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The Dodd-Frank Clawback Provision's Role in Creating a More Secure Corporate Governance Structure

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Introduction

The "Great Recession" of 2008 served as the catalyst for Congressional action on financial reform in the United States. [1]The resulting calamity from credit default swap use by Lehman Brothers, Fannie and Freddie Mac and the American International Group produced populist uproar throughout the nation. [2] In response to the financial collapse, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. The "Reform Act" overhauls federal financial regulation in a number of ways. Dodd-Frank provisions attempt to end the reviled "too big to fail" policy while adding a number of new securities regulation requirements. The "Reform Act" also introduces a number of provisions applicable to internal corporate governance. These corporate governance provisions include a "say on pay" provision requiring a non-binding vote by stockholders on executive pay, disclosure of executive compensation, establishment of independent compensation committees and mandatory adoption of provisions allowing for the clawback of incentive based executive compensation. [3]

The following paper illustrates how Dodd-Frank's changes in incentive-based executive compensation clawback provisions serve as a lynchpin in a broader effort to enforce accountability amongst executive officers. Dodd-Frank's clawback requirement does not serve to impede excessive executive compensation. The clawback provision's intention is two-fold. First, the provision is intended to bring greater accountability to financial institutions. Second, the

[1] Adam Nagourney, *Bracing for a Backlash Over Wall Street Bailouts*, New York Times, Mar. 16, 2009, at A1.
[2] Id.
[3] H.R. 4173, 111th Cong. (2010).

Dodd-Frank clawback provision attempts to create a more secure avenue of investment for potential and current shareholders of publicly held corporations. Still, the legislation enacted in the shadow of the largest economic downturn since the Great Depression falls just short of the American public's true goal; regulation meant to stop the next Wall Street collapse. Dodd-Frank does accomplish the goal of Congress, restoring faith in the American economy.

Section I discusses the definition of the term "clawback", how it has been interpreted in court, and the limits imposed by the language of the statute. Sections II and III examine the historical context in which the clawback provisions were enacted under both the Sarbanes-Oxley Act and the Dodd-Frank Act. Section IV examines the differences between the clawback provisions in Sarbanes-Oxley and Dodd-Frank. Section V details the specific improvements made in Dodd-Frank's newly enacted clawback policy. Section VI addresses objections made to the clawback policy adopted in Dodd-Frank. Finally, the conclusion analyzes the improvements made to the clawback provision, addressing the greater context of corporate governance provisions in Dodd-Frank and how the "Reform Act" creates a more accountable and trustworthy financial system for investors.

I. Defining the Term Clawback

In their article "Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes", Professors Miriam Cherry and Jarrod Wong define 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." [4] Cherry and Wong proceed to distinguish between two distinctive types of clawbacks.. The first type, the

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[4] Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes,* 94 Minn. L. Rev. 368, 371-72 (2009)

retroactive clawback, is "imposed after the contractual right to the bonuses has arisen and the benefits have occurred." [5]Attempts to tax excessive executive compensation after the company confers serve as an example of a retroactive clawback. The second category, the prospective clawback, is written into an investment or employment contract before the time the benefit can be claimed.[6] The clawback provision in Dodd-Frank exemplifies the prospective clawback. Because Dodd-Frank's clawback provision only provides for prospective clawbacks, this article will not consider the merits of retroactive clawbacks.

While serving as its own recursive definition, the term "clawback" was originally coined by the press in describing federal action through section 304 of the Sarbanes-Oxley Act. Section 304, entitled "Forfeiture of Certain Bonuses and Profits", creates an avenue of enforcement for the SEC to "clawback" incentive based compensation earned under false pretenses. The statute provides that the company's CEO and CFO must disgorge any incentive-based compensation received 12 months prior to the filing of the restatement if an accounting restatement is filed as a result of misconduct resulting in material noncompliance with SEC reporting requirements. [7] Although a number of companies adopted clawbacks into their employment contracts following Sarbanes-Oxley, the provision did not make adoption mandatory. [8]

Adoption of a broad statute by the SEC left a number of issues to the discretion of the courts. The most influential of those cases was 2010's *SEC v. Jenkins*. The Jenkins decision involved the CEO of CSK Auto Corporation, an auto parts retail company. [9] According to the complaint, CSK reported greater pretax profits under a vendor allowance program than were

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[5] Id. at 373.
[6] Id.
[7] H.R. 3763, 107th Cong. (2002).
[8] Paul Hodgson, *2008 Proxy Season Foresights #11: Clawback Policies*, Governance Metrics International (June 4, 2008), http://www2.gmiratings.com/reports.php?reportid=197&keyword=clawback.
[9] *SEC v Jenkins*, 718 F.Supp.2d 1070, 1072 (D.AZ 2010).

actually earned. [10] Maynard Jenkins, the CEO of CSK, was not alleged to have taken part in the fraudulent concealment of false profits perpetrated by fellow CSK officers. [11] He had however profited from those misstatements through bonuses and other incentive-based payments. [12] The court held that the Sarbanes-Oxley Act did not require personal misconduct on behalf of the CEO or CFO to trigger the clawback provision. [13]

The 9th Circuit Court of Appeals first held that no private right existed under SOX's claw-back provisions dealing in the matter of Digimarc Corporation's Derivative Litigation in *Diaz v. Davis*. [14] Digimarc involved a shareholders action against corporate officers alleging a breach of fiduciary duties in breach of section 304 of the Sarbanes-Oxley Act. [15] The court noted that in other section of the Sarbanes-Oxley Act, private rights of action had been specifically provided for through the language of the statute. [16]No such language was present in section 304. Following the Digimarc ruling, the 2nd Circuit Court of Appeals additionally found that a settlement agreement could not release a CEO or CFO from liability under Sarbanes-Oxley provisions. [17] *Cohen v. Viray* involved an employment agreement releasing and indemnifying the CEO and CFO of DHB Industries Inc. against any liability under section 304 of the Sarbanes'-Oxley Act. [18] The Court held that such an agreement was an attempted end-around SEC action that "vitiates the SEC's role and is inconsistent with the law." [19]

Following the world wide recession of 2008, Congress enacted the Dodd-Frank Act. Section 954 provides that each issuer must, in the event of an accounting restatement, develop

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[10] *id.*
[11] *id.*
[12] *id.*
[13] *Id.* at 1074.
[14] *Diaz v. Davis (In re Digimarc Corp.),* 549 F.3d 1223, 1226 (9th Cir. 2008).
[15] *Id.*
[16] *Id.* at 1230.
[17] *Cohen v. Viray,* 622 F.3d 188, 192 (2nd Cir. 2010).
[18] *Id.*
[19] *Id.* at 195.

and implement a policy to recover from any former executive officer any excessive incentive based commission over a three year period. Additionally, subsection (a) of the law requires that all publicly listed companies adopt a clawback provision or risk being delisted from national securities exchanges. [20]

American courts have not yet had an opportunity to encounter Dodd-Frank's section 954 clawback provision. It is assumed the Courts will continue finding no implied private right for shareholders. [21] Still, the new clawback provision includes a number of changes. To fully understand these changes, it is important to comprehend the context in which each form of the clawback provision was adopted, and Congress' intention in doing so.

II. Historical Context of the Origins of Clawback Provisions: Enron and the Sarbanes Oxley Act

The Enron and WorldCom accounting scandals of 2001 served as the impetus for developing a policy to recover erroneously awarded compensation, or, as it would later become known, the clawback provision. [22] The original clawback provision was part of federal legislation known as the Sarbanes-Oxley Act of 2002. Sarbanes-Oxley was largely the product of the corporate accounting scandals and the ensuing exposure of compensation schemes that rewarded vast benefits to corporate executives based on faulty profits. [23] Congress passed the Sarbanes-Oxley Act with the intent of preventing further corporate accounting scandals and changing corporate governance in ways that would prohibit the types of executive compensation schemes used by those fraudulent institutions.

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[20] *See supra* note 3.

[21] Robert E. Scully, *Executive Compensation, the Business Judgment Rule, and the Dodd-Frank Act: Back to the Future for Private Litigation?*, 58-JAN Fed.Law.36, 40 (2011).

[22] Bernhard Kuschnik, *The Sarbanes Oxley Act: "Big Brother is watching" you or Adequate Measures of Corporate Governance Regulation?* 5 Rutgers Bus. Law Journal, 64,67 (2008).

[23] *Id.*

The Enron Corporation, an energy and commodities company known for its influence in international energies markets, at the time served as the pinnacle of American corporate greed. [24] Through their use of mark to market accounting, Executive Officers at Enron inflated stock prices by listing as assets profits that had not yet come to fruition. At one time selling for over ninety dollars a share, Enron would file for chapter 11 bankruptcy in late 2001, taking with it over 20,000 jobs and driving stock prices down to less than a dollar a share. [25] Until the chapter 11 bankruptcy filings of WorldCom and later Lehman Brothers, Enron stood as the largest single financial catastrophe in the history of the financial world. [26]

The year of 2001 was notable for reasons other than the corporate accounting scandals previously mentioned. On September 21st, 2001, a symbol of American prosperity and financial dominance was attacked when nineteen terrorists high-jacked four commercial planes, flying two of the planes into the Twin Towers. [27] The effect of the terrorist attacks on both Wall Street and Main Street in many ways dwarfed any attempts by Congress to curb those corporate governance abuses. Adopted approximately a year following the 9/11 attacks, the Sarbanes-Oxley Act was intended to address corporate accounting abuses and the issues surrounding those scandals. Not until the events surrounding the 2008 Recession did Congress have the intent or the political support to implement financial regulation expansive enough to significantly affect the governing structures of American corporations.

Sarbanes-Oxley's clawback provision served more as a last resort for federal authorities than as a tool for investors to increase corporate accountability. The aim of Sarbanes-Oxley Act

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[24] Bethany McLean & Peter Elkind, *The Smartest Guys in the Room*, (2004).
[25] *Id.*
[26] Sam Mamudi, *Lehman folds with record $613 billion debt*, Marketwatch.com, Sept. 15, 2008, http://www.marketwatch.com/story/lehman-folds-with-record-613-billion-debt?siteid=rss.
[27] Serge Schmemann, *U.S. ATTACKED; President Vows to Exact Punishment for 'Evil'*, New York Times, Sept. 12, 2001, at A1.

was to curtail fraudulent corporate accounting practices. Corporate governance played a less significant role in Sarbanes-Oxley than it would eight years later in Dodd-Frank. Through Sarbanes-Oxley, Congress sought to prevent fraudulent corporate accounting from causing a greater financial meltdown. [28] The clawback provision served as a way to hold CEOs and CFOs accountable for fraudulent practices occurring in their company even if claiming ignorance of the purported fraudulence. The clawback provision was a direct response to the claims by Enron CEO Jeff Skilling and CFO Ken Lay that they were unaware of the fraud being committed on their watch. [29]

Congress adopted the original clawback provision intending to prevent corporate accounting malpractice. [30] The fraudulent practices of Enron and WorldCom were fresh in Congress' mind when they included the misconduct requirement in Sarbanes-Oxley's clawback provision. [31] Not until the financial recession of 2008 did Congress would begin considering clawback measures for incompetent and uninformed executive officers as a potent weapon in maintaining the integrity of the American financial system. The following section describes the context under which the clawback provision morphed from an afterthought of corporate accounting malpractice legislation to a central tool in restoring faith in the American financial system through stronger corporate governance.

III. Historical Context of the Origins of Claw-back Provisions: The 2008 Economic Crisis and the Dodd-Frank Wall Street Reform and Consumer Protection Act

[28] *See supra* note 19.
[29] *See supra* note 21.
[30] *See supra* note 19.
[31] *See supra* note 19.

Beginning in 2007, the United States experienced its greatest economic recession since the Great Depression. Reckless lending practices involving the use of mortgage backed securities caused the collapse of a number of major American financial institutions. Amidst a worldwide housing bubble, financial institutions made huge gains by offering adjustable-rate mortgages to financially unreliable individuals. Banks then packaged these mortgages into mortgage backed securities. Willing investors were offered these mortgage backed securities at lower rates in exchange for one time cash payments. As introductory rates on adjustable rate mortgages expired, both mortgage rates and defaults rose sharply. With the burst of the housing bubble, bank profits based on instruments heavily reliant on mortgage backed securities fell dramatically. The consequences were felt worldwide, culminating in the collapse of such financial juggernauts as Lehman Brothers and Bear Sterns. [32]

The financial downturn resulted in high unemployment, losses to pension funds and nation-wide public outrage directed towards the powers that be on Wall Street. [33] In 2008, Senator Barak Obama was elected President of the United States, swept into office by the public's demand for financial reform. [34] As foreclosures and unemployment rose to record levels, the American people decried the perceived arrogance and hypocrisy exuding from corporate boardrooms throughout the country. [35]Financial reform became the top priority of a newly elected Congress and President. [36]

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[32] Stephen Labaton, *Agency's 04' Rule Let Banks Pile Up New Debt*, The New York Times, Oct. 3, 2008, at A1.
[33] Mark Trumbull, *Eight Ways the Great Recession has Changed Americans*, The Christian Science Monitor, June 30, 2010, http://www.csmonitor.com/Business/2010/0630/Eight-ways-the-Great-Recession-has-changed-Americans.
[34] Adam Nagourney, *Obama Elected President as Racial Barrier Falls*, The New York Times, Nov. 4, 2008, at A1.
[35] Mark Decambre, *Rage and Record Earnings at Goldman*, New York Post, Jan. 22, 2010, http://www.nypost.com/p/news/business/rage_and_record_earnings_at_goldman_2r8mQO9LXxLxAFjSyXa4VK
[36] Sue Chang, *Obama Urges Congress to Pass Wall Street Reforms*, MarketWatch.com, June 26, 2010, http://www.marketwatch.com/story/obama-urges-congress-to-pass-wall-street-reforms-2010-06-26.

As anti-Wall Street fervor mounted, Congress slowly began to act. Protests came from both sides of the aisle when then President Bush enacted the Emergency Economic Stabilization Act of 2008. [37] . Public outrage reached its apex when it was discovered that executive officers of companies accepting tax-payer provided assistance were being rewarded with multimillion dollar bonuses. Congressional action was taken to recoup those bonuses by way of heavy tax burdens. [38]For Congress, extinguishing the flames of public anger scorching Wall Street was not the only concern. More importantly, Americans had lost faith in the economy. [39] Restoring faith in the economy was the United States government's driving intention. One of the major concerns confronting Congress as they began developing reform legislation was the issue of executive compensation. Congress sought a way to provide transparency and accountability in addressing public concerns over corporate governance and executive compensation procedures. [40]

The American public's reaction was massive to 2008's TARP legislation. As middle class families struggled through cuts in work hours and job losses, the federal government was supplying billions of taxpayer dollars in "bailout funds" to the very individuals that had created the financial downturn. To the average American, it seemed as if the two most powerful beings in America, Washington and Wall Street, were working together against anyone not making a six figure salary. The backlash was unbridled and in many ways, became illogical. Lack of regulation had led to a mortgage industry in which fraud had been made legal. Investment banks devised ways not only to make money off of the sale of mortgage-backed securities, but to profit

[37] Ken Bensinger *Masses Aren't Buying Bailout*, The Los Angeles Times, Sept. 26, 2008, http://articles.latimes.com/2008/sep/26/business/fi-voxpop26
[38] Helen Kennedy, *AIG Bonus Checks May be Taxed at up to 100%*, The New York Daily News, Mar. 17, 2009,
[39] Jim Kuhnhenn, *Poll: Financially Pinched, Young Adults Lose Faith*, Bloomberg Business Week, March 9, 2010, http://www.nydailynews.com/money/2009/03/17/2009-03-17_aig_bonus_checks_may_be_taxed_at_up_to_1.html
[40] 156 Cong. Rec. H5233-01, 2010 WL 2605437 (Cong. Rec.)

from their demise after the banks realized they would not succeed. Anti-government and Wall Street anger spread from anti-Tarp protests to anti-Wall Street reform protests.

Somehow, Americans had confused the necessity of bailing out Wall Street with the productivity in reforming Wall Street regulation. Through the imperfect system that is the American Congress in the 21st century, Wall Street received a law that would accomplish that which it set out to do, and nothing more.

Two years after the beginning of America's financial downturn, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law. On July 10, 2010, Congress adopted legislation meant to address the mortgage backed securities scandal as well as quell public concerns over executive compensation. The Act included new securities disclosure requirements, attempted to abolish the abhorrent "Too Big to Fail" Policy despised by the public, and contained a number of corporate governance requirements intended to restore investor faith in the American economy. [41]

The corporate governance requirements included in Dodd-Frank were intended to provide greater "accountability and transparency in the financial system". [42] Title XI of the Dodd-Frank Act, entitled "Investor Protections and Improvements to the Regulation of Securities", includes a number of corporate governance provisions. Among Title IX's sections is a "Say on Pay" vote requirement, a whistleblower protection provision and a mandatory clawback provision. [43]

Section 954 of the Dodd-Frank Act, entitled "Recovery of Erroneously Awarded Compensation", requires that all publicly-listed companies incorporate a clawback provision of incentive based compensation in the event that the company must prepare an accounting

[41] *See supra* note 3.
[42] H.R. 4173 Title Page, 111th Cong. (2010).
[43] H.R. 4173, Title IX, 111th Cong. (2010).

restatement of its finances.[44] The Dodd-Frank clawback contains marked improvements when compared to the Sarbanes-Oxley clawback provision. Those improvements, when placed in the greater context of corporate governance restructuring within Dodd-Frank, provide for greater accountability and transparency within corporate America. In order to appreciate the improvements made between Sarbanes-Oxley and Dodd-Frank, it is vital to investigate and compare the differences between the two provisions.

IV. Comparing the Sarbanes-Oxley Claw-Back Provision with the Dodd-Frank Claw-back Provision

The clawback provisions contained in the Sarbanes-Oxley and Dodd-Frank Acts differ in a number of ways. First, the Sarbanes-Oxley Act applied only to the Chief Financial and Chief Executive Officer of the corporation. In contrast, Dodd-Frank applies to all "executive officers" receiving incentive based compensation.[45] Second, the time period contained in the Dodd-Frank Act was extended to a three year window, an increase from the one year time limit imposed in Sarbanes-Oxley.[46] Third, the Sarbanes-Oxley Act's clawback provisions applied to all incentive based compensation. The Dodd-Frank Act has limited this power to the amount of incentive based compensation awarded to an executive over that which they would have earned based on the restatement.[47]

The Dodd-Frank Act has also eliminated Sarbanes-Oxley's requirement that some sort of "misconduct" occur. Under Dodd-Frank, the production of an accounting restatement suffices to trigger the clawback provision. Finally, Dodd-Frank made adoption of a clawback policy

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[44] *Id.*
[45] T. Gorman, *Dodd-Frank: Clawback*, www.secaction.com, (Sept. 9, 2010), www.secactions.com/p=2564.
[46] *Id.*
[47] *id.*

mandatory on all publicly listed companies. Failure to implement a clawback provision on executive officers will result in the company being delisted from the national securities exchange. [48]

The Dodd-Frank clawback provision also contains its limits. Critics point to the continued lack of a statutorily provided private action for shareholders. [49] Although the issue is yet to be encountered in American Courts, prevailing wisdom is that clawbacks will continue to be barred from use in private rights of action. [50] Furthermore, the SEC remains the lone enforcer of Section 954 outside of the corporate world. [51] The single greatest point of contention surrounding Dodd-Frank's clawback policy remains its inability to curb excessive corporate compensation. Still, the benefits of the new and improved clawback provision far outweigh the potential drawbacks.

Sarbanes-Oxley's clawback provision was not without its faults. First, adoption of a clawback provision was not mandatory. As a result, the SEC stood as the single enforcer of the clawback provision. [52] Additionally, the provision's use as a tool is severely narrowed by its lack of a private right of action. Liability only extended to the CEOs and CFOs under the SOX clawback provision; shielding federal accountability from the majority of executive officers. Sarbanes-Oxley also required misconduct before the clawback provision kick in. [53]

V. An Overview of the Improvements of the Dodd-Frank Act's Claw-back Provision

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[48] *Id.*
[49] Doreen E. Lilienfeld & Kenneth J. Laverriere, *The Impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 on Executive Compensation*, 2011 WL 190439 (2011).
[50] *See supra* note 17
[51] *Id.*
[52] *Id.*
[53] Harold S. Blumenthal, *Sarbanes-Oxley Act in Perspective 11:6*, SEC-SOAP 11:6 (2010).

The proceeding six sections address specific improvements of clawback provisions provided by the Dodd-Frank Act. Improvements made through the changes, as well as legal and financial issues arising from those changes will be addressed. The first improvement, removal of the misconduct requirement, establishes the clawback as a remedial form of enforcement while providing for greater fairness to investors. The second improvement, the application of clawbacks to all executive officers, widens the reach of the clawback provision and in doing do, strengthens the shareholders position.. Third, limiting the clawback remedy to incentive based compensation ensures that executives that contractual employment obligations will be met by corporations while ensuring shareholders that incentive based compensation will not be paid without performance..

The extension of the time period of the clawback policy from one to three years deters companies from adopting policies like those used during the option backdating scandal. Finally, Dodd-Frank's requirement that all publicly listed companies adopt a clawback provision serves a wide range of favorable results. Among them are greater accountability of executive officers and the Board of Directors, an added level of pressure for executive officers to perform due diligence in running their companies, the establishment of further checks and balances between the Board of Directors and executive officers of a company, and a restored faith in investors that their investments will be used solely for the benefit of the company.

a. Removal of the Misconduct Requirement

The first major change in the clawback provision is the removal of the misconduct requirement. Sarbanes-Oxley requires that the SEC show misconduct leading to a financial misstatement in order to trigger the clawback provision. Dodd-Frank removed the misconduct

hurdle. [54] The SEC would not need to demonstrate misconduct to clawback erroneously awarded compensation from executive officers. The Sarbanes-Oxley clawback provision served as a weapon against executive officers who chose to bury their heads in the sand while fraudulent activities earned the erroneously awarded compensation. In contrast, the Dodd-Frank clawback provision has been stripped of the misconduct requirement.

The events surrounding each Act serve as convincing evidence of what each version of the clawback provision was meant to produce. The Sarbanes-Oxley clawback provision focused on fraudulent activities leading to unearned compensation by CEOs and CFOs. The actions Sarbanes-Oxley sought to address were ones deserving of punishment. The Dodd-Frank Act had grander intentions in changing the clawback provision. By removing the misconduct requirement, Dodd-Frank has replaced the punishment aspect of the crime with the intention of making the investor feel safe and protected. Assurance that investor money is safe and not subject to deception and fraud serves to provide faith in the financial system. The same man who refuses to invest money in a place known for its fraudulent practice will balk at investing money in a business where one regularly earns more than they produced.

The Dodd-Frank Act's section 954 states "that in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer", the clawback will be triggered. [55] This language replaces the Sarbanes-Oxley misconduct requirement. The clawback provision is triggered when an accounting restatement is filed due to material noncompliance with any requirement under securities laws. The question becomes, what is "material noncompliance"? Material noncompliance is generally known as not complying

[54] *See supra* note 45.
[55] *See supra* note 3.

with specific rules or material, often provided in the form of statutes or other legal instruments. Still, no formal definition is provided through the legislation.

Removal of the misconduct requirement was not intended to punish innocent executive officers for the mistakes of those over which they have limited or no control. Removal of the misconduct requirement instead serves as way for investors and stockholders to evil the playing field. Gone are the days where corporate executives earned immense salaries only by steering clear of any fraudulent activities. With Dodd-Frank's adoption of a clawback provision lacking any misconduct requirement, Congress did not make any attempt to limit excessive executive compensation. Instead, they sent the message that executive officers will once again be forced to earn their excessive compensation

b. Application to all "Executive Officers"

Section 304 of the Sarbanes-Oxley Act was only applicable to the CEO and CFO of a company. Section 954 of the Dodd-Frank Act is applicable to all "executive officers" of the company. This change represents an important step in defining clawback provisions as tools in the creation of a more efficient and inviting marketplace for investors. [56]

The historical context in which the clawback provisions were initially enacted provides a pristine picture of Congress' intent. The story of Enron executive Lou Pai serves as a perfect example of the type of occurrence Congress hoped to end. Pai served as CEO of Enron Energy Services, a venture capital division of Enron. During his time at Enron, Pai was regarded as a close confidant of Enron CFO Jeffery Skilling. Referred to as "the invisible CEO", Pai was an instrumental figure in the rise and eventual fall of the Enron Corporation. Just months prior to

[56] *See supra* note 45.

the descent and eventual bankruptcy of Enron, Pai cashed out and sold a large portion of his stock options, garnering over $250 million dollars in the process. Lou Pai has never been charged with criminal wrongdoing in court and has paid only $30 million dollars in an out of court settlement on charges of insider trading. Currently, Lou Pai is the second largest landowner in the state of Colorado. [57]

Taken in context, the intent of Congress to stop individuals like Lou Pai from profiting from fraudulent activities becomes clear. If meant to deter the mismanagement of a company's finances, Sarbanes-Oxley's clawback provision casts a surprisingly shallow net in doing so. The incentive to maintain a spotless accounting record rests solely with the CEO and CFO. In large companies, this provides for an almost impossible task for the chief officers. The CEO and CFO of each company were not only liable for typos in the accounting books, but the individuals positioned just below them on the corporate ladder were now working from a distinct advantage; they could take risks while being guaranteed maximum reward.

The Dodd-Frank Act increases the exposure of all "executive officers" in an effort to develop stronger accountability in the American financial system. No longer will the law bend to incompetency by executive officers not privileged to yet be among the top two individuals. Each and every one of the financial industry's decision makers will be paid for the product they produce. When placing their savings into a company, investors will know that every member of the company responsible for decisions that affect stock prices will be paid what they earn. Not only does the extension of clawback liability to all executive officers produce accountability in the investment world, it also creates a greater incentive among the powers that be to work together and create a better product.

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[57] *See supra note 24.*

c. Limiting Clawbacks to Incentive Based Compensation

In an attempt to address an earlier concern over clawback provisions, the Dodd-Frank Act limits clawbacks to that incentive based compensation earned in excess of the compensation paid under the new accounting restatement. Under Sarbanes-Oxley, any bonus or incentive-based compensation gained in the event of an accounting restatement was liable for a clawback. [58] Under this policy, tiered compensation schemes could become slippery slopes due to slight accounting errors. Dodd-Frank seeks to remedy this issue by only making the difference in compensation earned before the restatement and after the restatement liable to a clawback.

By addressing this flaw in the SOX clawback provision, Congress has solidified its position that executive compensation should reflect the benefit provided to the stockholder. Executive officers should neither be overpaid nor underpaid for their services. The clawback provision does not serve as a tool to fight excessive executive compensation. Dodd-Frank's clawback provision serves as an equalizer between investor and executive officer, assuring the average stockholder that their money is only subject to the expected avenues of loss and gain.

The new language of the clawback statute does produce a complicated issue. What is "incentive-based compensation"? The Dodd-Frank Act specifically names "stock options awarded as compensation" as a form of incentive based compensation. Keeping the intention of Congress in mind, "incentive-based compensation" can broadly be defined as any form of compensation that can be increased or decreased through deceptive or fraudulent practices. While Dodd-Frank does not require that the executive officer be involved or even aware of any wrongdoing for the clawback measure to be executed, it is important to note the legislation's

[58] *Practical Guide to Corporate Governance and Accounting: Implementing the Requirements of the Sarbanes-Oxley Act*, WGL-SOACT 304, 2005 WL 487767 (2005).

intent; an end to the practice of basing executive compensation on projections of profits not yet realized. [59] Such a system, deplete of any form of checks and balances, rewards executives more for optimism than realistic assessments of production.

d. Extension of Claw-back Period to Three Years

The Sarbanes-Oxley Act's clawback provision contained a twelve month time period during which the SEC could enact the clawback provision against a CEO or CFO. Dodd-Frank has extended the time period to three years. The reasoning behind the extension of the time period to three years is obvious. The statute of limitations should not create a loophole for creative executive officers. The statute of limitations begins running with the filing of the financial restatement and applies to any incentive based pay paid to the executive during the three years previous to the day of the refilling of the restatement.

Extending the time period during which performance based compensation is liable to clawbacks provides greater accountability in the financial system for shareholders. Not all cases of fraud or accounting typos will be discovered within twelve months of their occurrence. Extending the time period to three years allows for greater ability and fairness for shareholders while minimizing the draw of misguided practices for executive officers. The extension of the time period from one to three years serves as another tool in producing an accountable and reality-based financial system. Of course, the previously discussed tools used in restoring trust and accountability in the American financial system would be worthless without Dodd-Frank's threat of being delisted without mandatory compliance with the clawback provisions.

e. Mandatory Compliance and the Penalty of Delisting a Non-complying Corporation

[59] *See supra* note 3.

The Reform Act requires that all publicly listed companies adopt a clawback policy or risk being delisted from the public exchange. Under SOX, individual clawback policies were only suggested by the SEC. Previously, the SEC had the power to enact clawbacks on any publicly traded company, but limited resources resulted in selective enforcement of the federal clawback provision. While some corporations followed SOX's lead and willfully implemented clawback provisions into executive employment contracts, [60] the single greatest deterrent remained the SEC and the threat of federal litigation. [61] The threat of action by the SEC served more as a hindrance for executive boards than as an impetus to strengthen corporate governance.

The additions of mandatory corporate compliance and being delisted from the national exchanges upon noncompliance serve to strengthen the "Reform Act's" attempts to create a more stable accountable corporate system. The burden of enforcement has been placed on corporate boards, solving the problems encountered when dealing with the limited resources of constant federal litigation. The SEC remains the clawback provision's sole enforcer outside of executive boardrooms, but the SECs role and overall burden have been greatly diminished. The threat of being delisted from the national exchanges, a fate unimaginable for the vast majority of corporations, serves as the perfect deterrent and greatest assurance of corporate compliance.

VI. Arguments against Clawback Provisions

There remain a number of concerns regarding the changes in corporate governance regulation. The following section explains each of those concerns and attempts to remedy those purported shortcomings through close analysis.

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[60] Anne Cotter, *An Analysis of Recently Adopted Clawback Provisions*, Dodd-Frank.com, Dec. 27, 2010.

[61] *See supra* note 9.

The first issue addressed is whether or not American corporate officers are in fact overpaid. In a 2009 article, Richard Prossner addressed this issue by comparing the income of American executives to that of international executives. [62] Mr. Prossner found that American executives made double the salary earned by their non-American counterparts. The reason for the large discrepancy in executive pay, according to Prossner, was the existence of large bonus and stock option compensation mechanisms in the employment contracts of American executives. [63]

Whether or not executive officers are overpaid is not an issue in this paper. The Dodd-Frank Act does not curtail excessive compensation of corporate officers. Under Dodd-Frank, executive boards are well within their power to continue raising corporate salaries. The Dodd-Franck Act only requires that those salary raises not be obtained fraudulently and are disclosed to shareholders. Any argument that corporate executives are paid what they deserve finds no dissent in the text f Dodd-Frank. In fact, the clawback policy guarantees it.

There also exist some general concerns over how the newest version of the clawback provision came to be passed as part of the "Dodd-Frank Reform Act". Professor Stephen Bainbridge has borrowed from Professor Roberta Romano [64] and found that the Dodd-Frank Act equates to "quack corporate governance". [65] To qualify as "quack" corporate governance, a law must (1) be enacted in response to a major economic crisis; (2) within the environment of that crisis; (3) in response to populist backlash; (4) at the federal level; (5) at the expense of state power; (6) supported by federal interest groups; (7) developed prior to the economic downturn

[62] Richard A. Prossner, *Are American CEOs Overpaid , and, if so, what if Anything should be Done about It?*, 58 Duke L.J. 1013 (2009).
[63] *Id* at 1020.
[64] Roberta Romanao, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L.J. 1521 (2005).
[65] Stephen M. Bainbridge *Dodd-Frank: Quack Corporate Governance Round II*, (UCLA Sch. of Law, Law-Econ. Research Paper No. 10-12, 2010), available at http://ssrn.com/abstract=1673575.

by an interest group and (8) supported by mixed empirical data that shows the proposal to be unwise. [66] Professor Bainbridge points to the rushed nature of the legislation as his central reason in not supporting the law.

The first four requirements of the obviously negative connotation of quack governance suggest that when faced with an economic crisis, its best to do nothing. It is obvious that Professors Bainbridge and Romano do not favor government intervention in the economic field. Action in the face of crisis is not reactionary; it is the role of government. An economic crisis affects the country as a whole. Waiting for state action to experiment with potential remedies to current problems while the strongest tool in our pocket, the commerce power of the federal government, lays idle is unwise and irresponsible. By definition, a crisis demands immediate action. Often, immediate action can mean saving the jobs, homes and lives of those the government serves. Furthermore, the overriding theme of quack governance is that the provisions have not been tested and debated thoroughly enough to constitute dependable financial regulations. The federal clawback provision has been used by the federal government for almost ten years. Prepared corporate legislation does not equate to out-dated ideas from special interest groups. Often, those laws are well reasoned and researched steps in a logical progression toward productive regulation.

Finally, there is the concern of making individuals return money they may have already spent. This concern is coupled with executive officers constantly being in fear that their savings will be disgorged. [67] Each of these concerns can be brushed aside with some common sense and leniency. Unless criminally indicted, no executive officer will be liable for the full amount of

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[66] *Id* at 1.

[67] Michael C Macchiarola, *In the Shadow of the Omniprescent Claw: In Response to Professors Cherry and Wong,* 93 Minn. L. Rev., Headnotes 1. (2010).

their savings. In most cases, the amount will be a small percentage of their overall worth. In the extreme case that a burden is placed on the officer in paying back the fees, nothing in the statute bars payment plans from being worked out through the independent commission committees. Even if a payment plan would place a burden on a former executive officer, not having the money due to a purchase or investment will not be a sufficient answer for shareholders.

VII. Conclusion

In 1988, the American public became infatuated with an investment vehicle producing exorbitant profits for Wall Street investors. It seemed that Wall Street investment bankers had developed a way to profit directly at the expense of the stockholder. To make things better, only the world's most wealthy were in a position to take advantage of these opportunities if they so chose. The leveraged buyout had entered the lexicon of American kitchen tables with the competing bids of Kohlberg Kravis and the RJR executive team approaching $25 billion. As public outrage spiraled over reports of job cuts at one of America's oldest and most successful companies, only the insides of the boardrooms involved in the leveraged buyout of RJR Nabisco were more tumultuous. [68]

The topic of the RJR Nabisco buyout is pertinent to the discussion of financial regulation and corporate governance because of the number of ways regulation could have improved the outcome. RJR Nabisco shareholders profited from the final outcome of the heated bidding process between the competing camps. Still, many stockholders, including a large number of RJR employees, wanted more than marked up stock prices. They wanted to retain employment. They wanted to keep their company in Winston-Salem, North Carolina. They wanted a say in their company. The American public shared the same concerns. Knowledge of a CEOs pay

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[68] Bryan Burrough & John Helyar, *Barbarians at the Gate: The Fall of RJR Nabisco*, (1990).

package became a factor in choosing a cigarette. More than anyone, the eventual owners of RJR Nabisco would have greatly benefited from knowledge of how the corporation was governed. A major issue throughout the bidding process became an employment contract held by the executive officers at RJR so egregious it surprised even Wall Street. In short, disclosure is good for business.

The rise of LBOs coincided with the rise of incentive-based executive compensation packages in the 80's. [69] The driving force behind the idea was in the "incentive". Each executive officer would work as hard as humanly possible for their personal benefit and, by association, the benefit of the shareholder. The market refused to consider that such a situation would produce executive officers driven by short term profits. The current executive is much more willing to ignore what is best for the company in the long term. [70] Long term risk in exchange for short term reward has become a way of life on Wall Street, and in part led to the 2008 financial collapse.

Politicians will often speak of a "free market" in which Americans can prosper to their hearts fullest content, unencumbered by the shackles of government regulation. The idea of a free market economy has become as American as apple pie in the past thirty years, representing more of a rallying cry than the laissez-faire economic belief it once embodied. In judging the effectiveness of the corporate governance provisions contained in the Dodd-Frank Act, it is important to consider that apart from the "free market" we have all grown accustomed to, Americans also desire an "open market"; an open market in which information and ideas are n passed freely. Information such as executive compensation plans serves as a conduit for sound investment and reason.

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[69] Janice K. McClendon, Bringing the Bull to Bear: Regulating Executive Compensation to Realign Management and Shareholders' Interests and Promote Corporate Long-Term Productivity, 39 Wake Forest L. Review 971 (2004).
[70] *Id.*

Information serves as the greatest bargaining chip a lesser opponent could possess. In curtailing corporate waste, a stockholder deprived of information is at an insurmountable disadvantage compared to his opponent. The business judgment rule serves as a required barrier to frivolous action against an unpopular board, but the availability of information is mandatory if the corporate veil is to be pierced when executives step out of line. As new ways to step out of line are developed, so must stockholder abilities to fight such attempts. The corporate governance provisions of the Dodd-Frank Act together serve as just such a development in stockholder action. Reassurance through the granting of information and the guarantee of action only serves to reaffirm the faith of investors in the American economy.

To appreciate the full affect the mandatory clawback provision has on investor confidence, it is important to understand the value of the information supplied by other corporate governance provisions in Dodd-Frank. Requirements include a non-binding "say-on-pay" vote by shareholders, independence of the commission committee, disclosures of executive compensation compared to average employee wage and company performance, disclosure of whether the positions of CEO and President are held by the same individual, and access to proxy solicitation materials for shareholders. [71] Each of these requirements provides the shareholder with information that helps to restore and maintain confidence in the economy. Potential investors also improve the basis upon which they invest their money. Investor knowledge that their money is relatively safe is reassuring.

As trust grows in the investor, so too does the market's trust. Say on Pay votes may at times serve as an instrument to express shareholder frustration, but will more often serve as a confidence builder for corporate executives in their actions. Say on Pay votes can serve as magnets for individuals looking for safe investments. Low ratios of executive, average worker

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[71] *See supra* note 45.

pay can also serve as attractions for potential investors. Finally, the knowledge that selling one's investment is not the only resort if management takes an unpopular turn may retain a number of investors that previously would have sold their shares. Information provided through Dodd-Frank's corporate governance provisions serves to rebuild the trust and reliance between corporation and investor that existed prior to the economy's downfall.

Nestled among those informational corporate governance requirements, the clawback serves as the hammer through which the other provisions gain their strength. Mandatory compliance with the clawback provision serves to build investor confidence in the market. American investors are not concerned so much with overpaid executive officers as they are with fraudulently paid executive officers. The clawback provision mandatory nature coupled with the required independence of the compensation committees serves to assure investors that the headlines they encountered of multi-million dollar bonuses for executives of bankrupt companies will not reappear. It is that confidence, confidence that the known fear will not reoccur, that reengages investors and strengthens the market. Punishment of the guilty in the Great Recession of 2008 will continue in criminal courts and public opinion throughout the country. But it will not occur through corporate governance legislation. It is through corporate governance that faith will be restored in the American economy.