INTERPRETING DODD-FRANK SECTION 954: A CASE FOR CORPORATE DISCRETION IN CLAWBACK POLICIES

Stuart R. Lombardi*

This Note presents the author's original empirical study of the clawback policies of large public companies, and uses the study's findings to help interpret Section 954 of the Dodd-Frank Act. A clawback policy is an agreement between a company and its employee, made when the company pays the employee, stating that if certain events take place in the future, the company can recoup some or all of that compensation. Section 954 requires publicly traded companies to develop and implement clawback policies that apply against executive officers, reach incentive compensation, and are triggered by accounting restatements. The study presented in this Note reveals that companies value the discretion to determine when and how to exercise their clawback powers. Accordingly, if regulators interpret Section 954 in a manner that strips companies of all such discretion, companies will face a powerful incentive to turn to compensation arrangements that are not governed by Section 954. This Note argues that to avoid this result, regulators should interpret Section 954 in a manner that gives companies limited discretion to determine on a case-by-case basis whether to exercise their clawback powers.

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* J.D. Candidate 2012, Columbia Law School; B.A. Economics 2009, Hamilton College. The author is grateful for the support he received from academic and professional resources. Professor Robert J. Jackson, Jr. provided invaluable guidance. The staff of the *Columbia Business Law Review* provided excellent editorial assistance. The author interviewed Robert W. Kaufman, Vice President of the Legal and Technical Resource Group at Clark Consulting. The Corporate Library and Equilar, an executive compensation research firm, graciously provided the author with complimentary use of their reports for research and academic purposes.

I. INTRODUCTION

Imagine that a company reports record profits in 2011 and pays its executives handsome bonuses in accordance with its accounting-based incentive compensation system. Then, in 2012, the company discovers that, due to an accounting error or outright fraud, it overstated its 2011 profits. Clawback policies offer a remedy for such a scenario. A clawback policy could allow the aggrieved company to recoup a portion of those 2011 executive bonuses. A clawback policy is an ex ante agreement[1] between a company and an employee stating that the company reserves the right to recover previously awarded compensation ex post if an

[1] For a discussion of the impact of contract doctrine on clawback policies, see Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 416–19 (2009).

event triggering the clawback occurs. In other words, a clawback policy is an agreement between a company and its employee, made when the company pays the employee, stating that if certain events take place in the future, the company can recoup some or all of that compensation.[2] Clawback policies may take various forms.[3] This Note explores the very type of clawback just described: the recoupment of accounting-based incentive compensation following a negative accounting restatement, regardless of whether the initial error was the product of fraud or an honest accounting mistake.[4]

Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") in the wake of the financial crisis of 2008 to "provide for financial regulatory reform" and to "protect consumers and investors[.]"[5] Section 954 of the Dodd-Frank Act requires publicly traded companies to develop and implement clawback policies that apply against executive officers, reach

[2] For a helpful discussion of clawbacks in this and related circumstances, a discussion of the various forms clawback provisions can take, and an argument in favor of clawback provisions, see Cherry & Wong, *supra* note 1. *See also* Miriam A. Cherry & Jarrod Wong, Headnotes, *Reply: Clawback to the Future*, 95 MINN. L. REV. 19 (2010).

[3] The term "clawback" can refer to various legal and political theories or methods of recouping money. Cherry & Wong, *supra* note 1, at 368–73. Many of these theories or methods fall beyond the scope of this Note. This Note exclusively discusses prospective contractual clawback policies in the employee compensation context.

[4] Companies have a variety of methods at their disposal for actually collecting the money they are entitled to pursuant to their clawback policies. For example, they could offset against future compensation, require the employee to pay money back to the company directly, or withdraw money from deferred compensation accounts. This latter method—drawing from deferred compensation—constitutes a "holdback" approach, and may offer significant benefits. For a discussion of holdbacks, their benefits, and their applicability to Section 954, see *Fortifying Your Defenses: Choosing a Multifaceted Approach to Incentive-compensation Recoupment*, CLARK CONSULTING (Aug. 23, 2010), *available at* http://www.sec.gov/comments/df-title-ix/executive-compensation/executivecompensation-22.pdf (attached as an appendix, beginning on page 8).

[5] H.R. REP. NO. 111-517, at 1 (2010).

incentive compensation, and are triggered by accounting restatements.[6] However, several details of Section 954 remain unclear, and the Securities and Exchange Commission ("SEC") has yet to exercise its rule-making authority to interpret and implement Section 954. This Note explores one ambiguity of Section 954: whether Section 954 leaves companies discretion to determine when to exercise their clawback powers.

Using original empirical data on the clawback policies of large public companies, this Note argues that federal regulators should interpret Section 954 in a manner that gives companies limited discretion to determine when to exercise their clawback powers.[7] This Note further argues that Section 954 does not require companies to exercise their clawback powers in all instances, and that giving companies some discretion constitutes sound policy. However, granting companies complete discretion could render Section 954 impotent by exacerbating the very problems clawback policies are supposed to address. Accordingly, regulators should grant companies limited discretion. When a company issues an accounting restatement that triggers a Section 954 clawback, regulators should give the company's board two options: (1) publicly announce the board's clawback decision and its reasoning; or (2) turn decision-making authority over to an independent actor, giving the independent actor full authority to decide whether the company will exercise its clawback powers.

The remainder of this Note is structured as follows. Part II provides the context for an examination of Section 954 by discussing the goals of clawback policies, potential problems associated with clawback policies, and the history of and motivations behind clawback legislation in the United

[6] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010).

[7] One could further argue that, in addition to retaining discretion to determine *when* to recoup compensation, companies should also retain discretion to determine *how much* compensation to recoup in a given instance. This Note exclusively explores the first form of discretion: discretion to determine when to recoup compensation at all.

States. Part III presents the author's empirical findings on the clawback policies of large public companies that underpin the arguments presented in Part IV. Part IV makes the case for granting companies limited discretion to determine when to exercise their clawback powers, drawing on both earlier research and the author's empirical data.

II. BACKGROUND: CLAWBACK THEORY AND RELEVANT U.S. LAW

A. Goals of Clawback Policies

Clawbacks operate as a partial remedy to a well-known problem in corporate law: agency costs (including costs stemming from managerial power).[8] Contractual clawbacks also serve to fill gaps in existing recoupment doctrine.[9] Finally, clawbacks may satisfy fundamental notions of fairness.[10]

The concept of agency costs highlights the potential tension between the interests of management (e.g., executive officers) and owners (e.g., shareholders in a publicly traded company). The basic premise is that if managers and owners are self-interested, profit-maximizing actors, the two groups may have conflicting interests that, at times, cause managers to act in a manner that is harmful to owners.[11] Owners can limit the degree to which managers act contrary to their interests—reducing overall agency costs—by using bonding arrangements.[12] A bonding arrangement is an

[8] *See* Cherry & Wong, *supra* note 1.

[9] *Id.* at 414.

[10] *Id.* at 371–72 (defining a clawback as "a theory for recovering benefits that have been conferred under a claim of right, but are nonetheless recoverable because unfairness would otherwise result."); *cf. id.* at 391 (stating that clawbacks calm public outrage).

[11] *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (defining and explaining agency costs and discussing means of reducing agency costs).

[12] *Id.* at 326.

agreement between owners and managers that ensures that either: (1) managers will not take specific actions contrary to owners' interests; or (2) if managers do take specific actions contrary to owners' interests, managers will compensate the owners for their harm.[13]

A clawback policy can function as a bonding arrangement by allowing the company to recoup previously awarded compensation from its managers in response to some harm that the company suffers at the hands of its managers (such as a negative accounting restatement or fraud).[14] Thus, clawback policies offer a partial remedy to the agency cost problem.[15] According to one view, clawback policies "force executives to align their interests with that of the long-term growth of the company."[16] This is not necessarily true; for example, management could still choose not to make a decision (e.g., to invest or to restructure the company) that would depress short-term earnings but increase growth in the long-term. Even so, at the least, clawback policies serve to reduce short-term earnings manipulation by reducing "executives' incentive to manipulate" earnings.[17] The mechanics are relatively simple: the existence of a clawback policy reduces the expected value of earnings manipulation, because if the executive gets caught manipulating earnings, the company can claw back a portion of the executive's compensation.

Boards of directors, like managers, may have interests that do not perfectly align with shareholders' interests. A company's board should act in the interest of the company, and its duties in this role include monitoring management.

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[13] *Id.* at 308.

[14] *See infra* notes 16–17 and accompanying text.

[15] *See infra* notes 16–17 and accompanying text.

[16] Cherry & Wong, *supra* note 1, at 423.

[17] Jesse Fried & Nitzan Shilon, *Excess-Pay Clawbacks*, 36 J. CORP. L. 721, 735, 744 (2011) ("It would also reduce executives' incentive to manipulate performance metrics, thereby avoiding the value destruction that is often a byproduct of such manipulation . . . . Such a policy would reduce executives' incentive to manipulate earnings to boost the short-term stock price . . . .").

However, proponents of the managerial power theory argue that board members' interests may be more closely aligned with management's interests than with shareholders'.[18] For example, management has influence over the appointment and reappointment of board members.[19] In response, boards may side with management (rather than shareholders) on important issues such as executive compensation, resulting in excessive executive compensation arrangements.[20] According to one scholar, this misalignment of interests arises in the following manner:

> In many of America's leading corporations, management is supervised by a board of directors largely appointed by management. This situation, in which board members owe their positions to executive largesse, creates an environment in which corporate directors have little incentive to monitor management, but great reason to acquiesce to any management initiative.[21]

Clawback policies also offer a potential remedy to the managerial power problem.[22] To the extent a clawback provision requires the board to recoup compensation from an

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[18] *See, e.g.*, Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002) (referring to this misalignment as "managerial power," and partially rejecting the "optimal contracting" approach); Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649 (1995) (referring to this misalignment as "management capture").

[19] *See* Bebchuk, Fried & Walker, *supra* note 18, at 770–71.

[20] *See* Bebchuk, Fried & Walker, *supra* note 18, at 768 ("The social dynamics of the board, the members of which have been selected in large part by the CEO or with his input, play an important role in deterring objection to executive compensation programs.") (citation omitted); Elson, *supra* note 18, at 650–51 ("[C]orporate directors have little incentive to monitor management, but great reason to acquiesce to any management initiative. This problem, more commonly referred to as 'management capture,' is the real cause of the overcompensation problem.") (citations omitted).

[21] Elson, *supra* note 18, at 650–51, 664–65 (providing a detailed discussion of the cause of such misalignment).

[22] *See* Cherry & Wong, *supra* note 1, at 390–92.

employee when an event triggering the clawback policy occurs, the clawback policy represents a decision the board makes today to prevent itself from being swayed by management in the future. Thus, a binding clawback policy becomes what behavioral economists call a "commitment device": a means one's present-self uses to commit one's future-self to a particular course of action.[23] But the very problem itself (managerial power) can make the solution (a clawback policy) more difficult for the board to impose on executives in employment agreements.[24] This concern falls away if legislation *requires* companies to implement clawback policies. The Dodd-Frank Act includes just such a clawback requirement.[25]

In addition to reducing agency costs, clawback policies serve to fill gaps in existing legal doctrines.[26] Absent an express clawback provision in the initial compensation agreement, a company would likely face significant legal hurdles in an effort to recoup compensation from an employee due to the employee's "countervailing legal rights" to the compensation.[27] The existence of a contractual clawback policy simplifies the recoupment process, and can

[23] *See, e.g.*, Stephen J. Dubner & Steven D. Levitt, *The Stomach Surgery Conundrum*, N.Y. TIMES, Nov. 18, 2007, *available at* http://www.nytimes.com/2007/11/18/magazine/18wwln-freakonomics-t.htm (defining commitment device and providing examples).

[24] Noel E. Addy, Jr., Xiaoyan Chu & Timothy R. Yoder, Recovering Bonuses After Restated Financials: Adopting Clawback Provisions (Aug. 29, 2009) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1463992 (finding that "management entrenchment . . . makes a clawback provision less likely").

[25] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010).

[26] *See infra* notes 27–28 and accompanying text.

[27] Cherry & Wong, *supra* note 1, at 414. However, legal theories are still available for recouping compensation absent an equitable clawback. For a discussion of such alternatives to contractual clawbacks, see Manning Gilbert Warren III, *Equitable Clawback: An Essay on Restoration of Executive Compensation*, 12 U. PA. J. BUS. L. 1135 (2010).

assist the company in overcoming claims the employee would otherwise have on the previously awarded compensation.[28]

Clawback policies may also satisfy fundamental notions of fairness, which calms public outrage.[29] Recouping compensation from an employee who committed—or was complicit in—a fraudulent act that harmed the company may satisfy fundamental notions of fairness, in that the clawback both provides restitution to the harmed company and its shareholders and punishes the culpable employee.[30] Even absent outright fraud, a clawback can serve to make shareholders whole, therefore mitigating harm to shareholders. For example, in the case of a negative accounting restatement resulting from honest human error rather than fraud, a clawback policy could enable shareholders to recover erroneously awarded compensation paid based on incorrect financial statements.[31] But in this latter, non-fraudulent example, fairness to shareholders may exist in some tension with fairness to the non-culpable executive.

B. Problems With Clawbacks in Practice

Clawback policies offer the various advantages discussed above, but they also can create difficulties in practice.[32] Clawback policies may make recoupment easier, but they do not necessarily make the process pain-free.[33] The challenges companies face include determining when to recoup compensation, deciding how much compensation to recoup, and addressing issues of culpability and fairness.

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[28] Cherry & Wong, *supra* note 1, at 414.

[29] *Id.* at 371–72 (defining a clawback as "a theory for recovering benefits that have been conferred under a claim of right, but that are nonetheless recoverable because unfairness would otherwise result."); *cf. id.* at 391 (stating clawbacks calm public outrage).

[30] *See id.* at 371–72.

[31] *Id.* at 390 ("Some clawback provisions require that an employee be actually involved in a fraud in order to trigger the repayment requirement. Others merely require the amounts to have been paid in error based on incorrect accounting results.").

[32] *See infra* notes 34–41 and accompanying text.

[33] *See infra* notes 34–41 and accompanying text.

At the outset, companies must determine when to recoup compensation. What event should trigger the company's clawback policy? A 2010 study by Equilar, an executive compensation research firm, found seven different categories of clawback policy triggers among Fortune 100 companies, including financial restatements, ethical misconduct, and noncompete violations.[34] Furthermore, in any given instance, a company may wish to consider whether the benefits of recouping compensation outweigh its costs.[35]

Once a company decides to recoup compensation, simply calculating the amount of money to clawback can become a complicated endeavor.[36] Companies calculate executive compensation in a variety of ways, some of which may make it difficult for the company to determine how much money to clawback.[37] For example, if the original compensation was not calculated in a purely formulaic, incentive-based manner (such as where $1 in profits directly corresponds to $X in compensation), but rather was calculated in a mixed formulaic and discretionary manner, how should the company calculate the clawback? The Center on Executive Compensation discusses this mixed-calculation scenario and other pay formulas that raise problems in a comment letter to the SEC.[38] The federal income tax code further complicates the process of deciding how much money to clawback, as a clawback can raise significant tax issues.[39]

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[34] EQUILAR, 2010 CLAWBACK POLICY REPORT 12 (2010), *available by request at* http://info.equilar.com/Clawback_Policy_Report_2010.html.

[35] *See, e.g.*, Letter from ABA Bus. Law Section to the SEC (Sept. 29, 2010), *available at* http://www.sec.gov/comments/df-title-ix/executive-compensation/executivecompensation-19.pdf.

[36] *See infra* notes 37–39 and accompanying text.

[37] *See* Letter from the Ctr. on Exec. Comp. to the SEC 9–13 (Sept. 1, 2010), *available at* http://www.sec.gov/comments/df-title-ix/executive-compensation/executivecompensation-8.pdf.

[38] *Id.*

[39] *See* Matthew A. Melone, *Adding Insult to Injury: The Federal Income Tax Consequences of the Clawback of Executive Compensation*, 25 AKRON TAX J. 55 (2010).

Issues of fairness may arise as well, particularly if the executive was not culpable.[40] Clawing-back erroneously awarded compensation from a non-culpable employee may seem unfairly punitive. Stephen M. Bainbridge argues that a clawback provision that does not require individual culpability is an "over inclusive" deterrent because "[s]ome innocent executives . . . will have to forfeit . . . pay."[41] On the other hand, declining to claw back erroneously awarded compensation, even from a non-culpable employee, may seem unfair to shareholders, who will suffer lost profits due to the erroneous over-compensation. Accordingly, when a company chooses either to claw back or to decline to claw back compensation from a non-culpable executive, either management or the shareholders will likely feel short-changed.

C. A Brief History of Contractual Clawback Policies in the United States

Contractual clawback policies are not new; companies have long used contractual clawback provisions "as part of non-compete and non-disclosure agreements."[42] As discussed below, statutory provisions in the Sarbanes-Oxley Act of 2002 ("SOX"), laws that enable and govern the Troubled Asset Relief Program ("TARP"), and the Dodd-Frank Act *require* companies to claw back compensation if certain conditions are met. Furthermore, some companies have willingly adopted clawback provisions that (at least in part) go beyond any statutory requirements.[43]

SOX, passed in the wake of the Enron scandal and similar corporate frauds,[44] imposed a broad clawback

[40] An example would be a clawback that is triggered by an accounting restatement necessitated by an honest accounting mistake made by another employee, rather than by the executive's own wrong-doing. *See infra* note 41 and accompanying text.

[41] Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1806 (2011).

[42] Melone, *supra* note 39, at 70.

[43] EQUILAR, *supra* note 34, at 4.

[44] Melone, *supra* note 39, at 63.

requirement.[45] SOX Section 304 ("SOX 304") states, in relevant part, that if a company:

> [I]s required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for—
> (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and
> (2) any profits realized from the sale of securities of the issuer during that 12-month period.
> (b) Commission exemption authority. The Commission may exempt any person from the application of subsection (a), as it deems necessary and appropriate.[46]

SOX 304 "is only triggered if the restatement is the result of misconduct, applies only to the CEO and CFO, and seeks to recoup only those amounts received in the year following the first improper filing."[47] "The language of [SOX 304] is mandatory: the CEO and CFO 'shall reimburse the issuer[,]'" but only the SEC—not the company, and not its shareholders—may enforce SOX 304.[48] Furthermore, subsection (b) grants the SEC authority to "exempt any person from the

[45] *See* 15 U.S.C. § 7243, 116 Stat. 745 (2010).

[46] *Id.*

[47] PEPPER HAMLTON LLP, DODD-FRANK'S MANDATORY EXECUTIVE COMPENSATION CLAWBACK 1 (Aug. 18, 2010), *available at* http://www.pepperlaw.com/pdfs/SecuritiesLitAlert081810.pdf.

[48] Rachael E. Schwartz, *The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean*, 64 BUS. L. 1, 2 (2008) (written by Senior Counsel, Division of Enforcement, U.S. Securities and Exchange Commission) (citing cases for the proposition that there is no private right of action under SOX 304). *See also* 15 U.S.C. § 7243(a).

application" of the statutory clawback.[49] Although there have been "thousands of restatements" since SOX 304 came into effect, by 2008 the SEC had used its clawback powers under SOX 304 only twice.[50]

Companies receiving TARP assistance faced new requirements as a condition of the government's assistance.[51] The American Recovery and Reinvestment Act of 2009 required all TARP recipients to recover any bonus paid to a senior executive officer or any of "the next twenty most highly compensated employees during the TARP period . . . if the bonus payment was based on materially inaccurate financial statements."[52] The requirement grants an exception if the TARP recipient successfully shows, in a particular instance, that exercising its clawback power would be "unreasonable" given the circumstances—for example, if "the expense of enforcing the rights would exceed the amount recovered."[53]

Although the TARP regulations narrowly applied to companies receiving TARP assistance, and despite SOX 304's limits, many companies adopted clawback provisions in the first decade of the twenty-first century.[54] In a 2003 study, the Corporate Library found that less than 1% of the 1,800 companies in the study had clawback policies.[55] Five years later, in a study of 2,121 companies, the Corporate Library found that 13.9% of the surveyed companies had clawback policies.[56] In a 2010 study, the Corporate Library found 18.9% of surveyed companies had clawback policies, and that

[49] *See* 15 U.S.C. § 7243.

[50] Schwartz, *supra* note 48.

[51] *See, e.g.*, TARP Standards for Compensation and Corporate Governance, 31 C.F.R. § 30.8 (2010).

[52] *Id.*

[53] *Id.*

[54] *See infra* notes 55–58 and accompanying text.

[55] THE CORPORATE LIBRARY, 2008 PROXY SEASON FORESIGHTS #11: CLAWBACK POLICIES 1 (2008), *available by request at* http://www2.gmiratings.com/reports.php?reportid=197&keyword= (comparing findings of 2008 study to findings of 2003 study).

[56] *Id.*

39.8% of the S&P 500 had clawback policies.[57] A 2010 Equilar study found that 82.1% of Fortune 100 companies had publicly disclosed clawback policies, up from just 17.6% in 2006.[58]

The Dodd-Frank Act, passed in response to the financial crisis of 2008, includes a clawback requirement.[59] This clawback requirement, contained in Section 954, does not merely require employees to reimburse their employers if specific conditions are met (as does SOX 304),[60] nor does it merely require companies to recoup compensation if certain conditions are met (as TARP did).[61] Section 954 does something that (to the author's knowledge) no other part of the Dodd-Frank Act—and no previous federal clawback legislation—does: it forces companies to enter into specific contracts with their employees. Section 954 *requires* publicly traded companies to "develop and implement" recoupment policies satisfying specific requirements.[62] The penalty for non-compliance is *delisting*—removal of the company's stock from the stock exchanges.[63]

Section 954 in full states:

> SEC. 954. RECOVERY OF ERRONEOUSLY AWARDED COMPENSATION.

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[57] THE CORPORATE LIBRARY, 2010 PROXY SEASON FORESIGHTS #3: THE GROWTH OF CLAWBACK PROVISIONS (2010), *available by request at* http://www2.gmiratings.com/reports.php?reportid=311&keyword=clawback.

[58] EQUILAR, *supra* note 34.

[59] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010).

[60] *Compare* 15 U.S.C. § 7243 (2010) *with* Dodd-Frank Wall Street Reform and Consumer Protection Act, § 954.

[61] *Compare* TARP Standards for Compensation and Corporate Governance, 31 C.F.R. § 30.8 (2010) *with* Dodd-Frank Wall Street Reform and Consumer Protection Act, § 954. Various recoupment policies—including setoffs and holdbacks, which can be viewed as either forms of or alternatives to clawbacks—could satisfy the requirements of Section 954. *See supra* note 4.

[62] Dodd-Frank Wall Street Reform and Consumer Protection Act, § 954.

[63] *Id.*

> The Securities Exchange Act of 1934 is amended by inserting after section 10C, as added by section 952, the following:
> "SEC. 10D. RECOVERY OF ERRONEOUSLY AWARDED COMPENSATION POLICY.
> "(a) LISTING STANDARDS.—The Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not comply with the requirements of this section.
> "(b) RECOVERY OF FUNDS.—The rules of the Commission under subsection (a) shall require each issuer to develop and implement a policy providing—
> "(1) for disclosure of the policy of the issuer on incentive- based compensation that is based on financial information required to be reported under the securities laws; and
> "(2) that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement."[64]

Section 954 differs from SOX 304 in a number of ways. Among other differences, Section 954: (1) appears to place the burden of enforcement on the companies themselves (to the extent it requires companies to adopt clawback provisions); (2) applies to more employees than SOX 304; (3) reaches more years of compensation than SOX 304; (4) only requires recoupment of erroneously awarded compensation;

[64] *Id.*

and (5) applies even if the restatement was *not* necessitated by fraud or misconduct.[65]

III. EMPIRICAL DATA

This section presents empirical data from a study the author conducted of the clawback policies of all thirty companies in the Dow Jones Industrial Average ("DJIA"). The study examines the clawback landscape prior to the implementation of Section 954 of the Dodd-Frank Act.[66] The study provides three primary benefits in that it: (1) uncovers gaps between current practices and those required by Section 954; (2) informs an understanding of what Section 954 does (and should) mean; and (3) provides a pre-Dodd-Frank reference point that future researchers can use to examine the degree to which Section 954 changed the executive compensation landscape.

More specifically, the study serves to answer two primary questions. First, how do large public companies factor culpability into their clawback policies? A company could, for example, state that it will clawback compensation from an executive only if it finds the executive was responsible for the error that led to the executive's over-compensation. Second, what amount of discretion do large public companies reserve to determine on a case-by-case basis when and how to exercise their clawback powers? The former question is important because it appears Section 954 applies without regard to the executive's culpability.[67] The latter question is important because Section 954 is silent on the issue of discretion.[68]

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[65] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010). *See also infra* Part IV.A (arguing that Section 954 has no culpability requirement).

[66] All data were collected on or before October 26, 2010. Any public filings released after October 26, 2010 are not included in this study.

[67] *See infra* Part IV.A.

[68] *See infra* Part IV.B.

A. Methodology

The study uses the DJIA as its sample. The DJIA presents an ideal sample because it is a well-known and respected index of leading U.S. companies from all industries (other than transportation and utilities).[69] Furthermore, the DJIA consists of thirty companies,[70] and thus offers a manageable sample size.[71]

The underlying data are the clawback policies[72] (or summaries thereof) for all companies in the DJIA.[73] More specifically, the data consist of the companies' public filings (proxy statements and Form 8-K, 10-K, and 10-Q filings) and the portions of the companies' websites relating to clawbacks. Additionally, the author contacted the companies directly and requested all relevant information regarding each company's clawback policy or policies.[74]

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[69] *Fact Sheet*, DOW JONES INDUS. AVERAGE, http://www.djindexes.com/mdsidx/downloads/fact_info/Dow_Jones_Industrial_Average_Fact_Sheet.pdf (last visited Dec. 1, 2011).

[70] *Id.*

[71] At least one other study has examined a larger sample of companies. *See* Fried & Shilon, *supra* note 17. The author of this Note deliberately chose to perform an in-depth analysis of a relatively narrow sample of prominent companies. This decision reflects the author's preference for depth of analysis rather than breadth of data.

[72] For this study, a clawback policy is defined as a policy that enables the company to recoup part or all of an employee's compensation when the company later determines the employee was overcompensated. Possible triggers for such a clawback include a financial restatement, a downward revision of a financial or performance metric, and employee misconduct. Some companies in the study have both a traditional clawback policy and a general, catchall "detrimental activity" provision. Such detrimental activity provisions are often broad and vague, tend to encompass all activity detrimental to the company (as determined by the company on an incident-by-incident basis), and therefore are ill-suited for interpretation in a study such as this. When a company has both a clawback policy and a broader detrimental activity provision, this study excludes the detrimental activity provision and instead focuses on the more specific clawback policy.

[73] In some cases, the publicly available information is vague or incomplete. Assumptions are indicated below in footnotes.

[74] Twelve companies responded, and all twelve included or referenced publicly available information (no company responded with information

The study classifies clawback policies using the following four factors:[75]

> (1) Culpability: Does the clawback require individual culpability? As shown below, some clawback policies allow the company to recoup compensation only from employees who engaged in misconduct or are otherwise culpable. This factor helps to answer the culpability question presented above.
>
> (2) Trigger: What triggers the clawback policy? Possible triggers include a financial restatement, a downward revision of a financial or performance metric, and employee mis-conduct. This factor also helps to answer the culpability question presented above.
>
> (3) Discretion: Does the company reserve discretion to exercise its clawback powers as it sees appropriate, or does the policy *require* the company to recoup compensation? This factor helps to answer the discretion question presented above.
>
> (4) Amount clawed back: What portion of an affected employee's compensation will the

that was not otherwise publicly available). While most companies broadly pointed to their public filings, a few companies more helpfully pointed to specific pages or terms in their proxy statements and related filings.

[75] The author's original study included an additional nine factors that are beyond the scope of this Note: period (the number of years a clawback reaches back—essentially the clawback's statute of limitations); who (the employees subject to the clawback policy); interest (whether the company collects interest on clawed-back compensation); method of repayment (how the company will collect the money it seeks); incentive or performance-based compensation (whether the company uses incentive or performance-based compensation); "NQDC" (whether the company offers a nonqualified deferred compensation plan); equity (whether the clawback reaches equity awards and profits thereon), former employees (whether the clawback reaches employees after they leave the company); and compensation (whether the clawback only reaches accounting-based incentive compensation, or whether it also reaches discretionary incentive compensation).

> company recoup? For example, some companies may seek to recoup the portion of compensation that was erroneously awarded—the difference between what the company actually paid the employee and what it now, retrospectively, would have paid the employee. This factor also helps to answer the discretion question presented above.

B. Findings

The culpability factor reveals that the current majority approach to culpability among companies in the DJIA is not consistent with the requirements of Section 954.[76] The trigger factor reveals that a majority of companies in the DJIA are in substantial compliance with the trigger requirement of Section 954.[77] The discretion and amount clawed-back categories reveal a significant market preference: companies appear to value the ability to determine on a case-by-case basis when and how to exercise their clawback powers. It is this market preference, coupled with the manner in which Section 954 will force companies to change their approaches to culpability, that forms the basis for the recommendations offered in Part IV.

TABLE 1: CULPABILITY REQUIREMENTS

	Count	**Percentage**
Require Individual Culpability	18	60%
Do Not Require Individual Culpability	9	30%
Other	3	10%

There is a clear split in how companies approach culpability in their clawback policies. Eighteen companies (60%) have clawback policies that require individual culpability. Nine companies (30%) have plans that apply whether or not

[76] *See infra* Part IV.A.

[77] *See infra* note 88 and accompanying text.

the employee is culpable, but all nine of these companies reserve (or appear to reserve) discretion to determine on a case-by-case basis whether to exercise their clawback powers. Three companies (10%) have clawback policies that defy binary classification: 3M,[78] Bank of America,[79] and United Technologies.[80]

The majority approach may indicate that a majority of companies agree with Bainbridge's argument that clawbacks should not apply against "innocent" executives.[81] Alternatively, the majority approach could be the result of executive influence (managerial power)—boards may have acquiesced to executives' preference for a culpability requirement.[82] Likewise, the implications of the minority approach are somewhat unclear. The nine companies that do not require culpability may believe that even non-culpable employees should return compensation that they received in error. But these nine companies could just as easily believe that adjudicating culpability is simply too costly, and perhaps too likely to lead to litigation by shareholders (if the board finds the executive not culpable[83]) or by the executive (if the board finds the executive culpable). One thing is clear: the wide diversity of approaches, with no clear industry trends,[84] strongly suggests that forced homogeneity

[78] 3M does not require culpability if the award was made within the past three years, but does require culpability if the award was made more than three years later. 3M Co., Quarterly Report (Form 10-Q), Exhibit 10.49 (Aug. 4, 2010).

[79] Bank of America does not require culpability in its equity-compensation clawback policy (although the company reserves discretion to determine when to exercise such clawback powers), but it does require culpability in clawbacks reaching other compensation. Bank of Am. Corp., Proxy Statement (DEF 14A), at 36 (Mar. 17, 2010).

[80] United Technologies *must* claw back compensation if it finds the employee is culpable but may elect (in its discretion) to clawback compensation even if it finds the employee was not culpable. United Tech. Corp., Quarterly Report (Form 10-K), Exhibit 10.1 (Feb. 11, 2009).

[81] *See* Bainbridge, *supra* note 41, at 1806.

[82] *See* Addy, Chu & Yoder, *supra* note 24.

[83] *But see infra* note 89 and accompanying text.

[84] Practices vary widely, even within a single industry.

may be costly. Forced homogeneity will require a substantial number of companies to modify their practices.

TABLE 2: CLAWBACK TRIGGERS

	Count	Percentage
Restatement	19	63%
Restatement *or* Revision to Other Performance Metric	5	17%
Misconduct Only	4	13%
Other	2	7%

Most companies (63%) have policies that are triggered solely by a restatement.[85] Five companies (17%) have policies that are triggered by either a financial restatement or a revision to another financial or performance metric used to determine compensation. Thus, a total of 80% of companies have clawback policies that are triggered by a restatement, but may also be triggered by additional events. Four companies (13%) have policies that are triggered exclusively by misconduct, regardless as to whether a restatement occurred. Two companies (7%), Verizon[86] and Bank of America,[87] have clawback policies that did not conform to any of the other categories.

The data show that the vast majority of companies in the DJIA are already in compliance with the Dodd-Frank Act's trigger requirement. Section 954 of the Dodd-Frank Act requires companies to adopt clawback policies that are triggered by "an accounting restatement due to the material

[85] Companies use various terms to describe the triggering restatement. This study lumps all restatements into a single category.

[86] Verizon's clawback policy is triggered by "financial misconduct[.]" Verizon Commc'ns Inc., Proxy Statement (DEFA14A), at 44 (Mar. 30, 2010).

[87] Bank of America's equity clawback is triggered when "Bank of America or the executive officer's line of business . . . experiences a loss[,]" and its Incentive Compensation Recoupment Policy is triggered by a financial restatement. Bank of Am. Corp., Proxy Statement (DEF 14A), at 36 (Mar. 17, 2010).

noncompliance of the issuer with any financial reporting requirement under the securities laws[.]"[88] Thus, for the 80% of companies in the DJIA that have clawback policies that are triggered by a restatement, coming into compliance with Section 954's trigger requirement will require minor changes to existing policies, at most.

TABLE 3: CLAWBACK DISCRETION

	Count	Percentage
Complete Discretion	24	80%
Discretion to Determine Culpability	4	13%
Discretion if Corporation Does Not Find Employee Culpable	2	7%

The vast majority of companies reserve complete discretion to determine on a case-by-case basis when to exercise their clawback powers, and all companies are able to exercise at least some discretion in applying their clawback provisions.

Twenty-four companies (80%) have policies that allow the company to exercise complete discretion to determine on a case-by-case basis whether to exercise its clawback powers.

Four companies (13%) do not expressly reserve discretion, but are still effectively able to exercise discretion in choosing when to utilize their clawback powers. Each of these four companies has a clawback policy that requires culpability, but that also allows the company to make the initial and/or final determination of the employee's culpability. Since these four companies have the power to decide if the employee is culpable, each company is effectively able to

[88] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010).

exercise discretion. If the company finds the employee not culpable, the company does not clawback compensation.[89]

Two companies (7%) have more nuanced policies: General Electric and United Technologies.[90] General Electric must recoup compensation if it finds that the "executive engaged in fraudulent misconduct" but reserves discretion otherwise.[91] United Technologies must recoup compensation if it finds the employee culpable but reserves discretion if it does not find the employee culpable.[92] Note that for both General Electric and United Technologies, the company itself determines culpability, and therefore is able to exercise discretion.[93] In short, every company in the study is able to exercise at least some discretion in applying its clawback policy.

This finding—that every company in the DJIA is able to exercise at least some discretion in applying its clawback policy—presents clear evidence that companies value such discretion. This study's finding that companies value discretion provides empirical support for the argument, discussed more fully below, that the SEC should grant companies limited discretion to determine on a case-by-case

[89] If the board finds an executive not culpable, shareholders could sue alleging that the board's decision was in error, and that the board's error constitutes a breach of its fiduciary duties. But given the deference boards receive under the business judgment rule, there is little reason to believe, absent egregious facts, that such a suit is likely to succeed. *Cf.* LATHAM & WATKINS LLP, CLIENT ALERT: A TALE OF CLAWBACKS 5 (Aug 10. 2010), *available at* http://www.lw.com/upload/pubContent/_pdf/pub3662_1.pdf (stating that a board's decision to claw back compensation—or to decline to claw back compensation—under SOX 304 is likely protected by the business judgment rule).

[90] *See infra* notes 91–92 and accompanying text.

[91] Gen. Elec. Co., Proxy Statement (Schedule 14A), at 26 (Mar. 5, 2010). General Electric's policy always requires culpability, but distinguishes "fraudulent misconduct" from the broader category of "conduct detrimental to the company[.]" *Id.*

[92] United Techs. Corp., Annual Report (Form 10-K), Exhibit 10.1 (Feb. 11, 2009).

[93] *See supra* note 89.

basis whether to exercise the clawback powers mandated by Section 954.[94]

TABLE 4: AMOUNT CLAWED BACK

	Count	Percentage
All (Entire Bonus)	1	3%
All or Part	6	20%
Portion Erroneously Awarded	8	27%
Not Stated	13	43%
Other	2	7%

With regard to the amount of compensation each company will clawback, practices vary widely and many companies are not specific. One company, Hewlett-Packard, appears to recoup the entire bonus.[95] Six companies (20%) reserve discretion to recoup all or part of the compensation falling within the clawback policy. Eight companies (27%) can only recoup the portion of the compensation that was erroneously awarded. Thirteen companies (43%) do not clearly state what portion of the affected compensation they will recoup, suggesting the companies reserve discretion to make such determinations on a case-by-case basis. Two companies (7%) have more nuanced policies: Bank of America[96] and Microsoft.[97]

[94] *See infra* Part IV.

[95] Hewlett-Packard's 2010 proxy contains a brief summary of its recoupment policy, and mentions that its board approved the policy in 2006. Hewlett-Packard Co., Proxy Statement (Schedule 14A), at 53 (Jan. 27, 2010). Its 2007 proxy contains what appears to be the actual recoupment policy. Hewlett-Packard Co., Proxy Statement (Schedule 14A), at 56–57 (Jan. 23, 2007). Although the language regarding the portion of the bonus recouped is open to interpretation, one plausible reading is that the company will recoup the *entire* bonus ("all such bonuses"). *Id.*

[96] Bank of America may recoup all or part of affected equity awards, but for other awards it may only recoup the portion erroneously awarded. Bank of Am. Corp., Proxy Statement (Schedule 14A), at 36 (Mar. 17, 2010).

Adding a few categories together reveals a clear majority practice: two-thirds of companies are able to exercise considerable discretion in determining what compensation to recoup. Thirteen companies (43%) reserve such discretion by default, by not clearly stating what portion of compensation they will recoup. Six companies (20%) reserve such discretion by expressly stating they reserve the right to recoup all or part of the affected compensation. One company, Microsoft, reserves such discretion by granting itself the option to recoup "the entire payment" from an employee who engaged in "intentional misconduct[.]"[98] By contrast, less than one-third of companies limit themselves to only recouping erroneously awarded compensation.

That two-thirds of companies in the DJIA are able to exercise considerable discretion in determining what compensation to recoup offers further evidence that companies value discretion to determine on a case-by-case basis how to exercise their clawback powers. This study's finding that companies value discretion provides empirical support for the arguments presented in the following section.

IV. THE CASE FOR DISCRETION

The data presented above show that companies in the DJIA value discretion to determine when and how to exercise their clawback powers. The discretion and amount clawed-back categories, in particular, reveal a significant market preference for case-by-case discretion. This section

[97] Microsoft generally only recovers the portion erroneously awarded, but it may "recover the entire payment" if the employee "engaged in intentional misconduct[.]" Microsoft Corp., Proxy Statement (Schedule 14A), at 30–31 (Sept. 30, 2010). Conclusions regarding Microsoft are based on both its 2010 proxy statement, *id.*, and a statement of its clawback policy appearing on its website, *Executive Compensation Recovery Policy*, MICROSOFT, http://www.microsoft.com/investor/CorporateGovernance/ShareholderAccountability/recoveryPolicy.Aspx (last revised Sept. 14, 2010). Although the two sources do not conflict, in some instances one source is more specific than the other. In all such instances, all conclusions are based on the more specific source.

[98] Microsoft Corp., *supra* note 97, at 31.

draws inferences from this Note's original empirical data to answer an important regulatory question: should regulators and courts interpret Section 954 in a manner that grants companies limited ex post discretion? This Note concludes that granting companies limited discretion to determine on a case-by-case basis whether to exercise the clawback powers mandated by Section 954 is desirable as a matter of policy and consistent with the statutory language and legislative intent of Section 954. Importantly, the arguments that follow do not hinge on an assumption that the market preference for discretion is necessarily efficient. Rather, the arguments hinge on the following inference: companies clearly value discretion, and so if regulators interpret Section 954 in a manner that strips companies of all such discretion, companies will face a powerful incentive to adopt compensation arrangements that are not governed by Section 954.[99]

This section begins by discussing how Section 954 applies without regard to an executive's culpability. It then argues that Section 954 does not prohibit board discretion, makes the case for granting companies some discretion, and addresses the problems associated with granting companies too much discretion. This section closes by proposing a middle ground solution that maximizes the benefits of discretion while minimizing the costs.

A. Section 954 Will Force Companies to Change the Way in Which They Approach Culpability

The majority of companies in the study presented in Part III have clawback policies that apply only against culpable employees.[100] However, Section 954 has no culpability require-ment—it applies against non-culpable employees, and it applies even if the erroneous award was not the product of *anyone's* misconduct.[101] Accordingly, a majority of

[99] *See infra* Part IV.C.

[100] *See supra* Part III.B.

[101] Commentators widely agree that Section 954, unlike SOX 304, does not require any misconduct or individual culpability. *See, e.g.*, WILLKIE

companies in this study will have to change the way in which they approach culpability as they adjust their clawback policies in response to Section 954.

While Section 954 contains no mention of culpability, misconduct, or fraud. SOX 304, an earlier statute, expressly requires misconduct.[102] SOX applies to "accounting restatement[s] due to the material noncompliance of the issuer, *as a result of misconduct*,[103] with any financial reporting requirements under the securities laws[.]"[104] Contrasting Section 954 to SOX 304 suggests that Congress did not intend to include a culpability requirement in Section 954. If Congress intended to include such a requirement, it could have done so explicitly, as it did in SOX 304.[105]

The legislative history offers an even clearer indication that Section 954 applies against both culpable and non-culpable employees.[106] The Senate Committee on Banking, Housing, and Urban Affairs included the following comment about Section 954 in its committee report: "[i]t does not require adjudication of misconduct in connection with the problematic accounting that required restatement."[107]

FARR & GALLAGHER LLP, DODD-FRANK PROVISIONS ADDRESS EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE 3 (July 27, 2010), *available at* http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C3457 %5CDodd-Frank-Provisions-Address-Executive-Comp.pdf.

[102] *See* Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7243, 116 Stat. 745 (2010).

[103] Notably absent from the statute is a clear indication of whose misconduct is required. At least one court interpreted the statute to mean that the CEO or CFO subject to the clawback need not have personally engaged in misconduct, so long as another employee engaged in misconduct necessitating the subsequent restatement. SEC v. Jenkins, 718 F. Supp. 2d 1070, 1074 (D. Ariz. 2010) (denying defendant's motion to dismiss and finding that SOX 304 can apply against a CEO who did not engage in misconduct).

[104] 15 U.S.C. § 7243 (emphasis added).

[105] *See supra* notes 102–04 and accompanying text.

[106] S. Rep. No. 111-176, at 135–36 (2010), *available at* http://www.gpo.gov/fdsys/pkg/CRPT-111srpt176/pdf/CRPT-111srpt176.pdf.

[107] S. REP. NO. 111-176, at 135–36.

Although Congress's legislative judgment on the issue of culpability is clear, its decision may draw criticism.[108] Some commentators and practitioners are critical of clawback requirements that apply without regard to individual culpability, arguing that recouping compensation from a non-culpable employee does little or nothing to deter future misconduct.[109] These commentators and practitioners may offer similar criticisms of Section 954. The majority of companies in the DJIA may agree with these commentators, as 60% of companies in the DJIA have clawback policies that require individual culpability.[110] Even so, companies in the DJIA divide in their approach to culpability. Nearly one-third of companies in the DJIA do not include individual culpability as a condition precedent in their clawback policies.[111]

In short, companies in the DJIA differ in their approach to culpability, but Congress clearly settled on just one approach. In drafting Section 954, Congress decided not to include a culpability requirement. The remaining sections of this Note explore an issue that Section 954 does not directly address: discretion.

B. Section 954 Does Not Prohibit Board Discretion

Granting companies limited discretion to determine on a case-by-case basis whether to claw back compensation is consistent with Section 954. Section 954 requires companies to "develop" and "implement" clawback policies.[112] It does not, however, expressly require companies to enforce such clawback policies in all instances.

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[108] *See, e.g.*, note 109 and accompanying text.

[109] *See supra* note 41 and accompanying text. *See also* John F. Savarese & Wayne M. Carlin, *SEC Pursues Unprecedented Sarbanes-Oxley "Clawback"*, WACHTELL, LIPTON, ROSEN & KATZ (July 24, 2009), *available at* http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.16845.09.pdf.

[110] *See supra* Part III.B.

[111] *See supra* Part III.B.

[112] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010).

One can read the term "develop" to mean companies must draft clawback policies, and the term "implement" to mean companies must adopt such clawback policies.[113] Based on such a reading, Section 954 stops short of requiring companies to enforce their clawback policies in all instances.[114] Section 954 could have required companies to develop, implement, *and enforce* clawback policies, but it does not.[115] Such a reading would explain why Section 954, in contrast to SOX 304 and applicable TARP regulations,[116] does not include an express allowance for a government-granted exemption to recoupment: SOX 304 and applicable TARP regulations mandate recoupment,[117] whereas Section 954 requires companies to implement clawback policies, but it does not require companies to enforce their clawback policies in all instances.

Furthermore, the legislative history offers no indication that Congress intended Section 954 to completely abrogate company discretion.[118] The Conference Report and the Senate Report from the Committee on Banking, Housing, and Urban Affairs both briefly discuss Section 954, but neither report bears on the issue of discretion.[119] Certainly, neither report indicates that Section 954 requires companies to clawback compensation even when the cost of doing so would outweigh the benefits. Since requiring companies to

[113] Although Section 954 merely requires companies to "develop" and "implement" clawback policies, other sections of the Dodd-Frank Act expressly require regulated entities to "*enforce*" certain policies. *Compare id.* § 954(b) *with, e.g., id.* § 932(a)(4) ("Each nationally recognized statistical rating organization shall establish, maintain, *and enforce* policies and procedures . . . .") (emphasis added).

[114] *See* § 954(b).

[115] *See id.*

[116] *See supra* notes 46, 49, and 53 and accompanying text.

[117] 15 U.S.C. § 7243 (2010) ("the chief executive officer and chief financial officer of the issuer *shall* reimburse the issuer") (emphasis added); TARP Standards for Compensation and Corporate Governance, 31 C.F.R. § 30.8 (2010).

[118] *See infra* notes 119–21 and accompanying text.

[119] S. REP. NO. 111-176, at 135–36 (2010); H.R. REP. NO. 111-517, at 872–73 (2010) (Conf. Rep.).

claw back compensation without exception—even when the costs out-weigh the benefits—would represent a stark departure from the standards used in SOX 304 and TARP regulations,[120] it is unlikely that Congress would have made such a shift in the law without offering a clear indication of its intent to do so.[121]

C. The Benefits of Discretion

To enable companies to exercise their best business judgment, federal regulators should give companies broad discretion to determine on a case-by-case basis whether to clawback compensation. Companies should retain such discretion even in situations in which the accounting benefit of recoupment is expected to outweigh the accounting cost.[122] Granting companies such discretion is both desirable and reasonable because: (1) it will reduce the risk that Section 954 will produce unintended consequences by encouraging companies to abandon incentive-based compensation; and (2) share-holders will punish boards that abuse this discretion.

First, granting companies discretion reduces the risk that companies will abandon incentive-based compensation in response to Section 954. The study presented in this Note reveals that companies value discretion to determine when and how to exercise their clawback powers.[123] If regulators interpret Section 954 in a manner that strips companies of this discretion, companies could simply choose to avoid Section 954's reach. Section 954 applies exclusively to "incentive-based compensation . . . based on" a financial accounting statement that is later restated "due to the material noncompliance" of the company "with any financial

[120] *See supra* notes 46, 49, and 53 and accompanying text.

[121] *See* Rebecca M. Kysar, *Statutory Interpretation: How Much Work Does Language Do?*, 76 BROOK. L. REV. 953, 963 (2011) (stating that under the "dog-doesn't-bark canon" of statutory interpretation, "if a statutory interpretation would significantly change the existing legal landscape, a lack of congressional debate on the issue is evidence that Congress did not intend that interpretation.").

[122] *See infra* note 136.

[123] *See supra* Part III.B.

reporting requirement under the securities laws[.]"[124] If companies feel the regulations enforcing Section 954 are overly restrictive, they could simply decrease their use of accounting-based incentive compensation (to reduce the amount of compensation subject to Section 954).[125]

Several law firms and consulting agencies have already suggested that companies could take such measures in response to an overly restrictive interpretation of Section 954.[126] For example, some have suggested that companies could decrease their use of accounting-based incentive compensation by increasing base salary.[127] Others suggest companies could increase their use of incentive compensation systems that are not accounting-based.[128] Existing research shows companies are willing to take such measures: "[A]fter [SOX] . . . companies increased non-forfeitable, fixed-salary compensation and decreased incentive compensation, thereby providing insurance to managers for increased risk."[129]

This argument holds regardless of why companies prefer discretion. At least one article argues that companies' preference for discretion may be the product of managerial power,[130] but such an argument is somewhat beside the

[124] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010).

[125] It is unclear precisely which forms of accounting-based incentive-based compensation fall under Section 954's reach. *See, e.g.*, Letter from Ctr. on Exec. Comp. to the SEC, *supra* note 37, at 9. This issue falls beyond the scope of this Note.

[126] Law firms and consulting firms have offered these suggestions in white papers and client advisory memoranda. *See infra* notes 127–28 and accompanying text.

[127] *See, e.g.*, *Mandated Clawbacks Will Create New Tensions Between Executives and the Board*, TOWERS WATSON, 5 (Sept. 7, 2010), http://www.towerswatson.com/assets/pdf/2402/2402_6.pdf.

[128] *See, e.g.*, TOWERS WATSON, *supra* note 127, at 5–6; PEPPER HAMILTON LLP, *supra* note 47, at 5; LATHAM & WATKINS LLP, *supra* note 89, at 5.

[129] Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-term*, 26 YALE J. ON REG. 359, 366 (2009).

[130] Fried & Shilon, *supra* note 17, at 743–44.

point. What matters is that, for one reason or another, companies value discretion, and if regulators interpret Section 954 in a manner that strips companies of this discretion, boards may well respond by abandoning incentive-based compensation.

Motivating companies to abandon accounting-based incentive compensation is undesirable. If based on well-chosen and accurate financial metrics, accounting-based incentive compensation may serve a valuable role in aligning executives' incentives with those of the company and its shareholders, thereby reducing agency costs.[131] Furthermore, there is no indication in the legislative history that Congress intended Section 954 to discourage companies from using accounting-based incentive compensation. Rather, there is every indication that Congress simply sought to maximize the value of accounting-based incentive compensation by ensuring that it is based on accurate financials.[132]

Second, granting boards discretion is reasonable because shareholders will punish boards that abuse this discretion. If informed of the board's decision through an appropriate disclosure system, dissatisfied shareholders can punish boards that abuse this discretion.[133] For example, if a board declines to claw back compensation from an executive, but shareholders believe that the board should have exercised its clawback powers, dissatisfied shareholders could simply sell their shares, driving the value of the company's stock down. A drop in the company's stock price not only decreases the value of each director's shares, but also may elicit a response from activist shareholders or attract a hostile bidder. This chain of effects will punish a board that abuses its discretion, and thereby serves to deter inefficient behavior.

By failing to account for the costs of shareholder retribution, some academics underestimate the incentive boards will face to clawback compensation in appropriate

[131] *See, e.g.*, Jensen & Meckling, *supra* note 11.

[132] S. Rep. No. 111-176, at 135–36 (2010); H.R. Rep. No. 111-517, at 872–73 (2010) (Conf. Rep.).

[133] *See infra* Part IV.E.

circumstances.[134] For example, Jesse Fried and Nitzan Shilon weigh the costs to board members of recouping compensation against a single (and very small) benefit: each director's fractional share (based on each director's stock ownership) of the compensation the board recovers.[135] In so doing, Fried and Shilon fail to consider what may be the single biggest benefit to board members of recouping compensation: avoiding retribution from dissatisfied shareholders.

That companies currently reserve broad discretion suggests that companies believe that determining whether to enforce a clawback is a highly fact-specific inquiry, and thus must be made on a case-by-case basis. It also suggests that companies believe that even if the *accounting* benefit of recouping compensation in a particular circumstance outweighs the accounting cost, the *economic* benefit may not outweigh the economic cost.[136] If companies believed otherwise, they could have drafted simple accounting cost/benefit exceptions into their clawbacks, stating that they will not pursue recoupment in a given circumstance if the accounting cost of the clawback is likely to exceed the amount of money recovered. But they did not; instead, they reserve broad discretion to weigh the total *economic* costs and benefits in each case.

Giving companies discretion to determine on a case-by-case basis whether to exercise their clawback powers in a particular circumstance is consistent with Section 954.

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[134] *See, e.g.*, Fried & Shilon, *supra* note 17, at 732–35, 739.

[135] *Id.*

[136] As used in this Note, the terms "accounting cost" and "accounting benefit" refer to costs and benefits that would appear on balance sheets, such as litigation costs and the amount of money recovered from the executive. In contrast, "economic cost" and "economic benefit" include accounting costs and benefits plus additional factors that do not appear on balance sheets, such as: good- (or ill-) will from employees, shareholders, and the public; deterrence; and the impact on the company's ability to negotiate new employment contracts and recruit new managers. The terms "economic cost" and "economic benefit" thus describe the full range of costs and benefits a company faces when determining whether to clawback compensation in a particular circumstance.

Moreover, doing so will minimize the risk of unintended conse-quences.[137] When companies are able to exercise the discretion they value, as this Note's study shows,[138] they can make the fact-specific inquiries necessary to determine if clawing-back compensation in a particular circumstance will yield positive economic benefits for the company and its shareholders.

D. Problems Associated With Excessive Board Discretion

However, regulators should not grant companies limitless discretion. If boards held unlimited discretion, managerial power concerns would resurface, and the clawback requirement could become ineffectual. Proponents of the managerial power theory argue that managers exert significant influence over boards, and that this management influence causes boards to side with management—rather than with shareholders—on important issues such as executive compensation.[139] If boards hold limitless discretion, managerial influence could render the clawback requirement in Section 954 ineffectual; powerful management could pressure a board to decline to exercise its clawback powers.

Existing research validates concerns that excessive board discretion would yield sub-optimal results.[140] Pre-Dodd-Frank research shows that companies with high levels of "management influence" on corporate governance are less likely to have clawback provisions, whereas companies with "more independent monitoring" in corporate governance are more likely to have clawback provisions.[141] If managers at some companies were able to pressure their boards into declining to adopt clawback provisions before Dodd-Frank, then surely some managers could pressure boards to decline

[137] *See supra* notes 124–29 and accompanying text.

[138] *See supra* Part III.

[139] *See supra* notes 18–21 and accompanying text.

[140] *See infra* note 141 and accompanying text.

[141] Addy, Chu & Yoder, *supra* note 24.

to exercise the clawback powers required by Section 954. Limitless board discretion would thus retrigger the managerial power problem, reducing the efficacy of Section 954.

E. A Middle-Ground Solution

Whenever a company issues an accounting restatement that triggers a Section 954 clawback, regulators should give the company's board two options: (1) publicly announce the board's decision to claw back compensation, or to decline to claw back compensation, and the reasons justifying such a decision; or (2) turn decision-making authority over to an independent actor (such as a compensation consultant, auditor, or arbitrator), giving the independent actor full authority to decide whether the company will exercise its clawback powers. This approach gives companies the case-by-case discretion they value, but both options would also reduce management's influence over the decision-making process. The first option would give shareholders the information necessary to hold the board accountable for its decision, thereby placing pressure on the board to make a decision that serves the best interests of the shareholders. The second option would avoid the managerial power problem by placing the decision in the hands of an independent authority.

Requiring boards to publicly announce their decisions, and the reasons justifying their decisions, would give shareholders the information they need to hold boards accountable. Armed with the information contained in the disclosures, if shareholders find the board's decision unacceptable, they could impose "outrage costs" on the board.[142] This, in turn, would put pressure on boards to make decisions that serve shareholders' interests in the first instance. Research confirms that shareholder-opinion places constraints on executive compensation, and that the

[142] *See* Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, J. ECON. PERSP. 71, 75 (2003). *See also supra* notes 133–35 and accompanying text.

transparent disclosure of compensation practices allows shareholders to influence executive compensation decisions.[143] Thus, requiring boards to disclose their decisions and their reasoning would allow shareholders to constrain and influence boards' decisions. Boards could even take a page from Dodd-Frank's say-on-pay provision[144] and adopt a more aggressive version of this proposal: they could give shareholders the power to vote[145] on the board's clawback decision.[146]

Alternatively, requiring boards to vest decision-making authority in the hands of an independent actor would help shield the decision-making process from managerial influence. This independent actor would then weigh, from the company's perspective, the full economic costs and benefits of clawing back (or declining to claw back) compensation. Requiring the board to grant the independent actor binding authority would prevent management from pressuring the board to reject the independent actor's decision.

There is one potential flaw with the independent actor proposal: management could place pressure on boards to choose independent actors that are likely to make decisions favorable to management. A mandatory disclosure regime would address this problem. When a company turns its decision-making process over to an independent actor, regulators could require the company to disclose the independent actor's decision and its reasoning. This would enable shareholders to hold the board accountable if the board appoints an independent actor that shows a pro-management bias. Knowing that investors have such

[143] *See id.* at 76.

[144] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (2010).

[145] This shareholder vote could be either non-binding (but informative for the board) or binding.

[146] To be clear, such voting procedures would exceed the minimum requirements of the disclosure rule that this Note proposes. The disclosure rule proposed in this Note would simply require boards to, at a minimum, disclose their clawback decisions and their reasoning.

powers, boards will have an incentive to choose neutral independent actors, and independent actors will have an incentive to act in an even-handed manner.

V. CONCLUSION

The study presented in this Note reveals that companies value discretion to determine when and how to exercise their clawback powers. This suggests that if regulators interpret Section 954 in a manner that strips companies of all such discretion, companies will face a powerful incentive to change their compensation systems in order to avoid Section 954. Fortunately, Section 954 allows regulators to give companies the discretion they value. However, because limitless discretion could allow managers to undermine Section 954, regulators should require boards either to: (1) publicly announce their clawback decisions and their reasoning; or (2) give independent actors full authority to determine whether to clawback compensation. This limited discretion proposal offers companies the discretion they value, minimizes managerial power concerns, and is consistent with the text and legislative history of Section 954.