

What Are Compensation ‘Clawbacks’?

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Capping executive compensation is one way that boards can rein in outrageous payouts. Another form of censure, called “clawbacks,” takes pay limits one step further. With clawbacks, boards can force executives to pay back some of their compensation for wrongdoing. As a punitive measure, the tactic can be powerful. Executives are forced to dip into their own piggybanks to cough up the cash.

Key Stats

- **Legal underpinnings:** Section 304 of the 2002 Sarbanes-Oxley Act
- **Prevalence:** About 42 percent of Fortune 100 companies and 34 percent of Standard & Poor’s 500 companies have clawback policies.
- **Key practitioners:** Bristol-Myers Squibb, Citigroup, Eastman Kodak, General Motors, Interpublic Group, and Monsanto
- **Biggest clawback:** \$468 million in options, bonuses, and compensation owed by former head of UnitedHealth Group, Dr. William W. McGuire, for a stock options backdating scandal in 2006.

How Clawbacks Work

There are two basic kinds of clawbacks, says Daniel Ryterband, president of Frederick W. Cook & Co., a New York-based executive compensation consulting firm. In the first type, an executive can trigger a clawback by committing broad malfeasance. A criminal conviction isn’t necessarily required; knowing and abiding in an accounting fib can be a trigger.

The second type, Ryterbrand says, has to do with executives violating restrictive covenants such as non-compete clauses. For example, if an executive moves on to a similar position at a competing company in violation of his contract, the clawback provisions can kick in, forcing the executive to pay back certain remuneration to the first firm.

The Fine Print

Enforcing clawbacks can be more difficult than it seems. “The problem is that it is often hard to define good and bad performance, and [determine] if the malfeasance is intentional fraud and if the CEO is responsible,” says Ryterband.

The 2002 Sarbanes Oxley Act does little to clear up the ambiguity. According to Section 304 of the law, an executive must pay back his or her bonus, other incentives, equity-based compensation, or trading profits if his or her misconduct forces the firm to restate its finances. The payback period would encompass any compensation given within 12 months of the filing of the financial restatement.

But because the definition of “misconduct” is left open to interpretation, Section 304 is especially difficult to enforce, says Kevin Lacroix, a lawyer with OakBridge Insurance Services.

What’s Next

The impetus is strong for clawbacks to be included in upcoming legislation, given the public outrage over the Wall Street meltdown, Lacroix says, but efforts to toughen clawbacks predate the debacle. In April, [Sen. Hillary Clinton, D-New York](#), introduced [Senate Bill 2866](#) in an attempt to more clearly define “misconduct” and to triple the payback period to 36 months. The Clinton bill also proposes a \$1 million cap on the amount of compensation that can be deferred each year, which would affect so-called “golden handcuff” clauses for top corporate officials. “Golden handcuffs” is an industry term for the way companies try to retain executives and encourage their long-term performance by paying out benefits, such as cash and stock awards, over the long term. The catch is that if the executive is fired for misconduct or leaves and violates non-compete provisions, clawbacks can snatch away these benefits.

Despite the current rage against C-suites in the financial crisis, clawbacks should be approached carefully. Lacroix says he was involved in a court case in which a bank went bust. A director who wasn’t really involved was hit by a clawback provision and forced to come up with pay-back funds. He had to sell his restaurant and declare personal bankruptcy — “all because he was asked to be on the board of a local bank,” says Lacroix.

Additional reporting by John Maas.