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Deterring Opportunism Through Clawbacks: Lessons for Executive Compensation from Minor League Baseball

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DETERRING OPPORTUNISM THROUGH CLAWBACKS: LESSONS FOR EXECUTIVE COMPENSATION FROM MINOR LEAGUE BASEBALL

INTRODUCTION

Highly talented baseball players are scarce commodities. For this reason, they often command large sums of money prior to ever stepping on a major league baseball field, as teams annually pay large bonuses to the most talented players drafted in Major League Baseball's ("MLB") amateur draft. Combined, the thirty MLB teams awarded $228,009,050 in signing bonuses to 2011 draftees.[1] The most talented individuals—the first-round draftees—received on average $2,653,375 per player in 2011.[2] Both numbers set records for spending, as did the $8 million bonus given to the number one overall pick, Gerrit Cole.[3]

These sums of money are not given for performance but are given simply as an incentive to sign with the team. Teams view these expenditures as investments into the future of their organization, but the development of baseball players can be risky business.[4] For instance, over the twenty-five drafts from 1981 to 2005, a total of 32.7 percent of the top draftees never played in the major leagues.[5] Injuries frequently occurred, and players sometimes simply walked away from the game and retired after only a few years. When they did, they took their bonuses with them.

In 2006, MLB recommended that teams protect these investments by using clawback provisions in initial minor league contracts.[6] The practice quickly caught fire, and the clawback provision became an industry standard.[7] The provision acts as a deterrent to opportunistic behavior,[8] and, as will be seen

1. Jim Callis, *No Matter the Slots, Teams Spent Freely in 2011*, BASEBALL AM. (Aug. 18, 2011), http://www.baseballamerica.com/today/draft/news/2011/2612233.html.

2. *Id.*

3. *Id.*

4. *See infra* Part II.A.2.

5. Marty Dobrow, *MLB draft can be risky business*, ESPNBOSTON.COM, http://sports.espn.go.com/boston/columns/story?id=6628930 (last updated June 6, 2011).

6. Telephone Interview with Bobby Evans, Vice President of Baseball Operations, San Francisco Giants (Oct. 20, 2011).

7. *See infra* Part II.A.3.

8. *See* George M. Cohen, *The Negligence-Opportunism Tradeoff in Contract Law*, 20 HOFSTRA L. REV. 941, 953–961 (1992) (discussing the doctrine of opportunism).

below, it is possible that both team and player benefit from this new contractual agreement.

Just as clawbacks in baseball are a relatively new phenomenon, the general use of clawbacks in contracts is also a relatively new development. However, clawback clauses have increased dramatically in recent years, particularly in executive compensation contracts.[9] Executive compensation clawbacks gained much attention with the passage of the Sarbanes-Oxley Act in 2002.[10] Attention heightened when Congress passed the Dodd-Frank Act in 2010, which requires all publicly listed companies to now include clawback provisions in their executive compensation agreements.[11] Yet despite the increased usage of clawbacks, they are not without critics. The study of them is still nascent, and many commentators question the utility and fundamental fairness of contractual clawbacks.[12]

This Comment begins by discussing possible definitions offered for clawbacks and the evolution of their use in executive compensation agreements, both before and after the 2008 financial crisis. It continues by analyzing clawback provisions in minor league contracts. A discussion of the events leading to their widespread implementation in baseball will be followed by a discussion on their benefit from a law and economics perspective. Their enforceability will also briefly be addressed, as the use of these clawbacks in minor league contracts is not without some procedural unconscionability.

As will become apparent, the use of prospective clawbacks in minor league contracts demonstrates the utility of clawbacks as a tool to protect risky investments, to deter opportunisitic behavior by reallocating risk, and to recoup losses after the exhibition of opportunistic behavior. Their increased usage should continue in other contractual realms where opportunism is possible, such as executive compensation agreements.

9. *See, e.g.*, Jesse Fried & Nitzan Shilon, *Excess-Pay Clawbacks*, 36 J. CORP. L. 721, 723 (2011) (stating that more than 80% of Fortune 100 firms began using clawbacks even before the Dodd-Frank Act required it); Matthew A. Melone, *Adding Insult to Injury: The Federal Income Tax Consequences of the Clawback of Executive Compensation*, 25 AKRON TAX J. 55, 120 (2010) ("Compensation clawback provisions are proliferating.").

10. Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (2006). SOX allowed for the clawing back of executive bonuses in certain circumstances of wrongdoing. *Id.*

11. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376, 1904 (2010).

12. *See, e.g.*, Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1806 (2011) (stating that clawbacks are both overinclusive in some aspects and underinclusive in others); Michael C. Macchiarola, *In the Shadow of the Omnipresent Claw: In Response to Professors Cherry & Wong*, 95 MINN. L. REV. HEADNOTES 1, 6 (2010), http://www.minnesotalawreview.org/wp-content/uploads/2011/06/Macchiarola_PDF1.pdf (stating that clawbacks are unnecessarily inflexible).

I. CLAWBACKS GENERALLY

A. Clawbacks Defined

Though the usage of clawbacks has increased in the past decade, the study of them is still in its nascent stage.[13] As a result, the term often assumes a different meaning depending on the context in which it is used.[14] For instance, the meaning of the term clawback when used in an employment relocation contract will differ considerably from its meaning when used in the context of electronic discovery.[15]

Black's Law Dictionary supplies two potential meanings for clawback: 1) "[m]oney taken back", or 2) "[t]he retrieval or recovery of tax allowances by additional forms of taxation."[16] Neither definition offers anything truly meaningful to the emerging doctrine of clawbacks. The simplicity and broadness of the first definition renders it nearly useless—it is almost limitless in its nature—while the second provides a more specific definition that is inapplicable to the more common modern usages of the term.

Perhaps due to the lack of a consistent, useful definition of the term, Professors Cherry and Wong recently offered their own definition.[17] They proposed "that a clawback be defined as a right to, or action for, the restitution of unfair enrichment that is otherwise justified or permitted under prevailing applicable law."[18]

Upon first glancing at this definition, one aspect immediately captures attention: the introduction of the concept of "unfair enrichment." In discussing this term, Professors Cherry and Wong say that the concept of unfair enrichment is related to the more traditional contract concept of unjust

13. For a discussion of the scant availability of scholarly works concerning clawbacks, see, for example, Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 410–412 (2009), and Macchiarola, *supra* note 12, at 2.

14. Cherry & Wong, *supra* note 13, at 410–11.

15. *Compare* John Chung, *Are Relocation Package "Claw Back" Clauses Legal in China?*, CHINA LEGAL BRIEF (Mar. 17, 2011) (on file with the *Saint Louis University Law Journal*) (defining a clawback in a relocation agreement as a covenant requiring "the return of a portion or all of the relocation bonus, payment or similar payments paid by the company if the employees decide to leave the company within time periods specified in the agreement"), *with* Shira A. Scheindlin & Jonathan M. Redgrave, *Special Masters and E-Discovery: The Intersection of Two Recent Revisions to the Federal Rules of Civil Procedure*, 30 CARDOZO L. REV. 347, 357 (2008) (defining a clawback as used in electronic discovery as an "agreement regarding a procedure for retrieving privileged information that has been inadvertently produced in the course of discovery").

16. BLACK'S LAW DICTIONARY 286 (9th ed. 2009).

17. Cherry & Wong, *supra* note 13, at 412.

18. *Id.*

enrichment, as both focus on the unjust nature of a person's gains.[19] Yet unfair enrichment extends beyond unjust enrichment to include instances in which "the person unfairly enriched has a preexisting legal right to payment."[20] Thus, because of a legal right, unjust enrichment would not apply and the offending person would be permitted to keep the benefit obtained, even if this were unjust to the other party. However, the concept of unfair enrichment offers a solution to this problem, as clawbacks offer the possibility of recouping all or part of this unfair enrichment.

One might question whether this new concept is truly necessary, and, indeed, this proposed definition is not without critics. For instance, Professor Macchiarola recently remarked that the inclusion of unfair enrichment in the definition "introduces unwelcomed subjectivity to decisions of whether and to what extent a person's monies might be subject to return at some future date."[21] He also contended that the predictability of law would suffer, and the transaction costs of contracting would rise.[22]

It should be noted that Professors Cherry and Wong distinguish between two types of clawbacks that manage to co-exist within their definition.[23] The first type, deemed a retroactive clawback, is imposed *after* the contractual right has arisen and *after* the benefit conferred.[24] Conversely, a prospective clawback is introduced into a contract *before* the contractual right occurs and *before* the benefit conferred.[25]

Prospective clawbacks operate more effectively than retroactive clawbacks,[26] and many of the ills described by Professor Macchiarola disappear when clawbacks are used prospectively.[27] Since the terms of the clawback result from the contractual process of drafting the provision, the uncertainties inherent in retroactive clawbacks disappear.[28] Moreover, the parties have bargained for the terms in prospective clawbacks, so each side has had the opportunity to accept or reject the exact terms of the agreement.

19. *Id.*
20. *Id.* at 413.
21. Macchiarola, *supra* note 12, at 7.
22. *Id*.
23. Cherry & Wong, *supra* note 13, at 371–72.
24. *Id.* at 372.
25. *Id*.
26. *Id.*
27. Miriam A. Cherry & Jarrod Wong, *Reply: Clawback to the Future*, 95 MINN. L. REV. HEADNOTES 19, 24 (2010), http://www.minnesotalawreview.org/wp-content/uploads/2011/06/Wong_Cherry_PDF.pdf.
28. *Id.*

B. Use of Clawbacks in Executive Compensation Agreements

Whether done prospectively or retroactively, the usage of clawbacks has clearly increased in recent years.[29] One prominent area in which clawbacks are now frequently used is in executive compensation agreements.[30] Their usage in such agreements both before and after the 2008 financial crisis will be discussed below.

1. Executive Compensation Clawbacks Prior to the 2008 Financial Crisis

President Bush signed the Sarbanes-Oxley Act ("SOX") into law in 2002, and with it arrived the legal possibility of executive compensation clawbacks.[31] If a company is forced to issue an accounting restatement due to material noncompliance with a financial reporting requirement, the law allows the SEC to recoup any incentive-based compensation received within the twelve-month period preceding the restatement.[32]

This provision, however, has its limitations. The clawing back is only permitted when the restatement results from misconduct.[33] Also, only the budget-constrained SEC can initiate the clawback.[34] For these and other reasons, the clawback provision of SOX was almost never used except when an executive was convicted of criminal fraud.[35]

After the passage of SOX, some companies began voluntarily implementing their own clawback policies that went beyond the SOX requirements.[36] In 2006, around eighteen percent of Fortune 100 firms utilized clawback provisions, and by the middle of 2010 the number of Fortune 100 firms implementing clawbacks had grown to eighty percent.[37] Close to fifty percent of Fortune 500 firms had implemented clawbacks by this date.[38]

29. Gretchen Morgenson, *Pay It Back if You Didn't Earn It*, N.Y. TIMES, June 8, 2008 (Sunday Business), at 1.

30. *See, e.g.*, Fried & Shilon, *supra* note 9, at 723 (stating that more than 80% of Fortune 100 firms began using clawbacks even before the Dodd-Frank Act began requiring it); Melone, *supra* note 9, at 120 ("Compensation clawback provisions are proliferating.").

31. Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (2006).

32. *Id.*

33. *Id.*

34. Fried & Shilon, *supra* note 9, at 731.

35. *Id.*; *see also* Cherry & Wong, *supra* note 13, at 376–77 (stating that the clawback provision of SOX has "been largely ignored" and that only two enforcement actions were brought in the first seven years after the passage of the Act). *But cf.* Jeffrey S. Klein & Nicholas J. Pappas, *New Clawback Requirements for Listed Public Companies*, N.Y. L.J., Oct. 4, 2010, at 3 (noting that although the SEC has traditionally only initiated a clawback suit when the CEO or CFO is personally involved in the misconduct, the SEC has recently taken a more aggressive approach in regulating this issue).

36. Fried & Shilon, *supra* note 9, at 735–36.

37. *Id.*

38. *Id.* at 736.

Nevertheless, most of these clawbacks lacked robust enforcement provisions, as they did not *require* directors to recoup excess pay, but instead granted directors discretionary powers.[39] The majority of those that did require recoupment only did so when misconduct occurred.[40]

The discretionary nature of these provisions severely limited their utility, as the personal cost to directors of instituting a recoupment procedure was likely to dwarf the personal benefit gained by directors from any type of recovery.[41] Also, the misconduct hurdle further permitted excess pay to be hoarded by undeserving executives.[42] Consequently, companies had little chance of recouping any excess pay despite the enactment of these provisions.

2. Executive Compensation Clawbacks After the 2008 Financial Crisis

On September 29, 2008, the Dow Jones Industrial Average dropped 778 points.[43] It was the largest single-day drop in the history of the widely used index, as $1.2 trillion in market value vanished in a matter of hours.[44] As Warren Buffett would later say, the economy had "fallen off a cliff," and the losses continued to mount.[45] By March 9, 2009, the index had fallen to 6547.05[46]—almost fifty-four percent below its all-time high of 14,164.53 reached only seventeen months before.[47]

Banks failed in large numbers, [48] home values catapulted downward,[49] and the federal government scrambled to inject money into a failing financial system.[50] The effort culminated with the enactment of the controversial Troubled Asset Relief Program ("TARP") in October of 2008.[51]

39. *Id.* at 737.

40. *Id.*

41. Fried & Shilon, *supra* note 9, at 739.

42. *Id.* at 741.

43. Vikas Bajaj & Michael M. Grynbaum, *7% Drop in Dow*, N.Y. TIMES, Sept. 30, 2008, at A1.

44. *See id.*

45. Betsy Stark, *Tracking the Dow One Year After Rock Bottom*, ABC NEWS (Mar. 9, 2010), http://abcnews.go.com/Business/year-ago-today-dow-hit-bottom-recession/story?id=10046578.

46. *Id.*

47. *Dow Jones Industrial Average (DJIA) History Chart: January 1, 1931 Through August 12, 2011,* http://www.nyse.tv/djia-chart-history.htm (last visited June 10, 2012).

48. *See Bank Failures in Brief*, FDIC, http://www.fdic.gov/bank/historical/bank/2009/ (last updated Jan. 20, 2012) (reporting that 140 banks failed in 2009 alone).

49. Les Christie, *Home Prices: 'Double-dip' Confirmed*, CNNMONEY (May 31, 2011, 10:43 AM), http://money.cnn.com/2011/05/31/real_estate/march_home_prices/index.htm.

50. Among the many measures taken, almost $200 billion was extended to mortgage lenders Fannie Mae and Freddie Mac in September of 2008. David Ellis, *U.S. Seizes Fannie and Freddie*, CNNMONEY (Sept. 7, 2008, 8:28 PM), http://money.cnn.com/2008/09/07/news/companies/fannie_freddie/index.htm. Additionally, insurance giant AIG received $85 billion the same month. Matthew Karnitschnig et al., *U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject*

TARP placed limits on executive compensation for those financial companies receiving funds from the program.[52] However, it wasn't until the passage of the American Recovery and Reinvestment Act of 2009 that an attempt was made to claw back portions of excess bonuses paid out with funds from TARP.[53] The statute required the recovery "of any bonus, retention award, or incentive compensation paid to a senior executive officer and any of the next [twenty] most highly-compensated employees . . . based on [financial statements] that are later found to be materially inaccurate."[54] Yet the Act also stated that it would not prohibit the paying of a bonus for employment contracts executed prior to February 11, 2009.[55]

The effect of the TARP clawback requirement was muted.[56] Kenneth Feinberg, nominated by President Obama to be the "watchdog" for executive pay, found in 2010 that seventeen companies paid out $1.6 billion in bonuses after receiving bailout money the previous year.[57] Though he remarked the bonuses were paid in "bad judgment," he also noted that "they didn't violate any statute, they didn't violate any regulation at the time."[58] He also remarked that "[t]he taxpayer has a right to be outraged."[59]

In response to this report and the public's outrage, President Obama reemphasized the importance of financial reform legislation.[60] In fact, just days before the Feinberg report surfaced, President Obama signed into law the

Cash as Credit Dries Up, WALL ST. J. (Sept. 16, 2008), http://online.wsj.com/article/SB122156561931242905.html.

51. Greg Hitt & Deborah Solomon, *Historic Bailout Passes as Economy Slips Further*, WALL ST. J. (Oct. 4, 2008), http://online.wsj.com/article/SB122304922742602533.html.

52. Emergency Economic Stabilization Act of 2008 § 111, 12 U.S.C. § 5221 (2006 & Supp. IV 2008) (providing required guidelines for a company receiving bailout funds); *see also* Hitt & Solomon, *supra* note 51. For a more in-depth discussion of the subsequent bailouts, see Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373 (2008).

53. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 516–520 (2009) (amending the Emergency Economic Stabilization Act of 2008).

54. *Id.* at 517.

55. *Id.* at 518.

56. *See* Cherry & Wong, *supra* note 13, at 385 (noting that the Act was weak and ineffective in limiting compensation); *see also* Mark Maremont & Joann S. Lublin, *Loopholes Sap Potency of Pay Limits*, WALL ST. J. (Feb. 6, 2009), http://online.wsj.com/article/SB123387352310154241.html (describing the loopholes of the TARP requirements).

57. Matthew Jaffe, *'Right to be Outraged:' Pay Czar Slams Banks for Executive Pay After Bailouts*, ABC NEWS (July 23, 2010), http://abcnews.go.com/Politics/pay-czar-report-slams-banks-executive-pay-bailouts/story?id=11235894.

58. *Id.*

59. *Id.*

60. *Id.*

Dodd-Frank Act of 2010.[61] With it came the requirement of clawbacks in executive compensation agreements.[62]

3. Clawbacks Required by the Dodd-Frank Act of 2010

The Dodd-Frank Act requires all publicly listed companies to include clawbacks prospectively in their incentive compensation packages.[63] The clawback provision triggers when a company is forced to prepare an accounting restatement due to a material noncompliance.[64] More specifically, the company must recover incentive-based compensation from executive officers derived from 1) erroneous data; 2) received during a "[three]-year period preceding the date on which the issuer is required to prepare an accounting restatement"; 3) in excess of the pay that would have resulted under the restatement.[65] The clawback must be strong enough to allow the company to recover any compensation that executives derive from erroneous data in excess of what would have been paid under the restatement.[66]

One of the chief benefits of this requirement is that it forces companies to include clawbacks that trigger whether or not the executive engages in any misconduct.[67] This represents a difference—and an improvement[68]—from SOX, which required misconduct and lessened the likelihood that the provision would ever be enforced.[69] However, the Act has been criticized for only requiring clawbacks that trigger when an accounting restatement is issued.[70] Furthermore, it might permit executives "to keep excess pay arising from the sale of equity incentives at inflated prices."[71] Also, some have commented that

61. Helene Cooper, *Obama Signs Contentious Overhaul of the Financial System*, N.Y. TIMES, July 22, 2010, at B3.

62. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376, 1904 (2010); *see also* Fried & Shilon, *supra* note 9, at 745 (stating that section 954 of Dodd-Frank requires every listed company to put in place a clawback policy).

63. Dodd-Frank Act § 954.

64. *Id.*

65. *Id.*

66. *Id.*

67. Fried & Shilon, *supra* note 9, at 746.

68. Not all would agree that this is an improvement. In fact, Professor Bainbridge describes the Dodd-Frank clawback as "seriously flawed" partly because the requirement will over-inclusively result in some innocent executive officers forfeiting pay despite their lack of responsibility. Bainbridge, *supra* note 12, at 1806.

69. Fried & Shilon, *supra* note 9, at 730.

70. *Id.* at 747–48. Professors Fried and Shilon state that "[a] restatement requirement is problematic because an executive could receive excess pay even if a restatement is not considered to be required." *Id.* at 748. This could be for one of three reasons: 1) a small accounting error would not necessarily require a restatement but could trigger a large compensation bonus; 2) a firm may use non-financial metrics in calculating an executive's bonus; or 3) a firm may find that a restatement isn't necessary even though neutral observers would believe the contrary. *Id.*

71. *Id.* at 751.

the Act lacks a procedural mechanism for enforcement.[72] It remains possible that this latter concern might be alleviated once the SEC, as the agency charged with implementing the Act, develops its rules for the clawback requirement.[73] However, the SEC has yet to adopt rules for this portion of the Act.[74]

For this reason, some have suggested that firms should go beyond the requirements of the Dodd-Frank Act and voluntarily institute more robust clawback provisions.[75] The clawback could be written in a way that not only complies with Dodd-Frank requirements, but also allows for a broader approach that covers unanticipated events.[76] In this manner, the clawback would be mandatory in some circumstances, and in other circumstances the board of directors could be given broad discretion in dealing with "inevitable, real-world variation."[77]

C. Are There Problems with Using Clawbacks?

As demonstrated above, the usage of clawbacks in areas such as executive compensation has increased in recent years. In fact, with the passage of Dodd-Frank, prospective clawbacks have become a legal requirement for companies. While many would cheer this development, others find problems with this increased usage.

Some have remarked that the entire arrival of clawbacks reflects a reactionary approach. For instance, the passage of SOX took place hastily in

72. Cherry & Wong, *supra* note 27, at 22 (expressing concerns that a shareholder derivative suit might be needed to actually claw back the compensation).

73. *Cf.* Klein & Pappas, *supra* note 35, at 9. (discussing the possibility of the SEC adopting rules for *de minimis* clawbacks similar to that adopted in TARP regulation).

74. *Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act—Upcoming Activity*, SEC, http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml (last visited Feb. 12, 2012) (stating that rules regarding the recovery of executive compensation were planned for implementation between July 2012 and December 2012).

75. *See* Cherry & Wong, *supra* note 27, at 22–23 (stating the Dodd-Frank Act "certainly could be stronger" and that companies are free to go beyond the requirements); Fried & Shilon, *supra* note 9, at 749 (stating all firms should include clawback provisions that will trigger whether a restatement is necessary or not). *But see* Bainbridge, *supra* note 12, at 1815–16 (finding no utility in any of the corporate governance measures included in Dodd-Frank since corporate governance flaws were not a cause of the financial crisis).

76. Ben W. Heineman, Jr., *Making Sense of Clawbacks and Holdbacks*, BLOOMBERG BUSINESSWEEK (Aug. 13, 2010, 2:59 PM), http://www.businessweek.com/managing/content/aug2010/ca20100813_666706.htm.

77. *Id.* Of course, granting a board of directors such discretion might limit the utility of any clawback provision, as it will make it unlikely that the board will ever exercise this discretion in a manner adverse to management.

the wake of Enron and other corporate fiascos.[78] Similarly, the drafting and passage of Dodd-Frank took place as a reaction to the 2008 financial crisis.[79] Consequently, some see Congress as quickly acquiescing to public pressure, and perhaps recklessly enacting unnecessary and destructive legislation simply to appease mass outrage.[80]

In addition to these reactionary concerns, others express concerns over the increase in uncertainty that clawbacks add.[81] In a world of compensation uncertainty, an executive will constantly be "monitoring the rear view mirror" and will never be "free to relax."[82] Moreover, the valuation difficulties that may lead to the clawback-inducing problem in the first place will likely still be present at a later date.[83] At this later date, any evaluation might also be affected by hindsight bias.[84]

There might also be practical difficulties in getting a person to pay back money when enforcing a clawback, as checks are cashed quickly and money spent even quicker.[85] Additionally, an overly aggressive clawback provision might stifle beneficial risk-taking and hamper the recruitment of new corporate talent.[86] Lastly, a clawback may result in unfair tax implications.[87]

While some of these concerns might be legitimate, the utility of clawbacks outweighs the potential drawbacks, as another industry far from Wall Street demonstrates. The industry? Professional baseball, whose franchises frequently utilize clawbacks to protect bonus-laden contracts and to tame opportunistic behavior.

II. CLAWBACKS IN MINOR LEAGUE CONTRACTS

A. *The Origin of Clawbacks in Baseball Contracts*

Each year as MLB teams seek to reload and upgrade the young talent within their organizations, large bonuses are paid to previously amateur

78. *See* Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW. 1079, 1081 (2008) (describing SOX as "crisis-inspired legislation").

79. *See* Bainbridge, *supra* note 12, at 1782–83 (stating that "populist outrage motivated Congress to pass the Dodd-Frank [Act] . . .").

80. *See id.* at 1786 (stating that congressional intrusion into corporate governance occurs in a cycle of "boom, bust, and regulation," and SOX and Dodd-Frank were simply the latest iterations of this).

81. Macchiarola, *supra* note 12, at 7.

82. *Id.* at 7–8.

83. *Id.* at 15.

84. *Id.*

85. *Id.*

86. Melone, *supra* note 9, at 72.

87. *Id.* at 75.

players. As noted in the Introduction, the thirty MLB teams combined to award $228,009,050 in signing bonuses to 2011 draftees,[88] most being between the age of eighteen and twenty-one. This total amount did not include the large sums of money spent on Latin American players,[89] who are not subject to MLB's Rule 4 draft.[90] The very top draftees annually command signing bonuses in the millions of dollars, with this year's number one pick in the Rule 4 draft, Gerrit Cole, netting an $8 million signing bonus.[91]

Despite the large sums of money paid upfront to amateur players, the investment remains risky.[92] These young players possess the impressive talent that leads to the ability to command large signing bonuses, yet many fail to blossom as projected. Incredibly, of the 917 first-round draft picks from the twenty-five year period between 1981 and 2005, *32.7% never played in the major leagues*.[93] Furthermore, 19.2% of the total top-ten overall picks from the same time period—the most talented draftees of all—never reached the major leagues.[94] Most incredibly, two of the number one overall selections never even stepped on a major league diamond.[95]

These picks represent the best of the best—players who have been vetted almost as extensively as Supreme Court nominees.[96] Faced with such a risky

88. Callis, *supra* note 1.

89. MLB teams spent an estimated $102 million on Latino signing bonuses for the year ending in 2010. Kevin Baxter, *Latin American Baseball Players Train Hard to Build English Skills*, L.A. TIMES, June 30, 2011, *available at* http://articles.latimes.com/2011/jun/30/sports/la-sp-0701-baseball-esl-classes-20110701/2.

90. For a thorough discussion of MLB's current draft system and the possible legal problems that result from excluding certain players from the draft based on nationality, see Daniel Hauptman, *The Need for a Worldwide Draft to Level the Playing Field and Strike Out the National Origin Discrimination in Major League Baseball*, 30 LOY. L.A. ENT. L. REV. 263 (2009–10). *See also* Jim Callis, *MLB's Amateur Attitude is Baffling*, BASEBALL AM. (July 13, 2011), http://www.baseballamerica.com/online/prospects/column/2011/2612097.html (discussing the differences between the process for acquiring international talent and for acquiring domestic talent, and discussing the continued escalation of international signing bonuses within a free market system).

91. Callis, *supra* note 1.

92. Dobrow, *supra* note 5.

93. *Id.*

94. *Id.*

95. Brien Taylor, picked by the New York Yankees in 1991, and Matt Bush, picked by the San Diego Padres in 2004, never reached the major leagues. *Id.*

96. Each team has a legion of "bird dogs," area scouts, cross-checkers, international scouts, and assistant general managers that constantly assess amateur talent. Top prospects are usually observed over a period of several years by multiple people within an organization before being selected. *See*, *e.g.*, Amalie Benjamin, *Search Party: Red Sox Scouts are Always on the Lookout for Talent*, BOS. GLOBE, Dec. 28, 2008, *available at* http://articles.boston.com/2008-12-28/sports/29272903_1_scouts-minor-leagues-draft (describing the incessant scouting process employed by the Boston Red Sox).

investment, MLB has tried a number of measures, with the primary approach to the problem[97] focusing on efforts to suppress signing bonuses.

1. MLB's Efforts to Suppress Signing Bonuses

Major League Baseball has long engineered various mechanisms to curtail signing bonuses of amateur athletes. As long ago as 1946, MLB instituted a bonus rule that required a team to place any player signed to a bonus above a fixed amount (often $4,000 to $6,000) on the major league roster.[98] With only a limited amount of major league roster spots, baseball executives hoped this would deter teams from signing numerous amateur players to bonuses above the threshold.[99]

Despite this rule, teams continued to spend on top talent, prompting the adoption of a new rule in 1959.[100] Deemed the "first-year draft rule," it required teams to protect their top prospects on the equivalent of an expanded major league roster or else risk losing the players to other teams.[101] When this too failed to curb bonuses, the teams resorted to a more drastic measure: a formal draft.[102]

MLB established the Rule 4 draft in 1965.[103] Much like today,[104] teams selected draft picks in a set order and had exclusive negotiating rights with their selections. Since teams were no longer free to compete with one another for top talent, the draft immediately depressed signing bonuses.[105] While five

97. Many would argue that, despite the risky investment, this is not a problem at all, as acquiring talent through signing amateur players still remains the most cost-effective means of acquiring talent. *See* Kevin Baxter, *Talent Search Goes Out of States*, L.A. TIMES, June 18, 2011, at C5 (discussing the cost-efficiencies of signing and developing international amateur players); Andrew Keh, *For Mets, Different Approach Pays Off*, N.Y. TIMES, Aug. 17, 2011, at B13 (discussing the New York Mets' new approach to paying premium dollars for amateur players since it is the "most cost-efficient way for a team to acquire talent").

98. Allan Simpson, *Despite Baseball's Best Efforts, Bonuses Just Keep Growing*, BASEBALL AM., June 20–July 3, 2005, at 10.

99. *Id.*

100. *Id.* at 11.

101. *Id.* at 10–11. The rule allowed players to be protected on a "40-man" roster, as opposed to the normal active roster consisting of twenty-five players. *Id.* If a prospect were not placed on the 40-man roster, he would be subject to acquisition via waivers or the Rule 5 draft. *Id.* A system with many modifications and differences from this 1959 system still exists. *See* Kary Booher, *Explaining the Rule 5 Draft*, BASEBALL AM. (Nov. 20, 2008), http://www.baseballamerica.com/today/majors/news/2008/267230.html (describing the Rule 5 draft process).

102. Simpson, *supra* note 98.

103. *Id.*

104. For a description of current rules, *see First-Year Player Draft, Official Rules*, MLB.COM, http://mlb.mlb.com/mlb/draftday/rules.jsp (last visited June 20, 2012).

105. Simpson, *supra* note 98.

players in 1964 had signed six-figure bonuses, only the number one overall pick commanded such a bonus in 1965.[106]

For more than two decades, the depressed bonuses persisted. In fact, in 1987, the highly talented Ken Griffey, Jr.—the number one overall pick—signed with the Seattle Mariners for a mere $169,000 bonus.[107] It seemed MLB had solved its problem of escalating signing bonuses, yet the solution proved temporary.

Soon after Griffey signed, bonuses began to escalate again. The year 1989 marked a dramatic intensification of negotiation, with rising super-agent Scott Boras securing a $350,000 bonus for Ben McDonald.[108] Only a few years later in 1993, Boras secured an astounding $1.55 million bonus for a high school lefty named Brien Taylor.[109] Average bonus payments to first-round picks skyrocketed from $252,577 in 1990 to $613,037 in 1993.[110] And the escalation did not cease there.

In 1996, Boras and other agents used a loophole in the draft process to allow four draft-eligible players to become free agents.[111] Once on the open market, the players freely negotiated with all major league teams. The result: Matt White inked a *$10.2 million* bonus with the Tampa Bay Devil Rays.[112] The other three players inked deals of $10 million, $6.075 million, and $3 million.[113]

Faced with this escalation, MLB again sought new methods of depressing signing bonuses. In 2000, MLB instituted signing bonus guidelines (or recommendations) to teams in the form of "soft slotting."[114] For each pick in

106. *Id.*

107. Ross Newhan, *Costly Draft Could Leave Some Teams Cold*, L.A. TIMES, June 1, 1997, at C12.

108. Simpson, *supra* note 98. The $350,000 bonus was part of an overall package worth $824,300. *Id.* Another player, John Olerud, received a $575,000 bonus as part of an $800,000 package the same year. *Id.*; *see also* Bob Nightengale, *Only the Money is Guaranteed*, USA TODAY, June 3, 2009, at 1C. (comparing Ben McDonald to Stephen Strasburg, who was also represented by Scott Boras twenty years later).

109. Simpson, *supra* note 98; Jim Bowden, *The GM's Office: Negotiating with Scott Boras*, ESPN (June 4, 2011), http://m.espn.go.com/mlb/story?storyId=6625521&pg=1&wjb=.

110. Simpson, *supra* note 98.

111. *Id.*

112. *Id.*

113. *Id.*

114. *Id.* MLB could not make the slotting recommendations mandatory, as such a change would need to be established through collective bargaining with the Major League Baseball Players Association. MLB executives still seek mandatory slotting today, and the issue was discussed during the 2011 collective bargaining talks. *See* Callis, *supra* note 90 (noting that MLB wanted a hard slotting system); Jon Heyman, *Draft Maneuvers by Nationals, Pirates Drawing the Ire of Selig*, SI.COM, http://sportsillustrated.cnn.com/2011/writers/jon_heyman/08/19/draft-cap/index.html (last updated Aug. 19, 2011, 4:01PM) (stating that Commissioner Selig's biggest interest in the 2011 negotiations was a new slotting system). It was not expected to be included in

the first five rounds, MLB provided teams with specific bonus recommendations, and for each pick after the fifth round, a flat cap on bonuses was instituted.[115] Teams were pressured to stay within the recommended bonus levels for each of the top picks in the draft.[116] Nevertheless, the guidelines were not mandatory.[117] Although the soft slotting system curbed the escalation in signing bonuses,[118] it did not depress them.[119] For this reason, MLB teams began to turn to other measures in order to protect their investments.

2. The Impetus for Clawback Clauses in Minor League Contracts

Despite the increase in signing bonuses, teams continued to retain little protection for their large, risky investments. Like other professional sports, injuries unexpectedly stifled the anticipated brilliance of many talented signees.[120] Other things also unexpectedly limited player development, as, in fact, sometimes players simply chose to walk away from the game.

Ryan Jaroncyk perhaps best exemplifies this phenomenon. Drafted in the first round by the New York Mets in 1995, Jaroncyk netted an $850,000 signing bonus.[121] He had all the physical assets to be a major league

the next agreement. Jim Callis, *Jim Callis Chat: Aug. 17*, BASEBALL AM. (Aug. 17, 2011), http://www.baseballamerica.com/today/prospects/chat/2011/2612226.html (stating that the prospect for hard slotting was next to zero).

115. Jim Callis, *Prospects Chat with Jim Callis*, BASEBALL AM. (June 16, 2010), http://www.baseballamerica.com/today/prospects/chat/2010/2610204.html.

116. *See* Callis, *supra* note 1 (stating that in 2011 MLB "leaned on teams harder than ever to adhere to an informal slotting system" and that "political pressure" is exerted on clubs "to toe the line").

117. *See* Kevin Goldstein, *Future Shock: Do We Really Need to 'Fix' the Draft?*, BASEBALL PROSPECTUS (Aug. 20, 2010), http://www.baseballprospectus.com/article.php?articleid=11804 (describing the lack of an enforcement mechanism in soft slotting).

118. Since soft slotting was instituted in 2000, first-round bonuses have increased by 2.3% per year, compared to an increase of 26.9% per year in the 1990s. Callis, *supra* note 90.

119. Major League Baseball and the players' union agreed in a new collective bargaining agreement, effective in December 2011, to make major changes to the Rule 4 draft. *MLB, MLBPA Reach New Five-Year Labor Agreement*, MLB.COM (Nov. 22, 2011, 1:20 PM), http://mlb.mlb.com/news/article.jsp?ymd=20111122&content_id=26025138&vkey=pr_mlb&c_id=mlb. Each team will be provided a pool of money to spend on draft picks selected in the top ten rounds. *Id.* The pools will be calculated based upon a team's specific draft picks and teams who exceed their allotted spending pool will be penalized. *Id.* While not the equivalent of mandatory slotting, the new system is still more binding than the previous "soft slotting" system due to the enforcement mechanism of penalty taxes. *See* J.J. Cooper & Jim Callis, *New CBA Will Bring Sweeping Changes to Talent Acquisition*, BASEBALL AM. (Dec. 20, 2011), http://www.baseballamerica.com/today/draft/news/2012/2612723.html (detailing the penalty tax scheme).

120. *Cf.* Dobrow, *supra* note 5 (noting that a total of 32.7 percent of the top draftees between 1981 and 2005 never made the major leagues).

121. Buster Olney, *A Met Prospect Walks Away from Baseball*, N.Y. TIMES, May 30, 1997, at B7. The bonus also included a $100,000 college scholarship plan. *Id*.

shortstop.[122] But he lacked one mental tool that would overshadow all of his physical talents: he had no desire to play the game.[123]

Despite the physical attributes and the large bonus, Jaroncyk said that he "always thought [baseball] was boring."[124] So at the ripe age of twenty years, just two years after signing his contract and being completely healthy, he walked away from what he considered to be a "boring" game.[125] He never set foot on a major league baseball field, and the Mets never recovered a dime of their investment.[126]

Though uncommon, others would follow Jaroncyk's lead and join him in the land of lost prospects. Jaroncyk, who once remarked that he "play[ed] for God,"[127] would be joined in his deistic pursuit by Grant Desme, who retired from baseball on the verge of stardom to become a priest.[128] Justin Hoyman, a 2004 second-round pick by the Cleveland Indians who received a $725,000 signing bonus,[129] played all of two seasons in the minor leagues before promptly retiring.[130] Quan Cosby, who received an $825,000 bonus as an eighteen-year-old in 2001, also left the game after a short career in the minor leagues.[131] Cosby's reason? He wanted to play football for the University of Texas.[132] Another former prospect, Tom Wilhelmsen, received $250,000 in 2002 from the Milwaukee Brewers as an eighteen-year-old. He filed retirement papers in 2005 after "a lot of beer and grass."[133]

Many might be wondering why a talented player would ever walk away from baseball so early in his career. While the answer might vary greatly from individual to individual, it no doubt stems in part from the fact that almost all

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.*

126. Olney, *supra* note 121.

127. *Id.*

128. Jane Lee, *Desme Retires to Pursue Priesthood*, MLB.COM (Jan. 22, 2010, 8:08 PM), http://mlb.mlb.com/news/article.jsp?ymd=20100122&content_id=7954958.

129. *Baseball America Draft Database, 2004 MLB Draft: Round 2*, BASEBALL AM., http://www.baseballamerica.com/draftdb/rnd.php?rnd=2 (last visited Oct. 22, 2011).

130. *Justin Hoyman*, THE BASEBALL CUBE, http://www.thebaseballcube.com/players/profile.asp?P=Justin-Hoyman (last visited Oct. 22, 2011). Hoyman might not be considered a pure runaway, as his brief career was limited by an elbow injury. Kevin T. Czerwinski, *Back to School with Justin Hoyman*, MLB.COM (Feb. 27, 2006, 11:27 AM), http://www.minorleaguebaseball.com/news/article.jsp?ymd=20060227&content_id=43772&vkey=news_milb&fext=.jsp.

131. *Player Profile, Quan Cosby,* CBSSPORTS.COM, http://www.cbssports.com/nfl/draft/players/565752 (last visited Oct. 22, 2011).

132. *Id.*

133. Geoff Baker, *Pitcher Thriving in 2nd Chance*, SEATTLE TIMES, Feb. 18, 2011, at C1; Bob Harkins, *Partied His Way Out, Then Got 2nd Chance*, NBC SPORTS (Mar. 8, 2011, 12:51 PM), http://nbcsports.msnbc.com/id/41925004/ns/sports-baseball/. In 2010, Wilhelmsen began a comeback attempt with another team. Harkins, *supra* note 133.

prospects spend years in baseball's minor leagues prior to reaching the major leagues. Though a full discussion is beyond the scope of this Article, the minor league lifestyle is less than glamorous.[134] The tiresome travel, most of which is done by bus, grates on players.[135] Many young players become homesick from being away from home for the first time.[136] And of course, some, like Jaroncyk above, simply lack a love for the game. Whatever the reason, baseball executives soon realized they needed to better protect their risky investments. Consequently, teams began turning to clawbacks.

3. The Introduction of Clawback Provisions in Minor League Contracts

In 2006, MLB's Office of the Commissioner of Baseball responded to the multiple incidents of young prospects retiring after only a few seasons. The office distributed new recommended minor league contract language to the thirty MLB teams.[137] The language included a clawback provision to help protect teams' investments.[138]

Recognizing the utility of these provisions, teams quickly added the language to their uniform player contracts ("UPCs"). By 2007—only a year later—nearly all teams had begun utilizing the provisions.[139] Moreover, due to the top-down process of incorporation, in which the central office offered recommended language and teams quickly adopted it, the provisions all looked remarkably similar. This will be discussed more in the next section.

134. For a discussion of the living environment of players in the minor leagues, see Garrett Broshuis, *Playing for Peanuts*, BASEBALL AM. (Mar. 31, 2010), http://www.baseballamerica.com/today/minors/season-preview/2010/269689.html.

135. *See* Garrett Broshuis, *Postcards from the Bushes*, THE SPORTING NEWS, July 21, 2006, at 69 (describing the feeling of sleeping on a bus like a contortionist).

136. *See id.* (providing thoughts of missing home during a long season).

137. Telephone Interview with Bobby Evans, *supra* note 6. Because of antitrust exemptions and the absence of a minor league players union, MLB can unilaterally recommend contract language without going through collective bargaining; most teams subsequently implement it. *See* James T. Masteralexis & Lisa P. Masteralexis, *If You're Hurt, Where is Home? Recently Drafted Minor League Baseball Players are Compelled to Bring Workers' Compensation Action in Team's Home State or in Jurisdiction More Favorable to Employers*, 21 MARQ. SPORTS L. REV. 575, 575–76 (2011) (describing the unilateral implementation of workers' compensation clauses into minor league UPCs).

138. Telephone Interview with Bobby Evans, *supra* note 6.

139. This information was obtained by reviewing more than forty minor league contracts from the relevant time period. However, the implementation of the provisions was not unanimous. In fact, the St. Louis Cardinals decided not to utilize the provisions at all. Email Interview with John Mozeliak, Vice President and General Manager of Baseball Operations, St. Louis Cardinals (Jan. 14, 2011). The Cardinals still do not use them, because they rarely have a need for clawbacks and prefer greater tax flexibility. *Id.*

B. *The Various Clawbacks Used by MLB Teams*

The clawback provisions instituted by MLB teams all lie within an addendum to the UPCs that they utilize.[140] At their most basic level, they all operate similarly; they allow a team to recoup a portion of a player's bonus if a certain event occurs to trigger the recoupment clause. The triggering event usually involves either the failure to report to a playing assignment or an unexcused leave of absence longer than a period of a few weeks.

However, some differences exist in the operational length of the provisions. Accordingly, two clubs' provisions will be examined in more detail, with one provision extending the full length of the contract and the other being a moderate length provision.

1. The New York Yankees' Provision Allows Recoupment over the Entire Length of the UPC

The New York Yankees include a clawback provision in an addendum to their minor league UPCs that allows for the recoupment of a portion of the signing bonus for the full-length of the agreement.[141] The exact wording of this provision is included in Appendix A.

Subpart 2, concerning the operational aspect of the clawback, is particularly relevant.[142] If the triggering event occurs, the team can recoup a portion of the bonus according to the following formula: the signing bonus paid to the player is multiplied by the number of seasons remaining on the player's contract and then divided by the length of the contract.

An example might further clarify this formula. The initial contracts signed by minor leaguers almost always span seven years. If a player plays two seasons before the triggering event occurs, the above-described formula allows the team to recoup five-sevenths of the already paid signing bonus. To use Jaroncyk as a hypothetical, this provision would have allowed the team to recoup $607,142.86 of his $850,000 signing bonus since he retired after only two years.[143] If he had instead played five seasons instead of two, the team could have still recouped two-sevenths, or $242,857.14, of the bonus. This

140. This addendum, Addendum B, is one of the only parts of the contract that is negotiable, as altering other portions of the contract is discouraged. *See* David M. Szuchman, Note, *Step Up to the Bargaining Table: A Call for the Unionization of Minor League Baseball*, 14 HOFSTRA LAB. L.J. 265, 281–82, 287–90 (1996) (discussing the parts of minor league contracts that are negotiable and also discussing the mechanics of the draft and baseball's antitrust exemption in great detail).

141. First-year minor league player agreements, with very few exceptions, last for seven seasons (the equivalent of roughly seven years). Szuchman, *supra* note 140, at 282.

142. Paragraph 1 of the provision also allows for the relinquishment of any right to an unpaid signing bonus, though this will rarely come into effect since the full amount of signing bonuses are usually paid within two years. *See infra* Appendix A.

143. Olney, *supra* note 121.

would have been a significant deterrent to leaving the game prior to the expiration of the agreement, and certainly a deterrent to leaving early in the agreement.

2. The San Diego Padres Utilize a More Moderate Length Clawback Provision

While the Yankees' clawback extends the full length of the agreement, other teams extend the provision for a more moderate length. The San Diego Padres, for instance, include a clawback provision lasting only the first three years of the seven-year agreement.[144] The actual provision is included in Appendix B. The language of the clawback remains strikingly similar to the Yankees' provision with the exception of the second paragraph. In this paragraph, the language clearly states that the "Recoupment Period" will only last for the first three seasons of the UPC. The formula used to calculate the recoupment amount remains the same.

This change in language becomes very important. While Jaroncyk would be subjected to the same clawback under either provision since he only played two seasons, some of the other players described above would not be subjected to any clawback at all. For instance, Quan Cosby played four minor league seasons before choosing to play football at Texas.[145] Under the Yankees' provision, he would be subjected to a clawback of three-sevenths of his bonus, but under the Padres' provision he would be subjected to no clawback at all, as the three-year recoupment period would have expired.

As demonstrated, the difference between the provisions can potentially be significant. Nevertheless, there are more overall similarities between the provisions—and between all provisions used by MLB teams—than there are differences. Importantly, they are all an example of a prospective clawback,[146] and they are all robust enough to operate as a deterrent to unfair behavior.[147]

3. New Clawback Regulations in the 2011 CBA

The 2011 Major League Baseball-Major League Baseball Players Association Collective Bargaining Agreement ("CBA") mandates an unexpected change in minor league clawback provisions. While the exact details have not been publicly released, industry insiders state that specific

144. *See infra* Appendix B.

145. *Quan Cosby*, THE BASEBALL CUBE, http://www.thebaseballcube.com/players/profile.asp?P=Quan-Cosby (last visited Oct. 22, 2011).

146. *See* Cherry & Wong, *supra* note 13, at 414–15 (discussing the benefits of prospective clawbacks).

147. *Cf.* Fried & Shilon, *supra* note 9, at 735 (calling for businesses to adopt "robust" clawbacks in executive compensation agreements).

guidelines will regulate signing bonus clawbacks.[148] Importantly, the window for repayment will be limited according to the size of the bonus. For bonuses above $1,000,000, teams will be able to institute a five-year recoupment period, and for bonuses between $250,000 and $1,000,000, a four-year recoupment period will be available.[149] For all other bonuses below this threshold, the maximum recoupment period will be three years.[150]

This will force teams such as the Yankees to make changes to their clawback clauses. More importantly though, it demonstrates the importance that both MLB and the players' union place on the clawback provisions. In short, the clawback has become an industry standard, recognized through collective bargaining by both sides of the industry.

C. Limitations of the Clawback Provisions

As discussed above, the clawback provisions were instituted to prevent players from retiring during the early years of their contracts. Considering the multitude of problems that can occur over a seven-year contract, however, one must question whether the clawback provision might also extend to other unexpected (and often undesirable) behavior. For instance, will the provisions extend to an inability to play due to visa problems or to instances of misconduct?

1. The Story of Angel Villalona, a Top Prospect Turned Murder Suspect

An exploration of the career of young prospect Angel Villalona demonstrates the potential magnitude of visa problems and possible misconduct. In 2006, the San Francisco Giants signed the sixteen-year-old Villalona to a contract with a $2.1 million signing bonus.[151] The young Dominican possessed tremendous power and he quickly became the organization's third-ranked prospect.[152]

Once in the United States, Villalona began the process of assimilating to American culture.[153] However, like many Latino players, Villalona returned to his home nation during the off-season. While visiting his mother in September

148. Telephone Interview with Erik Johnson, MLB Certified Player Agent, Platinum Sports & Entertainment (Jan. 4, 2012).

149. *Id.*

150. *Id.*

151. Chris Haft, *Villalona Appears Headed Back to Giants' System*, MLB.COM (Sept. 2, 2011, 10:40 PM), http://sanfrancisco.giants.mlb.com/news/article.jsp?ymd=20110902&content_id=24129456&vkey=news_sf&c_id=sf.

152. *Id.*

153. *See* Garret Broshuis, *Villalona: Teammate Turned Murder Suspect*, LIFE IN THE MINORS (Sept. 21, 2009), http://minorleaguelife.blogspot.com/2009/09/villalona-teammate-turned-murder.html (describing Villalona's reactions while navigating through "the labyrinth that is professional baseball").

of 2009, he went to a nightclub that he frequented.[154] According to reports, a fight broke out after a man refused to give Villalona his usual seat.[155] The fight rolled out to the streets, and the man was eventually shot to death.[156]

Villalona was quickly arrested and charged with murder.[157] The police claimed he was the shooter while supporters insisted he was wrongly blamed because of his wealth.[158] Either way, the once promising prospect, in which the Giants invested more than $2 million, was unable to play baseball. After being released on $14,000 bail, Villalona had his visa revoked by the U.S. Embassy and he could not travel.[159] For two years, Villalona battled the charges far from any baseball field.[160] Finally, all charges against him were dropped by prosecutors in 2011.[161]

2. Would a Standard Clawback Provision Allow Recoupment in These Circumstances?

Villalona now hopes to rejoin the Giants,[162] who recently added him to their roster.[163] Despite this, it is worth exploring whether the Giants might be able to recoup a portion of the $2.1 million signing bonus due to the lost time.

A review of a Giants minor league contract reveals the use of a clawback provision identical to that used by the Yankees (Appendix A). Importantly, the provision states that "if Player fails to report for, or abandons Club without permission and is absent from Club for a material portion, or for at least two weeks, of any playing season . . . during the term of this Minor League Uniform Player Contract" recoupment may take place. The express language of this broad provision would probably cover Villalona's situation. Even though he did not retire, as was the case with Jaroncyk, and even though he was not convicted of a crime, he certainly failed to report to his club for a material portion of a playing season, as he was out of baseball for two years.

154. Nanette Asimov & John Shea, *Giants Prospect's Friends Stunned*, S.F. CHRON., Sept. 22, 2009, at C5.

155. *Id.*

156. *Id.*

157. *Id.*

158. Henry Schulman & John Shea, *Ready to Take Another Swing*, S.F. CHRON., Sept. 3, 2011, at B3.

159. Jesse Sanchez, *Villalona has U.S. Visa Revoked*, MLB.COM (Nov. 13, 2009, 7:42 PM), http://mlb.mlb.com/news/article.jsp?ymd=20091113&content_id=7664896&vkey=news_mlb&fext=.jsp&c_id=mlb.

160. Schulman & Shea, *supra* note 158.

161. *Id.* Additionally, Villalona reportedly paid the family of the victim $138,306. *Id.*

162. *Id.*

163. Chris Haft, *Villalona among Giants 40-Man Roster Additions*, MLB.COM (Nov. 19, 2011, 2:15 AM), http://mlb.mlb.com/news/article.jsp?ymd=20111119&content_id=26005812&vkey=news_mlb&c_id=mlb.

Villalona might argue that this provision was not intended to cover such circumstances. Moreover, unusual and unanticipated events made him unable to report to his team. Yet the express language of the provision would still allow the Giants to recover a portion of Villalona's signing bonus. He failed to receive permission prior to not reporting during the two-year period. Assumedly, the provision would also cover any other type of visa problems or other issues that make a player unable to report to an assignment.

The provision fails to explicitly mention misconduct.[164] For this reason, a player who experiences legal problems but who still reports to their work assignment would probably not be subjected to the clawback provision. For instance, had Villalona been arrested for a less egregious crime which did not result in the revocation of his visa, the clawback provision would not apply so long as he reported to work. However, if properly instituted, the broadly worded clawback can still operate as a deterrent to behavior that might be deemed misconduct, for misconduct might eventually lead to the inability to report to a work assignment.

III. ANALYSIS OF MINOR LEAGUE CLAWBACKS THROUGH CONTRACT LAW

The above discussions demonstrate the utility of clawbacks in minor league contracts. But where do such clawbacks fit within contract law? And are they enforceable? These questions will be addressed below.

A. Clawbacks Reallocate Risk and Discourage Opportunism

One effective way of evaluating minor league clawback provisions comes by viewing these clauses through the lens of law and economics. After all, these prospective clawbacks are entirely about allocating the risk upfront, at the early stages of contract formation. As noted above, teams invest large sums of money in raw talent, yet these investments remain risky.[165] Not only must teams bear the risk of injury, but, without these provisions, they must bear the risk of a player simply choosing to walk away from the game.[166]

Under the default rules, a player can leave at any time after receiving his large signing bonus and still retain the full amount of the bonus. Contract remedies such as unjust enrichment and breach of good faith would not allow

164. Minor league UPCs do contain a misconduct provision in section XIX of the UPCs, entitled "Termination." Minor League Uniform Player Contract (Nov. 11, 2011) (on file with author). This provision allows a team to terminate a contract if a player fails to conform to "high standards of good citizenship and good sportsmanship." *Id.* It also applies if, among other things, a player fails "to keep himself in first-class physical condition." *Id.* However, the mere termination of a contract would not allow for the recoupment of any signing bonus already paid to a player.

165. Dobrow, *supra* note 5.

166. *See* discussion *supra* Part II.A.2.

any recoupment. Yet almost any outside observer would find that there is some inherent unfairness in this.[167] Even though the bonus was provided as an incentive to sign a contract, the club expected the player to put forth a good faith effort to develop to his full potential.

These clawback provisions allow teams to reset the default rules.[168] The risk of walking away from the game is shifted from the team to the player. The player is in the best position to prevent this behavior, so the risk re-allocates to the least-cost avoider.

While legal and economic theory is often used to discourage negligent contracting, it can also be used to discourage opportunism in contracting.[169] As Professor Cohen states, contracting parties are vulnerable both because they cannot foresee all possible problems that might arise under the contract and because parties perform obligations sequentially rather than simultaneously.[170] The latter factor is particularly important in promoting opportunism.[171]

As applied to minor league contracts, it is impossible for either party to foresee everything that will happen during the seven-year term of the agreement. This is true both on the player's side and the team's side. The team might sign a veteran free agent or sign other amateur players at the same position as the young player receiving the signing bonus, which might impede

167. Some inside observers and player advocates would argue that no unfairness is present due to MLB's efforts to artificially depress signing bonuses and the miniscule salaries paid to minor league players. For a discussion on the effort to depress signing bonuses, *see supra* Part II.A.1. For a discussion on minor league salaries, *see* Broshuis, *supra* note 135.

168. The term "default rules" used in this sense merely means the rules that govern the contract if no provision is adopted to stipulate otherwise. *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989) (defining default rules and describing a system for assigning efficient default rules). Given that the default in the current system of minor league bonuses negatively affects the team, this might be termed a penalty default. According to Professors Ayres and Gertner, "[p]enalty defaults are designed to give at least one party to the contract an incentive to contract around the default rule and therefore to choose affirmatively the contract provision they prefer." *Id.* at 91. However, true penalty defaults are intentionally set in this manner to provide such an incentive, *id.*, whereas the current default rules for minor league bonuses seem to simply have been adopted arbitrarily out of custom.

169. For a discussion of the traditional focus on negligent contracting and the ability of law and economics to be applied to opportunistic contracting, see Cohen, *supra* note 8, at 952. Cohen defines opportunism as "any contractual conduct by one party contrary to the other party's reasonable expectations based on the parties' agreement, contractual norms, or conventional morality." *Id.* at 957. *See also* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 93–94 (6th ed. 2003) (describing the problem of opportunism in contract law and stating the "fundamental function of contract law (and recognized as such at least since Hobbes's day) is to deter people from behaving opportunistically toward their contracting parties . . .").

170. Cohen, *supra* note 8, at 954–55; *see also* POSNER, *supra* note 169, at 93 (stating that "the problem of contract opportunism arise[s] from the sequential character of economic activity").

171. Cohen, *supra* note 8, at 955.

his path to the major leagues.[172] The player might also suffer from injuries,[173] which would hinder his development. These problems present unforeseeable challenges, and both team and player assume some risk due to these unforeseeable challenges.

Yet lack of simultaneous contractual obligations also creates the risk of opportunism. The team pays the signing bonus in advance, typically paying half of the signing bonus almost immediately upon the player's signing and the second half during the next year.[174] A major contractual obligation for the team is therefore fulfilled early in the contract. Yet the team does not expect a benefit from this contract until several years later, as time must be allotted for the development of the player.[175] If a player chooses to retire during this developmental time period, he may do so. Consequently, it creates an environment ripe for opportunism.

According to Professor Cohen, one party "may intend to mislead or deceive the other party from the beginning of the relationship, before the other party has invested in it."[176] It is impossible to read a player's mind, and a player such as Jaroncyk, for instance, may know from the very beginning that his heart is not in baseball. He may sign the contract simply to obtain the lucrative signing bonus and then retire as soon as he receives this bonus. At the least, the team runs the risk that the player will simply not enjoy professional baseball as much as he had imagined and will have a change of heart. Though this latter scenario might be termed unintentional opportunism, it is still opportunism, and perhaps bad faith.

The default rules do little to discourage this opportunistic behavior,[177] as most of the risk allocates to the team. The addition of the clawback provision re-allocates this risk to the player, who is both the least-cost avoider and the potentially opportunistic party.[178] In this manner, potential opportunism is discouraged.

172. *Cf.* Jason Martinez, *About*, MLBDEPTHCHARTS.COM, http://www.mlbdepthcharts.com/2009/03/site-contributors-jason-martinez-san.html (last visited Apr. 4, 2012) (explaining that the website is devoted strictly to the ever-changing world of MLB depth charts).

173. *Cf.* Nate Silver & Will Carroll, *The Injury Nexus*, BASEBALL PROSPECTUS (Feb. 26, 2003), http://www.baseballprospectus.com/article.php?articleid=1658 (providing a statistical breakdown of the rate of injuries in pitchers and finding that pitchers under the age of 24 are more prone to elbow and shoulder injuries).

174. Darren Heitner, *Value of Signing Bonuses*, SPORTS AGENT BLOG (July 24, 2006), http://www.sportsagentblog.com/2006/07/24/value-of-signing-bonuses/.

175. *See* Ben Lindbergh, *Overthinking It*, BASEBALL PROSPECTUS (Feb. 22, 2011), http://www.baseballprospectus.com/article.php?articleid=13018 (computing the average age of major league debuts and the amount of previous minor league experience for prospects).

176. Cohen, *supra* note 8, at 955.

177. *See* Ayres & Gertner, *supra* note 168, at 98.

178. For a discussion on when a party is both a least-cost avoider and a "most-likely-opportunist," see Cohen, *supra* note 8, at 979.

B. Clawback Provisions as a Good Business Practice

Although these provisions discourage opportunism, some might still question the utility of these provisions. After all, by using these provisions, a team exerts pressure on a player to remain at a job against his will. This assumedly results in an unhappy employee, and most personnel managers would agree that an unhappy employee is not a good employee.[179] Moreover, one person's unhappiness can easily spread to others, and the development of other talented young players might be hindered.[180]

It is also questionable whether a player seeking to walk away will ever develop to his full potential. As Jaroncyk, Desme, and other examples demonstrate, young players sometimes realize that baseball simply is not for them. Once a player realizes this, it is unlikely they will enthusiastically work to fully develop their skills. If the player is pressured to stay, the team will continue to invest time in the player's development and will continue to give the player opportunities. The time and opportunities invested in the player will cost the team money.[181] Moreover, these resources could be devoted to other, more committed players. Consequently, perhaps the most efficient solution would allow the team and player to simply sever their relationship.

However, human beings are prone to attitudinal changes as situations change.[182] This is no doubt especially true of young, talented athletes who are still in the midst of identity formation.[183] Perhaps the presence of a clawback provision persuading a player to remain within an organization for a longer time will result in the player experiencing a change-of-heart. For instance, one of the Kansas City Royals' top prospects, Danny Duffy, recently sought to leave the game while attending spring training in 2010.[184] Instead of altogether quitting the game, the Royals persuaded Duffy to take a short leave of

179. *See, e.g.*, Lise M. Saari & Timothy A. Judge, *Employee Attitudes and Job Satisfaction*, 43 HUMAN RES. MGMT. 395, 398 (2004) (reviewing research on employee satisfaction and performance).

180. *See* Rob Stein, *Happiness Can Spread Among People Like a Contagion, Study Indicates*, WASH. POST, Dec. 5, 2008, at A8 (stating that unhappiness spreads from person to person, though not as strongly as happiness).

181. *See* Andrew Zimbalist, *Reflections on Salary Shares and Salary Caps*, 11 J. OF SPORTS ECON. 17, 18 (2010) (noting that MLB teams spend an average of $20.6 million each year on player development).

182. *See*, *e.g.*, David C. Funder & Daniel J. Ozer, *Behavior as a Function of the Situation*, 44 J. OF PERSONALITY AND SOC. PSYCHOL. 107, 108–110 (1983) (providing an overview of some of the more famous examples of situationism).

183. *Cf.* Peter Kaufman & Kenneth A. Feldman, *Forming Identities in College: A Sociological Approach*, 45 RES. IN HIGHER EDUC. 463, 488 (2004) (studying the effect of the college experience on identity formation).

184. J.J. Cooper, *Royals Lefty Duffy Quits Baseball*, BASEBALL AM. (Mar. 24, 2010, 10:57 AM), http://www.baseballamerica.com/blog/prospects/2010/03/royals-lefty-duffy-quits-baseball/.

absence.[185] After this leave of absence, Duffy had a change-of-heart and returned to the team.[186] The next year he was pitching in the major leagues.[187]

Clawbacks have the potential to facilitate more success stories similar to Duffy.[188] Even though the provisions pressure a player to remain in the game against his will, they might allow time for attitudinal change. The stress of a previous bad season might pass if success is again found, and homesickness might fade as a player matures. Moreover, the provisions simply persuade a player to fulfill an expected part of the bargain.[189] In short, the use of clawback provisions is a sound business practice within baseball.

C. Enforceability of Clawback Provisions in Baseball UPCs

As previously described, these clawback provisions efficiently re-allocate the risk to the party who is both the least-cost avoider and the potentially opportunistic party. Despite this efficiency, questions might still arise as to the enforceability of these contract provisions, as these types of clawbacks have never been challenged.[190] Specifically, the provisions might be challenged under the doctrine of unconscionability due to the contractual circumstances surrounding the bargaining process.

According to the Restatement (Second) of Contracts, courts may choose not to enforce an unconscionable contract.[191] While the Restatement does not define unconscionability,[192] the official comment section places importance on the setting, purpose, and effect of the contract.[193]

When analyzing unconscionability, many courts focus on the presence of unreasonably favorable terms or the absence of meaningful choice.[194] These

185. Rustin Dodd, *The Return of Danny Duffy. . . (and Why the Royals May Need to Open a Leftorium)*, K.C. STAR (June 3, 2010, 5:57 PM), http://royalsblog.kansascity.com/?q=node/546.

186. *Id.*

187. Steve Gardner, *Royals Calling Up Pitching Prospect Danny Duffy*, USA TODAY, http://content.usatoday.com/communities/fantasywindup/post/2011/05/royals-calling-up-pitching-prospect-danny-duffy/1 (last updated May 18, 2011).

188. During my playing career with the San Francisco Giants, I saw first-hand the ability of clawbacks to bring forth such a possibility. Similar to Duffy, one of the Giants' prospects—who will remain anonymous—sought to leave the game during spring training. He had only pitched in the minor leagues for a single season, and when he informed the Giants' organization of his intentions, he was told that he would have to pay back a large portion of his bonus due to language in his contract. Upon hearing this, he remained with the organization, and he ultimately became a successful major league pitcher.

189. *See supra* Part III.A.

190. Non-disclosure clawbacks have been challenged. Melone, *supra* note 9, at 70.

191. RESTATEMENT (SECOND) OF CONTRACTS § 208 (1979).

192. *Id*. The UCC also fails to define unconscionability in its codification of the doctrine. U.C.C. § 2-302 (1977).

193. RESTATEMENT (SECOND) OF CONTRACTS § 208 cmt. a (1979).

194. E. ALLAN FARNSWORTH, CONTRACTS § 4.28, at 301 (4th ed. 2004).

two concepts have often been called substantive unconscionability and procedural unconscionability.[195] Courts typically require at least some evidence of both elements in order for a contract provision to be deemed unconscionable.[196]

The substantive element "focuses on overly harsh or one-sided results."[197] The procedural element, on the other hand, focuses on oppression or surprise.[198] Oppression in contracting derives from an inequality of bargaining power resulting in an absence of meaningful choice,[199] while surprise is found when terms are deceptively hidden[200] or when a party is incapable of understanding the terms.[201]

In examining these contract provisions, one immediate procedural problem arises from the bargaining circumstances. Since MLB teams have collectively acted to limit a player's choices through the implementation of the draft, the players' relative bargaining power has diminished. After all, this was the very reason behind the implementation of the draft, as MLB hoped that the diminished bargaining power would result in depressed signing bonuses.[202]

Further evidence of the players' lower relative bargaining power is found due to their ability—or often inability—to secure representation. The NCAA places strict regulations on a player's ability to obtain representation during the draft process through its "No Agent" Rule.[203] Many top players still retain agents such as Boras to bargain for them,[204] but teams know that players risk

195. *Id.*; *see also* Arthur Allen Leff, *Unconscionability and the Code—the Emperor's New Clause*, 115 U. PA. L. REV. 485, 487 (1967) (delineating between substantive and procedural unconscionability).

196. FARNSWORTH, *supra* note 194, § 4.28, at 302. Courts will allow for a sliding scale between the two elements, for if one element is found in great magnitude, sometimes less evidence of the other element will be required. *Id.*

197. Gatton v. T-mobile, 61 Cal. Rptr. 3d 344, 356 (Cal. Ct. App. 2007).

198. *Id.* at 352.

199. *Id.*

200. *Id.*

201. Weaver v. Am. Oil Co., 276 N.E.2d 144, 148 (Ind. 1971).

202. *See supra* Part II.A.1.

203. NCAA bylaws allow a player to obtain advice from an "advisor," but the advisor cannot have direct contact with any MLB team on the player's behalf. Consequently, if an advisor does any negotiating, the player will lose his amateur status even if he does not sign a professional contract. *See* Richard T. Karcher, *The NCAA's Regulations Related to the Use of Agents in the Sport of Baseball: Are the Rules Detrimental to the Best Interest of the Amateur Athlete?*, 7 VAND. J. ENT. L. & PRAC. 215 (2005); Brandon D. Morgan, *Oliver v. NCAA: NCAA's No Agent Rule Called Out, but Remains Safe*, 17 SPORTS LAW. J. 303 (2010).

204. Aaron Fitt, *Nebraska's Ehlers Suspended for 60 Percent of Season*, BASEBALL AM. (Mar. 9, 2011, 1:05 PM), http://www.baseballamerica.com/blog/college/2011/03/nebraskas-ehlers-suspended-for-60-percent-of-season/ (stating that "major league scouting directors and college coaches have reaffirmed to Baseball America time and time again, nearly every drafted player has an adviser who has contact with professional clubs on his behalf . . .").

their amateur status (and NCAA eligibility) if they fail to come to terms with the team.[205] This limits a player's options, as a team may use this as a bargaining chip during negotiations, resulting in reduced bargaining power.

While top players employ representation, many lower level players elect not to use representation when going through the draft. Due to their lack of representation (and lower level of talent) these players have far less bargaining power than top picks. Yet, they still will be subjected to the clawback provision.

Although there is no evidence that agents have attempted to negotiate these clawback provisions out of contracts, one irony is that the top picks—for whom the clawbacks were implemented—are in the greatest position to negotiate the removal of these provisions. They have the high level of talent that leads to increased leverage, and they usually employ representation to aid in bargaining. The lower picks, however, have no ability to negotiate such a removal.

One could easily state from these facts that an inequality in bargaining power is present, especially for lower picks. This results in a lack of meaningful choice. However, unequal bargaining power alone does not make a contract provision unconscionable.[206] While it satisfies procedural unconscionability, substantive unconscionability must also be found.

Substantive unconscionability requires overly harsh or one-sided results, and the best argument for this might be found in the lower picks. These players often are not deemed prospects and have a far lower chance of making it to the major leagues than the top picks. Yet the implementation of clawback provisions pressure these players to continue to play in the minor leagues until

205. Pitcher Logan Ehlers was suspended for sixty percent of his 2011 collegiate season after violating the "no agent" rule prior to enrolling at the University of Nebraska. *Id.* Amateur pitcher Andy Oliver rejected an offer of $390,000 after being drafted by the Minnesota Twins in 2006. Morgan, *supra* note 203, at 303–04. He subsequently played at Oklahoma State, but when the NCAA learned in 2008 that Oliver had representation through the prior draft process, they ruled him ineligible to play. *Id.* at 304–05. Shortly thereafter, a similar situation developed with pitcher James Paxton after talks broke down between his agent, Scott Boras, and the Toronto Blue Jays, and he attempted to re-enroll at the University of Kentucky. Richard G. Johnson, *Submarining Due Process: How the NCAA Uses its Restitution Rule to Deprive College Athletes of their Right of Access to the Courts…Until* Oliver v. NCAA, 11 FLA. COASTAL L. REV. 459, 501–03, 579 (2010).

206. RESTATEMENT (SECOND) OF CONTRACTS § 208 cmt. d (1979) ("A bargain is not unconscionable merely because the parties to it are unequal in bargaining position, nor even because the inequality results in an allocation of risks to the weaker party. But gross inequality of bargaining power, together with terms unreasonably favorable to the stronger party, may confirm indications that the transaction involved elements of deception or compulsion, or may show that the weaker party had no meaningful choice, no real alternative, or did not in fact assent . . . to the unfair terms."); FARNSWORTH, *supra* note 194, § 4.28, at 302 ("[I]nequality of bargaining power is not by itself enough . . . .").

a) the team relieves them of their duties, or b) their contract expires. The use of the longer clawback provision (exhibited by the Yankees) effectively constrains their mobility for fear of the economic recoupment of their bonus. Many would say that such an employment situation results in at least some unfairness.

Even when the long-term clawback provision is applied to these lower picks, however, the level of unfairness does not reach the point of an overly harsh or one-sided bargain. After all, the clawback provision merely ensures that the player will perform his duties as expected under the contract. The provision acts as a condition,[207] and it only becomes operable when a player fails to perform his obligations under the employment contract. Moreover, clawbacks have now become part of the latest CBA.[208] As a result, the recoupment period will be limited to three years for the lower picks, which will eliminate some of the harshness involved. In certain circumstances, some unfairness might still result, but it will not be enough to meet the standards of substantive unconscionability.

Courts typically require both procedural and substantive unconscionability. While substantial evidence of procedural unconscionability arises under these bargaining conditions, there exists little evidence of substantive unconscionability. Consequently, these provisions—even the harshest of them as applied to the weakest of players—will be upheld.

IV. APPLICATIONS OUTSIDE OF MINOR LEAGUE BASEBALL

The use of clawback provisions in minor league baseball demonstrates their contractual utility, especially in an environment ripe for opportunism. But will this utility extend to other business arenas, such as executive compensation?

A. Executive Compensation: Another Environment Ripe for Opportunism

Similar to highly talented baseball prospects, experienced business executives are a scarce commodity. Due to their scarcity and talent, they command large bonuses.[209] Also, as will be demonstrated below, the potential for opportunism exists in the realm of executive compensation just as it exists in minor league baseball.

Potential opportunism in executive compensation stems in part from the agency problem created by the separation of ownership and control in publicly

207. *See* Cherry & Wong, *supra* note 13, at 416–17 (discussing how clawback provisions operate as conditions).

208. Telephone Interview with Erik Johnson, *supra* note 148.

209. *See* In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 702–04 (Del. Ch. 2005) (describing Disney's efforts through a bidding war to land a talented executive who ultimately received $130 million after only fourteen months on the job).

traded companies, which places executives in a position to take advantage of their power.[210] Moreover, executives often exert great influence over the board of directors, which limits executive oversight.[211] Even when businesses utilize pay committees comprised of independent directors, the great influence of the executive might still be felt.[212] After all, managers influence the appointment of independent directors, and independent directors are influenced by board dynamics that reduce arms-length bargaining.[213] Such an environment encourages opportunistic behavior, as it places the executive in a position to take advantage of another party's vulnerabilities.[214]

As a potential solution, many companies attempt to align compensation to company success through performance metrics.[215] However, opportunism can still remain a problem. For instance, if performance metrics are too simplistic, or if too much cash or too many equity options are linked to short-term performance, then opportunistic behavior is still incentivized.[216] In such a situation, even the most honest executive might be tempted to maximize short-term gains at the expense of long-term company goals.

B. Like in Baseball, Executive Opportunism Can Be Deterred Through Clawbacks

Just as the institution of clawback provisions in minor league contracts deter potential opportunism, properly drafted clawback provisions in executive compensation contracts can operate similarly. To do so, the provisions should be drafted carefully, since executive compensation packages are more complicated than minor league contracts. Annual cash and equity earnings should be covered, but long-term incentives and deferral programs should also be covered.[217] Moreover, the triggering act must be broader than the material

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210. *See* M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs Are Low*, 101 NW. U. L. REV. 1543, 1545 (2007) (describing the "managerial power school" of executive compensation that believes that "pay practices represent a taking advantage of . . . the agency problems in large public firms").

211. Fried & Shilon, *supra* note 9, at 733.

212. Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 766 (2002) (stating that "[t]he key problem is the pervasive influence of management . . . on all facets of the pay-setting process").

213. *Id.*

214. *See* Posner, *supra* note 169, at 93–95 (describing different scenarios that allow a person to opportunistically take advantage of another's vulnerabilities).

215. *See* Susan J. Stabile, *Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance?*, 2 U. PA. J. LAB. & EMP. L. 227, 233–241 (1999−2000) (describing the movement towards performance-based executive compensation).

216. *See* Heineman Jr., *supra* note 76 (calling for an end to "naked" cash bonuses and "naked" stock options).

217. *Id.*

restatement of financials required by the Dodd-Frank Act.[218] This recommendation stems from the fact that even a small error in a firm's earnings might lead to an executive receiving substantial excess pay if a performance threshold is met.[219] Yet the small error might not be deemed material, so no restatement would be required, and no Dodd-Frank clawback would be triggered.[220]

C. Potential Obstacles to Implementation

One potential obstacle to implementing broader clawbacks in executive compensation contracts emerges from the fact that, unlike young baseball prospects, business executives bargain for their contracts in a purely open market system. As discussed above, the use of a draft system allows a baseball prospect to only bargain with a single team. No such restriction exists with executives. Furthermore, the same executive power that leads to potential opportunism also makes the implementation of more robust clawbacks problematic. After all, an executive with great sway over directors—and even sway over independent directors on a pay committee—might successfully resist any implementation that goes beyond the legal requirements.

While these obstacles might make implementation more problematic, clawbacks are worth the battle required to overcome the obstacles. Ultimately, a well-drafted and robust clawback provision has the ability to systematically deter opportunistic behavior by holding senior leadership accountable while simultaneously promoting long-term growth, sustainability, proper risk taking, and balanced senior leadership.[221] Consequently, the utility of clawback provisions necessitates their inclusion.[222]

CONCLUSION

Although the use of clawbacks has grown tremendously in the past fifteen years, commentators still question their utility. However, the use of clawback provisions in minor league baseball contracts demonstrates their ability to deter opportunism. Furthermore, clawbacks can be used to deter opportunism in

218. *Id.*
219. Fried & Shilon, *supra* note 9, at 748.
220. *Id.*
221. Heineman Jr., *supra* note 76.
222. It has been argued that government-regulated clawbacks will reduce incentive pay, and a similar argument might be made against voluntary clawbacks. *See* Bainbridge, *supra* note 12, at 1807 (arguing that Dodd-Frank clawbacks will reduce the use of incentive compensation). However, this argument is based on an unpublished study focused on the SOX clawback, which differs significantly in that the SOX clawback requires all incentive compensation to be recouped in the event of both misconduct and a restatement. Fried & Shilon, *supra* note 9, at 746–47. As Professors Fried and Shilon point out, merely requiring an executive to pay back undeserved pay should not distort pay arrangements. *Id.*

other arenas, such as executive compensation. If drafted properly and instituted prospectively, a robust clawback provision can effectively reassign risk to the least cost avoider, and can simultaneously allow desired behavior such as proper risk-taking by an executive.

As one court stated not long ago, "[a]spirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors avoid liability."[223] Indeed, properly drafted prospective clawbacks that go beyond the minimal legal requirements do possess such mystical potential. Their usage should not only continue but increase.

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223. Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000).

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APPENDIX

Appendix A: New York Yankees clawback provision from a 2009 minor league UPC

Signing Bonus

Subject to the conditions set forth below, Player shall receive a signing bonus, only upon approval of this contract by the Office of the Commissioner of Baseball, which shall be payable as shown below.

If Player fails to report for, or abandons Club without permission and is absent from Club for a material portion, or for at least two weeks, of any playing season (which includes the championship season, any training required by Club in preparation for such championship season and any post-season that the team or affiliate to which the Player is assigned participates) during the term of this Minor League Uniform Player Contract ("UPC"),

1) Player shall relinquish and forfeit any right to, and Club shall not be obligated to pay, any portion of the amount not yet paid pursuant to the payment schedule set forth in this signing bonus provision and

2) Player shall immediately return and refund to Club, and relinquish and forfeit any right to, that portion of the signing bonus already paid to Player by Club, regardless of the year of payment, that exceeds the amount of signing bonus already paid to Player by Club (i) multiplied by the number of championship seasons Player reported to, and did not subsequently abandon without permission, Club and (ii) divided by the number of championship seasons covered by the term of this UPC.

Appendix B: San Diego Padres clawback provision from a 2011 minor league UPC

Signing Bonus

Subject to the conditions set forth below, Player shall receive a signing bonus, only upon approval of this contract by the Office of the Commissioner of Baseball, which shall be payable as shown below:

If Player fails to report for, or abandons Club without permission and is absent from Club for a material portion, or for at least two weeks, of any playing season (which includes the championship season, any training required by Club in preparation for such championship season and any post-season that the team or affiliate to which the Player is assigned participates) during the first 3 (three) playing seasons of the term of this Minor League Uniform Player Contract ("UPC") (the "Recoupment Period"),

1) Player shall relinquish and forfeit any right to, and Club shall not be obligated to pay, any portion of the amount not yet paid pursuant to the payment schedule set forth in this signing bonus provision and

2) Player shall immediately return and refund to Club, and relinquish and forfeit any right to, that portion of the signing bonus already paid to Player by Club, regardless of the year of payment, that exceeds the amount of signing bonus already paid to Player by Club (i) multiplied by the number of championship seasons Player reported to, and did not subsequently abandon without permission, Club and (ii) divided by the number of championship seasons covered by the term of this UPC.