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In the Shadow of the Omnipresent Claw: A Reply to Professors Cherry & Wong

Michael C. Macchiarola

Response

In the Shadow of the Omnipresent Claw: In Response to Professors Cherry & Wong

Michael C. Macchiarola†

As the American economy continues to totter against an ever-growing populist momentum, it seems likely that clawback mechanisms of various sorts will be put to increasing use in the coming months and years.[1] Very generally, a clawback attempts to regain previously conferred monies or benefits following a certain triggering event, usually involving some change in circumstances. In a sense, clawbacks offer the opportunity for a "do-over"—a convenient antidote to both the uncertainty that characterizes American financial markets and the calls for accountability that grow louder with each corporate

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† Distinguished Lecturer, City University of New York.

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1. *See, e.g.*, Spencer C. Barasch & Sara J. Chesnut, *Controversial Uses of the "Clawback" Remedy in the Current Financial Crisis*, 72 TEX. B.J. 922, 927 (2009) ("As governmental entities, court-appointed receivers and trustees, and corporations continue to react to the financial crisis, aggressive use of clawback remedies can be expected."); Alexis Leondis & Margaret Collins, *Empty Clawbacks?*, BLOOMBERG BUSINESSWEEK, Jan. 25, 2010, at 20, *available at* Business Source Premier, File No. 47601293 (noting that 70 of the top 100 U.S. companies by revenue have clawback provisions allowing them to recoup revenues from executives); *see also* Gibson, Dunn & Crutcher LLP, *"Clawbacks" of Executive Compensation*, GIBSON DUNN PUBLICATIONS (Jul. 9, 2008), http://www.gibsondunn.com/publications/Pages/ClawbacksOfExecutiveCompensation.aspx [hereinafter Gibson Dunn Memo] ("[T]he subject of recouping, or 'clawing back,' executive compensation in the event of financial statement errors is likely to remain a focal point for boards of directors."). In fact, the trend toward including clawbacks as part of compensation schemes is already well underway. A recent industry report found that "[f]rom 2006 to 2009, the prevalence of Fortune 100 companies with publicly disclosed clawback policies increased from 17.6 percent to 72.9 percent." *See* Press Release, Equilar, Clawback Policies Get More Clarity in 2009 (Nov. 18, 2009), *available at* http://www.equilar.com/press_20091118.php.

misstep, real or perceived.[2] Yet, as Professors Cherry and Wong note in *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes* (the "Article"), the term clawback "has been subject to neither rigorous analytical scrutiny nor definition and exposition."[3] Against this backdrop, the authors' undertaking to advance a so-called doctrine of clawbacks is both bold in its aspiration and laudable in its result. The Article succeeds in establishing a firm foundation for additional examination and discovery and highlights the importance of clear rules of the road to guide all market participants.

This Response (the "Response") attempts to bolster and improve upon the still nascent discussion surrounding clawbacks. Moreover, the Response challenges Professors Cherry and Wong, and the academic community more broadly, to address a number of questions that remain unsettled. It seems intuitive that the retroactive imposition of clawbacks, by legislation or otherwise, is less desirable than more prospective efforts.[4] Yet, the complexity of the subject matter demands more than a reflexive call for the organic inclusion of clawback provisions in investment contracts or compensation agreements as a matter of course.

This Response proceeds in three parts. Part I introduces the basic framework through which the Article's authors analyzed the uncertain world of clawbacks. This section very brief-

2. *See, e.g.*, Andrew Grossman, *The AIG Clawback: Possibly Unconstitutional, Doubtlessly Imprudent*, HERITAGE FOUND. (Mar. 19, 2009), http://www.heritage.org/Research/Reports/2009/03/The-AIG-Clawback-Possibly-Unconstitutional-Doubtlessly-Imprudent (describing the efforts to recoup AIG bonuses as "intended to punish the company's employees and executives for conduct that Congress and the public believe demonstrates greed and selfishness"). *But cf.* Lawrence A. Cunningham, *A.I.G.'s Bonus Blackmail*, N.Y. TIMES, Mar. 17, 2009, at A27, *available at* 2009 WLNR 5101548 ("[M]oral outrage and public rebuke do not provide legal grounds for backing out of a contract."). Yet, Professor Cunningham fails to make appropriate accommodation for the fact that the obligation to pay under the employment contracts, originally owed by the AIG shareholders, has now "been foisted upon [the taxpayer] through the mechanism of the financial bailouts." Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 379 (2009).

3. Cherry & Wong, *supra* note 2, at 411; *see also* Robert A. Prentice and Dain C. Donelson, *Insider Trading as a Signaling Device*, 47 AM. BUS. L.J. 1, 15 (2010) (observing that clawback provisions were "essentially unknown" before Sarbanes-Oxley).

4. Larry Ribstein, *Clawbacks*, TRUTH ON THE MARKET (June 23, 2010), http://truthonthemarket.com/2010/06/23/clawbacks/ ("A mandatory provision that operates prospectively is at least better than one inserted ex post.").

ly recounts the Madoff and AIG affairs. Here, little exposition is required, as both episodes remain fresh in the minds of most Americans. Part I also introduces the mechanics of the clawback in the less controversial context of the long-established preference period immediately preceding a firm's bankruptcy filing. Part II examines the lens through which Professors Cherry and Wong suggest that market participants understand, interpret and employ clawbacks. This section also introduces the primary shortcoming of their approach—its latent subjectivity. Part III offers additional critiques, primarily concerned with the practical difficulties in realizing the robust and developed clawback regime the authors envision. Finally, I conclude with a warning that the clawback does not represent the magic bullet it might first appear to be. And, we should resist reflexively embracing its application absent careful consideration and deliberation.

I. CHERRY AND WONG'S "CLAWBACK" ANALYSIS

Cherry and Wong examine two episodes from our recent past—the AIG executive bonus fiasco and the Madoff Ponzi scheme payouts to investors—to illustrate the clawback in action. The two affairs are not easily latticed, as one concerns government ineptitude and subsequent remorse and the other features a massive fraud and ensuing bankruptcy. In each instance, however, monies previously disbursed are sought for return.[5]

In the AIG matter, following the insurance giant's near bankruptcy and subsequent government bailout, Congress pursued a retroactive marginal tax rate of ninety percent on the performance-based bonuses that AIG proposed to pay to its executives.[6] Political posturing aside, it appears as though the proposed tax was targeting the recovery of the compensation that AIG awarded its employees for meeting certain performance goals when the company's performance was later found

5. *See generally* Jeffrey N. Gordon, *"Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 334 (2009) ("[The clawback] seems useful to protect shareholders against managers' ability to create the appearance of performance or to provide coinsurance against apparently profitable strategies that fail when evaluated over a longer timeframe.").

6. For a brief description of the events surrounding the AIG "clawback," see Cherry & Wong, *supra* note 2, at 368–69. For a concise summary of AIG's demise, see Stephen J. Lubben, *Repeal the Safe Harbors,* 18 AM. BANKR. INST. L. REV. 319, 319–20 (2010).

to be illusory.[7] In the case of the Madoff investors, Federal Bankruptcy Court Judge Burton Lifland recently found himself playing King Solomon, left to decide the question of whether a trustee is authorized to clawback from one set of the fund's investors for the benefit of another investor group.[8] Of the Article's two examples, the Madoff case highlights the more traditional variety of a clawback, applying the device to recover payments that were made out of the corrupt fund before its fraud was uncovered and to redistribute those monies to the victims pursuant to the priorities established by the Bankruptcy Code.[9] The AIG case is a newer flavor, born of the desire to revisit compensation previously paid to employees in the event that a firm's reality turns out less rosy than it once appeared.[10]

Few actually dispute that any payments (whether return of principal or earnings) an entity makes in the ninety days prior to the filing of a bankruptcy petition must be returned *in toto* to a bankruptcy trustee. Under the Bankruptcy Code, such a payment is presumed by law to be a "preference," favoring the interests of a withdrawing creditor over other creditors at a time when the firm's bankruptcy was inevitable.[11] Preference law reaches back over a defined period prior to bankruptcy and

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7. *See generally* John Cassidy, *Wall Street Pay: Where's the Reform?*, THE NEW YORKER RATIONAL IRRATIONALITY BLOG (Jul. 23, 2010), http://www.newyorker.com/online/blogs/johncassidy/2010/07/wall-street-pay.html (bemoaning bonus-laden incentive structures that provide "traders and their managers a big incentive to generate short-term gains while ignoring longer-term risks").

8. For a brief description of the events surrounding the Madoff "clawback," see Tally M. Wiener, *On the Clawbacks in the Madoff Liquidation Proceeding*, 15 FORDHAM J. CORP. & FIN. L. 221 (2009). *See also* Diana B. Henriques, *In Court, Impassioned Challenges of Madoff Trustee's Plans*, N.Y. TIMES, Feb. 2, 2010, at B1, *available at* 2010 WLNR 2234184 (describing the arguments before the Bankruptcy Court on behalf of the so-called winning and losing investors); Erik Larson, *Madoff Victims Wait for Ruling on Claims as Judge Hears Case*, BLOOMBERG (Feb. 3, 2010), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=avn0fdJxHQCY (describing the trustee's methodology and the positions of the various stakeholders).

9. *See* Bennett W. Lasko, *"Clawbacks" in the Aftermath of Madoff and Other Investment Frauds*, DRINKER BIDDLE HEDGE FUND ALERT (Mar. 11, 2009), http://www.drinkerbiddle.com/files/Publication/e65f9106-d70f-4aca-881f-0369a75ff435/Presentation/PublicationAttachment/5c09f9ad-7e87-4e87-b0b6-0bd14571a404/Aftermath%20of%20Madoff.pdf (describing and explaining the two types of clawback claims: preference actions and fraudulent conveyance actions).

10. While certainly beyond the scope of this Article, one cannot help but wonder whether the federal government would like to replay its "fund first, diligence later" approach to the entire AIG episode.

11. *See* 11 U.S.C. § 547 (2006).

attempts to level the overall treatment received by similar creditors. The resulting restructuring of transactions is not intended to imply that any particular prepetition transfer was somehow immoral or improper at the time that it was made.[12] Rather, individual prepetition transfers are avoided in order to ensure fidelity with the Bankruptcy Code's goal of equitable distribution of a debtor's assets or income.[13]

Beyond these preference decisions, however, the curious world of clawbacks becomes far more inchoate.

II. EXAMINING CHERRY AND WONG'S "CLAWBACK"

In a broader context, Professors Cherry and Wong offer that the term "clawback" generally describes a mechanism designed to address "inequities that cannot easily be resolved by existing remedies under the law because of countervailing legal rights independently supporting such inequities."[14] Further, their Article attempts to make the case that clawbacks can effectively "bridge the gap in remedies under prevailing law for addressing unfair enrichment."[15]

Introducing the "unfair enrichment" concept seeks to synthesize clawbacks; yet it also highlights the uncertainty that accompanies their implementation. According to Cherry and Wong, the concept represents a close cousin to the better-known unjust enrichment, yet "extends to those situations where the enrichment cannot readily be said to be unjust (per unjust enrichment principles)."[16] By such an interpretation, the clawback can be utilized even when the one being enriched can assert a preexisting legal right to the payment.[17] Of course, traditional unjust enrichment principles would preclude such an application, instead only allowing recoupment of monies where the recipient lacks an adequate legal basis for receipt in

12. *See generally* 4 WILLIAM L. NORTON, JR. & WILLIAM L. NORTON III, NORTON BANKRUPTCY LAW AND PRACTICE § 66:1 (3d ed. 2008) (indicating that the preferential transfer provisions were created to avoid "payments or other prepetition transfers made to a creditor that increase the creditor's recovery ahead" of similar creditors).

13. *Id.*

14. Cherry & Wong, *supra* note 2, at 414.

15. *Id.*

16. *Id.* at 413 ("[U]nfair enrichment could be regarded as a variant, albeit an unfamiliar one, of unjust enrichment.").

17. *See id.*

the first place.[18] While the unjust enrichment standard might be seen simply as a mechanism to refuse to enforce an ineffective or defective attempt at transfer, the unfair enrichment standard goes quite a bit further.

The professors offer the following example to illustrate their unfair enrichment remedy at work:

> [A]lthough an individual AIG executive may be blameless and have otherwise valid contractual rights to a bonus, payment of the bonus is unfair because bonuses should not be decoupled from a company's performance, particularly where taxpayer money is involved. We thus have to turn to a retroactive clawback to override the contractual rights in this situation in order to prevent unfair enrichment of the executive.[19]

The suggested response to the so-called blameless executive's situation seems so noble, yet suffers from unnecessary inflexibility. Moreover, it has all the feel of analysis worked backwards from a desired result. Subjective notions of unfairness aside, it is not difficult to envision a scenario in which it is entirely appropriate to decouple an individual's bonus from a company's performance.[20] A compliance officer's bonus, for example, need not be tied to a company's sales successes or profits. In fact, a compliance officer or in-house legal employee at AIG might have become more valuable as the company's performance began to wane (and its employees became more desperate to keep up appearances or compromise best practices). In a similar vein, a company whistleblower would certainly be less likely to come forward with a claim in a regime where her legitimate contractual rights to a bonus might be compromised as a consequence of her own disclosures. Moreover, if such a whistleblower could potentially protect taxpayer monies, the chilling effect of the proposed unfair enrichment regime could be all the more unfortunate.

18. *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 cmt. b (Discussion Draft 2000) ("Unjustified enrichment is enrichment that lacks an adequate legal basis: it results from a transfer that the law treats as ineffective to work a conclusive alteration in ownership rights.").

19. Cherry & Wong, *supra* note 2, at 414.

20. In fact, a burgeoning scholarship is developing around the notion, once popular, that incentive pay should be limited. *See, e.g.*, Jay Lorsch & Rakesh Khurana, *The Pay Problem,* HARVARD MAG., May–June 2010, at 35 ("The recent economic crisis and the role that our compensation systems played in fomenting it require a holistic re-examination not only of compensation but of the assumptions and values underlying the economic system we have created.").

The concept of "unfair enrichment," as described by Professors Cherry and Wong, introduces unwelcomed subjectivity to decisions of whether and to what extent a person's monies might be subject to return at some future date. Most basically, the authors fail to answer why the contractual risk bargained for by two arms-length parties should be subject to the later assessment of an interloping arbiter. In fact, in the scenario they outline, the fact that neither party to the contract necessarily feels aggrieved seems of little consequence. Nonetheless, where unfair enrichment is the watchword, some all-knowing, all-fair third party arrives to set the world straight. The authors remain remarkably silent on just who constitutes the "we" in need of protection in the example that they offer. Also absent is an explanation of just who should decide whether to characterize a certain payment as somehow "unfair."

The authors' example is particularly troubling for those concerned with the predictive value of the rule of law. It is likely that, in such a world, the transaction cost of contracting will rise as private arrangements more routinely become subject to Monday-morning quarterbacking. And, of course, inequity is often in the eye of the beholder.[21] Unlike the traditional respect for a preexisting right, the Article's test serves to highlight the difficulty of a clawback regime that lays waste to any clear line of delineation, and instead favors burdening payment recipients with the task of vigilantly monitoring the rear view mirror.[22] Under the authors' proposed approach, a legitimate worry

21. For example, not all will agree with the authors' assertion that "although an individual AIG executive may be blameless and have otherwise valid contractual rights to a bonus, payment of the bonus is unfair because bonuses should not be decoupled from a company's performance, particularly where taxpayer money is involved." Cherry & Wong, *supra* note 2, at 414; *cf.* Jake DeSantis, *Dear A.I.G., I Quit!*, N.Y. TIMES, Mar. 24, 2009, at A29, *available at* 2009 WLNR 557590 (asserting, in a letter to the CEO of AIG, that he was entitled to his full bonus earned as an executive vice president of the company, that he "deserved to be paid as promised," and observing that he "personally suffered . . . with the rest of the taxpayers"). On the other hand, some might think that the authors' interpretation does not go far enough. *See, e.g.*, Kate Phillips, *Senator Wants Some Remorse from C.E.O.'s*, N.Y. TIMES, Mar. 18, 2009, at A17, *available at* 2009 WLNR 5101597 (clarifying the earlier comments of Senator Charles Grassley who suggested that the AIG executives should consider committing suicide).

22. Traditionally, unjust enrichment provides a more reliable and objective standard. For example, the following five elements generally establish unjust enrichment: (1) an enrichment; (2) an impoverishment; (3) a connection between the enrichment and the impoverishment; (4) an absence of a justification for the enrichment and impoverishment; and (5) an absence of a remedy provided by law. *See* Schroeder v. Buchholz, 622 N.W.2d 202, 207 (N.D. 2001).

arises that employees or investors will come to fear that their monies are forever doomed to the fate of the stuffed animal in the arcade game—never free to relax in the shadow of the omnipresent claw.

The law of fraudulent conveyance applies to a bankruptcy beyond the preference period and its thoughtful prescription can be instructive for clawbacks more broadly.[23] Under state law and the Bankruptcy Code, for example, if the debtor sells its assets for insufficient value, that transaction may be undone as a constructive fraudulent transfer.[24] In the context of a Ponzi scheme, "[t]he basic rule is that withdrawals of fictitious profits have to be returned to the bankruptcy estate, whereas redemptions of principal do not, unless the investor knew or should have known of 'red flags' at the time of the transaction."[25] The theory behind such a rule is that when an investor buys into a fraudulent fund, she also purchases a rescission claim against the fund and its operators.[26] A later redemption of principal, in turn, reduces the investor's rescission claim dollar-for-dollar by the redemption amount, and the Bankruptcy Code considers this reduction to be an exchange of equivalent

23. *See, e.g.*, Cunningham, *supra* note 2 (positing that whether any AIG bonuses constitute fraudulent conveyances is a "relevant question for the government to probe").

24. *See* 11 U.S.C. § 548 (2006). Again, the clawback should not be seen as a punitive provision aimed at punishing a wrongdoer. *See, e.g.*, Eric Pan, *Madoff Investors Redemptions Subject to Clawback*, CARDOZO L. (Mar. 13, 2009), http://www.cardozo.yu.edu/MemberContentDisplay.aspx?ccmd=BlogDisplay&ucmd=UserDisplay&userid=10534&contentid=10212&folderid=2364&clt=Blog ("[The clawback] represents a determination by Congress that redeeming investors should be in the same position as other similarly situated investors who did not redeem."). *But cf.* 11 U.S.C. § 548(a)(1)(A) (stating that if the debtor transfers its assets with the actual intent to harm creditors, an "actual" fraudulent transfer might be both avoidable and a criminal offense).

25. Lasko, *supra* note 9, at 2; *see also In re* Bayou Group, 396 B.R. 810, 844–51 (Bankr. S.D.N.Y. 2008) (allowing defrauded investors to retain withdrawals of principal to the extent that they could prove that the withdrawals were not taken after the investor became aware of "red flags"). In a recent release, the SEC provided a nonexhaustive list of these "red flags." The list included (i) high investment returns with little or no risk; (ii) overly consistent returns; (iii) unregistered investments; (iv) unlicensed sellers; (v) secretive and/or complex strategies; (vi) issues with paperwork; and (vii) difficulty receiving payments. *Ponzi Schemes–Frequently Asked Questions*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/ponzi.htm (last visited Oct. 25, 2010).

26. For example, when a purchaser buys securities and the prospectus contains a material misstatement or omission, section 12(a)(2) of the Securities Act of 1933, as amended, provides for rescission of the purchase. *See* 15 U.S.C. § 77l(a)(2) (2006).

value for the cash received upon redemption.[27] The Bankruptcy Code's approach is sound, because "forcing innocent investors to return funds they contributed to the defunct entity does nothing more than create new victims of the fraud because it deprives those investors of their actual out-of-pocket contributions."[28]

Unlike the return of principal, the payment of profits out of a Ponzi scheme cannot survive the equivalent value test. Accordingly, profits are usually subject to clawbacks. And, in many cases when a Ponzi scheme is uncovered, "the only asset available to provide any payment to the many investors and other creditors are legal claims to recover sums paid out by the entity before the crash."[29] Profits represent transfers not deemed "for value" and are, therefore, "presumed to be fraudulent regardless of any knowledge or intent on the part of the redeeming investor."[30] While the requirements of fraudulent conveyance might introduce a certain layer of subjectivity, such concerns are diminishing over time, as precedent and case law establish its parameters with increasing detail.

In the Madoff case, for example, Judge Lifland's recent decision "approved the fiercely disputed method used by the court-appointed trustee to calculate victim losses"[31] and established that a fund investor's losses should be defined as the difference between her investments into the fund and the amount withdrawn before the fund's collapse.[32] Such a decision fits nicely with the traditional approach.[33] In embracing a so-called Net Investment Method, the judge scored a victory for objective standards and rejected the emotional arguments of hundreds of Madoff investors seeking a damages calculation based on the

27. *See* Lasko, *supra* note 9, at 2.

28. Jeffrey G. Hamilton, *Clawback Claims Against Innocent Investors: The SEC vs. the Stanford Receiver*, 28 AM. BANKR. INST. J. 12, 12 (2009).

29. Barasch & Chesnut, *supra* note 1, at 924; *see also* Cherry & Wong, *supra* note 2, at 395 ("In a Ponzi scheme, losing investors would therefore look, naturally enough, to other solvent investors who have profited from the scheme, whether witting or not.").

30. Lasko, *supra* note 9, at 3.

31. Diana B. Henriques, *Madoff Judge Endorses Trustee's Role on Losses*, N.Y. TIMES, Mar. 2, 2010, at B1, *available at* 2010 WLNR 4322471.

32. *See In re* Bernard L. Madoff Inv. Sec. LLC, 424 B.R. 122, 125 (Bankr. S.D.N.Y. Mar. 1, 2010).

33. *See, e.g.*, Cherry & Wong, *supra* note 2, at 402 ("[T]he general rule regarding recovery as against innocent winning investors in Ponzi schemes is that only payments made to them in excess of the amounts of principal originally invested are avoidable as fraudulent transfers.").

securities listed on the final account statement Madoff provided them.[34] The court noted that the superiority of the Net Investment Method derives from the fact that it "relies solely on unmanipulated withdrawals and deposits and refuses to permit Madoff to arbitrarily decide who wins and who loses."[35] In explaining the desirability of a method which "looks solely to deposits and withdrawals that in reality occurred," the court quoted extensively from the "refreshing clarity"[36] of a *pro se* brief of a Madoff victim. The brief embodies the traditional rescission theory underpinning fraudulent conveyance and, at the same time, respects notions of equitable fairness:

> In a Ponzi scheme, the perpetrator takes in money from investors, promising a return that is wholly fictitious, and instead pays cash returns to early investors with cash collected from later investors. This means that any cash returned to an investor was either his own, *or more likely, was taken from another later investor*. No money is actually invested for either gain or loss. Money is simply moved by the perpetrator from one investor to another.
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> . . . .
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> Such cash that [Net Winners] withdrew in excess of their deposits was, by definition, cash that other customers put in, NOT a return on their purported investment, since there was no investment made, and hence no return.[37]

Compared to Madoff-like clawbacks in the bankruptcy context, the recoupment of corporate executive compensation is a far newer endeavor.[38] And, not surprisingly, the current crop of

34. In essence, the "Net Investment Method" favored by the trustee defines an individual investor's net equity in the fund as the amount of cash deposited by the customer into the customer's account less any amounts already withdrawn by the investor. *Cf. Madoff*, 424 B.R. at 139 ("The Objecting Claimants assert that Madoff customers . . . are entitled to the value of the securities listed on their final account statements."); Michael Rothfeld, *Madoff Trustee Goes After 'Net Winners,'* WALL ST. J. LAW BLOG (Nov. 30, 2010, 6:04 PM), http://online.wsj.com/article/SB10001424052748703994904575647234142325618.html?mod=WSJ_hp_LEFTWhatsNewsCollection (describing Trustee Picard's most recent attempts to recoup monies from those Madoff investors whose withdrawals were greater than their investment).

35. *Madoff*, 424 B.R. at 140.

36. *Id.* at 142.

37. *Id.* at (alteration in original) (*quoting* Brief for the Trustee's Motion, *Madoff*, 424 B.R. 122 (2009) (No. 05-1631)).

38. *See, e.g.*, Barasch & Chesnut, *supra* note 1, at 923 (noting that until recently, "executive officers have not faced financial liability for corporate securities law violations absent an allegation that the officer had engaged in misconduct"). In addition, as Professors Cherry and Wong observe, the American Recovery and Reinvestment Act of 2009, passed in response to the financial crisis, provides "for the recovery . . . of any bonus, retention award, or incentive compensation paid to a senior executive officer and any of the next

examples derives from shakier statutory footing and suffers from far less robust precedent upon which to rely.[39] Also contributing to the difficulty of applying the clawback in the compensation context is the fact that "the amount of payment involved is often contingent, difficult to value, or, at times, not fully transparent."[40]

Following the corporate scandals of the Enron era and the subsequent enactment of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), attention focused on companies' ability to recover incentive compensation previously awarded to senior executives in the event that their activities played a significant role in the restatement of a financial statement, and it was determined that the executives had received unearned incentive compensation as a direct result of their own misconduct.[41] In response to these concerns, Sarbanes-Oxley included a specific clawback provision, section 304, which basically "empowers the SEC to bring an action to recover money from executives to blame for a fraud."[42] As Professors Cherry and Wong point out, however, this provision "has been largely ignored," with very few enforcement actions having been brought since its adoption.[43] Perhaps more disappointing than the lack of case law is

[twenty] most highly-compensated employees . . . based on [financial results] that are later found to be materially inaccurate." Cherry & Wong, *supra* note 2, at 381 (quoting from American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 517).

39. *See* Memorandum from Willkie Farr & Gallagher LLP, *SEC Invokes Sarbanes-Oxley Clawback Provision Without Alleging Wrongdoing By Defendant*, WILLKIE FARR & GALLAGHER LLP (Aug. 25, 2009), http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C3092%5CSEC%20Invokes%20Sarbanes%20Oxley%20Clawback%20Provision.pdf [hereinafter Willkie Farr Memo] ("[N]o clear definition exists of a 'restatement due to the material noncompliance of the issuer,' which is a prerequisite to prosecution under the clawback provision."); *see also* Scott Harshbarger & Goutam U. Jois, *Looking Back and Looking Forward: Sarbanes-Oxley and the Future of Corporate Governance*, 40 AKRON L. REV. 1, 29 (2007) (arguing that the clawback provisions of Sarbanes-Oxley are "extraordinarily weak").

40. Cherry & Wong, *supra* note 2, at 373.

41. *See* Gibson Dunn Memo, *supra* note 1.

42. Cherry & Wong, *supra* note 2, at 376. For a thorough examination of the provision and its potential, see generally Matthew A. Melone, *Adding Insult to Injury: The Federal Income Tax Consequences of the Clawback of Executive Compensation*, 25 AKRON TAX J. 55, 63–65 (explaining the history and scope of the Sarbanes-Oxley clawback provisions); Rachael E. Schwartz, *The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean*, 64 BUS. LAW. 1 (Nov. 2008) (discussing Sarbanes-Oxley's clawback provision).

43. Cherry & Wong, *supra* note 2, at 376; *see also* Stephen Taub, *SOX 304 Forfeiture Clause Goes Unused*, COMPLIANCE WKLY (June 6, 2006) ("So far,

the dearth of legislative and procedural history resulting from the hasty manner in which the Sarbanes-Oxley provision became law. As one commentator noted, the Senate engaged in "little discussion of the clawback provision."[44] Moreover, the conference committee adopted the Senate's version of the provision without modification, and the conference report accompanying the law contained no substantive comments.[45]

In sum, though we might wish otherwise, a close examination of the clawback reveals its limitations. A fanciful rewriting of yesterday's ills suffers all the idiosyncrasies of the individual facts and circumstances that underlie each instance of what the Article's authors might label "unfair enrichment." Moreover, an after-the-fact characterization often lacks the proper respect for the context in which the decisions giving rise to such unfairness were made.

III. CRITIQUING CHERRY & WONG'S "CLAWBACK"

As troubling as the idea that the broader acceptance and expansion of clawbacks—in either the compensation or bankruptcy context—might embrace subjectivity at the expense of predictability, is the authors' suggestion that contractual clawbacks be written into investment agreements and employment contracts as a matter of course.[46] In fact, this view is not theirs alone. Increasingly, politicians, commentators, and regulators are embracing some recoupment method to correct perceived past wrongs.[47] Prospective contractual clawbacks represent a

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that seemingly significant provision of SOX has proven to be a dud when regulators and aggrieved investors try to retrieve prior bonuses and compensation earned thanks to fraud."). *But cf.* SEC v. Jenkins, Civ. No. CV 09-1510-PHX-JWS, D. Ariz., July 22, 2009, SEC Litigation Release No. 21149A (July 23, 2009), *available at* http://www.sec.gov/litigation/litreleases/2009/lr21149a.htm (announcing litigation seeking the clawback of bonuses and stock sale proceeds from Maynard L. Jenkins, the former chief executive officer of a public company that the SEC had previously charged with fraud, absent an allegation that Jenkins had any involvement in or knowledge of the corporate misconduct). The SEC recently scored a victory as the court denied a motion to dismiss. *See* Jef Feeley and Emily Heller, *Former CSK Chief Executive Jenkins Loses Bid to Dismiss SEC Clawback Suit,* BLOOMBERG (June 10, 2010), http://www.bloomberg.com/news/2010-06-10/former-csk-chief-executive-jenkins-loses-bid-to-dismiss-sec-clawback-suit.html.

44. Willkie Farr Memo, *supra* note 39, at 3.

45. *Id.*

46. *See* Cherry & Wong, *supra* note 2, at 372 ("[W]e suggest writing prospective clawback terms into contracts directly.").

47. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 954, 124 Stat. 1904 (providing for a broader

natural progression from recent events and seem the perfect tonic to the authors' view that "the 2009 Recovery Act's provisions regarding executive compensation are extremely problematic."[48] In a certain sense, this prescription is not controversial, as it aspires to a world of more developed contractual negotiation *ex ante* in the hope of avoiding uncertainty *ex post*.[49] And, the idea is born of the notion that "attempting to impose clawbacks retroactively through legislation is certainly not as efficient as including clawback provisions organically within the body of the initial contract."[50] As the remainder of this Response hopes to show, however, the devil lies in the details.

As Professors Cherry and Wong correctly observe, in the investment fund context, the inclusion of such contractual clawbacks as boilerplate might be frustrated by the lack of privity among investors, as "the investment structure usually consists of individual, separate contracts between each investor and the investment fund."[51] The fix offered for this impediment

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clawback than the executive compensation clawback embodied in the Sarbanes-Oxley Act); LATHAM & WATKINS, *A Tale of Two Clawbacks: The Compensation Consequences of Misstated Financials*, Latham & Watkins Client Alert (Aug. 10, 2010), http://www.lw.com/upload/pubContent/_pdf/pub3662_1.pdf#page=1 (summarizing the requirements of Sarbanes-Oxley Act section 304 and Dodd-Frank Act section 954); Adam Levitin, *Shared Appreciation Clawbacks*, CREDITSLIPS (Jan. 15, 2009, 8:40 PM), http://www.creditslips.org/creditslips/2009/01/shared-appreciation-clawbacks-.html (considering the clawback of principal for creditors in the event that there is an appreciation on a mortgage following its modification); Larry MacDonald, *Claw Back the Bankers' Bonuses*, CANADIAN BUS. ONLINE (Sept. 11, 2008), http://www.canadianbusiness.com/columnists/larry_macdonald/article.jsp?content=20080911_152853_13064 ("[E]xecutives who reaped outsized gains from bonuses, stock options, and other 'performance' perks during the era of frenzied growth, should be compelled to disgorge those benefits."); Dylan Ratigan, *Fix the Deficit: Clawbacks Before Cutbacks*, HUFFINGTON POST (June 28, 2010), http://www.huffingtonpost.com/dylan-ratigan/fix-the-deficit-clawbacks_b_628243.html ("It's time to tell these bankers that if you can change rules to steal money from the taxpayer, we can the [sic] change rules to take it back."); Andrew Ross Sorkin, ed., *Lawmakers Call on Six Firms to Claw Back Bonuses*, N.Y. TIMES DEALBOOK BLOG (July 29, 2010), http://dealbook.blogs.nytimes.com/2010/07/29/lawmakers-call-on-6-firms-to-claw-back-bonuses/ (reporting that more than forty members of Congress called on six financial firms to halt executive bonuses and return monies to the government from bonuses challenged by Kenneth Feinberg).

48. Cherry & Wong, *supra* note 2, at 385.

49. *See id.* at 415 (discussing the frustration of retroactive application as opposed to prospective efforts); Ribstein, *supra* note 4 (arguing for a prospective application of clawback provisions).

50. Cherry & Wong, *supra* note 2, at 383–84.

51. *Id.* at 407.

is to limit the enforceability of the clawback and subsequent redistribution to other investors with similar clawbacks in their investment contracts.[52] Yet, such a system leaves a participating investor to roll the dice on whether he will have company in the event the clawback is triggered. If not, there seems little benefit to his election, as a resulting redistribution takes on a sense of the arbitrary. In fact, without the complete participation of all of a fund's investors in such a plan, the coveted perfect redistribution according to the principle of fairness remains elusive. For example, Professors Cherry and Wong prefer the contractual approach in the Ponzi scheme context because it allows for the risk of fraud to be "more equally allocated among the investors" through "equitable redistribution among all innocent investors on a pro rata basis, in accordance with the principal amount invested."[53] Such a result relies on the inclusion of all investors and a perfect ability to make subjective characterizations of "innocent investors." In the end, then, such a system embodies some of the very subjectivity it seeks to avoid. Moreover, the boilerplate contractual investment agreement clawback regime the authors prescribe leaves a great many questions unresolved.

First, the world of investment contracts is characterized by intense and detailed negotiation and customization. The resulting contractual provisions are based upon the relative bargaining strength of an individual investor and the fund itself (and the skill, experience and attention of their respective counsel). Very rarely will two investors enjoy identical agreements with a fund. Instead, side letters will often memorialize additional private arrangements, often accompanied by a provision for confidentiality.[54] Moreover, the agreements with individual investors are negotiated and signed over time, as funds contract with new investors as they find them. The negotiation, customization, individual tastes of investors, evolving mindset of the investment fund, and various provisions for confidentiality are all likely to frustrate any regime that relies on standardization of investment contracts for enforcement.

52. *See id.*

53. *Id.* at 405–06.

54. For a general discussion of the proliferation of side letters and their contents, see FRANCOIS-SERGE LHABITANT, HANDBOOK OF HEDGE FUNDS 119–20 (2006) ("[S]ide letters are used to cut side deals outside the constitutional or contractual arrangements of the hedge fund with specific investors, sometimes to the detriment of other investors.").

Second, the reflexive embrace of compensation clawbacks might have drawbacks of its own, and firms "might rationally decide against including such provisions in employment agreements."[55] A future, subjective assessment that revisits the wisdom of a past payment can be a tricky business.[56] And, the value of the device as a compensation recovery tool may prove somewhat limited. Often, the valuation difficulties of yesterday remain today. Measurement issues are exacerbated by a hindsight bias and the fact that cause and effect are not easily understood or reconciled.[57] In addition, the timing and responsibility of profits or losses can be challenging to assign.[58] It is not surprising then that the Sarbanes-Oxley attempts at compensation recovery are triggered by wrongdoing or responsibility for bad acts, as any lesser standard will likely suffer significant measurement difficulties.[59]

Aside from measurement problems, the practical difficulties of getting employees to return paychecks that they have already cashed, spent, and paid taxes on are likely to represent a significant burden to effective implementation.[60] And, there

55. Ribstein, *supra* note 4.

56. *See* Alexis Leondis & Margaret Collins, *Spending Bonus Cash Becomes Risky as Clawback Rules Increase*, BLOOMBERG BUSINESSWEEK (Jan. 8, 2010), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aYy32W7YlV38 ("Defining excessively risky behavior in a quantifiable way is almost impossible.").

57. Very generally, "hindsight bias" refers to the tendency, after the fact, to believe that our forecasts were more accurate than they actually were. *See generally* Baruch Fischhoff, *An Early History of Hindsight Research*, 25 SOC. COGNITION 10 (2007), *available at* http://sds.hss.cmu.edu/media/pdfs/fischhoff/HindsightEarlyHistory.pdf (representing a description of the history of hindsight bias research by its creator).

58. Practical considerations notwithstanding, the recent meddling of the federal government into the area of clawbacks represents "just one little aspect of the mammoth federalization of corporate law." Ribstein, *supra* note 4. At least in the realm of executive compensation, these efforts have trampled a previously respected area for private negotiation. The concern is not lost on Professor Ribstein, who recently observed that writing a clawback provision into a federal law "sets in stone a novel approach to disclosure penalties and executive pay despite the lack of a clear idea what its consequences will be. The need for flexibility and experimentation is a good reason for leaving compensation arrangements to contracts and the market for state law." *Id.*

59. *See* Melone, *supra* note 42, at 74 (highlighting many of the difficulties surrounding the discretion that might accompany a clawback provision).

60. *See* Stephen Gandel, *Can Financial Firms Get Executives to Give Back Pay?*, TIME, (Jan. 27, 2010), *available at* http://www.time.com/time/business/article/0,8599,1956081,00.html (describing the differences in design of the recently adopted Wall Street clawbacks). Also, not addressed directly in this Response, is the idea that wage laws in some states may limit the ability to re-

seems no end to the subjectivity that can be implicated once the clawback seal is breached, as a high-minded company might design its clawback policy with considerable discretion and flexibility. For example, the company might desire to waive the repayment requirement of an employee unable to return the required amount without undue hardship. The exercise of such discretion, however benevolent, would compromise the consistent and fair implementation of the policy.[61] Again, subjectivity abounds!

Third, there remains the additional question of whether (and to what extent) privately negotiated provisions, whether in the investment agreement or executive compensation context, will be respected by a regulator or a court. As the Madoff investors now appreciate, albeit in the retroactive context, the actions of bankruptcy courts and trustees can be difficult to predict. Also, if we have learned anything from our recent economic history, we know that the swings of public opinion make government policy subject to volatility. Moreover, when big money is on the line, appeals and legislative influence are likely to be fully exhausted.[62]

Finally, the authors seem to sidestep the question of the appropriate time bar on the ability of a party to recoup monies via clawback. Under the Bankruptcy Code, for example, a trustee is allowed two years from the filing of the bankruptcy petition to assert preference or avoidance actions,[63] and state law claims for fraudulent transfer or fraudulent conveyance

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cover amounts paid or owed in connection with the performance of services. *See generally* Scott E. Landau & Bradley A. Benedict, *How Effective Is Your Clawback?*, PILLSBURY ADVISORY (Feb. 3, 2010), at 3, http://www.pillsburylaw.com/index.cfm?pageid=34&itemid=39549 (discussing how wage laws limit the ability to recover). For a terrific summary of the practical tax implications of clawbacks in the executive compensation setting, see Melone, *supra* note 42.

61. *See* Landau & Benedict, *supra* note 60, at 3 (observing that certain selective applications might "implicate the Sarbanes-Oxley Act's prohibition against issuing companies granting loans or extending credit to executive officers and directors").

62. *See, e.g.*, Henriques, *supra* note 8 (describing the high likelihood of appeal in the *Madoff* case); *see also* Press Release, Congressman Gary Ackerman, Members of Congress Introduce Legislation to Improve Relief for Victims of Madoff & All Ponzi Schemes,(Apr. 15, 2010), *available at* http://ackerman.house.gov/index.cfm?sectionid=186&parentid=4&sectiontree=&itemid=978 (describing legislative efforts aimed at, among other things, restricting the SIPC from clawing back funds from Ponzi scheme victims "regardless of whether or not they had any involvement in or knowledge of the fraud").

63. *See* 11 U.S.C. § 546(a)(1) (2006).

typically range from two to six years.[64] Further, section 304 of Sarbanes-Oxley provides for recoupment of compensation received within the twelve-month period following the public release of financial information that was subsequently restated.[65] In all cases, these laws respect the idea that there must be some deadline following payment after which the recipient should be allowed to exhale—and to debit the reserves account on its balance sheet.

CONCLUSION

Both the AIG bonus saga and the issues surrounding the appropriate Madoff redistributions among fund investors continue to wind their way through the American system of justice and the court of public opinion.[66] Each brings its own complexity and, in each case, regardless of result, one party or the other will undoubtedly feel aggrieved.[67] The use of the clawback device is likely to expand in the years ahead, however, as the American public adjusts from decades of perceived abundance to the sobering reality of economic scarcity.[68] Professors Cherry

64. *See generally* Lasko, *supra* note 9, at 4 ("Fraudulent conveyance actions under the Bankruptcy Code apply to transfers occurring up to two years prior to the bankruptcy petition."). New York, for example, has a six year statute of limitations for fraudulent conveyance. N.Y. C.P.L.R. 213(8) (McKinney 2010) ("[T]he time within which [an] action [based upon fraud] must be commenced shall be the greater of six years from the date the cause of action accrued or two years from the time the plaintiff or the person under whom the plaintiff claims discovered the fraud, or could with reasonable diligence have discovered it.").

65. *See* Sarbanes-Oxley Act § 304(a), 15 U.S.C. § 7243(a) (2006).

66. *See, e.g.*, Alan Rappeport, *Madoff's Investors to Face Clawback Lawsuits*, FIN. TIMES (July 26, 2010), *available at* http://www.ft.com/cms/s/0/625742be-98ee-11df-9418-00144feab49a.html (suggesting that the Madoff trustee is moving toward the phase of the recovery effort that includes seeking the return of proceeds from Madoff "net winners").

67. *See, e.g.*, Henriques, *supra* note 8 (quoting Judge Lifland as saying "[n]o matter how I come down and rule, it will be unpalatable to one party or another").

68. *See, e.g.*, Mary Thompson, *Pay Czar Will Seek Stricter Clawbacks from TARP Firms*, CNBC (July 20, 2010), http://www.cnbc.com/id/38333143?__source=aol%7Cheadline%7Cquote%7Ctext%7C&par=aol (reporting that Kenneth Feinberg, the Special Master for Executive Compensation, will ask several financial firms to strengthen their clawback provisions in executive pay agreements, but will not require the firms to recover bonuses paid at the height of the financial crisis); *see also* Cassidy, *supra* note 7, (suggesting that the clawback has not taken hold because of a "straightforward coordination problem" and imploring the Federal Reserve to implement new pay guidelines for Wall Street that include a sensible clawback); Joann S. Lublin, *Law Sharpens "Clawback" Rules for Improper Pay*, WALL ST. J. (July 25, 2010), http://

and Wong have done an invaluable service in providing the opening framework through which academicians, practitioners, investors, and firms can begin to think more deeply about the clawback and its uses and limitations. That said, as relevant stakeholders are reminded with each passing day, the mere presence of a clawback, whether explicitly provided *ex ante* or added in an attempt at equity *ex post*, is no panacea. In fact, the clawback itself can often increase the mess, adding a layer of cost and complexity in the form of uncertainty, unpredictability, and discontinuity.

online.wsj.com/article/SB10001424052748704249004575385500170389086.html (observing that the new financial overhaul law requires the SEC to order companies to adopt clawback policies).