 2005) (holding that SOX §304 does not provide a private right of action to recover value from executives); *In re Digimarc Corp. Derivative Litig.*, 549 F.3d 1223, 1238 (9th Cir. 2008) (same).

45. See, e.g., *Major Human Capital Challenges at SEC and Key Trade Agencies: Hearing Before the S. Comm. on Governmental Affairs Subcomm. on Oversight of Gov’t Mgmt., Restructuring & the Dist. of Columbia*, 107th Cong. (2002), available at <http://www.gao.gov/new.items/d02662t.pdf> (reporting that “limited resources have forced SEC to be selective in its enforcement activities and have lengthened the time required to complete certain enforcement investigations”); Peter J. Henning, *For the SEC, Problems of Time and Money*, DEALBOOK (Feb. 22, 2011), <http://dealbook.nytimes.com/2011/02/22/for-the-s-e-c-problems-of-time-and-money/?nl=business&emc=dlbkpma22> (describing how resource constraints compromise SEC enforcement efforts).

46. See Jerry W. Markham, *Regulating Excessive Executive Compensation—Why Bother?*, 2 J. BUS. & TECH. L. 277, 299 (2007) (explaining that, as of 2007, the SEC had only sought recovery from executives criminally convicted of fraud); Rachael E. Schwartz, *The Clawback Provisions of Sarbanes–Oxley: An Underutilized Incentive to Keep the Corporate House Clean*, 64 BUS. LAW. 1, 2 (2009) (reporting that as of the sixth anniversary of the enactment of SOX, the SEC has only twice sought to claw back bonuses and compensation, despite the thousands of restatements since SOX was signed into law); Robert Khuzami, SEC Director of Enforcement, Speech to the Society of American Business Editors, Securities and Exchange Commission (Mar. 19, 2010), available at <http://www.sec.gov/news/speech/2010/spch031910rsk.htm> (reporting that in the previous two and a half years the SEC has sought Section 304 reimbursements in 11 cases). Two recent cases in which the SEC sought recovery from executives that were not alleged to have committed misconduct themselves include *SEC v. Jenkins*, 718 F. Supp. 2d 1070, 1073 (D. Ariz. 2010) and *SEC v. O’Dell*,

We cannot precisely determine the number of cases in which the SEC could have deployed the SOX clawback but did not do so. But it is likely to be a significant number, given that thousands of firms restated their earnings during this period.⁴⁷ In many of these firms, executives likely received excess pay as a result of some form of misconduct. For example, the deliberate secret backdating of stock option grants improperly boosted earnings by billions of dollars at hundreds of affected firms.⁴⁸ In short, the likelihood that an executive who had received excess pay would be required to return it via the SOX recovery provision—even if there had been misconduct—has been quite small.⁴⁹

2. Directors' Reluctance to Recoup Excess Pay

The SEC has been unable or unwilling to recover excess pay, except in rare cases. But what about a firm's directors? Assuming that the firm did not structure its compensation arrangement to ensure that an executive could keep excess pay, the firm will have the right to recover any extra pay that the executive received due to a measurement error. Unfortunately, directors who have the right to recover an executive's excess pay cannot be counted on to do so. Indeed, they rarely seek to recover excess pay from executives. As the *New York Times* reported, "[C]ompanies very, very rarely—as in almost never—get that money back."⁵⁰

As we discuss below, the failure of directors to voluntarily recover excess pay can be explained by their personal cost-benefit analyses: for directors, the financial benefit to recovering excess pay from either a current or departed executive is extremely small relative to the cost.

a. Personal Benefit of Recouping Excess Pay

Although directors typically receive some of their compensation in the form of stock

No. 1:10-CV-00909 (D.D.C. June 2, 2010). In both of these cases, there was an allegation that the issuer, but not the defendant, had committed misconduct. As of this writing, *Jenkins* is being settled. See Joel Rosenblatt et al., *Ex-CSK Auto CEO Jenkins Settles SEC Clawback Lawsuit, Court Records Show*, BLOOMBERG BUSINESSWEEK (Mar. 25, 2011), <http://www.businessweek.com/news/2011-03-25/ex-csk-auto-chief-settles-sec-clawback-suit-records-show.html>. In *O'Dell*, the defendant CEO agreed to return the compensation requested by the SEC pursuant to a settlement agreement. SEC v. O'Dell Complaint ¶ 8 (June 2, 2010).

47. There were 4609 financial restatements during the years 2006–2009 among the approximately 10,000 publicly-traded firms. See MARK CHEFFERS ET AL., 2009 FINANCIAL RESTATEMENTS: A NINE YEAR COMPARISON, AUDIT ANALYTICS TREND REP. (2010) (reporting on a study of financial restatements).

48. Fried, *supra* note 20, at 874.

49. Another limitation of the SOX recovery provision is that it can only be used if there is a restatement. As we explain in Part IV, an executive may receive excess pay—perhaps due to misconduct—in situations where the firm does not restate its earnings. Thus any excess-pay recovery provision that cannot be triggered absent a restatement will necessarily be under-inclusive.

50. Jonathan D. Glater, *Sorry, I'm Keeping the Bonus Anyway*, N.Y. TIMES (Mar. 25, 2005), <http://query.nytimes.com/gst/fullpage.html?res=9A00E4DC143CF930A25750C0A9639C8B63>; see Dvorak & Ng, *supra* note 37, (reporting that most boards do not try to recover excess pay received by executives). In unusual cases, executives may give some of the excess pay back. For example, following the Nortel Network episode described in the text, certain executives “volunteered” to give back \$8.6 million in bonuses that they received as a result of inflated earnings. Nonetheless, compensation specialists say that such an event is very rare. See Mark Heinzl & Ken Brown, *Nortel Unveils New Accounting Flubs, Company Details Mistakes, Says Executives Will Return Millions in Bonus Payments*, WALL ST. J., Jan. 12, 2005, at A3 (describing compensation experts' reactions to the voluntary return of \$8.6 million in unearned bonuses by Nortel executives).

or stock options, each director's equity stake as a fraction of outstanding shares is usually insignificant. One study found that median independent director stock ownership is only 0.005% of firm shares.⁵¹ As a result, each director can expect to reap only a tiny amount of the excess pay recovered from a typical executive. Consider, for example, a director who owns 0.005% of the company's shares. Suppose that the director is contemplating whether to seek recovery of \$10 million of excess pay. The increase in value of the director's holdings as a result of recovery would be only \$500. Such a benefit, or even one several times larger, is highly unlikely to exceed the costs of seeking recovery that we detail below.

b. Personal Cost of Recouping Excess Pay

The cost of recouping excess pay from an executive will depend on whether the executive is still at the firm or has departed. We consider both scenarios.

(1) Recovering from Current Executives

As Lucian Bebchuk and one of us have argued, executives have power and influence over directors in publicly-traded U.S. companies that make it personally costly and difficult for directors to make compensation decisions that executives oppose.⁵² For example, a director who was put on the board by a particular executive might feel disloyal in subsequently suggesting that the executive's pay should be reduced or tied more closely to performance. In general, there are a variety of financial, social, and psychological reasons why directors cannot always be counted on to make shareholder-serving compensation decisions.

Forcing a current executive to return excess pay would obviously impose a financial cost on the executive. It could also embarrass the executive, especially if the executive was in some way responsible for the error that gave rise to the excess pay. To the extent that directors feel loyal to the executive or otherwise care about their relationships with the executive, they are likely to find it personally costly to seek to recover excess pay.⁵³ These costs to directors are likely to exceed the small personal financial benefit of recovering excess pay.

Consider the board of Las Vegas Sands Corporation. It accidentally gave chairman and CEO Sheldon Adelson an extra \$1 million in 2005 as a result of what the company

51. John E. Core et al., *Corporate Governance, Chief Executive Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 384 (1999).

52. See, e.g., BEBCHUK & FRIED, *supra* note 13, at 23–27 (describing sources of executives' influence over directors in public companies).

53. To be sure, directors could indirectly recover excess pay by reducing current compensation. However, if the amount of excess pay is sufficiently large, it may not be feasible to reduce current compensation by enough to fully offset the excess payment. Suppose, for example, that the overpayment is \$2 million and the executive's current compensation package is \$3 million. The board thus could in principle reduce current compensation by \$2 million to \$1 million. However, the executive may refuse to work for only \$1 million. And if the executive refuses to work for only \$1 million, ex post settling up will be impossible. Moreover, even if the executive were willing to work for \$1 million, the \$1 million pay package may not provide optimal incentives for the executive to maximize firm value going forward. Thus, even if it were possible to settle up in this manner, it may well be undesirable from shareholders' perspective to recoup previously received excess pay by reducing current compensation.

termed an “improper interpretation” of his employment contract.⁵⁴ But the compensation committee of the board voted 3–1 to allow Adelson to keep the \$1 million.⁵⁵ Although Sands’ stock declined 18% during the year, the committee justified its decision based on the “outstanding performance of the company in 2005.”⁵⁶ Of the three compensation committee members voting to allow Adelson to keep the excess pay, two were or had been affiliated with another of Adelson’s businesses. Yet they were still considered “independent” directors according to the New York Stock Exchange’s listing standards, and thus eligible to serve on Sands’ compensation committee.⁵⁷

(2) *Recovering from Departed Executives*

By the time the board learns that an executive has received excess pay, the executive may well have departed the company. In S&P 500 firms, median CEO tenure is now under six years.⁵⁸ There is thus a reasonable likelihood that an executive will be gone—or on his way out—when the board discovers that the executive has received excess pay.

One might believe that it would be less costly for directors to recover excess pay from a departed executive. After all, the executive has much less influence over directors once he has left the firm. However, directors will still incur substantial personal costs in seeking to recoup excess pay from departed executives—at least relative to the trivial financial benefit to them from such a recovery.

First, an executive will typically litigate rather than turn over the money sought by the board.⁵⁹ Litigation imposes costs on directors. The executive’s lawyers will aggressively question the directors in depositions to put them on the defensive and expose any wrongdoing on their part. This process is not merely unpleasant for directors; it could also reveal potentially embarrassing facts about the directors’ service on the board. For individual directors, the psychological and opportunity costs associated with litigation could be considerable.

More importantly, 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.”⁶⁰ A departing CEO is

54. See Gretchen Morgenson, *Big Bonuses Still Flow, Even if Bosses Miss Goals*, N.Y. TIMES, June 1, 2006, at A1, available at <http://www.nytimes.com/2006/06/01/business/01bonus.html>.

55. *Id.*

56. *Id.*

57. *Id.*

58. See John C. Coates, IV & Reinier H. Kraakman, *CEO Tenure, Performance and Turnover in S&P 500 Companies* (Harv. L. and Econ. Discussion Paper No. 595, 2007), available at <http://ssrn.com/abstract=925532> (reporting an average and a median CEO tenure in companies listed on the S&P 500 from 1992 to 2004 to be fewer than 7 years and 5.5 years, respectively). See also Steven N. Kaplan & Bernadette A. Minton, *How Has CEO Turnover Changed?* (Aug. 2008) (unpublished manuscript), available at <http://faculty.chicagobooth.edu/steven.kaplan/research/km.pdf> (suggesting that average CEO tenure in large companies since 2000 has been less than six years).

59. See Dvorak & Ng, *supra* note 37 (describing executives’ resistance to returning disputed compensation to the firm).

60. See Suzanne Koudsi, *Why CEOs are Paid so Much to Beat it*, FORTUNE, May 29, 2000, at 34–35, available at http://money.cnn.com/magazines/fortune/fortune_archive/200/05/29/280626/index.htm (explaining why directors treat departing executives favorably).

more likely to be a friend if directors do not aggressively pursue the recovery of any excess pay that she received.

Directors' desire to ingratiate themselves with departing executives is evidenced by the fact that directors often provide departing executives with all sorts of emoluments not required by the executives' contracts.⁶¹ Such "gratuitous goodbye" benefits take a number of forms, including accelerated vesting of options and restricted stock, increases in pension benefits (e.g., by "crediting" CEOs with additional years of service), and promises of consulting contracts that will provide the departing CEO with generous annual compensation for little or no work.⁶²

Given this pattern, directors are likely to let executives departing the firm keep any excess pay as well as collect other gratuitous goodbye benefits. Indeed, this is precisely what happened at Fannie Mae. Franklin Raines, Fannie Mae's CEO, departed in late 2004 following an earnings-manipulation scandal after reaping millions of dollars in excess pay from bonuses based on inflated earnings.⁶³ Fannie Mae's directors not only allowed the departing CEO to keep his excess pay, but also gratuitously boosted his pension on the way out.⁶⁴

III. EXCESS-PAY CLAWBACK POLICIES BEFORE DODD-FRANK

As we explained in Part II, executives' ability to receive and retain excess pay can impose substantial costs on shareholders. These costs would not arise if the SEC or directors consistently recovered excess pay from either current or departed executives. However, neither directors nor the SEC can be relied upon to recoup such payments.

Firms could substantially reduce the costs associated with excess pay if they adopted what we call a "robust" clawback policy—one *requiring* the recovery of any excess pay received by executives, whether or not there was misconduct. Such a robust clawback policy would eliminate the diversion of value to executives via excess pay and improve pay-performance sensitivity. It would also reduce executives' incentive to manipulate performance metrics, thereby avoiding the value destruction that is often a byproduct of such manipulation.

Part III.A examines the excess-pay clawback policies that had been voluntarily adopted by S&P 500 firms on the eve of Dodd-Frank. Did firms in fact adopt robust clawback policies? The short answer is "no." We find that nearly 50% of S&P 500 firms had no excess-pay clawback whatsoever. Of the remaining firms, 81% gave directors discretion not to recoup excess pay. And among those firms that had committed to recoup excess pay in at least some circumstances, 86% indicated that they would not recoup excess pay unless the board first found that the executive had committed misconduct. Fewer than 2% of S&P 500 firms had policies requiring executives to return excess pay whether or not there was misconduct.

In Part III.B, we offer two explanations for why most firms did not adopt a robust

61. See BEBCHUK & FRIED, *supra* note 13, at 87–94 (describing the benefits executives receive when leaving their companies, even if they have performed poorly).

62. *Id.*

63. See Bebchuk & Fried, *supra* note 26, at 807 (describing Raines' departure from Fannie Mae); Dash, *supra* note 26 (explaining that Raines reaped tens of millions of bonus dollars as a result of manipulating earnings).

64. Bebchuk & Fried, *supra* note 26, at 814.

excess-pay clawback policy. First, directors are reluctant to adopt arrangements that executives oppose, and executives will understandably oppose a robust clawback policy. Second, the directors themselves may not favor a clawback if they seek to maximize their firm's short-term stock price and believe a clawback policy will inhibit an executive from aggressively boosting short-term results.

A. Excess-Pay Clawback Policies in the S&P 500

Over the last decade, many publicly-traded firms voluntarily adopted clawback provisions. For example, Equilar reports that, while fewer than 18% of Fortune 100 firms had a publicly disclosed clawback policy in 2006, over 80% of Fortune 100 firms had such a policy on the eve of Dodd-Frank in mid-2010.⁶⁵ But how many firms actually had robust excess-pay clawback policies requiring executives to return unearned pay?

To answer that question we examined the actual policies that S&P 500 firms had adopted prior to Dodd-Frank.⁶⁶ The securities laws require firms to provide information on their clawback policies in their proxy statements.⁶⁷ We reviewed each S&P 500 firm's last annual proxy statement before Dodd-Frank and recorded a description of any clawback policy.

Firms covered by the Troubled Asset Relief Program (TARP) were subject to a special clawback provision.⁶⁸ We thus exclude the 15 S&P 500 firms covered by TARP on the eve of Dodd-Frank, leaving us with a sample of 485 S&P 500 firms (denoted hereafter as "S&P 500 firms").⁶⁹

Of these 485 S&P 500 firms, 234 (48%) did not report the existence of an excess-pay clawback policy.⁷⁰ The remaining 251 (52%) had some form of excess-pay clawback policy. Of these 251 firms, 26 provided insufficient information for us to fully determine how their policies worked. This left 225 S&P 500 companies with excess-pay clawback policies that we could analyze (denoted hereafter as "S&P 500 firms with policies").

65. Press Release, *supra* note 7.

66. Cf. Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 389 (2009) (explaining that the actual effectiveness of a clawback mechanism depends on its terms).

67. Regulation S-K requires that publicly-traded firms disclose in their annual proxy statement "policies and decisions regarding the adjustment or recovery of awards or payments if the relevant registrant performance measures upon which they are based are restated or otherwise adjusted in a manner that would reduce the size of an award or payment." Executive Compensation Disclosure, 71 Fed. Reg. 78, 338 (Dec. 29, 2006) (altering Section 402 (b)(2)(viii) of Regulation S-K).

68. Section 111(b)(3)(B) of the Emergency Economic Stabilization Act of 2008 (EESA) required all financial institutions selling troubled assets to the government pursuant to the TARP to adopt a clawback that would recover any bonus, retention award, or incentive compensation paid to certain executives and any of the next 20 most highly compensated employees of the TARP recipient if the compensation was based on materially inaccurate statements of earnings, revenues, gains, or other criteria. 31 C.F.R. § 30.8 (2008).

69. We used data from the U.S. Treasury to identify those firms covered by TARP as of June 2, 2010. See *Troubled Asset Relief Program, Transactions Report for Period Ending June 2, 2010*, U.S. Treasury Dept. Office of Financial Stability, available at <http://www.financialstability.gov/docs/transaction-reports/6-4-10%20Transactions%20Report%20as%20of%206-2-10.pdf>. The 15 firms thereby excluded were AIG, Bank of America, Citigroup, Fifth Third Bancorp, First Horizon National Corp., Hartford Financial Services Group, Inc., Hudson City Bancorp, Huntington Bancshares Inc., KeyCorp, Lincoln National Corp., Marshall & Ilsley Corp., M&T Bank Corp., Regions Financial Corp., SunTrust Banks, and Zions Bancorp.

70. Some of these firms may have had clawbacks aimed at something other than excess pay, such as clawbacks that could be triggered if an executive engaged in "unethical" behavior.

1. No Excess-Pay Clawback Policy in Almost 50% of Firms

We begin by noting the most striking result of our study: nearly 50% of S&P 500 firms did not have an excess-pay clawback policy. Firms that lacked such a clawback policy ranged from companies like Apple and AT&T with market capitalizations in the hundreds of billions of dollars to smaller, less well-known firms.

Importantly, the likelihood of finding an excess-pay clawback policy was substantially lower in smaller companies within the S&P 500.⁷¹ To examine the effect of firm size on the use of excess-pay clawback policies, we divided the S&P 500 into three categories based on market capitalization: (1) Mega Cap firms (market capitalization over \$100 billion); (2) Large Cap firms (market capitalization between \$10 and \$100 billion); and (3) Mid Cap firms (market capitalization between \$1 and \$10 billion). The results are summarized in Table 1 below.

Table 1: Excess-Pay Clawback Policies in S&P 500 Firms (Mid 2010)

<i>Market Capitalization</i>	<i># Firms with Policy</i>	<i>% Firms with Policy</i>
Mega Cap (21 firms)	16	76%
Large Cap (214 firms)	126	59%
Mid Cap (250 firms)	109	44%

While 76% of Mega Cap firms had excess-pay clawback policies, only 59% of Large Cap and 44% of Mid Cap firms had such policies. The strong correlation between size and excess-pay clawback prevalence suggests that the frequency of excess-pay clawbacks among firms too small to be included in the S&P 500 is no higher than 50% and likely to be considerably lower. Indeed, in 2010 only 17% of the 3680 publicly traded firms covered by Institutional Shareholder Services had any type of clawback policy.⁷²

2. The Non-robustness of Excess-Pay Clawback Policies

We now turn our attention to those firms that had excess-pay clawback policies, focusing on those 225 S&P 500 firms that had fully disclosed excess-pay clawback policies on the eve of Dodd–Frank. A close reading of the details of these policies revealed that they generally did not require directors to recover excess pay. Of these 225 firms, 81% gave boards discretion to forego clawbacks of excess pay. Of the remaining

71. Market capitalizations were determined as of August 4, 2010.

72. See Lublin, *supra* note 19 (discussing the prevalence of clawback policies and Dodd–Frank’s new clawback rule).

firms—those that required a clawback in at least some circumstances—86% indicated they would not recoup excess pay unless the board made a finding of misconduct.

a. No Recovery Required

The overwhelming majority of excess-pay clawback policies gave boards discretion not to recoup excess pay, even if the executive had engaged in misconduct. We discuss the lack of a recoupment requirement and explain why it is extremely problematic.

(1) Discretionary Clawbacks

In 81% of the S&P 500 firms with policies (182/225), boards had discretion to forego recovering excess pay, even if the board found that the executive receiving the excess pay had committed misconduct.⁷³ Consider, for example, Procter & Gamble's 2010 clawback policy: "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."⁷⁴ Thus, Procter & Gamble fails to require the board to seek recovery of excess pay; instead, it merely gives directors the ability to seek recovery, allowing the board to decline to recover all or any excess pay.

In fact, fewer than 20% of S&P 500 firms with policies required directors to recover excess pay in at least some circumstances. Dell is an example of a firm that commits to recover excess pay, at least to the extent practicable. According to Dell's 2010 proxy:

If Dell restates its reported financial results, the Board will review the bonus and other awards made to the executive officers based on financial results during the period subject to the restatement, and, to the extent practicable under applicable law, Dell *will seek to recover or cancel* any such awards which were awarded as a result of achieving performance targets that would not have been met under the restated financial results.⁷⁵

One might argue that we are placing too much weight on the difference between phrases such as "will seek to recover" and "permits the company to recoup." In either case, the argument might go, boards can be expected to recoup excess pay if all other conditions of the clawback are satisfied. However, the choice of words matters, and the lawyers drafting these clawback policies—and the directors reviewing them—presumably paid

73. As we will discuss shortly, a clawback policy that bars recovery unless the board determines that there has been misconduct allows directors to avoid a clawback by wrongly determining that there has been no misconduct. Here we focus on a different problem: directors who have discretion over whether to recoup excess pay may decline to recoup that pay even if they have determined that all other requirements for an excess-pay clawback (such as misconduct) have been satisfied.

74. Procter & Gamble, Notice of Annual Meeting and Proxy Statement (Schedule 14A) at 42 (Aug. 27, 2010), *available at* <http://www.sec.gov/Archives/edgar/data/80424/000119312510198880/ddef14a.htm> (emphasis added).

75. Dell, Notice of Annual Meeting and Proxy Statement 2010 (Schedule 14A) at 39 (May 27, 2010), *available at* <http://www.sec.gov/Archives/edgar/data/826083/000095012310053687/d72405ddef14a.htm> (emphasis added) [hereinafter Dell Proxy Statement]. If Dell's directors were likely to use the "to the extent practicable" limitation to avoid recovering excess pay when it is in fact possible to recover such pay, Dell's clawback policy should be considered discretionary.

careful attention to the language used.

GE's policy illustrates how a single firm uses both "may" and "will" in the same policy to indicate that recovery will always be triggered in some cases but not in others. According to GE's 2010 proxy:

If the Board determines that an executive officer has engaged in conduct detrimental to the company, the Board *may* take a range of actions to remedy the misconduct, prevent its recurrence, and impose such discipline as would be appropriate. Discipline would vary depending on the facts and circumstances, and may include, without limit, (1) termination of employment, (2) initiating an action for breach of fiduciary duty, and (3) if the conduct resulted in a material inaccuracy in the company's financial statements or performance metrics which affect the executive officer's compensation, seeking reimbursement of any portion of performance-based or incentive compensation paid or awarded to the executive that is greater than would have been paid or awarded if calculated based on the accurate financial statements or performance metrics; *provided that if the board determines that an executive engaged in fraudulent misconduct, it will seek such reimbursement.*⁷⁶

GE makes it quite clear that, as long as the board determines that the "detrimental conduct" falls short of "fraudulent misconduct," directors can choose to allow an executive to keep excess pay. By contrast, if the board determines that the executive has engaged in fraudulent misconduct, directors are required to seek recovery.⁷⁷

(2) The Problem with Giving Boards Discretion

In a world where directors could be counted on to use their discretion to recover excess pay from executives, there would be no need for a clawback policy that requires the return of excess pay. When an executive received pay in error, directors would simply force the executive to return it. In such a world, a robust excess-pay clawback policy would be entirely superfluous.

However, as we explained in Part II, directors cannot be relied on to claw back excess pay; for them, the personal cost of seeking recovery dwarfs the personal benefit.⁷⁸ A robust excess-pay clawback policy—one that requires directors to seek recovery—is the only way to ensure that such recovery occurs. A clawback policy that does not require directors to recoup excess pay, but rather merely gives them the option to effect a clawback, may be little better than no clawback policy at all.

One might argue that giving directors discretion not to recoup excess pay could benefit shareholders by allowing boards to forego recovery in those cases where the costs of a clawback are greater than the amount of excess pay. But there are two problems with this argument. First, giving boards discretion is itself likely to drive up the cost of recovery. If an executive knows that the firm will pursue him until the excess pay is

76. Gen. Electric, Notice of Annual Meeting and Proxy Statement 2010 (Schedule 14A) at 26 (Mar. 5, 2010), available at <http://www.sec.gov/Archives/edgar/data/40545/000119312510048722/ddef14a.htm> (emphasis added).

77. Because GE's policy can be expected to give the board discretion in most cases, we classified it as one that gives the board discretion.

78. See *supra* Part II.B.2 (explaining directors' reluctance to recoup excess pay).

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, she has a strong incentive to drive up the cost of the process to deter recoupment. A policy requiring directors to recoup excess pay should therefore lower the cost of recovery.

Second, even if the cost of recovery always exceeds the excess pay recouped, there are likely to be desirable deterrent effects associated with 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 *ex ante*, and the firm will not be required to incur any recovery costs *ex post*. 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 unearned pay and the likelihood that such unearned pay will arise in the first instance.

b. No Misconduct, No Clawback

The overwhelming majority of S&P 500 firms with policies do not require a clawback if the board determines that there has been no misconduct by the executive. We discuss this misconduct requirement below and explain why it is also problematic.

(1) The Misconduct Hurdle to Recovery

Sixty-seven percent of S&P 500 firms with policies indicate that boards will not recoup excess pay unless there is a finding of executive misconduct.⁷⁹ In other words, an executive can keep excess pay—no matter how large an amount—unless the company determines that the executive has committed misconduct.⁸⁰ Among the approximately 20% of S&P 500 firms with policies requiring the recovery of excess pay in at least some circumstances, a full 86% prevent the board from recovering pay absent a determination that the executive has committed misconduct. Companies that have a misconduct requirement include such well-known firms as GE and IBM. Consider 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

79. Some clawback policies permit or require a clawback of excess pay if either misconduct or some other event (such as a restatement) occurs. We consider such policies as not requiring misconduct for recovery of excess pay.

80. Note that this approach is much more lenient than the SOX clawback, which (a) permits recovery if there is misconduct by *either* the executive *or* others at the firm and (b) permits recovery of all the executive's incentive compensation (not just excess pay) in the wake of a restatement. *See supra* Part II.B.1 (describing the scope of the SOX clawback).

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.⁸¹

Thus, IBM commits itself to recouping an inflated bonus from an executive only if the misstated financial results giving rise to the excess pay were due to the executive's misconduct. IBM does not commit itself to recoup an inflated bonus payment if there is no misconduct; the executive would be free to pocket the excess pay.

3M and many other firms make it even harder to claw back excess pay. According to 3M's proxy, "The Company's Board of Directors has adopted a policy requiring the reimbursement of excess payments made to an executive in the event that 3M is required to make a material restatement of its financial statements and that executive's *intentional misconduct* caused the need for the restatement."⁸²

An IBM executive may be subject to an excess-pay clawback if she engages in misconduct. By contrast, a 3M executive cannot be subject to an excess-pay clawback unless she engages in *intentional* misconduct. In other words, if a 3M executive engages in misconduct that is *unintentional*, she can keep her excess pay.⁸³

Only 32% of S&P 500 firms with policies did not impose any misconduct hurdle in their clawback policies. Consider again Dell's 2010 proxy:

If Dell restates its reported financial results, the Board will review the bonus and other awards made to the executive officers based on financial results during the period subject to the restatement, and, to the extent practicable under applicable law, Dell will seek to recover or cancel any such awards which were awarded as a result of achieving performance targets that would not have been met under the restated financial results.⁸⁴

Thus, in the event of a restatement, a Dell executive (unlike an IBM executive) must return excess pay whether or not he has committed misconduct.

(2) *Costs of a Misconduct Hurdle*

The costs of permitting an executive to keep excess pay absent misconduct are substantial. To begin, allowing an executive to pocket excess pay even in the absence of misconduct confers an undeserved windfall on the executive. This windfall, of course, comes at shareholders' expense ex post. It also reduces the performance sensitivity of the executive's compensation ex ante, thereby undermining his incentive to increase firm

81. IBM, Notice of Annual Meeting and Proxy Statement 2010 (Schedule 14A) at 36 (Mar. 8, 2010), available at http://www.sec.gov/Archives/edgar/data/51143/000110465910012758/a09-36376_1def14a.htm (emphasis added).

82. 3M, Notice of Annual Meeting and Proxy Statement 2010 (Schedule 14A) at 52 (Mar. 24, 2010), available at <http://www.sec.gov/Archives/edgar/data/66740/000104746910002668/a2196987zdef14a.htm> (describing 3M's clawback policy) (emphasis added).

83. *Id.* About half the firms with a "misconduct" requirement required something more than mere misconduct to trigger a clawback.

84. Dell Proxy Statement, *supra* note 75, at 39 (disclosing Dell's clawback policy).

value. There is no good reason why the culpability or innocence of an executive should affect an executive's ability to keep money that he did not earn.⁸⁵ Indeed, the executive should not be permitted to keep excess pay even if he took all reasonable steps to avoid the error that gave rise to that pay.

In addition, a misconduct hurdle 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 absent any policy: 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. In addition, 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 *ex post* and further undermine the deterrent effect of the clawback policy *ex ante*.

In short, a "misconduct" requirement enriches undeserving executives, undermines pay-performance sensitivity, and reduces deterrence against misconduct. Although there are many costs to the use of a "misconduct" requirement, there appear to be no significant offsetting benefits.⁸⁶ We certainly cannot think of any.

3. The Big Picture

To summarize the findings discussed above, before Dodd-Frank nearly 50% of S&P 500 firms had no excess-pay clawback policy whatsoever.⁸⁷ The remaining firms had extremely weak policies. Of the firms with policies, 81% (182/225) gave directors discretion to waive the clawback, and 68% (154/225) did not permit directors to recoup excess pay if the board determined that there was no misconduct on the part of the executive.⁸⁸ Fewer than 9% of S&P 500 firms (43/485) required recovery if the board determined that there was misconduct. Fewer than 2% of S&P 500 firms (6/485) required the recovery of excess pay whether or not there was misconduct.⁸⁹ A breakdown of S&P 500 excess-pay clawback policies is illustrated in Figure 1 below.

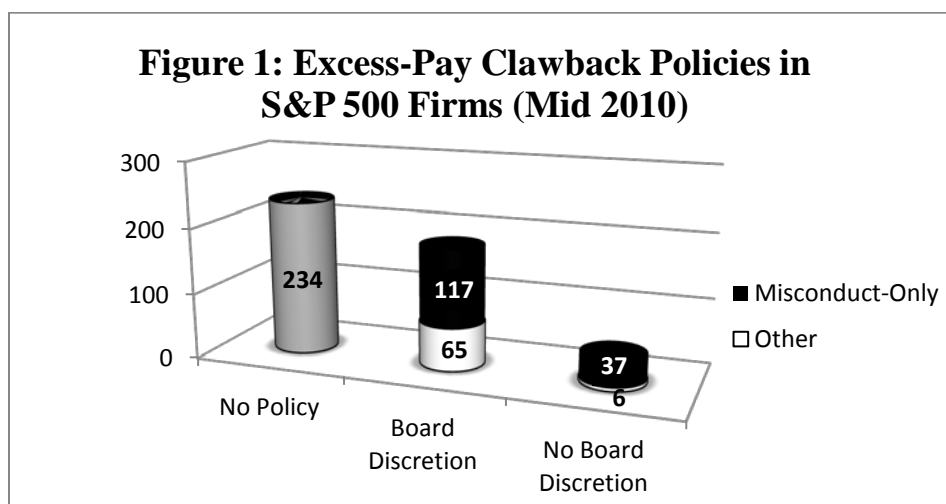
85. See Bebchuk & Fried, *supra* note 26, at 811–12 (explaining that an executive receiving unearned pay should be required to return it to the firm regardless of the executive's culpability).

86. Although a misconduct hurdle for excess-pay clawbacks is undesirable, we are not arguing that the misconduct requirement for the SOX recovery provision should be eliminated. SOX allows the clawback of *all* incentive-based compensation, both excess pay and properly earned pay. See *supra* Part II.B.1.a (describing SOX clawback). If SOX had no misconduct requirement, all of an executive's incentive pay could be recovered in the event of a restatement, many of which occur for innocent reasons. Absent a misconduct requirement, SOX would thus impose a large tax on the use of incentive-based pay and thereby distort compensation arrangements. For the SOX clawback, a misconduct requirement might thus be desirable. However, this over-deterrence concern does not apply where the clawback policy targets only *excess pay* that the executive should not have received in any event.

87. See *supra* Part III.A.1 (describing the widespread lack of excess-pay clawback policies in S&P 500 firms).

88. See *supra* Part III.A.2 (describing the deficiencies of excess-pay clawback policies that had been voluntarily adopted by S&P 500 firms).

89. Even among these six firms, clawback policies were far from comprehensive. Some of the policies did not apply to all of an executive's compensation, and others were not triggered unless there was a restatement. We discuss the problem with conditioning clawbacks on a restatement *infra* Part IV.C.



In this Part, we have focused on what we see as the two main problems with voluntarily adopted excess-pay clawback policies on the eve of Dodd–Frank. First, they generally did not require directors to recoup excess pay. Second, the clawback policies typically did not permit recovery absent a finding of misconduct.

Before we offer two explanations for the lack of robust excess-pay clawback policies, we pause to mention several other problems with these policies that are worth noting. First, many policies did not permit recovery from former executives. Second, almost 40% of the policies did not cover all elements of an executive’s compensation arrangement. They were instead limited to one or two elements of the arrangement, such as a particular incentive plan. Third and finally, 85% of the clawbacks could only be triggered in the event of a restatement, even though (as we explain in more detail in Part IV) an executive could receive excess pay even absent a restatement.⁹⁰ Thus, the excess-pay clawbacks that had been voluntarily adopted by firms prior to Dodd–Frank were even weaker than they might otherwise appear.

B. Explaining the Lack of Robust Clawback Policies

We offer two explanations for why boards have generally failed to adopt robust excess-pay clawback policies. First, executives can be expected to oppose adoption of such a clawback policy, and directors are generally reluctant to adopt arrangements opposed by executives. Second, directors themselves may oppose a clawback policy if they seek to boost their firm’s short-term stock price and believe that a clawback would discourage executives from aggressively boosting short-term results.

1. Managerial Power

The first explanation for the widespread lack of robust excess-pay policies is that executives will naturally oppose such a clawback policy, and many directors will be reluctant to adopt such a policy against executives’ wishes. As we discussed earlier,

⁹⁰. See *infra* Part IV.C.1 (discussing the problems with permitting executives to keep excess pay when there is no restatement).

executives in publicly-traded U.S. companies exert substantial influence over directors.⁹¹ For a variety of financial, social, and psychological reasons, directors generally have an interest in supporting, or at least going along with, the firm's top executives. Directors can thus be expected to acquiesce to compensation decisions that do not benefit shareholders and to refrain from decisions that are inconvenient for—and therefore opposed by—executives. Thus, directors with discretion over whether to recoup excess pay from an executive are likely to use that discretion to permit the executive to keep the pay.

Managerial power can also explain why directors are unlikely to adopt a policy that may require them to recover excess pay from an executive in the future. Executives will oppose adoption of a robust excess-pay clawback policy for obvious reasons. Having compensation clawed back would not only impose a financial cost on the executive but would also be embarrassing, especially if the executive was in some way responsible for the error giving rise to the excess pay. Directors will be reluctant to put in place such an arrangement over executives' objections. Indeed, there is evidence that a publicly traded firm is less likely to adopt any type of clawback policy if the firm's governance arrangements give executives relatively more power.⁹²

2. *Short-Termism*

Even if directors were open to adopting an arrangement opposed by executives, they may have their own reasons for declining to adopt a robust excess-pay clawback policy. In particular, directors who are seeking to maximize a firm's short-term stock price may avoid adopting an adequate clawback so as not to discourage executives from aggressively boosting short-term results.

Consider a board that is concerned that a low short-term stock price will expose it to shareholder pressure and perhaps attract the attention of activist investors or a hostile acquirer. The board will not want to discourage executives from taking steps to boost short-term results, even if those steps would reduce long-term value. On the contrary, the board may want to incentivize executives to do everything possible to boost the short-term stock price.⁹³

Suppose that the board must consider whether to adopt a robust excess-pay clawback policy. Such a policy would reduce executives' incentive to manipulate earnings to boost the short-term stock price. To the extent that the board is concerned about the short-term stock price, it may thus decline to adopt the clawback policy, even if the firm's executives were not opposed to it.⁹⁴

91. See *supra* Part II.B.2.b(1) (discussing the extent of managerial power in publicly-traded firms).

92. See Noel Addy et al., *Recovering Bonuses after Restated Financials: Adopting Clawback Provisions* (Aug. 29, 2009) (unpublished manuscript), available at <http://ssrn.com/abstract=1463992> (finding that public firms are less likely to adopt clawbacks when shareholder rights are weaker).

93. See Jesse M. Fried, *Current-Shareholder Bias* (2011) (unpublished manuscript) (on file with author) (explaining why the firm's current shareholders may want managers to boost the current stock price even if doing so destroys economic value).

94. Cf. Patrick Bolton et al., *Pay for Short-Term Performance: Executive Compensation in Speculative Markets*, 30 J. CORP. L. 721, 730–34 (2005) (explaining how, in speculative markets, boards seeking to maximize the short-term stock price may put in place compensation arrangements that encourage executives to manipulate earnings). Of course, if the market were completely rational and the presence or absence of a robust clawback policy were transparent to investors, investors pricing the firm's shares would pay a lower price for

IV. THE DODD–FRANK CLAWBACK AND ITS IMPLICATIONS

This Part describes and considers the implications of Dodd–Frank’s clawback requirement. Part IV.A describes the requirement and explains how it is likely to improve clawback arrangements at most publicly traded firms. Part IV.B explains why, contrary to critics’ claims, Dodd–Frank’s clawback requirement is unlikely to undesirably reduce the use of incentive pay. Part IV.C points out two possible limitations of the Dodd–Frank requirement that allow executives to keep some forms of excess pay; it then suggests how boards should structure their clawbacks and other pay arrangements to address these limitations.

A. The Dodd–Frank Clawback Requirement and its Benefits

We now turn to describe the Dodd–Frank clawback requirement and identify its likely benefits.

1. The Dodd–Frank Clawback Requirement

Section 954 of Dodd–Frank adds a new Section 10D to the Securities Exchange Act of 1934.⁹⁵ The new provision instructs the SEC to issue rules directing each national securities exchange to require every listed company to put in place a clawback policy to recover certain incentive compensation paid to executives when the firm is required to prepare an accounting restatement.⁹⁶ 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 (i) based on “erroneous data,” (ii) received during the “three-year period preceding the date on which the company becomes required to prepare an accounting restatement,” and (iii) in excess of what would have been paid if calculated under the restatement.⁹⁷

Section 954 of Dodd–Frank differs from the SOX recovery provision in a number of important ways. First, Dodd–Frank requires each firm to recover excess pay; the SOX clawback can only be invoked by the SEC which, we have seen, rarely does so.⁹⁸ Second, the SOX clawback can be triggered only if the restatement is the result of “misconduct;”⁹⁹ Dodd–Frank, on the other hand, can require recovery of excess pay even absent misconduct. Third, SOX allows the recovery of all incentive pay,¹⁰⁰ while Dodd–

the firm’s stock in the short run, everything else equal, if there were no clawback policy to discount for the reduced expected accuracy of the firm’s results. In such a market, adoption of an excess-pay clawback could increase the short-term stock price. But as Bolton and his co-authors emphasize, the market is not always completely rational. It can often be “noisy” or speculative, and in such conditions we can expect to see pay arrangements that encourage executives to manipulate earnings. *Id.* at 726–29 (discussing existence of speculative markets).

95. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §954, 124 Stat. 1376, 1904 (2010) (codified at 15 U.S.C. 78j-4).

96. *Id.*

97. *Id.*

98. *See supra* Part II.B.1 (describing SOX clawback).

99. *Id.*

100. *Id.* Two other differences are worth noting. First, the SOX clawback applies only to CEOs and CFOs.

Frank requires only the clawing back of certain types of excess pay.

2. Benefits of the Dodd–Frank Clawback Requirement

The SEC is currently developing regulations for implementing Dodd–Frank’s clawback policy requirement.¹⁰¹ The exact contours of this clawback requirement have not yet been determined. As is always the case, the devil will be in the details.

Nevertheless, it appears that Dodd–Frank will have significant effects on compensation arrangements. As we discussed earlier, prior to Dodd–Frank fewer than 2% 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.¹⁰² 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 clawbacks will generate three important benefits for their shareholders. First, it will reduce the ex post 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’ ex ante incentive to manipulate earnings and other compensation-affecting metrics.

B. Will Dodd–Frank Undesirably Reduce Incentive Pay?

A number of academics, including Professors Stephen Bainbridge, Sanjai Bhagat, and Roberta Romano, have argued that government-mandated clawbacks can cause firms to undesirably reduce their use of incentive pay.¹⁰³ They cite an unpublished study by several economists that seeks to examine the effect of SOX on the amount and level of incentive compensation given to executives.¹⁰⁴ The study finds that the average ratio of incentive compensation to fixed salary declines after SOX.¹⁰⁵ According to Bainbridge, Bhagat, and Romano, the study shows that the SOX clawback undesirably affected executive pay arrangements.¹⁰⁶ Bainbridge argues that this finding suggests the Dodd–Frank clawback will do so as well.¹⁰⁷

Id. By contrast, the Dodd–Frank clawback requirement applies to all current, and even former, executive officers. Second, the look-back period under SOX is the year following the first improper filing. *Id.* Dodd–Frank requires a clawback of erroneously awarded compensation received during the three-year period before a company is required to restate.

101. See Klein and Pappas, *supra* note 4 (reporting on the SEC’s schedule for implementing the Dodd–Frank clawback rules).

102. See *supra* Part III.A.3 (summarizing prevalence of excess-pay clawback policies in S&P 500 firms).

103. See Bainbridge, *supra* note 5, at 27 (arguing that the Dodd–Frank clawback provision is likely to undesirably reduce the use of incentive compensation); Bhagat & Romano, *supra* note 18, at 366 (claiming that the clawbacks required by the Sarbanes–Oxley Act of 2002 decreased incentive compensation, which led to the “perverse consequences” of “providing insurance to managers for increased risk”).

104. See Daniel A. Cohen et al., *The Sarbanes Oxley Act of 2002: Implications for Compensation Contracts and Managerial Risk Taking* (Nov. 9, 2007), (unpublished manuscript), available at <http://ssrn.com/abstract=1027448> (examining the effects of SOX on CEO compensation contracts and firm performance).

105. *Id.* at 28.

106. Bainbridge, *supra* note 5, at 29; Bhagat & Romano, *supra* note 18, at 366.

107. Bainbridge, *supra* note 5, at 29.

However, the study's findings do not mean that an excess-pay clawback like the one required by Dodd–Frank would have undesirable effects. First, the ratio of incentive compensation to salary is a rather crude measure of pay–performance sensitivity, which depends in large part on the specific features of the incentive compensation arrangements, such as the use of performance-conditioned vesting and equity-holding requirements. If the features of incentive compensation arrangements are improved, pay–performance sensitivity could increase even if the ratio of incentive compensation to salary declines. The economists who performed this study make no claim that the compensation changes supposedly caused by SOX were bad for shareholders. Indeed, they specifically look at the effect on firms' operating performance and find that their performance was not hurt by SOX.¹⁰⁸ Thus, the study fails to show that SOX's clawback provision adversely impacted compensation arrangements and hurt shareholders.

Second, and more importantly, even if the study showed that SOX's clawback adversely impacted compensation arrangements and hurt shareholders, the study would at most indicate that the *SOX clawback* was undesirable. But recall that the SOX clawback is quite different from an excess-pay clawback. It allows the SEC to recover *all* incentive compensation if there has been misconduct and a restatement, not just excess pay.¹⁰⁹ Even if the potentially punitive effect of the SOX clawback undesirably reduced the use of incentive compensation, Dodd–Frank's requirement that executives return unearned pay—a quite reasonable obligation—should not distort pay arrangements.

C. Two Limitations of Dodd–Frank's Requirements

Although Dodd–Frank's clawback requirement will substantially improve clawback arrangements at public firms, it does have two limitations: (1) Dodd–Frank does not mandate the return of excess pay if a restatement is not required; and (2) 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. We discuss each limitation in turn, and explain what firms should do about them.

1. No Restatement, No Clawback

Neither the SOX clawback nor the excess-pay clawback required by Dodd–Frank will be triggered unless the firm is required to restate its financials.¹¹⁰ A financial restatement is generally required upon discovery of an error or accounting irregularity that makes an earlier earnings statement materially false.¹¹¹ If an earlier financial

108. Cohen et al., *supra* note 104, at 4–5 (finding that SOX does not negatively impact firms' operating performance).

109. See *supra* Part II.B.1 (describing the SOX clawback).

110. See *S.E.C. v. Shanahan*, 624 F. Supp. 2d 1072, 1078 (E.D. Mo. 2008) (holding that “an issuer must be compelled or ordered to prepare a financial restatement, and must actually file the restatement” before the SEC can invoke the SOX clawback); Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §954, 124 Stat. 1376, 1904 (2010) (codified at 15 U.S.C. 78j-4) (mandating recovery of certain types of excess pay if a restatement is required and other conditions are met).

111. See Ronald E. Marden et. al., *The CEO/CFO Certification Requirement*, THE CPA J. (July 3, 2003), <http://www.nysscpa.org/cpajournal/2003/0703/features/f073603.htm> (reporting that a restatement indicates that the original financial statements were materially false when issued). See also Jap Efendi et al., *Can Short Sellers Anticipate Accounting Restatements?* 11 (July 20, 2005) (unpublished manuscript) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=591361 (describing different types of restatements,

statement is not materially false, there will be no financial restatement. A restatement requirement is problematic because an executive could receive excess pay even if a restatement is not considered to be required.

First, there could be a small error in the firm's earnings or other reported financial results that leads to a large increase in payout for the executive but is not considered "material" and thus does not necessitate a restatement. For example, suppose a CEO's contract indicates that he will receive a \$1 million bonus if earnings increase by \$10 million. Suppose that earnings are reported as having increased by \$10 million, even though they increased by only \$9.9 million. The CEO receives a large bonus because earnings appear to have increased by \$10 million. However, the firm may not be required to restate its earnings, because actual earnings were only \$100,000 less than reported earnings. The absence of a restatement may prevent recovery under a Dodd-Frank-compliant clawback policy.

Second, a firm may use non-financial metrics (such as customer satisfaction) in calculating an executive's bonus. Even if these metrics turn out to be highly erroneous and substantially inflate the executive's bonus, they need not be corrected by a financial restatement. Because a restatement is not required, a firm with a Dodd-Frank-compliant clawback policy need not recover the excess bonus pay. There is, however, no good reason to bar recoupment of excess pay resulting from an error in a metric whose correction does not require a restatement.

Third, a firm may take the position that a restatement is not "required" even though most neutral observers would believe otherwise.¹¹² This is not just a theoretical possibility. Consider the case of Michael Shanahan, the founder and former CEO of Engineered Support Systems.¹¹³ Shanahan had pleaded guilty to falsifying records by stock option backdating.¹¹⁴ The SEC alleged that Shanahan profited by \$8.9 million by approving misdated stock-option grants.¹¹⁵ The CFO was also involved in the scheme and pocketed an extra \$1.9 million.¹¹⁶ The SEC charged that the company overstated its pretax operating income by 25% by backdating the measurement dates of stock-option grants on at least ten occasions during the period 1997–2002.¹¹⁷ According to the SEC, that error warranted a restatement under generally accepted accounting principles. However, no restatement was filed.¹¹⁸ Consequently, the court did not permit the SEC to

including restatements caused by unintentional misstatements and restatements caused by fraudulent misstatements).

112. See Ya Fang Wang & Hung-Chao Yu, Do Restatements Really Increase Substantially after the Sox? How Does the Stock Market React to Them? 9 (Jan. 23, 2008) (unpublished manuscript), available at <http://ssrn.com/abstract=1087083>) (reporting that often "the decision as to whether a restatement is necessary may be a judgment call on the company's behalf, driven by interpretation of accounting principles rather than a mandate or clear-cut requirement").

113. See *Shanahan*, 624 F. Supp. 2d at 1072 (ruling that SOX clawback could not be invoked against executive because firm had failed to file a restatement); Sarah Johnson, *Sarbox Clawback Ruling Could Keep Pay in Some CFOs' Pockets*, CFO (Dec. 24, 2008), <http://www.cfo.com/article.cfm/12840062> (describing *Shanahan* decision).

114. Johnson, *supra* note 113.

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

deploy the SOX clawback against Shanahan and the CFO.¹¹⁹

As we have seen, Dodd–Frank’s “required restatement” condition is likely to enable executives to keep excess pay in a number of situations. Boards seeking to put in place shareholder-friendly clawback policies should thus require executives to give back excess pay even if a restatement is not required. Our research indicates that as of mid-2010, approximately 7% of S&P 500 firms already had clawback policies in place that allowed for recovery even absent a restatement. All firms should have such a provision.¹²⁰

2. No Clawback of Excess Stock-Sale Proceeds

Dodd–Frank requires firms to adopt a policy that will recover from an executive “who received incentive-based compensation” the “excess [over] what would have been paid to the executive” in the event that certain conditions are met.¹²¹ 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 when he unwinds equity incentives at a stock price inflated by errors in performance metrics. This omission is 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.¹²²

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, firms should limit the extent to which the payoff from stock sales depends on a single day’s price. Rather, as Lucian Bebchuk and one of us have argued, an executive’s equity payoff should be based on the average stock price over a significant period of time, perhaps six months or a year.¹²³ If the executive’s payoff were not based on the stock price over a short period, the executive’s incentive to

119. See *Shanahan*, 624 F. Supp. at 1078.

120. Although clawbacks should apply to all forms of incentive compensation and not depend on an executive’s culpability, there could of course be a carveout for “de minimis” amounts of excess pay. We see no real cost to such a carveout. Refraining from clawing back small amounts of excess pay will not substantially affect shareholders’ returns nor meaningfully reduce the deterrent effect of the clawback. At the same time, such a carveout will confer a benefit on shareholders by avoiding the transaction costs associated with effecting a clawback.

121. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §954, 124 Stat. 1376, 1904 (2010) (codified at 15 U.S.C. 78j-4).

122. See *supra* Part II.A.1.b (describing the link between earnings manipulation and executives’ stock sales). For an explanation as to why insider trading law is not effective at deterring this type of misbehavior, see Fried, *supra* note 14, at 460–62.

123. See Bebchuk & Fried, *supra* note 18, at 1945–47 (suggesting that the payoffs from executive stock sales should be based on the average stock price over a reasonably long period).

manipulate the short-term stock price prior to unwinding his 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.¹²⁴ 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.¹²⁵

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, a proposal one of us made some time ago.¹²⁶ Such advance disclosure would notify the market that executives might be manipulating the short-term stock price or 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.

V. CONCLUSION

Academic commentators have criticized the Dodd–Frank Act for mandating that public firms adopt a policy requiring the clawback of certain types of “excess pay”—pay that executives receive as a result of errors in the firm’s earnings or other compensation-related metrics. These commentators have argued that firms can be counted on to adopt optimal compensation policies and that there is no need for government intervention in this area.

124. See Fried, *supra* note 14, at 468–70 (proposing that executives’ equity be cashed out on a pre-arranged schedule as a means of reducing the costs to shareholders that arise when executives have the freedom to choose when to sell their stock).

125. At least one firm, Level 3 Communications, has adopted the “hands-off” approach to its option compensation. See Level 3 Commc’ns, 2009 ANNUAL REPORT 28 (2010), available at http://files.shareholder.com/downloads/LVLT/1197635810x0x363608/2ABB6CC9-B76E-4529-BFFF-B41A5F76B3AB/2009_Annual_Report-Proxy.pdf (“[R]ecipients of these [stock-indexed securities] will not be able to voluntarily exercise [them] as they will settle automatically with value on the third anniversary of the date of the award or expire without value on that date.”).

126. See Jesse M. Fried, *Reducing Corporate Insider Trading Profits with Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 349–53 (1998) (arguing that executives should be required to announce their buy and sell orders before transacting in the shares of their firms). For a more condensed version of the proposal, see Jesse M. Fried, *Advance Disclosure of Managers’ Stock Trades: A Proposal to Improve Executive Compensation*, ECONOMISTS’ VOICE, Nov. 2006, at 3–4, available at <http://www.bepress.com/ev/vol3/iss8/art7>.

After systematically analyzing the costs that excess pay imposes on shareholders, we have explained why such costs are unlikely to be reduced unless directors are obligated to recover excess pay from executives. Analyzing the clawback policies voluntarily adopted by S&P 500 firms prior to Dodd–Frank, we find that almost 50% of S&P 500 firms had no excess-pay clawback policy whatsoever. Among the remaining firms, clawback policies almost always either gave directors discretion not to recoup excess pay or permitted executives to keep excess pay absent a finding of misconduct. Only 2% of S&P 500 firms required the clawback of excess pay even if there was no finding of misconduct. Our findings suggest that private ordering failed to yield adequate clawback arrangements before Dodd–Frank, and that Dodd–Frank will improve these arrangements.

We also explained that Dodd–Frank still allows executives to keep some forms of excess pay. In particular, it does not mandate that firms claw back excess pay when no restatement is required, and it appears to permit executives to keep excess pay arising from the sale of equity incentives at inflated prices. We suggested how each of these limitations could best be addressed by boards seeking to improve executive pay arrangements. We hope that our work will be useful to regulators, investors, and directors seeking to improve pay arrangements at publicly-traded firms.