

Saint Louis University School of Law
Scholarship Commons

All Faculty Scholarship

2009

Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes

Miriam A. Cherry

Jarrold Wong

Follow this and additional works at: <https://scholarship.law.slu.edu/faculty>



Part of the [Banking and Finance Law Commons](#), [Bankruptcy Law Commons](#), [Business Organizations Law Commons](#), [Civil Law Commons](#), and the [Criminal Law Commons](#)

CLAWBACKS:
PROSPECTIVE CONTRACT MEASURES
IN AN ERA OF EXCESSIVE
EXECUTIVE COMPENSATION AND PONZI SCHEMES

Miriam A. Cherry
*Jarrold Wong**

INTRODUCTION

Months after insurance giant American International Group (AIG) faltered and the federal government provided financial assistance to keep the company afloat,¹ executive compensation and bonus practices at the company came under scrutiny.² Taxpayers balked when evidence came to light that large bonuses were being paid to executives — the same executives, in certain instances, who had been responsible for AIG’s losses.³ The disconnect between AIG’s huge losses and the multi-million dollar bonus payments is a striking example of “pay without performance,” a phenomenon that Professors Jesse Fried and Lucian Bebchuk documented in their book of the same name.⁴ Responding to public outrage,⁵ the House

* Miriam A. Cherry, Associate Professor of Law, University of the Pacific, McGeorge School of Law; B.A., 1996, Dartmouth College; J.D., 1999, Harvard Law School; Jarrod Wong, Assistant Professor of Law, University of the Pacific, McGeorge School of Law; J.D., University of California at Berkeley (Boalt Hall), 1999; LL.M., University of Chicago, 1996; B.A. (Law), Cambridge University, 1995. The authors wish to acknowledge Afra Afsharipour, Robert Bartlett, Gerald Caplan, Susan D. Franck, Emily Garcia Uhrig, Franklin A. Gevurtz, Matthew Hall, Michael Malloy, Thomas Main, Angela Onwauchi-Willig, Shruti Rana, Robert L. Rogers, Keith Rowley, Irma Russell, Chaim Saiman, William Sjostrom, John Sprankling, and Kojo Yelapaala for their comments and insights. Additional thanks to James Wirrell and Paul Howard for their excellent library assistance, Harriet Anderson, Brooke Tomlinson, and Adam Rosenberg for their research assistance, and the editors of the *Minnesota Law Review* for their help with the publication process.

¹ See William Sjostrom, *The AIG Bailout*, (forthcoming 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1346552 (describing circumstances surrounding AIG’s almost-bankruptcy and the subsequent bailout). Various sources have been tracking the recipients of government bailout money. See, e.g. ProPublica, Show Me the TARP Money, <http://www.propublica.org/special/show-me-the-tarp-money> (last visited Mar. 26, 2009); Matthew Ericson, et al, *Tracking the \$700 Billion Bailout*, N.Y. TIMES, Mar. 11, 2009, <http://projects.nytimes.com/creditorcrisis/recipients/table>.

² See, e.g. Deborah Solomon, *Uproar Over Geithner’s Role in Bonuses Could Vex Rescue*, WALL ST. J., Mar. 19, 2009, at A5.

³ Randall Smith & Liam Pleven, *Some Will Pay Back AIG Bonuses*, WALL ST. J., Mar. 19, 2009, at A1 (describing how certain members of AIG’s Financial Products group — responsible for a great deal of the losses — had received bonuses, but that some, under mounting public pressure, had decided to repay them).

⁴ LUCIAN A. BEBCHUK & JESSE M. FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

⁵ See, e.g. Liam Pleven, et al., *AIG Faces Growing Wrath Over Payouts*, WALL ST. J., Mar. 16, 2009 at A1; Jonathan Weisman, et al., *Congress Looks to a Tax to Recoup Bonus Money*, WALL ST. J., Mar. 18, 2009, A1, at A2 (quoting Republican Senator Charles Grassley as saying that AIG’s managers were to “take that deep bow and say ‘I’m sorry’ and then either do one of two things; resign or go commit suicide.”); Michael M. Phillips, *Outrage*

of Representatives sought to impose a retroactive marginal taxation rate of 90 percent on the AIG bonuses (as of the date of this writing, the bonus tax had passed in the House of Representatives, but not the Senate).⁶ During the debate over the bonus tax, both legislators and media alike described the pending bill as a “clawback” provision.⁷

The same term — “clawback” — was used to refer to remedies potentially available to defrauded investors in a Ponzi scheme.⁸ For over a decade, former director of NASDAQ Bernard Madoff had been pretending to operate a hedge fund that turned out to be one immense house of cards.⁹ The fraud robbed investors, including some charitable institutions, of billions of dollars¹⁰ and created a crisis of confidence in the capital markets.¹¹ In Madoff’s fund, there was in reality no investment strategy to provide “hedgies” against typical forms of risk. Indeed, there did not even appear to have been any trading of stocks for over a decade.¹² Rather, as in

Overflows on Capitol Hill as Lawmakers Denounce Bonuses, WALL ST. J., Mar. 19, 2009, at A4 (describing protests and pervasive anger among the public as well as in the House of Representatives, where “Members of the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises mentioned their outrage at . . . [AIG] 18 times. . . . [a]nd that was during 45 minutes of opening remarks, even before the immediate target of their outrage, AIG Chief Executive Edward M. Liddy, entered the room.”); John Christoffersen, *Protestors Visit AIG Officials’ Lavish Conn. Homes*, SEATTLE TIMES, Mar. 22, 2009 (discussing middle-class protestors who visited executives homes in hopes of convincing them to share by returning their bonuses; also discussing that certain executives receiving the bonuses had received death threats).

⁶ To Impose an Additional Tax on Bonuses Received from Certain TARP Recipients, H.R. 1586, 111th Cong. (2009) (passed House of Representatives, Mar. 19, 2009); see also Gregg Hitt & Aaron Lucchetti, *House Passes Bonus Tax Bill*, WALL ST. J., Mar. 20, 2009, at A1. The legality of such a tax is questionable, not only because of its retroactive nature, but also because targeting specific companies and individuals creates potential constitutional issues, i.e. bill of attainder. As of the time of this writing, the bonus tax is still being considered, but no action has been taken so far in the Senate. These issues are explored further in the section on AIG in the bailout, see *infra*, Part I(2). Although the constitutional issues are interesting in their own right (and the later portion of the article attempts some preliminary analysis) — they are not our main focus in this article. Instead, we are more concerned with writing clawback provisions into contracts prospectively and examining the consequences of their inclusion on contract law.

⁷ In the intervening months, other developments, including the appointment of Kenneth Feinberg as Special Master or “Compensation Czar” for TARP recipients, and the focus on passing a “Say on Pay” shareholder vote have taken more central places in the government’s policy toward executive compensation. See Press Release, U.S. Dept. of Treasury, Interim Final Rule on TARP Standards for Compensation and Corporate Governance (June 10, 2009), available at <http://www.treas.gov/press/releases/tg165.htm>; Press Release, U.S. Dept. of Treasury, Statement by Treasury Secretary Timothy Geithner on Compensation (June 10, 2009), available at <http://www.treas.gov/press/releases/tg163.htm>. See also Louise Story & Stephen Labaton, *Overseer of Big Pay is Seasoned Arbitrator*, N.Y. TIMES, June 11, 2009, available at <http://www.nytimes.com/2009/06/11/business/11feinberg.html>. These current developments are further discussed, *infra*, Part I (2).

⁸ See, e.g., Jane J. Kim, *As ‘Clawback’ Suits Loom, Some Investors Seek Cover*, WALL ST. J., March 12, 2009, at C3.

⁹ Some estimates place investor losses in the Madoff fraud in the range of \$50 billion to \$64.8 billion. The difference in estimates represents the amount of principal invested plus the phony trading profits that clients were told they had accrued. See Aaron Lucchetti & Tom Lauricella, *Investors Were Told They Had a Total of \$64.8 Billion*, WALL ST. J., March 12, 2009, at A2.

¹⁰ *Id.*

¹¹ See, e.g., Robert Frank, et al., *Madoff Jailed After Admitting Epic Scam*, WALL ST. J., March 13, 2009, at A1.

¹² See, e.g., Amir Efrati & Robert Frank, *Madoff Set to Plead Guilty to 11 Felonies*, WALL ST. J., Mar. 11, 2009, at A1 (describing lack of trading for over a decade).

a textbook Ponzi scheme, the early investors were bought off with the money from the later investors.¹³ In turn, the payouts to the early investors were relied upon as proof of profitability to convince later investors that returns were legitimate. Because Madoff and his “hedge fund” are now insolvent, the question has arisen as to whether the bankruptcy trustee may bring a “clawback” action on behalf of the later investors to recover the profits of the early investors.¹⁴

In recent months, Congress, the media, and other commentators have all employed the term “clawback” to describe a stunningly broad variety of contractual provisions, legislative enactments, and legal remedies. This leads to a series of questions surrounding so-called clawback provisions. First, what constitutes a “clawback”?¹⁵ Are provisions in the bailout law dealing with AIG or the remedies in Ponzi schemes clawbacks, or something else entirely? Why are the current remedies in these contexts inadequate?¹⁶ Why are these retroactive remedies so difficult to implement under current law? Going forward, how might prospective inclusion of clawback provisions and a robust interpretation of those provisions be desirable? What effect would clawback provisions have on other matters of well-settled contract doctrine that deal with allocation of risk?¹⁷ This Article aims to provide a framework for answering these questions, while using current situations at the forefront of the current financial crisis as salient examples. Specifically, we discuss executive compensation, as highlighted in the cases of AIG and Merrill Lynch, and Ponzi schemes, as most recently illustrated by the multi-billion dollar fraud in the Madoff hedge fund, both of which involve the controversial effort to impose clawbacks retroactively.

In this Article, we explore and develop the doctrine of clawbacks. We define “clawback” as a theory for recovering benefits that have been conferred under a claim of right, but that are nonetheless recoverable because unfairness would otherwise result. This definition includes both *retroactive* clawbacks — those that like the (pending) 90% tax on bonuses are imposed after the contractual right to the bonuses have arisen and the benefits have been conferred, and *prospective* clawbacks — those that are introduced into contracts before the claim of right to the benefits has arisen. For example, some companies, like Dell, are prospectively writing

¹³ See, e.g. Tom Lauricella, et al., *Madoff used U.K. Office in Cash Ploy, Filing Says*, WALL ST. J., Mar. 12, 2009, at C1 (describing criminal charges against Madoff); Chad Bray & Amir Efrati, *Prosecutors Target Madoff Cash, Bonds and Homes*, WALL ST. J., Mar. 17, 2009, at C3 (describing efforts to track Madoff’s assets and high burden that Ruth Madoff will face in proving the homes were purchased without the benefit of tainted assets).

¹⁴ See Kim, *supra* note 8.

¹⁵ The term “clawback” has been used in a somewhat casual way to describe any effort at recoupment of losses. In Part III of the Article we discuss a more precise definition of the term in greater detail. See Part III, *infra*.

¹⁶ See Part III(B), *infra*.

¹⁷ See Part III(C), *infra*.

provisions into their executive compensation contracts that would recover or cancel bonus awards in the event that the company must restate its financial results.¹⁸

As we will explain further, the structure of clawbacks indicates that they operate more effectively if they are prospective, rather than retroactive. Accordingly, we suggest writing prospective clawback terms into contracts directly, or implying them through default rules where possible, for example through potential amendments to the law of securities regulation.

The Article begins, in Part I, with a discussion of clawback provisions in executive compensation contracts. Part II moves to examine clawback clauses in the context of Ponzi schemes, primarily through a study of the Madoff hedge fund fraud. Next, Part III draws these strands together by discussing the definition of clawbacks, as well as the doctrinal implications of clawback clauses within the panoply of contractual remedies. Ultimately, we make the argument that clawback clauses will be an effective measure to avoid some of the predicaments in which shareholders and investors are currently embroiled.

I. CLAWBACK PROVISIONS AND EXECUTIVE COMPENSATION

Excessive executive compensation in United States companies has long been a problematic corporate governance issue,¹⁹ and one, that despite many reform proposals has been seemingly resistant to change.²⁰ From an international perspective, the United States has a larger discrepancy between the amount paid to top executives and the average worker than many countries in Europe.²¹ While there has been much concern about the problem of excessive executive compensation — from both corporate governance and social equality perspectives²² — and there has been much discussion about potential solutions,²³ the problem remains unsolved. The

¹⁸ See Appendix A, *infra*.

¹⁹ Much of the Delaware caselaw on everything from fiduciary duty to shareholder voting has arisen from disputes over executive compensation. See, e.g. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006); *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541 (1949).

²⁰ BEBCHUK & FRIED, *supra* note 4.

²¹ Richard A. Posner, *Are American CEOs Overpaid, and if So, What if Anything Should be Done about It?*, 58 DUKE L.J. 1013 (2009) (describing larger pay packages received by American CEOs when compared with their foreign counterparts). This discrepancy may perhaps be a result of the comparatively larger role of labor in foreign corporate governance process. Some figures, circa 2003, seem to put the gap at 500 times that of the average worker at the company. *CEOs and Their Indian Rope Trick*, THE ECONOMIST, Dec. 11, 2004, at 61; SAMUEL ESTREICHER & MIRIAM A. CHERRY, GLOBAL ISSUES IN EMPLOYMENT LAW 202 (2008).

²² See Brett H. McDonnell, *Two Goals for Executive Compensation Reform*, 52 N.Y.L. SCH. L. REV. 585, 586 (2007-2008) (describing both corporate governance and social equality concerns).

²³ See, e.g. Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 920 (2007) (examining provisions of the tax code enacted in 1993 in order to limit excessive compensation and concluding that these provisions have actually resulted in more costs to shareholders).

following section provides a brief overview of the issues, then moves to examine the compensation debate that has arisen specifically in the context of the bailout, and then proposes prospective clawback provisions as a potentially effective response to a long-standing conundrum.

A. Brief Overview of Executive Compensation

Part of the concern with executive compensation is that the amount of payment involved is often contingent, difficult to value, or, at times, not fully transparent. Many publicly traded companies provide a large portion of compensation in company stock or stock options, which have uncertain valuation.²⁴ Other companies have a large portion of compensation awarded in year-end bonuses, while others utilize deferred compensation, i.e. pension obligations. Still others reward executives with particular perks, such as use of the company jet, club memberships, or other fringe benefits.

Yet another form of compensation that has proven to be controversial is the so-called “golden parachute,” a payment to the executive that is typically triggered in the event of a change of control in the corporation.²⁵ The ostensible reason to adopt golden parachutes is to align the interest of the management with shareholders’ interests — otherwise incumbent management might resist an acquisition for the purpose of perpetuating their own tenure.²⁶ However, in the vivid words of one commentator, golden parachutes conjure the “image of a laughing executive landing softly with oodles of misappropriated corporate assets while his corporation goes down in flames.”²⁷ Looked at with skepticism as a payoff to existing management at the expense of shareholders, these payments have largely been regulated by unfavorable tax treatment in the Internal Revenue Code.²⁸

1. A Theory of Maximum Wages: Managerial Power

In the introduction to this Article, we mentioned the influential work of Professors Lucian Bebchuk and Jesse Fried, who have extensively studied

²⁴ See, e.g. Seinfeld v. Bartz, 2002 WL 243597 (N.D. Cal. 2002) (discussing valuation of stock options).

²⁵ See, e.g. Albert Choi, *Golden Parachute as a Compensation Shifting Mechanism*, 20 J. L. ECON. & ORG. 170, 171 (2004) (defining and providing mathematical example of golden parachute, arguing that golden parachutes increase value to shareholders); Richard P. Bress, *Golden Parachutes: Untangling the Ripcords*, 39 STAN. L. REV. 955, (1987) (analyzing policy reasons for adopting such contractual provisions).

²⁶ See, e.g. Cheff v. Mathes, 199 A.2d 548 (1964) (struggles for corporate control create potential conflict of interest between shareholders and members of the board).

²⁷ Richard P. Bress, *Golden Parachutes: Untangling the Ripcords*, 39 STAN. L. REV. 955, 960 (1987).

²⁸ I.R.C. § 280G (West. Supp. 2009); I.R.C. § 4999 (2006). See also Jamie Dietrich Hankinson, *Golden Parachutes Fall Flat: Tax Gross-Ups Soften their Impact to Executives and Square D Overinflates Their Coverage*, 34 STETSON L. REV. 767, 770-71 (2005) (describing the tax penalties on excess parachute payments, and mentioning the possibility that costs for such tax penalties will merely be shifted back onto shareholders).

different forms of CEO pay and who have ultimately concluded that currently widely-used incentive based payments have failed to deliver on their promise of performance.²⁹ Excessive pay packages in corporations with diffuse ownership have typically been seen as a classic agency problem³⁰ — the difficulty a largely passive group of shareholders has in monitoring the actions of the firm’s managers. Professors Bebchuk and Fried take the argument further, arguing that excessive compensation packages have their origin in the reluctance of directors to hold executives accountable for their performance, due to a structural bias among those who comprise boards of directors and management of corporations.³¹ Their critique speaks to deep structural flaws inherent in the separation of ownership and control in corporations.³²

2. Legal Landscape

The issue of executive compensation has mostly been addressed in the same way many other corporate governance issues have — through a fundamental federal dualism.³³ The first layer of regulation consists of state law, operating through state corporations statutes, that constrain the board of directors through the doctrine of fiduciary duty, and at its outer limits, the doctrine of corporate waste.³⁴ The second layer of regulation emerges through the federal laws governing the publicly held corporation, which focus on disclosure, transparency, and informed investor choice.³⁵

Unfortunately, these dual approaches have not been particularly successful at curbing excessive compensation packages.³⁶ Undoubtedly, one reason that might be so is that complete and accurate information on executive pay has not been publicly available, despite the ostensible

²⁹ See Bebchuk & Fried, *supra* note 4; see also Lucian Bebchuk & Jesse Fried, *Equity Compensation for Long Term Results*, WALL ST. J., June 16, 2009 (advocating tying executive compensation to long-term rather than short-term metrics).

³⁰ See, e.g. ADOLPH A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (REV. ED. 1968).

³¹ BEBCHUK & FRIED, *supra* note 4; see also Michael B. Dorff, *The Group Dynamics Theory of Executive Compensation*, 28 CARDOZO L. REV. 2025, 2029-2030 (2007) (describing related idea of “groupthink” leading to suboptimal outcomes among decisionmakers in executive compensation context).

³² BEBCHUK & FRIED, *supra* note 4.

³³ *Santa Fe Industries v. Green*, 430 U.S. 462 (1977) (discussing differences in approaches between state and federal regulation of corporations).

³⁴ Jennifer S. Martin, *The House of Mouse and Beyond: Assessing the SEC’s Effect to Regulate Executive Compensation*, 32 DEL. J. CORP. L. 481, 481 (2007) (describing gaps left by the different approaches taken in federal and state regulation of executive compensation).

³⁵ Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449, 450 (2002) (“primary policy of the federal securities laws involves the remediation of information asymmetries, that is, equalization of the information available to outside investors and insiders.”). Securities law places a priority on disclosure because securities themselves do not have fixed or inherent value. *Id.*

³⁶ See, e.g. Mary-Hunter Morris, *The Price of Advice*, 86 U. DET. MERCY L. REV. 153, 154-6 (2009) (describing compensation consultants as contributing to the problem of excess executive compensation).

disclosure regime.³⁷ While the Sarbanes-Oxley Act did not address executive compensation directly,³⁸ the law did contain provisions that would allow the Securities Exchange Commission (SEC) to freeze assets for extraordinary payments, which could be applied to freeze executives' golden parachutes in the instance of fraud.³⁹ Public companies were no longer allowed to provide personal loans to management or other insiders — a form of “hidden” compensation.⁴⁰ In certain circumstances, Section 304 of the Sarbanes-Oxley Act empowered the SEC to bring an action to recover money from the executives to blame for a fraud.⁴¹ However, this provision (the so-called Sarbanes-Oxley clawback) has been largely ignored, with the agency bringing only two enforcement actions in the seven years since Sarbanes-Oxley has been in effect.⁴² As with any law, the Sarbanes-Oxley Act is only as powerful as its implementation and enforcement.

Unsurprisingly, then, the Sarbanes-Oxley reforms did not “fix” the broken components of executive compensation.⁴³ The 2006 option backdating scandal demonstrated that many of the problems with executive compensation remained.⁴⁴ Stock options are ostensibly incentive payments that are tied to a rise in the company's stock price. In the backdating scandal, however, companies retroactively adjusted the date of grant of the options to a date on which the stock price was comparatively low.⁴⁵ With

³⁷ See, e.g. John D. Shipman, *The Future of Backdating Equity Options in the Wake of SEC Executive Compensation Disclosure Rules*, 85 N.C. L. REV. 1194, 1194 (2007) (describing complex nature of disclosure rules and in addition, efforts to shirk the rules by disguising true value of compensation).

³⁸ For a general description and analysis of the provisions of the Sarbanes-Oxley Act, see Miriam A. Cherry, *Whistling in the Dark? Corporate Fraud, Whistleblowers, and the Implications of the Sarbanes-Oxley Act for Employment Law*, 79 WASH. L. REV. 1029, 1055-69 (2004).

³⁹ SEC v. Gemstar-TV Guide Int'l, 384 F.3d 1090 (9th Cir. 2004) (en banc); Stephanie Francis Ward, *SEC Can Freeze CEO Payouts*, 4 No. 13 ABA J. E-REPORT 4, Apr. 1, 2005.

⁴⁰ Sarbanes-Oxley Act § 402, 15 U.S.C. § 78m (2006).

⁴¹ Sarbanes-Oxley Act § 304, 15 U.S.C. § 7243 (2006); see also Litigation Release No. 203887, SEC, Former United Health Group CEO/Chairman Settles Stock Options Backdating Case for \$468 Million (Dec. 6, 2007), <http://www.sec.gov/litigation/litreleases/2007/lr20387.htm>; Rachael E. Schwartz, *The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean*, 64 BUS. LAW. 1, 2 (Nov. 2008) (describing the fact that only the SEC can bring suit under § 304 and that there have only been two actions brought under this provision).

⁴² Linda Chatman Thomsen & Donna Norman, *Sarbanes-Oxley Turns Six: An Enforcement Perspective*, 3 J. BUS. & TECH. L. 393, 408 (2008) (explaining that the SEC has brought only two enforcement actions under this provision).

⁴³ See, e.g. Joann S. Lublin & Scott Thurm, *Money Rules: Behind Soaring Executive Pay, Decades of Failed Restraints*, WALL ST. J., Oct. 12, 2006, at A1.

⁴⁴ For an in-depth discussion of the option backdating scandal, see, e.g. Jesse M. Fried, *Option Backdating and its Implications*, 65 WASH. & LEE L. REV. 853, 857 (2008) (listing types of backdating and suggesting that such “secret” compensation arrangements reinforce inference of collusion between management and the board of directors). See also Jesse M. Fried, *Hands-Off Options*, 61 VAND. L. REV. 453, 453 (2008) (suggesting pre-arranged trading plans as a way to sidestep the problem of managerial exploitation of option grants; such pre-arranged trading plans currently provide a safe harbor from the insider trading laws).

⁴⁵ See David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561, 564 (2007) (“Although option valuation is complex, at one level the backdating story is simple. Imagine that on March 15 the stock of Tech Inc. closes at \$50/share. An option on Tech granted on that date would normally have an exercise price of \$50/share. Granting the option “at the money” ensures that the recipient profits only if the shares appreciate in value and the shareholders profit. But imagine that the CEO of

the benefit of hindsight, the options were guaranteed to be “in the money.”⁴⁶ Instead of incentive pay that would align the executives’ interest with that of the shareholders (and involved risk), backdated options became a “sure thing.” As the adjustments were never disclosed to investors in periodic filings as they should have been, the SEC investigated over one hundred companies for engaging in the practice.⁴⁷ In the aftermath of the backdating scandal, the SEC promulgated a series of regulations to govern disclosure of the value of executive pay. Most notably, the SEC required that an accurate and extremely detailed valuation of the top executives’ compensation packages, including options and bonuses, be provided as part of the periodic filings required of publicly traded companies under the 1934 Securities and Exchange Act.⁴⁸ In sum, the response to this particular executive compensation issue has been increased federal government regulation. Not all, however, would agree that that the issue of excessive executive compensation merits a similar response.

3. Counterarguments and Rebuttal

Those who believe in less government intervention might reply that these compensation packages are the result of an efficient market.⁴⁹ If corporations need to pay well in order to recruit the best talent, they should be allowed to do so, perhaps cabined in extreme circumstances by the state law doctrine of corporate waste.⁵⁰ In certain circumstances, a high degree

Tech looks back and notices that on February 15 the company's stock price was only \$40/share. By falsifying the paperwork to make it appear that the company granted him an at-the-money option on February 15, when in fact the option was granted on March 15, the CEO has effectively acquired an option that is “in the money” by \$10/share.”).

⁴⁶ See Shipman, *supra* note 37 (describing option backdating and describing the reforms in adopted in response to the scandal, which the author characterizes as largely ineffectual).

⁴⁷ See Walker, *supra* note 45 at 562 (examining extent of the scandal).

⁴⁸ For a description of these rules, see generally Kenneth M. Rosen, “Who Killed Katie Couric?” and Other Tales from the World of Executive Compensation Reform, 76 *FORDHAM L. REV.* 2907 (2008) (providing exhaustive detail regarding administrative rulemaking around SEC disclosure rules for executive compensation and more generally arguing that scandal-driven reform is poor regulatory technique); Sean M. Donahue, *Executive Compensation: The New Executive Compensation Disclosure Rules Do Not Result in Complete Disclosure*, 13 *FORDHAM J. CORP. & FIN. L.* 59, 61, n. 3 (2008); Leigh Johnson et al., *Preparing Proxy Statements Under the SEC’s New Rules Regarding Executive and Director Compensation Disclosures*, 7 *U.C. DAVIS BUS. L. J.* 373 (2007) (describing in detail proxy disclosure rules). But see Susan Lorde Martin, *Executive Compensation: Reining in Runaway Abuses — Again*, 41 *U.S.F. L. REV.* 147, 153 (2006) (discussing how previous measures of curbing executive pay have been ineffective, and stating that “new disclosure rules seem like a good idea; however, in the past, attempts to legislate transparency have not been effective in curbing abuses in executive compensation.”).

⁴⁹ See, e.g. John E. Core, et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 *MICH. L. REV.* 1142, 1173-79 (answering “no,” and arguing that executive compensation is aligned with performance through equity holdings and stock options); M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs are Low*, 101 *NW. U. L. REV.* 1543, 1618 (2007) (contending that compensation arrangements in bankruptcy result in similarly large pay packages, thus potentially disproving managerial power thesis).

⁵⁰ *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006) (“To recover on a claim of corporate

of skill could provide a huge benefit, whether that is in a competitive sport or in a business context.⁵¹ Additionally, one could argue that there is a market for executive services, and that it is appropriate to adopt the prevailing wage for a particular skill set.⁵²

In light of recent events, however, even Judge Richard Posner has, albeit reluctantly, come to the view that executive overcompensation is problematic.⁵³ Instead of tying compensation to the success of the company it would appear in some circumstances executives sought to profit regardless of outcome, and that even in the wake of near insolvency the executives protected themselves through contractual provisions. While “golden parachutes” for executives have long been part of the backdrop of corporate America,⁵⁴ this burden has been borne by shareholders (who preserve the ability to exit), not the public at large. However, as the taxpayers have come to realize, excessive pay practices were about to be foisted upon them through the mechanism of the financial bailouts.

B. Executive Compensation and “Clawbacks” in the Government Bailouts

1. Legal Landscape for Bonuses in the Bailout

In the past months, much attention has focused on the payout of bonuses at companies accepting TARP funds, the proposed (still pending) tax on those bonuses, the later appointment of Kenneth Feinberg as Special Master (“Compensation Czar”), and the urging of the Obama Administration that Congress pass a non-binding shareholder “say on pay” law for all publicly

waste, the plaintiffs must shoulder the burden of proving that the exchange was ‘so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.’ A claim of waste will arise only in the rare, ‘unconscionable case where directors irrationally squander or give away corporate assets.’ This onerous standard for waste is a corollary of the proposition that where business judgment presumptions are applicable, the board’s decision will be upheld unless it cannot be ‘attributed to any rational business purpose.’ (internal footnotes omitted). Although the standard that a plaintiff shareholder has to meet in allegations of corporate waste under *Disney* are extremely high, there is some hint that the doctrine of waste may be making a comeback in Delaware. Specifically, the shareholder complaint in the *Citibank* case has moved forward in part on this basis. *In re Citigroup Inc. Derivative Litig.*, 964 A2d 106 (Del. Ch. 2009) (allowing waste claim to survive motion to dismiss when “the Company paid the multi-million dollar compensation package to a departing CEO whose failures as CEO were allegedly responsible, in part, for billions of losses at Citigroup.”).

⁵¹ See Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1619 (2005) (noting the market for various services including basketball players, and going on to argue that caution is called for in reforming executive compensation).

⁵² For example, in *Disney*, Michael Ovitz was earning close to \$20 million per year as the head of Creative Artists. While his compensation package at Disney was enormous, that pay package did not look unreasonable if it was compared to his earnings and holdings in Creative Artists. *In re Walt Disney Co. Derivative Litig.*, 906 A2d at 37.

⁵³ Richard A. Posner, *supra* note 21, at 1014 (concluding reluctantly that the answer to the first question is “yes,” and listing quick responses to principal-agent problems inherent in corporate form).

⁵⁴ These practices still continue to date. Although a recent study of proxy statements filed between October and December 2008 indicated that CEO pay fell for only the second time in two decades, there were still a number of publicly traded companies that provided lavish bonuses to their executives — despite no return on equity or deep losses. See Phred Dvorak, *Poor Year Doesn’t Stop CEO Bonuses*, WALL ST. J., Mar. 18, 2009, at B1.

held companies.⁵⁵ The various Congressional mandates, Treasury Department interim rules, and executive pronouncements concerning executive compensation are complex, technical, and largely constitute compromise measures.⁵⁶

Title VII of the American Recovery and Reinvestment Act of 2009 (“2009 Recovery Act”) is aimed at providing aid to large industries in order to curb the financial crisis.⁵⁷ As part of its provisions, the 2009 Recovery Act specifically details limitations on executive compensation in companies that accept government bailout (TARP) funds.⁵⁸ The Recovery Act states that the Secretary of the Treasury shall require each bailout recipient “to meet appropriate standards for executive compensation and corporate governance.”⁵⁹ Critically, the statute requires a provision for the recovery of any bonus, retention award, or incentive compensation paid to a senior executive officer and any of the next 20 most highly-compensated employees based on financial results that are later found to be materially inaccurate.⁶⁰ It also prohibits making any golden parachute payment to a senior executive officer or any of the next 5 most highly-compensated

⁵⁵ See Press Release, U.S. Dept. of Treasury, Interim Final Rule on TARP Standards for Compensation and Corporate Governance (June 10, 2009), available at <http://www.treas.gov/press/releases/tg165.htm>; Press Release, U.S. Dept. of Treasury, Statement by Treasury Secretary Timothy Geithner on Compensation (June 10, 2009), available at <http://www.treas.gov/press/releases/tg163.htm>; see also Sarah Lynch, *Tsy Explains Why Only 7 Firms Must Answer to Compensation Czar*, WALL ST. J., June 11, 2009; Cari Tuna & Joann S. Lublin, *New Pay Guidelines Raise Questions*, WALL ST. J., June 10, 2009; Louise Story & Eric Dash, *U.S. to Propose Wider Oversight of Compensation*, N.Y. TIMES, June 8, 2009, at A1.

⁵⁶ Deborah Solomon & Mark Maremont, *Bankers Face Strict New Pay Cap*, WALL ST. J., Feb. 16, 2009, at A1. Apparently, several economists within the Obama administration expressed the countervailing concern that too many restrictions of executive pay might prevent banks from deciding to accept the bailout funds, even if it meant that the credit crisis would continue. *Id.*

⁵⁷ For an analysis of the financial crisis, its causes, and the subsequent bailouts in the law review literature, see Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 376 (2008) (“[m]ost of the causes . . . can be attributed to conflict of interest, investor complacency, and overall complexity, all exacerbated by cupidity.”); Davidoff & Zaring, *Big Deal: The Government’s Response to the Financial Crisis* (forthcoming 2009) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1306342 (“[t]he government decided, in the course of less than a month, to create through congressional action an unprecedented \$700 billion asset purchase program and then turned this authorization into a massive investment in the country’s largest financial institutions. It capstoned the investment by forcing the nation’s nine largest, remaining financial institutions to accept \$125 billion of government equity — a partial nationalization which the United States had never seen before.”). See also Henry M. Paulson, *Fighting the Financial Crisis, One Challenge at a Time*, N.Y. TIMES, Nov. 8, 2008, at A27 (former Secretary of the Treasury describing a “financial crisis more severe and unpredictable than any in our lifetimes,” and recounting that by “September the government faced a systemwide crisis. . . [by October] we needed to move quickly and take powerful steps to stabilize our financial system and to get credit flowing again.”).

⁵⁸ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115, Title VII, § 7001. Title VII of the American Recovery and Reinvestment Act of 2009 refers to executive compensation and specifically amends § 111 of the earlier recovery bill, the Emergency Economic Stabilization Act of 2008 § 111, 12 U.S.C.A. § 5221 (West Supp. 2009). For ease of reference, the following citations will track the changes 2009 Recovery Act made to Section 111 of the Emergency Economic Stabilization Act of 2008.

⁵⁹ American Recovery and Reinvestment Act of 2009, § 111 (b)(2).

⁶⁰ § 111 (b)(3)(B) (requiring a “provision for the recovery . . . of any bonus, retention award, or incentive compensation paid to a senior executive officer and any of the next 20 most highly-compensated employees . . . based on [financial results] . . . that are later found to be materially inaccurate”).

employees so long as any obligation arising from financial assistance in the bailout remains outstanding.⁶¹ A separate subheading limits “luxury expenditures,”⁶² which may include “entertainment or events,” “office and facility renovations,” “aviation or other transportation services” or the catchall category of “other activities or events that are not reasonable expenditures.”⁶³ Finally, the section ends by establishing a so-called “say on pay,” which requires disclosure of executive compensation and then a non-binding shareholder vote on the executive compensation package.⁶⁴

The most conflicted and troubling portion of the 2009 Recovery Act, however, is that in listing the prohibitions on executive compensation, previous bonuses that were awarded are expressly exempted from any limitations.⁶⁵ Specifically, the law states that the prohibition on awards of bonuses or restrictive stock “shall not be construed to prohibit any bonus payment required to be paid pursuant to a written employment contract executed on or before February 11, 2009, as such valid employment contracts are determined by the Secretary or the designee of the Secretary.”⁶⁶

1. Retroactive Application of the Laws to AIG Bonuses

A brief discussion of how these provisions relate to the AIG bonuses may be instructive. As referenced in the introduction, the House of Representatives passed legislation to tax a number of the AIG bonuses at a 90% rate, but that bill has not been passed by the Senate.⁶⁷ The pending bill faced various legal obstacles — one of which, as explained in the previous section, was that Congress had seemingly acquiesced in these very same bonus payments only a month earlier in the 2009 bailout bill.⁶⁸ It seems clear that the government had several opportunities to ensure that excessive bonuses were not paid, but unfortunately failed to act.⁶⁹ Notwithstanding,

⁶¹ § 111 (b)(3)(C) (mandating a “prohibition on . . . making any golden parachute payment to a senior executive officer or any of the next 5 most highly-compensated employees . . . during the period in which any . . . obligation arising from financial assistance [in the bailout] remains outstanding”).

⁶² American Recovery and Reinvestment Act of 2009, § 111 (d).

⁶³ § 111 (d)(1)-(4) (defining luxury expenditures to possibly include “entertainment or events; . . . office and facility renovations . . . aviation or other transportation services” or the catchall category of “other activities or events that are not reasonable expenditures”).

⁶⁴ § 111 (e)(1)-(2).

⁶⁵ § 111 (b)(3)(D)(iii).

⁶⁶ *Id.*

⁶⁷ *See To Impose an Additional Tax on Bonuses Received from Certain TARP Recipients*, H.R. 1586, 111th Cong. (2009) (passed House of Representatives, Mar. 19, 2009).

⁶⁸ 2009 Recovery Act, § 111 (b)(3)(D)(iii). An earlier version of the bill had much more serious restrictions — which gave the company a choice of having the bonuses be forfeited or charging the company a high tax rate. In providing the choice, Congress might have avoided the retroactivity problem. Unfortunately those parts of the bill were eliminated, and now members of Congress are blaming each other for its erasure. *See Jonathan Weisman, The AIG Controversy: Dodd’s Amendment at Crux of Bonus Issue*, WALL ST. J., March 19, 2009, at A4.

⁶⁹ *See Solomon, supra* note 2 (“Administration officials say they didn’t have enough time to deal with

Cherry & Wong

it is curious that AIG seemed to rush to pay bonuses,⁷⁰ when the board of directors might have had valid legal arguments that there were defenses to such payment.⁷¹ Nonpayment would have forced the executives to bring suit against AIG, at the very least providing the company with some delays, a respite from the scandal, and perhaps given Congress a chance to respond.⁷²

There are further legal concerns with the pending bonus tax bill. Its narrow focus on particular companies and executives may raise a concern about whether it constitutes an unlawful bill of attainder.⁷³ All of these legal concerns about the bill (which without a doubt constitute factors in its lingering non-passage by the Senate) underscore how difficult it can be to attempt retroactive remedies in the bonus context.⁷⁴ That is not to say that

bonuses before AIG . . . [paid them]. They say Mr. Geithner [the Treasury Secretary] learned of the payments on March 10 — just a few days after the Treasury loaned another \$30 billion to AIG.”)

⁷⁰ Among the justifications for paying out the bonuses was AIG CEO Liddy’s fear that the company would be assessed legal penalties under Connecticut labor laws for withholding employee wages. Letter from Edward M. Liddy, Chairman and Chief Executive Officer, Am. Int’l Group, Inc., to Timothy F. Geithner, U.S. Secretary of the Treasury (Mar. 14, 2009), <http://www.ft.com/cms/5a06ce90-118d-11de-87b1-0000779fd2ac.pdf>. However, the Attorney General of Connecticut expressed doubt about AIG’s interpretation. As Connecticut Attorney General Blumenthal put it, “AIG was categorically wrong when it claimed that state labor law compelled payments of these outrageous, unconscionable bonuses . . . A provision in Connecticut law requiring double payment for failure to pay wages does not apply to AIG bonuses . . . [was] a joke of a justification to reward financial failure and fiasco.” David Savage, *Connecticut Attorney General Does the Math on AIG Bonuses*, L.A. TIMES, March 22, 2009, <http://www.latimes.com/news/nationworld/nation/la-na-aig-more-bonuses22-2009mar22,0,3609134.story>.

⁷¹ See Lawrence A. Cunningham, Op-Ed., *AIG’s Bonus Blackmail*, N.Y. TIMES, Mar. 18, 2009, at A23 (listing a number of potential defenses to payment in op-ed piece; perhaps most convincing are the defenses based on changed circumstances or fraudulent conveyance law); see also Posting of Lawrence A. Cunningham to Concurring Opinions, *AIG Contracts Questions*, (Mar. 16, 2009, 14:42), http://www.concurringopinions.com/archives/2009/03/aig_contract_qu.html (weblog posting on same subject material, covered in more depth). In both of these analyses, Professor Cunningham was careful to stress that any opinion about the legality of the contracts would need to start with the organic documents themselves. For the contracts themselves, see AIG Fin. Prods. Corp., 2008 Employee Retention Plan (effective Dec. 1, 2007), http://www.house.gov/apps/list/press/financialsvcs_dem/employeeRetentionPlan.pdf; AIG Fin. Prods. Corp., Schedule 1 “Confirmation and Acknowledgement” to 2008 Employee Retention Plan (undated), http://www.house.gov/apps/list/press/financialsvcs_dem/confirmation_and_acknowledgement.pdf.

⁷² Cunningham, *AIG’s Bonus Blackmail*, *supra* note 71.

⁷³ While public outrage is in these instances is certainly understandable, some caution is indeed called for. The issue in these companies — unlike that in the Madoff hedge fund — is not fraud (the fraud that did occur was in the loan origination for certain subprime mortgages, but the financial derivatives that AIG traded were removed from such activity. Rather the issues were separating the profits from loan origination from the risks of default, failing to anticipate changes in market conditions, faulty financial modeling, and failures to respond to red flags. It is possible that some bonus-recipients neglected their duties or unjustifiably took risks (or failed to take risks). While taxpayers are understandably angry and frustrated with the cost of these bailouts, the poor results were some combination of the product of mismanagement and/or poor judgment of risks and market conditions, not intentional fraud.

⁷⁴ With the benefit of hindsight, it seems easy to avoid these problems. Before obtaining an 80% equity stake, the Department of the Treasury should have insisted that both AIG and its executives abrogate all but a small portion of the bonus contracts as a condition of the investment. Without such a “rescue” the companies would fall into bankruptcy, which would have put the executives on equal footing with all of the company’s other creditors. Cf. Steven M. Davidoff & David Zaring, *supra* note 57 (describing government policy in the bailout as a series of transactional “deals,” and suggesting that the government exhibited classic dealmaking behavior — walking away from situations that were unfavorable). Faced with a worthless claim for million in bonuses (or close to worthless, as they would receive little in the bankruptcy), the executives would likely agree to a reduced

arguments for recovery of these bonuses will be unsuccessful; but attempting to impose clawbacks retroactively through legislation is certainly not as efficient as including a clawback provision organically within the body of the initial contract.

2. Bonuses at Merrill Lynch

The original Fall 2008 recovery bill established that if the Department of the Treasury received a “meaningful equity or debt position in the financial institution” then the recipient of the aid had to “meet appropriate standards for executive compensation” so long as the government remained a stakeholder.⁷⁵ However, in the wake of the first bailout bill in the Fall of 2008,⁷⁶ it came to light that many of the troubled companies had paid large bonuses to executives before their woes had arisen, others had actually moved up bonuses even after problems had started, and some companies were still contractually bound to provide golden parachutes to departing executives. Estimates have varied wildly as to the amounts of the bonuses and the number of executives who received them.⁷⁷

There have been allegations that in the wake of its poor performance and scheduled acquisition by Bank of America, Merrill Lynch actually moved up the schedule for payment of bonuses.⁷⁸ At the time of this writing, the New York Attorney General is examining the bonus structure and the timing of payments at Merrill Lynch in order to determine whether the securities laws were violated in the days leading up to the merger.⁷⁹ Filings by the Attorney General allege that these bonus payments were in

bonus amount.

⁷⁵ Emergency Economic Stabilization Act of 2008 § 111, 12 U.S.C.A. § 5221 (West Supp. 2009).

⁷⁶ *Id.*

⁷⁷ As part of an article on excessive executive compensation, the *New York Times* commissioned a study that calculated that over \$500 million in performance-based payments had been made to top executives of seven “troubled companies” since 2005. See Gretchen Morgenson, *Gimme Back Your Paycheck*, N.Y. TIMES, Feb. 22, 2009, at B1. The seven troubled companies that were part of the study were American International Group, Bear Stearns, Citigroup, Countrywide Financial, Lehman Brothers, Merrill Lynch, and Washington Mutual. For a full list of the companies receiving funds in the bailout, see note 1, *supra*. However, the New York Times estimate seems suspect, in that it is very low compared to other numbers reported in the newspapers — the alleged AIG bonuses on their own being almost \$200 million — and the filings from the New York Attorney General’s Office that estimated the amount paid out in bonuses ranging in the billions. See note 80, *infra*. See also Aaron Lucchetti & Peter Lattman, *Wall Street Shudders as Lawmakers Take Aim at the Industry’s Pay System*, WALL ST. J., Mar. 20, 2009, at A6 (“Last year, Goldman Sachs Group Inc., Morgan Stanley, Merrill Lynch & Co., Lehman Brothers Holdings Inc. and Bear Stearns Cos. Likely paid more than \$20 billion in overall bonuses, even though they posted a combined net loss of nearly \$26 billion.”).

⁷⁸ See, e.g. Letter from Andrew M. Cuomo, Attorney General of the State of New York and the Honorable Barney Frank, Chairman, House Financial Services Committee to Kenneth D. Lewis, Chairman, Chief Executive & President, Bank of America Corporation (Mar. 9, 2009) (on file with author) (alleging that “late last year [2008] Merrill Lynch moved up its planned date to allocate bonuses and then richly rewarded many of its executives.”).

⁷⁹ Dan Fitzpatrick, *Merrill Pay Scrutinized*, WALL ST. J., Mar. 18, 2009, at A2; Susanne Craig, *Merrill’s \$10 Million Men, Top 10 Earners Made \$209 Million in 2008 as Firm Foundered*, WALL ST. J., Mar. 4, 2009, A1, at A11; Susanne Craig & Dan Fitzpatrick, *Merrill Men Paid Over \$10 Million Subpoenaed*, WALL ST. J., Mar. 5, 2009, at C1.

the aggregate worth approximately \$3.6 billion, and primarily went to enrich 700 of the top employees at Merrill Lynch.⁸⁰ Adding proverbial insult to injury, Merrill's then-CEO, John Thain, asked for an additional bonus at the end of what was a financially disastrous 2008 for the company.⁸¹ After deliberation, the board of directors decided not to pay Thain the requested bonus because of the potential public outrage it might have engendered.⁸² Although Thain apparently later withdrew his request in the wake of the board's opposition, the incident prompted further attention from the Attorney General's Office.⁸³

3. Analysis and Evaluation of Executive Compensation in the Bailout

By this point, it should be apparent that the 2009 Recovery Act's provisions regarding executive compensation are extremely problematic. Not only was the 2009 Recovery Act weak and ineffective in its provisions regarding limits on compensation, the law paradoxically *strengthened* the AIG executives' claim to the bonuses by exempting them from regulation.⁸⁴ The day after the 2009 Recovery Act was signed into law, "some critics identified weaknesses, suggesting the restrictions be retroactively applied to companies that already have received federal bailout cash [.]"⁸⁵ Other criticisms included the idea that the companies might give executives new titles in order to dodge the restrictions, and that the grants of restricted stock did not need to be tied to performance.⁸⁶ All of these weaknesses were brought into startling relief by the controversy surrounding the AIG bonuses.⁸⁷ As discussed above, there were many ways that the Treasury

⁸⁰ Letter from Andrew M. Cuomo, Attorney General of the State of New York, to the Honorable Barney Frank, Chairman, House Committee on Financial Services (Feb. 10, 2009) (on file with author).

⁸¹ Susanne Craig, *Heat Turns Up on Merrill Bonuses' Timing*, WALL ST. J., Mar. 12, 2009, at C1 (providing conflicting accounts regarding Thain's request for a bonus); Louise Story, *Bonus Season Afoot, Wall Street Tries for a Little Restraint*, N.Y. TIMES, Dec. 8, 2008, at B1 (describing Thain's request as being for \$10 million).

⁸² Story, *supra* note 81.

⁸³ *Id.* (reporting that Cuomo wrote a letter in which he severely criticized the idea of asking for additional performance bonuses to those at Merrill Lynch, calling such request "a thumb in the eye to taxpayers.")

⁸⁴ Mark Maremont & Joann S. Lublin, *Loopholes Sap Potency of Pay Limits*, WALL ST. J., Feb. 17, 2009, at A1.

⁸⁵ *Id.*

⁸⁶ *Id.*; see also Kate Kelly & David Enrich, *Wall Street Pursues Pay Loopholes*, WALL ST. J., Mar. 17, 2009, at C1.

⁸⁷ American Recovery and Reinvestment Act of 2009, § 111 (b)(3)(D)(iii). In the wake of public outrage regarding the bonuses, members of Congress are blaming each other for the poorly thought-out bonus exemption. See Weisman, *supra* note 5 (reporting that an earlier version of the bill "would have capped bonuses at \$100,000, retroactive to 2008. Companies awarding bonuses above that level would face the choice of returning those funds to the Treasury or having them taxed at 35%. Another, by Mr. Dodd, slapped sharp limits on all compensation of top employees, including bonuses. Both amendments passed the Senate easily, but during House and Senate negotiations, the Wyden-Snowe amendment dropped out of the bill with little fanfare. Lawmakers and the administration raised constitutional objections, since it would have taxed 2008 income retroactively. Its authors argued that because companies were given a choice whether to return the bonuses or face a tax, the measure was not actually taxing past income but would "tax" a company's future decision — made with full knowledge of the

Department could have dealt with the bonus issue, but instead the situation was mishandled.⁸⁸

Although it is not the focus of this Article, we present some options for addressing the problem that has been created — in a way that will pass constitutional muster. Public outrage, shaming, and pressure from elected officials (while not technically a legal remedy) are apparently having some effect on the AIG bonus recipients.⁸⁹ Another avenue would be to revisit the provision that allows the Secretary of the Treasury the ability to determine whether the bonus payments were made pursuant to “valid employment contracts.”⁹⁰ Between the strong public policy implications, the changed and unusual circumstances of an infusion of government money, the law of fraudulent conveyance, and the Attorney General of Connecticut’s statements that there was never the potential liability under the labor laws of that state, there could be a freeze on these executives’ assets until the Secretary of the Treasury (or the new Special Master / Compensation Czar designee) had an opportunity to review the bonuses for fairness. State law might provide shareholders some redress in the form of an action for recovery under the corporate waste doctrine.⁹¹ Although typically an exacting legal standard, the magnitude of the losses and these lavish rewards might actually provide an important test case for resurrecting the waste doctrine.⁹² Finally, other agency or employment law principles, such as the faithless servant doctrine, might provide some redress for aggrieved shareholders.⁹³

While there are these possibilities for recovery, retroactive legislative response or administrative rulemaking are difficult to fit within existing legal frameworks. Subsequent bills targeting bonuses distributed by TARP recipients have been introduced, but have also languished in Congress.⁹⁴

consequences.”) It does seem unfortunate that this earlier provision was dropped from the bill.

⁸⁸ See Plevin, Ng & Reddy, *supra* note 5, at A16 (“A top Democratic lawmaker suggested that earlier, stricter limits should have been placed on AIG. ‘Clearly there was a mistake at the beginning,’ said Rep. Barney Frank[.]”); see also Weisman, *supra* note 5.

⁸⁹ See, e.g. Jake De Santis, Op-Ed., *Dear AIG, I Quit!*, N.Y. TIMES, March 25, 2009 at A25 (op-ed of executive in AIG’s Financial Products division who, while using strong rhetoric about the validity of the contracts, is donating the \$750,000 bonus he received to charity and quitting his job). See also Brady Dennis, *Challenges Remain for AIG Employees*, WASH. POST, Apr. 14, 2009 (noting that employees at AIG’s Financial Products Division have agreed to return more than \$50 million).

⁹⁰ § 111 (b)(3)(D)(iii).

⁹¹ *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006).

⁹² *Id.*

⁹³ Restatement (Second) of Agency (1958), § 469 (“An agent is entitled to no compensation for conduct which is disobedient or which is a breach of his duty of loyalty; if such conduct constitutes a willful and deliberate breach of his contract of service, he is not entitled to compensation even for properly performed services for which no compensation is apportioned.”); see, e.g. Phansalkar v. Andersen Weinroth, 344 F.3d 184, 200 (2nd Cir. 2003) (“Under New York law . . . One who owes a duty of fidelity to a principal and who is faithless in the performance of his services is generally disentitled to recover his compensation, whether commissions or salary.”) (internal quotations and citations omitted). Although perhaps not as apt in the AIG situation, the faithless servant doctrine might have some application to Merrill Lynch, if the allegations that the dates and timing of particular bonuses are accurate, as that could implicate some difficult conflicts or duty of loyalty issues.

⁹⁴ To Amend the Executive Compensation Provisions of the Emergency Economic Stabilization Act of 2008

The Obama Administration and the Treasury Department, under pressure to take action, have cobbled together a multi-pronged approach in the months following the attention focused on bonuses. First, Kenneth Feinberg was named as a Special Master (termed in the media the “Compensation Czar”) with oversight responsibility for pay practices at the seven companies receiving the largest amounts of government assistance. Second, the Treasury Department is now pressing for legislation and SEC rulemaking that would require a non-binding say-on-pay vote by shareholders at all public-traded companies.⁹⁵

Perhaps these recent efforts will finally bring the problem of excessive executive compensation to a larger national audience that is empowered to seek change. Nonetheless, the pending bonus tax highlights the problem of attempting a “retroactive clawback” through the avenue of legislation. The question posed then is what, going forward, can we do to fix the problems identified in a constructive and prospective fashion?

C. Reverse Alchemy: Turning Gold Into Lead

The credit crisis and subsequent bailouts have cast a long shadow of uncertainty over many aspects of the investment banking industry, insurance, mortgage, and other businesses. However, in addition to ensuring that credit continues to be available, the bailouts might well provide an opportunity for meaningful reform of executive compensation.⁹⁶ One way that this might be accomplished would be writing clawback provisions into executive compensation contracts prospectively. The change would result in the routine and widespread use of clawback provisions in executive compensation contracts, and could (at some point) result in an SEC mandate for such provisions.

1. Prospective Voluntary Clawback Provisions

There are some indications that prospective voluntary clawback provisions might be becoming more commonplace. Over a year before the first bailout, computer giant Intel was already voluntarily implementing clawback provisions in the event that bonuses were paid out in error, on the

to Prohibit Unreasonable and Excessive Compensation and Compensation not Based on Performance Standards, H.R. Res. 1664, 111th Cong. (2009). This legislation is waiting for Senate approval.

⁹⁵ See *supra* note 55 and accompanying text.

⁹⁶ With a backward looking glance, some of the federal programs that helped end the Depression are instructive. Stabilizing the economy is an important goal, but the New Deal remains best-known for its social and regulatory programs than merely for its Keynesian deficit spending to stimulate economic recovery. Cf. William G. Ross, *When Did the “Switch in Time” Actually Occur?: Re-Discovering the Supreme Court’s “Forgotten” Decisions of 1936-1937*, 37 ARIZ. ST. L.J. 1153 (2005) (describing importance of New Deal legislation).

basis of accounting results that had to be restated.⁹⁷ A recent study by a compensation-tracking firm, Equilar, noted that clawback provisions in executive contracts have started to gain more acceptance in the past two years.⁹⁸ The study examined the SEC disclosures of the 95 companies within the Fortune 100 that are publicly traded.⁹⁹ The study, however, defines “clawback provision” broadly, thus sweeping a large number of contracts, provisions, and policies under this umbrella term, even if they might not be particularly effective.¹⁰⁰ The effectiveness of any contractual remedy, as discussed in Appendix A, *infra*, will depend on the language that the contract uses and how the clause is structured.

The investment firm Morgan Stanley, which received billions in the bailout, is one firm that has instituted a “voluntary” clawback clause. As an internal memorandum from Morgan Stanley’s CEO John Mack disclosed at the end of 2008, their analysis of year-end bonuses also attempted “to tie compensation more closely to multi-year performance and each employee’s contribution to [Morgan Stanley’s] profitability.”¹⁰¹ The memorandum goes on to state that the compensation packages will “include a new clawback provision which [Morgan Stanley] will implement as a permanent part of our compensation policy”:

In 2008 and beyond, for all bonus-eligible employees, we are making part of the year-end bonus deferral a cash award subject to a clawback provision that could be triggered if the individual engages in conduct detrimental to the Firm. The clawback could be triggered if an individual, for example, caused the need for a restatement of results, a significant financial loss or other reputation harm to the Firm or one of its businesses. . . . Starting in 2009, we expect to institute a multi-year performance plan for senior executives, including the CEO, that will tie a portion of their compensation directly to the Firm’s performance over a three-year period — with one third of this compensation tied to the Firm’s return on equity (ROE), a second third tied to Morgan Stanley’s relative ROE versus our peers, and the final third tied to total shareholder return on a relative basis.¹⁰²

⁹⁷ See Gretchen Morgenson, *Intel Can Recover Bonuses It Shouldn’t Have Paid*, N. Y. TIMES, Mar. 31, 2007, <http://www.nytimes.com/2007/03/31/business/31chip.pay.html?ref=businessspecial>.

⁹⁸ Equilar, *Executive Compensation Trends*, Nov. 2008 (on file with authors).

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ John Mack Memorandum (on file with authors).

¹⁰² *Id.*

According to a New York Times story, while Morgan Stanley's clawback is broader, it was actually modeled after an earlier November announcement by UBS.¹⁰³

In voluntarily adopting and implementing clawback provisions, many companies are attempting to fix the compensation disconnect.¹⁰⁴ The amount of actual reform, of course, will depend on the specifics of the clawback provision itself.¹⁰⁵ Because these contracts are individually negotiated, there is room for variation.¹⁰⁶ Some clawback provisions require that an employee be actually involved in a fraud in order to trigger the repayment requirement.¹⁰⁷ Others merely require the amounts to have been paid in error based on incorrect accounting results.¹⁰⁸

2. The Silver Lining of Prospective Reform

One of the questions that would naturally arise would be why corporations would voluntarily choose to institute clawback provisions, or perhaps, the more insightful question would be why any leading executives would agree to them?¹⁰⁹ If Bebchuk and Fried are correct in describing their managerial power thesis, and if previous efforts to constrain executive pay have been unsuccessful, why would clawback provisions be any different? After all, executive compensation has either stayed at the same levels or increased, even in the face of tax regulations,¹¹⁰ mandated disclosure,¹¹¹ and shareholder lawsuits.¹¹²

There is reason to think, however, that clawback provisions might prove more durable and effective than past efforts. Politically, this is an excellent time for reform. Currently there is a high level of public outrage at executive pay — created in large part by the economic crisis, the bonuses, the large risks taken, and the liabilities created for the government.¹¹³

¹⁰³ Louise Story, *Bonus Season Afoot, Wall Street Tries for a Little Restraint*, N.Y. TIMES, Dec. 9, 2008, at B1.

¹⁰⁴ See, e.g., David Zaring, *Best Practices*, 81 N.Y.U. L. REV. 294, 307 (2006) (describing best practices in both administrative agencies and business management as a “curiosity,” since the term is oft-used but ill-defined).

¹⁰⁵ See Appendix A, *infra* (categorizing various clawback provisions, culled from SEC disclosures, into those triggered by bad faith, fraud/misconduct, and restatement of financial results).

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ Morgenson, *supra* note 97.

¹⁰⁹ See Joann S. Lublin, *More Directors Are Cutting Their Own Pay*, WALL ST. J., Mar. 16, 2009, at B1 (describing cost-cutting measures at several companies, including General Motors, Ford, Eddie Bauer and Herman Miller, and an effort by the directors to show leadership at the top to turn performance around).

¹¹⁰ See *supra* Part I(A).

¹¹¹ *Id.*

¹¹² *Id.* As discussed above, however, the Disney opinion did little to constrain excessive executive compensation; in fact, if anything, the decision let the board off so easily that it almost countenanced such practices.

¹¹³ See Phillips, *supra* note 5.

Companies therefore have the incentive, for public relations purposes if nothing else, to include contractual clawbacks in their employment contracts.

Additionally, the political impetus may yet result in government regulation mandating such clawbacks. At the moment, these contractual clawbacks are voluntary provisions and constitute “best practices.”¹¹⁴ However, some language from the Treasury Department in a recent press release raises the possibility that what we might now consider the early emergence of a “best practice” may become a part of future federal regulation.¹¹⁵ In a recent release the Department of the Treasury stated:

The Secretary of the Treasury and the Chairman of the Securities and Exchange Commission should work together to require compensation committees of all public financial institutions — *not just those receiving government assistance* — to review and disclose executive and certain employee compensation arrangements and explain how these compensation arrangements are consistent with promoting sound risk management and long-term value creation for their companies and their shareholders. . . . Over the last decade there has been an emerging consensus that top executives should receive compensation that encourages more of a long-term perspective on creating economic value for their shareholders and the company at large. One idea worthy of serious consideration is requiring top executives at financial institutions to hold stock for several years after it is awarded before it can be cashed-out as this would encourage a more long-term focus on the economic interests of the firm.¹¹⁶

Similar intimations were made in a recent speech by an SEC official, who suggested that companies not involved in the bailout might, nonetheless, wish to follow these limitations for guidance on best practices.¹¹⁷ While currently voluntary, these provisions could be mandated in the future.¹¹⁸

We believe that the demands for change engendered by the financial

¹¹⁴ Zaring, *Best Practices*, note 104, *supra*.

¹¹⁵ Press Release, U.S. Dep’t of the Treasury, Treasury Announces New Restrictions on Executive Compensation, TG-15 (Feb. 4, 2009), available at <http://www.ustreas.gov/press/releases/tg15.htm>.

¹¹⁶ *Id.* (emphasis added by authors).

¹¹⁷ John W. White, Dir., Div. of Corporate Fin., Sec. and Exch. Comm’n, Executive Compensation Disclosure: Observations on Year Two and a Look Forward to the Changing Landscape for 2009 (Oct. 21, 2008), available at <http://www.sec.gov/news/speech/2008/spch102108jww.htm>.

¹¹⁸ See Richard R. Floersch, *The Right Way to Determine Executive Pay*, WALL ST. J., Mar. 5, 2009, at A15 (“In this climate [the financial crisis], those responsible for setting the parameters in the private sector need to start asking the right questions and taking actions, even if the results aren’t popular among executives. If they don’t, Congress will likely seek to change the way compensation is provided.”).

crisis can provide a “silver lining” — a genuine opportunity for meaningful change in the executive compensation arena. One of the major problems with executive compensation has been a focus only upon short-term performance. Such short-term thinking often leads to opportunistic behavior, at the expense of the long-term health of the company. By in a sense operating as a “lead parachute,” prospective clawback provisions begin to align incentives over a longer timeframe.

II. CLAWBACKS IN PONZI SCHEMES

The Madoff hedge fund fraud has grabbed headlines the world over, and with good reason. Apart from its soap-opera-like aspects,¹¹⁹ both the sheer scope of the fraud and the fact that ostensibly sophisticated investors across the globe from Abu Dhabi to Zurich were duped by a sprawling Ponzi scheme have gained the story a widespread and deserved notoriety.¹²⁰

Bernard L. Madoff, a former chairman of the NASDAQ Stock Market and a well-respected figure on Wall Street before his dramatic arrest in 2008,¹²¹ first began to lure investors into his scheme in the early 1990s.¹²² He attracted not only institutional clients like hedge funds, pension funds and charitable organizations,¹²³ but also prominent wealthy individuals like Steven Spielberg, billionaire art collector Norman Braman, New York Mets owner Fred Wilpon, and actor Kevin Bacon.¹²⁴ While his clients were told their investments were turning handsome profits in a hedge fund, Madoff had not been purchasing any securities in the decade leading to his arrest, never mind creating a hedge fund.¹²⁵ To keep up appearances, Madoff claimed to employ a “split-strike conversion strategy,” investing in a basket of stocks that would closely mimic the price movements of the Standard & Poor's 100 index, rotating out of the market into government-issued

¹¹⁹ Bernard Madoff confessed the fraud to his two sons, telling them he believed that the losses from the fraud exceeded \$50 billion and that he would turn himself in but not before distributing some \$200 to \$300 million currently in the fund's accounts to certain employees of the firm. In response, the two sons turned him in to the authorities. See Amir Efrati et al., *Top Broker Accused of \$50 Billion Fraud*, WALL ST. J., Dec. 12, 2008, at A1. In addition, Rene-Thierry Magon de la Villehuchetone, a prominent investor who traced his lineage to French aristocracy and had more than \$1 billion of his client's money entrusted with Madoff, committed suicide when the extent of the loss came to light. See Associated Press, *Suicide Madoff Investor Was 'Honorable Man,'* (Dec. 24, 2008), <http://www.msnbc.msn.com/id/28368421/>.

¹²⁰ See Diana Henriques, *Madoff Fraud Rippled Around the World*, INT'L HERALD TRIB., Dec. 21, 2008, <http://www.iht.com/articles/2008/12/21/business/madoff.php>.

¹²¹ See Amir Efrati, et al., *supra* note 119.

¹²² See Mark Hamblett, *Madoff Pleads and Is Led Off To Jail*, N.Y. L.J., Mar. 13, 2009, at 1 (summarizing Madoff's guilty plea).

¹²³ See *id.*

¹²⁴ See Keren Blankfeld Schultz & Duncan Greenberg, *Bernie Madoff's Billionaire Victims*, FORBES, Mar. 12, 2009, <http://www.forbes.com/2009/03/12/madoff-guilty-plea-business-wall-street-celebrity-victims.html>. No doubt Kevin Bacon wishes there were somewhat more than six degrees of separation between him and Madoff.

¹²⁵ See Hamblett, *supra* note 122.

securities like treasury bills and hedging the investments by buying and selling option contracts related to those stocks.¹²⁶ Madoff would further provide to clients false trading confirmations and account statements reflecting bogus transactions in support of this mythical “split-strike conversion strategy.”¹²⁷ All the while, Madoff was simply paying off the early investors with funds generated from the later investors.

Although there were skeptics who have insisted for years that Madoff could not have been investing his money legitimately, most accepted and believed that Madoff was a skilled investor with a proprietary investing platform that virtually could not lose.¹²⁸ Indeed, when Madoff was reported to the SEC, the agency failed to conduct a thorough investigation in part because of his sterling reputation on Wall Street.¹²⁹ In retrospect, with more complete information on Madoff’s investments, the alleged returns now appear to be virtually — and in some cases, physically — impossible to achieve. Madoff told investors that he returned an average of 15.7% per year going back to January 1996.¹³⁰ Between January 1996 and November 2004, a loss was reported only for three months, and most months reflected between 1% and 1.5% returns.¹³¹ Moreover, Madoff claimed to be executing more option trades than the entire market had on many days.¹³²

Unwieldy as it was, the “hedge fund” kept growing until 2008. At that point, presumably because of the downturn in the economy, it became impossible for Madoff to recruit enough new money to keep it afloat.¹³³ While Madoff allegedly confessed to running a \$50 billion scheme, investigators are still uncertain about how much money was actually lost.¹³⁴ Notwithstanding, the shortfall is staggering given that authorities have located only about \$1 billion in assets belong to Madoff, including such eclectic items as a \$39,000 piano and a \$2.2 million boat tragically named “Bull.”¹³⁵ Madoff has since pleaded guilty in federal court to 11 felony counts, including securities fraud, wire fraud, mail fraud, money laundering, perjury and false filings with the SEC,¹³⁶ and on June 29, 2009, he was

¹²⁶ See *id.*

¹²⁷ See *id.*

¹²⁸ See Gregory Zuckerman, *Chasing Bernard Madoff*, WALL ST. J., Dec 18, 2008, at A1.

¹²⁹ See *id.*

¹³⁰ See Efrati et al., *supra* note 119.

¹³¹ See *id.*

¹³² See Lauricella et al., *Firm Ran Vast Options Game; Charities Are Hit Hard*, WALL ST. J., Dec. 16, 2008, at A19.

¹³³ See *id.*

¹³⁴ See Associated Press, *Madoff Pleads Guilty to All 11 Charges*, <http://www.google.com/hostednews/ap/article/ALeqM5hmkPe640MG8WMCAvAwv5GqtqxsOAD96SHG7O0> (last visited March 14, 2009).

¹³⁵ *Madoffs Were Worth More than \$823m, Documents Show*, INT’L HERALD TRIB., Mar. 13, 2009, <http://www.iht.com/articles/ap/2009/03/13/business/NA-US-Madoff-Scandal-Assets.php>.

¹³⁶ See Press Release, United States Attorney Southern District of New York, *Bernard L. Madoff Pleads Guilty To Eleven-Count Criminal Information And Is Remanded Into Custody*, Mar. 12, 2009 <http://www.usdoj.gov/usao/nys/pressreleases/March09/madoffbernardpleapr.pdf>

sentenced to 150 years in prison.¹³⁷

Quite apart from its more sensational aspects, however, the fraud raises a series of complex and intriguing remedial questions: What remedies, if any, are available to investors that have lost some or all of their investment (“losing investors”) as against those investors who have profited from the scheme (“winning investors”)?¹³⁸ Do these remedies sufficiently protect such later investors and do or should they have the effect of deterring the fraud in the first place? If not, should we look to private ordering to solve this problem before turning to regulation?

These remedial questions arise because while the losing investors can turn to the courts to hold the operator of the fraud accountable, they are often forced to look elsewhere because the scheme and the operator are insolvent. The Madoff fraud serves as a prime example. While the investors will already be in line with other creditors in the Madoff bankruptcy proceedings, the value of his assets is substantially less than the loss incurred by the investors.¹³⁹

In a Ponzi scheme, losing investors would therefore look, naturally enough, to other solvent investors who have profited from the scheme, whether witting or not.¹⁴⁰ If the winning investor was aware of the fraud, that investor could be required to disgorge all payments received, which are avoidable as fraudulent transfers.¹⁴¹ Because many, if not most of the investors, are innocent of the fraud,¹⁴² the more useful but difficult question — and therefore subject of this Part of the Article — is whether any remedies lie as against innocent winning investors.

A short introduction to Ponzi schemes in general is in order here. Named after Charles Ponzi, the operator of the fraudulent scheme in

¹³⁷ See Chad Bray & Amir Efrati, *Madoff Is Sentenced to 150 Years in Multibillion-Dollar Ponzi Scheme*, <http://online.wsj.com/article/SB124604151653862301.html> (last visited June 29, 2009).

¹³⁸ While it is the case in many Ponzi schemes that the investors who profit are the early, initial investors, and the investors who lose some part of their investment are the ones who enter the fray later, this is of course not necessarily the case. Whether an investor ends up as a losing or winning investor will depend on the circumstances and structure of the particular scheme and choices made by the particular investor.

¹³⁹ See Associated Press, *supra* note 134.

¹⁴⁰ For example, in the Madoff fraud, the trustee as of May 15, 2009, had already sued to recover \$10.1 billion from six investors who withdrew substantial amounts from their Madoff accounts in the final years of the scheme. See Diana B. Henriques, *Trustee Sends \$30 Million to Victims of Madoff Fraud*, N. Y. TIMES, May 15, 2009, B3.

¹⁴¹ See *In re United Energy Corp.*, 944 F.2d 589, 596 n.7 (9th Cir. 1991) (“In recognizing these claims for rescission and restitution, we assume that the investors had no knowledge of the fraud the debtors were perpetrating. If investments were made with culpable knowledge, all subsequent payments made to such investors within one year of the debtors’ bankruptcy would be avoidable [as fraudulent transfers], regardless of the amount invested . . .”).

¹⁴² See, e.g., Eduardo J. Glas, *Redemption Payments Salvaged Prior To The Collapse Of Ponzi Schemes: Investors, Beware!*, BANKR. STRATEGIST, July 2007, at 3 (noting that the company, Bayou Superfund LLC “operated as a hedge fund which turned out to be a massive Ponzi scheme that snared a large number of innocent investors”).

Cunningham v. Brown,¹⁴³ a Ponzi scheme is an enterprise that makes payments to investors with monies received from newly-attracted investors, rather than from profits of a legitimate business venture. Typically, investors are promised large returns on their investments, and initial investors are paid sizeable returns. The money from new investors is then used to repay the earlier investors in order to keep the scheme afloat. Throughout this exercise, the promoter or Ponzi scheme operator draws off money from the enterprise, creating a loss. Ultimately, as the enterprise gets further and further into debt, the scheme collapses, leaving many but not all investors without their principal investments or the promised profits.¹⁴⁴ This phenomenon, as described above, is precisely what happened in the Madoff fraud.¹⁴⁵ The question that presents itself is whether the losing investors may proceed against the winning investors in the course of the bankruptcy proceedings that often follow.¹⁴⁶

As the discussion below will show, to the extent fraudulent transfer laws apply, any payments made to an innocent winning investor that is in excess — and only in excess — of the amounts of principal that she originally invested may be recoverable as fraudulent transfers. While this provides some protection for the losing investor, it is a less-than-optimal solution as this will still leave the winning investors in a better position vis-à-vis the losing investors, even though both groups may be equally innocent and pure circumstance alone determines which group any investor falls into. Further, such disparate outcomes may provide a disincentive to an investor to disclose any post-investment discovery of such fraud at least until that investor's principal is recouped. The introduction of clawback provisions in such investment contracts will not only potentially allocate the loss and therefore risk more evenly, it will counter the disincentive to so disclose. Significantly, because investors cannot in general determine beforehand whether they will be winning or losing investors, investors as a group will have the incentive to rely on and thus include clawback provisions in their investment contracts.

¹⁴³ 265 U.S. 1 (1924).

¹⁴⁴ See *In re Lake States Commodities, Inc.*, 272 B.R. 233, 241 (Bankr. N.D. Ill. 2002).

¹⁴⁵ See *supra* notes 120-137 and accompanying text.

¹⁴⁶ See Hon. Nancy C. Dreher, BANKR. SERVICE CURRENT AWARENESS ALERT, Sept. 2008, at 7 (“A common epilogue to a collapsed Ponzi scheme is a bankruptcy proceeding, and federal bankruptcy law expressly permits actions under the UFTA”). While the investor may additionally turn to the Congress-created Securities Investment Protection Corporation (SIPC), an institution that insures investor accounts in the event a brokerage firm fails owing customers cash and securities missing from those accounts, see <http://www.sipc.org/who/sipctrackrecord.cfm> (last accessed June 30, 2009), SIPC only insures up to \$500,000 per account and the scale of the Madoff fraud coming after the failure of Lehman has led the CEO of SIPC to question whether “SIPC’s resources will be adequate” to cover current losses. See Mary Pilon, *Is the SIPC Sick?*, WALL ST. J., Jan. 30, 2009, <http://blogs.wsj.com/wallet/2009/01/30/is-the-sipc-sick/>. As of May 15, 2009, 125 claims have been approved for payment that add up to losses of \$368 million. Almost all of the checks that have been mailed were for \$500,000. See Henriques, *supra* note 140.

A. Recovery Under Fraudulent Transfer Laws

To recover fraudulent transfers made by a debtor, a trustee may bring a claim under either Section 548 of the Bankruptcy Code or Section 544(b) of the Bankruptcy Code, which incorporates state fraudulent transfer laws.¹⁴⁷ In most states, such laws are derived from either the Uniform Fraudulent Transfer Act (“UFTA”) or the older Uniform Fraudulent Conveyance Act (“UFCA”).¹⁴⁸ There are but a few substantive differences between the two uniform statutes, or between the two statutes and Section 548 of the Bankruptcy Code.¹⁴⁹ A major distinction among the provisions is the applicable reachback period: While Section 548 of the Bankruptcy Code allows avoidance of only those transfers made within two years of the petition date,¹⁵⁰ the reachback period for fraudulent transfer claims under most states’ laws (which are based on either the UFTA or UFCA) is four years.¹⁵¹ In general, however, the basic principles governing fraudulent transfer actions are the same, regardless of the statutory basis used.¹⁵²

As a typical example, the UFTA provides in relevant part that:

(a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or

¹⁴⁷ This description of the fraudulent transfer laws in the context of Ponzi schemes is based in part on Mark McDermott’s excellent and concise treatment of the subject. *See Mark A. McDermott, Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157 (1998) (McDermott does not, however, examine clawbacks in the process). Additionally, the trustee may be able to recover certain payments to the investors as a preference. *See generally id.* at 181-188. However, because preferential transfer law under the Bankruptcy Code applies only to transfers made within the ninety-day period prior to the filing of the debtor’s bankruptcy case, *see* 11 U.S.C. § 547, its reach will in general be more limited than that of fraudulent transfer laws. *Cf. McDermott* at 181 (noting the potential advantage of a preference action in allowing the trustee to recover the return of an investor’s principal, even though the investor made the investment in both subjective and objective good faith).

¹⁴⁸ *See* David F. Kurwaza II, Note, *When Fair Consideration Is Not Fair*, 11 CORNELL J.L. & PUB. POL’Y 461, 465 (2002).

¹⁴⁹ *See* McDermott, *supra* note 147 at 159.

¹⁵⁰ *See* 11 U.S.C. § 548.

¹⁵¹ *See* Lisa A. Dunsky, *In re Bayou Group, LLC: The “Hotel California” Effect In Bankruptcies Of Fraudulent Hedge Funds*, 28 No. 2 FUTURES & DERIVATIVES L. REP. 13, Part II (Feb., 2008) (noting that although it varies from state to state, the reachback period for fraudulent transfer claims under most states’ laws is four years); David R. Weinstein et al., *Reachbacks, Statutes of Limitation and Deadlines: Demystifying the Avoiding Powers*, 26-5 AM. BANKR. INST. J. 1 n.12 (June 2007) (noting that the “pertinent provisions of the UFTA, usually § 9 [which describes a period of four years], are most often the source of the ‘look back’ period”). The reachback period provided under state law determines how far back in time before the filing of the bankruptcy petition the trustee or debtor can “look” to find fraudulent transfers upon which to bring a section 544(b) action. This is distinct from the statute of limitations for such actions, which is governed by section 546(a) of the Bankruptcy Code. *See* Dunsky at n. 10.

¹⁵² *See In re Pajaro Dunes Rental Agency, Inc.*, 174 B.R. 557, 572 (Bankr. N.D. Cal. 1994); *In re Carrozzella & Richardson*, 286 B.R. 480, 483 n. 3 (D. Conn. 2002) (“[T]he basic principles governing fraudulent transfer actions are the same, regardless of the statutory basis used.”); *In re Canyon Sys. Corp.*, 343 B.R. 615, 634 n.15 (Bankr. S.D. Ohio 2006) (“The fraudulent transfer provisions of the Code and the UFTA are substantially similar.”) (citations omitted).

incurred the obligation:

(1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or

(2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:

(i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due.¹⁵³

Courts have applied fraudulent conveyance laws to allow receivers or trustees in bankruptcy to recover money from winning investors in a Ponzi scheme.¹⁵⁴ Specifically, there are two theories of recovery that a trustee may rely upon under the fraudulent conveyance laws in these circumstances: actual fraud and constructive fraud.¹⁵⁵ However, under either theory, a trustee's recovery as against the innocent winning investor will generally be limited to recovering the profits earned by the winning investor, and will not extend to any amount representing a return of the investor's principal.¹⁵⁶

In recovering under either theory, the trustee must prove that the debtor (i.e., Ponzi scheme operator) had "an interest" in the property transferred.¹⁵⁷ There is no dispute in many fraudulent transfer actions arising in the context of bankruptcies involving Ponzi schemes that funds received involve property in which the debtor has an interest.¹⁵⁸ To the extent that proposition has been disputed, courts have generally rejected such challenges, and have held that debtors under these circumstances have an interest in funds transferred to the investors.¹⁵⁹

¹⁵³ UFTA § 4(a).

¹⁵⁴ See, e.g., *In re Agric. Research & Tech. Group*, 916 F.2d 528, 534 (9th Cir. 1990); *Scholes v. Lehmann*, 56 F.3d 750, 755 (7th Cir. 1995).

¹⁵⁵ See McDermott, *supra* note 147 at 159.

¹⁵⁶ See *id.*

¹⁵⁷ 11 U.S.C. §§ 548(a)(1); 544(b)(1). See McDermott, *supra* note 147, at 160.

¹⁵⁸ See McDermott, *supra* note 147, at 161.

¹⁵⁹ See, e.g., *In re Canyon Sys. Corp.*, 343 B.R. 615, 635 (Bankr.S.D.Ohio 2006) ("Payments made to investors in a Ponzi scheme constitute 'transfers' within the meaning of both § 101(54) of the Code and § 1336.01(L) of the Ohio UFTA. Further, a Ponzi scheme operator possesses a property interest in the transferred funds.") (citations omitted); *In re Ramirez Rodriguez*, 209 B.R. at 432 ("Funds obtained from investors in a Ponzi scheme are property of debtor, and are thus susceptible to preferential and fraudulent disposition by debtor."); *Jobin v. Lalan (In re M&L Bus. Mach. Co.)*, 160 B.R. 851, 857 (Bankr. D. Colo. 1993) ("There is no argument but that the investors gave their money to the Debtor voluntarily. Thus, at the time of each investment, the Debtor had at least the legal right to possession. It is elemental property law that one of the 'interests in property' included in the total bundle of property rights is the right of possession. All that § 548 requires is the transfer of an "interest" by the Debtor. True, that interest was subject to defeat by each investor, but it nevertheless was an "interest of the debtor in property."); *In re Indep. Clearing House*, 77 B.R. at 854 ("[W]hen a debtor obtains money by fraud and mingles it with other money so as to preclude any tracing and when the defrauded party ... accepts benefits under his contract with the debtor, the money is 'property' of the debtor within the meaning of section[] ... 548 of the Code.").

Cherry & Wong

To recover under the actual fraud theory, the trustee must further prove that the debtor made transfers to the winning investor "with actual intent to hinder, delay, or defraud" the losing investors,¹⁶⁰ a burden readily met under these circumstances given that courts have held that "[t]he mere existence of a Ponzi scheme is sufficient to establish [such] actual intent."¹⁶¹ Although proving actual fraud would ordinarily allow the trustee to recover all transfers made to a winning investor, including amounts which could be considered return of principal, there is a good faith defense that permits an innocent winning investor to retain funds up to the amount of the principal.¹⁶²

To recover under the constructive fraud theory, the trustee must additionally show that the transfer was made: (1) with the debtor receiving "less than a reasonably equivalent value in exchange for such transfer"; and (2) under circumstances involving one of three insufficient funds situations (including the situation where the debtor was insolvent at the time of transfer) or else to an insider under an employment contract and outside the ordinary course of business.¹⁶³

Courts in general hold that a debtor does not receive a reasonably equivalent value for any payments made to the winning investor that represent profits since such profits are regarded as having been gained through theft from losing investors.¹⁶⁴ Where the winning investor receives more than was invested, such "payments in excess of amounts invested are

¹⁶⁰ 11 U.S.C. § 548(a)(1)(A).

¹⁶¹ *In re AFI Holding, Inc.*, 525 F.3d 700, 704 (9th Cir. 2008). *Cf.* 5 Collier on Bankruptcy ¶ 548.04[1] at 548-26 (15th ed. rev.2006) (noting that the plaintiff meets the requirement on demonstrating that the transferor "acted under circumstances that preclude any reasonable conclusion other than that the purpose of the transfer was fraudulent as to creditors") (citing *Lesser v. Jewel Factors Corp.*, 470 F.2d 108, 110 (2d Cir.1972)).

¹⁶² See 11 U.S.C. § 548(c) ("[A] transferee or obligee of . . . a [fraudulent] transfer or obligation that takes for value *and in good faith* has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.") (emphasis added). See also *Scholes*, 56 F.3d at 759. See generally McDermott, *supra* note 147, at 175-181.

¹⁶³ See 11 U.S.C. § 548(a)(1)(B), which provides as follows:

(a)(1)The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily:

(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
(ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;
(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or
(IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

See also McDermott, *supra* note 147, at 164-173.

¹⁶⁴ *Scholes*, 56 F.3d at 757. See also Dreher, *supra* note 146.

considered fictitious profits because they do not represent a return on legitimate investment activity.”¹⁶⁵ In contrast, courts generally hold that a debtor does receive value for the return of an investor’s principal investments.¹⁶⁶ The rationale here is that the investor has a claim for restitution against the debtor for the investor’s principal investment with the debtor by virtue of the debtor’s fraud,¹⁶⁷ which claim constitutes a debt owed by the debtor to the investor.¹⁶⁸

Additionally, proving the existence of one of the three insufficient funds situations is a typically straightforward matter for the trustee since various courts have held that a debtor operating a Ponzi scheme is deemed insolvent from its inception as a matter of law.¹⁶⁹

As a result, federal courts generally determine whether the investor is liable by applying the so-called "netting rule."¹⁷⁰ Under this rule, amounts transferred by the Ponzi scheme perpetrator to the investor are netted against the initial amounts invested by that individual.¹⁷¹ If the net is positive, the receiver has established liability, and the court then determines the actual amount of liability, which may or may not be equal to the net gain, depending on factors such as whether transfers were made within the relevant reachback period or whether the investor lacked good faith.¹⁷² If the net is negative, the good faith (innocent) investor is not liable because as described above, payments received in amounts less than the principal investment are not avoidable under fraudulent transfer laws.¹⁷³

Thus, the general rule regarding recovery as against innocent winning investors in Ponzi schemes is that only payments made to them in excess of the amounts of principal originally invested are avoidable as fraudulent transfers. The remaining assets in the scheme, as well as the fraudulent transfers recovered, are then ratably distributed among all of the creditors,

¹⁶⁵ *In re United Energy Corp.*, 944 F.2d 589, 595 (9th Cir. 1991).

¹⁶⁶ *See McDermott*, *supra* note 147, at 165.

¹⁶⁷ *See, e.g., United Energy*, 944 F.2d 589; *Rosenberg v. Collins*, 624 F.2d 659 (5th Cir. 1980).

¹⁶⁸ Section 101(5) of the Bankruptcy Code defines a “claim” as:

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured

11 U.S.C. § 101(5) (2006). Section 101(12) defines “debt” as a “liability on a claim.” *Id.* § 101(12).

¹⁶⁹ *See, e.g., Warfield v. Byron*, 436 F.3d 551, 558 (5th Cir.2006) (observing that a Ponzi scheme “is, as a matter of law, insolvent from its inception”)(citation omitted); *In re Evergreen Security, Ltd.*, 319 B.R. 245, 253 (M.D.Fla.2003) (“Insolvency of the debtor as required by § 548(a)(1)(B) is established, when the Debtor is operating a Ponzi scheme.”); *Cunningham v. Brown*, 265 U.S. at 8, 44 S.Ct. at 425 (Ponzi scheme debtor was always insolvent and became more so each day business continued); *Guy v. Abdulla*, 57 F.R.D. 14, 17 (N.D.Ohio 1972) (possible to establish that Ponzi scheme was insolvent from its very inception).

¹⁷⁰ *See McDermott*, *supra* note 147, at 168-9.

¹⁷¹ *See id.*

¹⁷² *See id.*

¹⁷³ *See supra* Part II(a).

both losing investors and other noninvestor creditors of the estate.¹⁷⁴ Broadly speaking, the rationale for this approach is that "winners" in the Ponzi scheme, even if innocent of any fraud themselves, are not in an equitably stronger position vis-à-vis the losing investors, and should not be permitted to benefit at the expense of the losing investor. As one court framed the issue:

The money used for the [underlying investments] came from investors gulled by fraudulent representations. [The defendant] was one of those investors, and it may seem "only fair" that he should be entitled to the profits on trades made with his money. That would be true as between him and [the Ponzi scheme operator]. It is not true as between him and either the creditors of or the other investors in the corporations. He should not be permitted to benefit from a fraud at their expense merely because he was not himself to blame for the fraud. All he is being asked to do is to return the net profits of his investment — the difference between what he put in at the beginning and what he had at the end.¹⁷⁵

This observation would, technically, hold true for the Madoff fraud as well. To the extent the investors in the Madoff fraud are equally blameless, courts could hold that the investor who pulls out early to cash in on the profit is on par, equitably speaking, with the investor who leaves funds in and therefore loses his investment, and treat the former's profits as fraudulent transfers.

B. The Resulting Inequity Between Winning and Losing Investors

The remedies currently provided under the law are less than satisfactory since it will be a matter of chance whether a particular innocent investor is a winning rather than a losing investor, and thus whether or not she will walk away from the scheme with her principal intact. In other words, even though both the winning and the losing investor are equally blameless, the latter will suffer the greater loss in relative terms quite simply because that investor was "not so lucky."¹⁷⁶ As noted above, it is precisely this unfairness that justifies the treatment of any payments made to the winning investors representing profit that is avoidable as fraudulent transfers and requiring their disgorgement for the benefit of the losing investors.¹⁷⁷

While ameliorating the situation to some degree, fraudulent conveyance

¹⁷⁴ See McDermott, *supra* note 147, at 158.

¹⁷⁵ Scholes v. Lehmann, 56 F.3d 750, 757-58 (7th Cir. 1995).

¹⁷⁶ *In re United Energy Corp.*, 944 F.2d at 596.

¹⁷⁷ See *supra* note 174-175 and accompanying text.

laws are highly unlikely to bring both sets of investors to parity.¹⁷⁸ This disparity is further compounded by the fact that while payments of fictitious profit are potentially avoidable as fraudulent conveyances, the relevant reachback period may further restrict the payments the Ponzi scheme investor is required to repay. Only transfers made within the reachback period are avoidable as such.¹⁷⁹ In the case of an extensive fraud like that perpetuated by Madoff, the Ponzi scheme can extend over a decade. Those initial and innocent winning investors who withdrew their money, say, ten years ago, would effectively be removed from the equation.

For these reasons, courts have long held that it is more equitable to attempt to distribute all recoverable assets among the defrauded investors who did not recover their initial investments rather than to allow the losses to rest where they fall.¹⁸⁰ Indeed, because the typical losing investor nonetheless remains at an unfair disadvantage,¹⁸¹ courts have sought to rectify the balance in other ways.

For example, courts have begun to adopt a narrower reading of the good faith defense so as to potentially reach all payments received by an investor from the scheme, and not just the amounts representing the fictitious profits. In *In re Bayou Group, LLC*, a recent case also involving a massive hedge fund fraud, the Ponzi scheme persisted for years as a result of management's falsification of its financial disclosures and fraudulent misrepresentation of its investment performances.¹⁸² This was facilitated in part by management's termination of its independent auditor and the creation of a fictitious accounting firm to pose as the independent auditor.¹⁸³ The court ruled there that under the actual fraud recovery theory,¹⁸⁴ winning investors had to hand back their principal as well as their profits, even though they were not responsible for the fraud, if there was evidence that they redeemed their investments because there was a "red flag" that "put[] the investor on notice of some potential infirmity in the investment such that a reasonable investor would recognize the need to conduct some investigation" but who failed to do so.¹⁸⁵ In the *Bayou* case, for example,

¹⁷⁸ See, e.g., *Donell v. Kowell*, 533 F.3d 762, 776 (9th Cir. 2008) ("According to the Receiver, in this case approximately 6,000 investors participated in the Wallenbrock Ponzi scheme, but only about 800 received back more than their initial investment. It is likely that many of the other 5,200 losing investors will see only a portion of their initial investment returned."). See also *McDermott*, *supra* note 149, at 157-159 (explaining that assets recovered after a collapsed Ponzi scheme typically are insufficient to satisfy claims by losing investors).

¹⁷⁹ See *Warfield v. Alaniz*, 453 F. Supp. 2d 1118, 1131 (D. Ariz. 2006) (holding that a court appointed receiver could not base his claims under Arizona's UFTA on transfers that took place outside of the relevant time period); *Neilson v. Union Bank of California*, 290 F. Supp. 2d 1101, 1145-46 (C.D. Cal. 2003) (holding that plaintiffs could prevail if they could prove at trial that certain transfers made pursuant to a Ponzi scheme were made within the relevant time period of California's UFTA). See also *supra* notes 157-8, and accompanying text.

¹⁸⁰ See *Donell*, 533 F.3d at 776.

¹⁸¹ See *supra* notes 170-73 and accompanying text.

¹⁸² See *In re Bayou Group, L.L.C.*, 396 B.R. 810, 822 (Bankr. S.D.N.Y. 2008).

¹⁸³ See *id.*

¹⁸⁴ See *id.*

¹⁸⁵ See *id.* at 848. More specifically, the court held that "a defendant may establish his [good faith] defense

one “red flag” might be the lack of an independent auditor if diligent investigation would have revealed the same.¹⁸⁶ Already, some commentators have highlighted the possibility of the ruling in *Bayou* applying in any litigation of the Madoff fraud.¹⁸⁷

Notwithstanding the broad reading of applicable fraudulent conveyance laws, however, the law as it stands cannot in most cases return both sets of investors to parity. It cannot, in other words, require every innocent investor to surrender as fraudulent transfers any and all payments received by the investor from the scheme, for equitable redistribution among all innocent investors on a pro-rata basis in accordance with the principal amount invested respectively. Such a result is, however, potentially achievable with the use of *contractual* clawbacks in the underlying investment contracts.

C. Contractual Clawbacks in Ponzi Schemes

In examining contractual clawbacks in the context of investment agreements, this section will consider in turn the function of clawbacks, their structure, and their desirability from both the perspective of the investor and public policy.

1. The Function of Contractual Clawbacks

Contractual clawbacks in investment agreements provide a way of minimizing the risk that any individual investor will be left in the position of a losing investor in the event the investment turns out to be part of a Ponzi scheme. Instead of depending on courts to claw back payments made to winning investors at the back end — a remedy whose reach, as discussed above, is in general limited to a payment amount representing the (fictitious) profits — the investor could in theory better protect herself prospectively by including a provision in the investment contract that would claw back all amounts paid out to investors contingent on the fund becoming insolvent as a result of fraud. The provision would also establish that the amounts so recovered would then be distributed to all investors on a pro-rata basis.

[to a fraudulent conveyance claim] if he can prove by a preponderance of the credible *objective evidence* that his request for redemption was in fact the result of a good faith reason other than his knowledge of ‘red flags,’ even if he was on inquiry notice and did not make inquiry before redeeming.” *Id.* at 849 (emphasis in original).

¹⁸⁶ *Id.* at 852.

¹⁸⁷ Mark Hosenball, *Made Money with Madoff? Don’t Count on Keeping It*, NEWSWEEK, Jan. 12, 2009, at 9 (noting that an analysis by the KL Gates law firm, which represents victims of the earlier fraud, claimed the *Bayou* case “provide[s] instructive guidance to [Madoff] investors and other affected parties”).

What the contractual clawback does in effect is eliminate the distinction between winning and losing investors, since all investors would be treated similarly under the provision. The net result is that the risk of fraud in any investment would be more equally allocated among the investors. Such a risk distribution spread arguably reflects more accurately what the reasonable investor would have expected in the first instance,¹⁸⁸ but which expectation turns out to be false and can be restored post facto only to a limited extent. Clawbacks in investment contracts therefore operate to ensure that investors' expectations concerning risk allocation are not short-changed.

2. The Structure of Contractual Clawbacks

We believe clawback provisions would benefit good faith investors on balance if adopted into the standard boilerplate of investment contracts. Here, we propose, as one example, language for such a clause:

In the event of the investment fund becoming insolvent because of fraud, the investor agrees that any payments received by the investor under the fund representing any amount of principal invested may be recovered by an appointed Representative and deposited in a central repository for subsequent redistribution to all investors in amounts pro-rated according to the amount of principal invested by the particular investor.¹⁸⁹

A potential complication, however, is that there is typically no contractual privity among the investors themselves.¹⁹⁰ Rather, the investment structure usually consists of individual, separate contracts between each investor and the investment fund.¹⁹¹ Since the contractual clawback would bind only the particular parties to the contract, an investor would be bound under the provision to surrender all funds received without the assurance that other investors will do the same. In essence, the contractual clawback as rendered above would function as a third-party beneficiary contract.¹⁹²

¹⁸⁸ It may be argued that the reasonable investor may also and instead expect that any payments received and already spent by the investor should not be recoverable. Such a position again assumes the perspective of the innocent winning investor. However, the investor in general will not know ex ante whether she will turn out to be a winning or losing investor.

¹⁸⁹ The contractual clawback is limited to payments representing any amount of the principal invested since any payments in excess of that amount represents fictitious profits and will be treated as fraudulent transfers for redistribution not just to losing investors but all other creditors. See *supra* notes 164-65 and accompanying text.

¹⁹⁰ 13 WILLISTON ON CONTRACTS § 37:1 (4th ed. 2008); Cf. *Cheney v. Powell*, 15 S.E. 750 (Ga. 1892) (discussing privity of contract in context of fraud).

¹⁹¹ *Id.*

¹⁹² See generally Anthony Jon Waters, *The Property in the Promise: A Study of the Third Party Beneficiary Rule*, 98 HARV. L. REV. 1109 (1985). Under the Restatement approach, for example, a third party may recover if it is the 'intended beneficiary' of the contract. RESTATEMENT (SECOND) OF CONTRACTS § 302 (1981). To satisfy this requirement, the third party must show, among other things, that allowing it a contract remedy will 'effectuate

Cherry & Wong

One way of addressing the lack of contractual privity would be to qualify the contractual clawback with a reciprocal clause so that only investors with similar provisions in their investment contracts would be permitted to enforce the clawback.¹⁹³ For example, the sample contractual clawback above might limit the beneficiaries of the subsequent redistribution to investors with contractual clawbacks in their investment contracts, reading as follows:

In the event of the investment fund becoming insolvent because of fraud, the investor agrees that any payments received by the investor under the fund representing any amount of principal invested may be recovered by an appointed Representative and deposited in a central repository for subsequent redistribution among those investors *whose investment contracts contain similarly-rendered clawback provisions* in amounts pro-rated according to the amount of principal invested by the particular investor.

It is, of course, entirely possible that any clawback provision in the particular investment contract is a standard clause in all investment contracts entered into by the investment fund with its investors, so that a clawback would by default be included in all contracts. Indeed, the investment fund would appear to have little incentive to remove such a clawback since it reallocates the risk of loss only as among the investors, and has no impact on its bottom line.¹⁹⁴ If in fact the contractual clawback becomes a standard provision, the problems arising from the lack of privity would be much diminished, as would the need accordingly for reciprocal clawbacks.

3. The Desirability of Contractual Clawbacks

Thus far, we have assumed that investors will find contractual

the intention of the parties.' *Id.*

¹⁹³ An example of a reciprocal provision is the statutory provision regarding the alien's privilege to sue:

(a) Citizens or subjects of any foreign government which accords to citizens of the United States the right to prosecute claims against their government in its courts may sue the United States in the United States Court of Federal Claims if the subject matter of the suit is otherwise within such court's jurisdiction.

28 U.S.C. § 2502 (2006). An illustration of its operation can be found in the case of *Henriquez & Gornell, Inc. v. United States* where the court noted that a Panamanian citizen could sue the US defendant because the "Republic of Panama accords to citizens of the United States the right to prosecute claims against the Republic in its courts. Therefore, under the reciprocal provision of Title 28 U.S.C. 2502 (Alien's Privilege to Sue) plaintiff is entitled to bring its contract claim against the defendant in this court." 180 Ct. Cl. 1040, 1049-50 (Ct. Cl. 1967).

¹⁹⁴ It may be argued, however, that including such contractual clawbacks may have the effect of portraying the investment fund in a bad light to the extent it suggests that the fund is in fact a Ponzi scheme, in which case the fund would have an incentive to exclude such provisions. However, given the notoriety of the Madoff scheme and the fact that it had maintained the patina of respectability for the many years it was in operation, the market presumably expects investors to treat any and all funds with healthy skepticism, in which case the inclusion of contractual clawbacks will be regarded as a standard precautionary measure.

clawbacks desirable because they will want a more even distribution of the risk of loss. This may not be true, however, of all investors. Because the winning investor in a situation not involving contractual clawbacks (and who thus gets to keep payments received up to the amount of the principal invested) will nevertheless suffer a comparatively smaller loss than the investor who gets a pro-rata distribution as a result of a contractual clawback, there may be investors who would prefer to “gamble” on the odds of ending up a winning investor and thereby reject such a clawback provision.

It bears note, however, that the comparative upside here is as minimal as the downside is significant — the winning investor at best breaks even and does not get to keep any profits whereas the losing investor may forgo the entire principal invested. As such, and since it is not possible in general to determine *ex ante* whether one will be a winning or losing investor, we believe it fair to assume that in general the rational investor will have the incentive to include a clawback in its investment contract.¹⁹⁵

Whether investors desire clawbacks is a separate question from whether clawbacks are desirable from a public policy perspective. However, to the extent we agree that equally innocent victims of a fraud should not bear the resulting loss unequally simply because of pure circumstance — a conclusion that courts themselves have reached¹⁹⁶ — the two questions, and therefore their answers, converge.

Further, the disparate outcome as between winning and losing investors may provide an investor the incentive to delay disclosing any post-investment discovery of such fraud at least until the investor recoups its principal. Conversely, because the investor subject to a contractual clawback will generally stand to recover a greater amount the earlier the fraud is discovered, the incentive structure is reversed in favor of disclosure at the earliest possible time. Also, winning investors currently have no incentive to be involved in the bankruptcy and indeed may actively avoid participation, thereby potentially depriving the trustee of useful information about the fraud.¹⁹⁷ Indeed, winning investors in the Madoff fraud are apparently being advised to avoid litigation, and “to stay off the radar

¹⁹⁵ It may be the case that the initial investors in a smaller fund will in fact be aware of their status as such, and will not have the incentive to agree to contractual clawbacks. Presumably, however, such investors will constitute a small proportion of the investor population. Also, to the extent that such investors are put on notice of fraudulent behavior with regard to the fund, which may be more likely under these circumstances, all payments made to them may be recoverable in any event as fraudulent transfers under an actual fraud recovery theory since they will be unable to assert a good faith defense. *See supra* notes 141, 160-62 and accompanying text.

¹⁹⁶ *See, e.g., supra* notes 174-75, and accompanying text.

¹⁹⁷ *Cf.* Christine Seib, *Madoff Winners Stash Their Profits*, AUSTRALIAN, Mar. 16, 2009, http://www.theaustralian.news.com.au/business/story/0,,25192402-5017996,00.html?from=marketwatch_rss (“Investors facing the clawback are confused about whether to submit a claim for compensation from the Securities Investor Protection Corporation . . . Jason Cowart, a partner with Pomerantz, a New York-based class-action specialist, said that clients were ‘deeply concerned’ at the prospect of losing more money in a clawback.”).

screen of the trustee who is figuring out how to pursue the Madoff firm's remaining assets—including potential ‘clawback’ recaptures of purported profits paid to early investors.”¹⁹⁸

It may, however, be the case that the more equitable reallocation of risk resulting from the use of contractual clawbacks results in a generally less vigilant investor, since the reallocation reduces the risk of catastrophic loss for any individual investor. Even if so, that is arguably an acceptable price for using contractual clawbacks since there is no assurance that maintaining current levels of vigilance would in fact result in earlier discoveries of fraud — witness the SEC investigation debacle in Madoff¹⁹⁹ — whereas it is a certainty that when fraud *is* discovered, all innocent investors will be treated on an equal footing under a regime of contractual clawbacks.

III. A DOCTRINE OF CLAWBACKS

As noted in the introduction, the media and other commentators have used the term “clawback” extensively in the past few months, but in a reflexive way, with no consensus as to what is meant by the term.²⁰⁰ “Clawback” has been generally used to refer to any action for recoupment of a loss. Meanwhile, “clawback” has taken on narrow meanings as terms of art within specialized corners of legal doctrine. For example, “clawbacks” have been used in agreements between venture capitalists to spread profits and losses among funds,²⁰¹ to describe the effect of federalism on Medicare regulations,²⁰² the taxation of REITs and other real estate investment vehicles, and have a specialized meaning in the extraterritorial application of a nation’s laws.²⁰³ Finally, a “clawback agreement” also has a meaning in the context of electronic discovery, referring to an instance where the parties make a prospective agreement that any information inadvertently and inappropriately disclosed during the

¹⁹⁸ See Martha Neil, *Some Madoff Investors Made Money—And Are Now Lying Low*, A.B.A.J. LAW NEWS NOW, Jan. 23, 2009, http://abajournal.com/news/some_madoff_investors_made_moneyand_are_now_lying_low.

¹⁹⁹ See *supra* note 129 and accompanying text.

²⁰⁰ See *supra* note 15 and accompanying text.

²⁰¹ See, e.g. Robert P. Bartlett, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 U.C.L.A. L. REV. 37, 73-4 (2006) (describing “clawbacks” as used in venture capital arrangements; applied as a term of art in venture contracts to ensure that a venture capitalist “receives no more than her specified percentage of fund profits upon the termination of a fund.”).

²⁰² See, e.g. Elizabeth A. Weeks, *Cooperative Federalism and Healthcare Reform: The Medicare Part D “Clawback” Example*, 1 ST. LOUIS U. J. HEALTH L. & POL’Y 79 (2007) (describing “clawback” in the healthcare context as a federal government provision that places a condition on states’ receipt of Medicare funds); Nicole Huberfeld, *Clear Notice for Conditions on Spending Unclear Implications for States in Federal Healthcare Programs*, 86 N.C. L. REV. 441, 445 (2008) (same).

²⁰³ See, e.g. Austen Parrish, *The Effects Test: Extraterritoriality’s Fifth Business*, 61 VAND. L. REV. 1455, 1492, n.3 (2008) (describing “clawback” as a statute that enables a defendant who paid multiple damages in a foreign country to recover those multiple damages from plaintiff).

discovery process will be returned.²⁰⁴

Notwithstanding this plethora of references, the standard contracts treatise contains nary a section, never mind a chapter, on the elusive “clawback.”²⁰⁵ And even though the term is not of recent provenance, there is little sign of a consensus on “clawback doctrine” to speak of, since the term has been subject to neither rigorous analytical scrutiny nor definition and exposition. Thus, the challenge for this Article in proposing a doctrine of clawbacks is to determine where one might find clawbacks in a contracts treatise, what the chapter on clawbacks would say, and how it would relate to other established bodies of contract doctrine.

We begin the exercise by identifying what appear to be two distinctive features common to many applications of the term “clawback.” The first feature, adumbrated in its very name, is that a clawback is a recovery device that is potentially draconian but justifiable under the circumstances that trigger the clawback because of an inherent unfairness that would otherwise prevail. The second feature, as evidenced in our examination above of clawbacks with respect to executive compensation and Ponzi schemes, is that clawbacks are generally more effective when they operate prospectively rather than retroactively.

Accordingly, in constructing a framework within which to analyze clawbacks, we advance below a definition that we believe not only takes account of these features, but that encompasses many of the term’s current applications. Relying on that definition, we then examine the nature of clawbacks, which explains in turn their function and necessity, and also why clawbacks are that much more effective when employed prospectively rather than retroactively. We then go on to examine the implications of such clawback provisions on other areas of contract doctrine. We conclude this section by discussing the relative merits and drawbacks of bottom-up versus top-down solutions, and the role of government in mandating prospective clawbacks in certain situations.

A. A Proposed Definition

To lay a foundation for the doctrine, we propose that a clawback be

²⁰⁴ See, e.g. 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) (clawback in context of discovery refers to “agreement regarding a procedure for retrieving privilege information that has been inadvertently produced in the course of discovery.”).

²⁰⁵ Although it is always difficult to find a citation for a negative proposition like this one, the authors did a quick survey of the contracts casebooks in their respective offices, including E. ALLEN FARNSWORTH, ET AL., *CONTRACTS: CASES AND MATERIALS* (7th ed. 2008); BRIAN A. BLUM & AMY C. BUSHAW, *CONTRACTS CASES, DISCUSSIONS, AND PROBLEMS* (2008); RANDY BARNETT, *CONTRACTS CASES AND DOCTRINE* (3rd ed. 2008) and did not find chapters or significant discussion of anything related to clawbacks in the books. Likewise, the authors also consulted their textbooks on business associations / corporate law and did not find the term there either.

defined as a right to, or action for, the restitution of *unfair enrichment* that is otherwise justified or permitted under prevailing applicable law. As used here, the term “unfair enrichment” shares certain features with but also appears to vary in other respects from the traditional concept of unjust enrichment. The traditional concept of unjust enrichment focuses on disgorgement from the breaching party.²⁰⁶ In the words of one leading commentator, the underlying premise of unjust enrichment is that “gains produced through another’s loss are unjust and should be restored.”²⁰⁷

Unfair enrichment, like unjust enrichment, can apply to those situations where the person unfairly enriched is not responsible for the underlying wrongdoing or event leading to the unfair enrichment. For example, the innocent winning investor in Ponzi schemes who is not responsible for the fraud is nevertheless subject to the clawback of fraudulent conveyance laws.²⁰⁸ To take an example from the executive compensation context, an AIG executive who did not directly work on mortgage-backed securities or credit default swaps but received a bonus would still have to surrender 90% of the bonus if the pending bill passes.²⁰⁹

Unfair enrichment also, however, extends to those situations where the enrichment cannot readily be said to be unjust (per unjust enrichment principles) insofar as the person unfairly enriched has a legal pre-existing right to payment.²¹⁰ In essence, clawbacks generally target certain inequities that are not wholly legally cognizable or relevant because they are in tension with independent legal rights that already justified or allowed for such inequities to exist in the first place. And thus while it is unfair that the losing investor in a Ponzi scheme will suffer a comparatively greater loss than the winning investor when both are equally blameless, recognizing that inequity is in tension with the fact that the winning investor has a contractual right to the payments received as well as a restitutionary claim for the principal investment.²¹¹ Similarly, it seems unfair that an executive at AIG could walk away with a bonus when the company he had a responsibility to assist is failing. Nonetheless under existing law making an equitable claim under these circumstances is problematic as it must tackle the executive’s original contractual claim to the bonus.²¹²

It may be that as sketched out above, unfair enrichment could be

²⁰⁶ JOSEPH D. CALAMARI & JOSEPH M. PERILLO, *THE LAW OF CONTRACTS* 599-605 (4th ed. 1998).

²⁰⁷ John P. Dawson, *The Self-Serving Intermeddler*, 87 HARV. L. REV. 1409 (1974).

²⁰⁸ See *supra* Part II (A).

²⁰⁹ See *supra* notes 67-74, and accompanying text.

²¹⁰ See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT, § 1 cmt. b (Discussion Draft 2000) (“Unjust enrichment is enrichment that lacks an adequate legal basis: it results from a transfer that the law treats as ineffective to work a conclusive alteration in ownership rights.”).

²¹¹ See *supra* Part II(A).

²¹² See *supra* notes 67-74, and accompanying text.

regarded as a variant, albeit an unfamiliar one, of unjust enrichment.²¹³ Regardless, we think it is useful here to designate the concept separately to delineate those features of clawbacks that not only identify them but that also explain their nature.

B. The Nature of Clawbacks

As defined above, a clawback addresses inequities that cannot easily be resolved by existing remedies under the law because of countervailing legal rights independently supporting such inequities. Accordingly, absent the clawback, the unfair enrichment will stand. Although the lack of legal remedies ordinarily connotes the absence of a cognizable legal wrong, such a conclusion does not sit well in situations involving unfair enrichment, and appears to be out of step with prevailing notions of fairness. To the extent we think that these particular notions of fairness should be honored, i.e., that these are inequitable situations that need redress notwithstanding the countervailing legal rights, we would have to look to clawbacks to override such countervailing rights so as to allow for restitution of the unfair enrichment.

For example, although an individual AIG executive may be blameless and have otherwise valid contractual rights to the bonus, the payment of the bonus is seen to be unfair because of the notion that bonuses should not be decoupled from a company's performance, particularly where taxpayer money is involved.²¹⁴ We would have to turn to a retroactive clawback to override the contractual rights in this situation in order to prevent unfair enrichment of the executive.

Thus, clawbacks function to bridge the gap in remedies under prevailing law for addressing unfair enrichment, or perhaps more accurately, to manage the claim of right preventing the restitution of unfair enrichment. Analyzed in these terms, we can now explain by reference to their function why *prospective* clawbacks are generally more effective than retroactive

²¹³ One might argue, for instance, that unfair enrichment is consistent with unjust enrichment if we note the views of Warren Seavey and Austin Scott, the reporters of the first Restatement in Restitution. They cautioned that restitution law responds only imperfectly to the basic premise of unjust enrichment and that institutional limitations and historical accidents that render it "impossible to be just to one without being unjust to the other" prevent the perfect embodiment of "the fundamental conception of restitution" into rules. Warren A. Seavey & Austin W. Scott, *Restitution*, 213 L.Q. REV. 29, 29, 31-32, 36-37 (1938). See also LORD GOFF OF CHIEVELEY & GARETH JONES, *THE LAW OF RESTITUTION* 14 (Gareth Jones ed., 6th ed. 2002) (unjust enrichment is a "principle of justice which the law recognizes and gives effect to in a wide variety of claims"). Alternatively, one might paint broader strokes by postulating, as Peter Linzer does, that the prevention of unjust enrichment should serve as a source for applying "rough justice" in individual cases when normally sound rules produce unsatisfactory results. See Peter Linzer, *Rough Justice: A Theory of Restitution and Reliance, Contracts and Torts*, 2001 WIS. L. REV. 695 (2001). Cf. HANOCH DAGAN, *THE LAW AND ETHICS OF RESTITUTION* 13 (stating that Linzer's position "is indefensible because . . . "[t]here is nothing both unique to restitution and common to all subjects of restitution that justifies a greater disregard of rules than judges would countenance in other areas of law.") (citation omitted).

²¹⁴ *Id.*

clawbacks. Prospective clawbacks are those clawbacks that are introduced before the claim of right to the benefits or enrichment has arisen. For instance, some companies, like Dell, are prospectively writing provisions into their executive compensation contracts that would recover or cancel bonus awards in the event of restatement of financial results.²¹⁵ In contrast, retroactive clawbacks are those clawbacks that, similar to the proposed 90% tax on bonuses, are imposed after the contractual right to the bonuses has arisen and the benefits have been conferred.

Our earlier examination of clawbacks in the context of executive compensation and Ponzi schemes indicated that the use of prospective clawbacks — writing clawbacks directly into the original contract — was preferable to and more effective than that of retroactive clawbacks — statutory provisions that might retroactively tax a bonus, for example, or the fraudulent conveyance laws. The reason for this difference in result lies in the corresponding difference between their respective approaches to managing the legal impediment preventing the restitution of unfair enrichment.

As defined above, clawbacks address unfair enrichment that is otherwise justified or permitted under prevailing applicable law. Since such prevailing applicable law justifies or allows for the inequity at issue, any efforts to cure the inequity retroactively have to confront head-on the particular legal rights that maintained that inequity initially. Conversely, efforts to prevent the inequity prospectively avoid such potential confrontation to the extent that they remove or modify the nature of such rights from their inception. In this way, there is little or no legal impediment to begin with that would prevent the restitution of any unfair enrichment that exists.

For example, in the context of Ponzi schemes, while the retroactive clawback of fraudulent conveyance laws is in tension with the winning investor's contractual and restitutionary claim,²¹⁶ such tension is not present when employing prospective contractual clawbacks. If there is a prospective clawback provision in the original contract, the winning investor no longer has those contractual and restitutionary claims under specified unfair enrichment circumstances, because they were modified by the clawback provision in the investor agreement. Likewise, while we could try to implement retroactive clawbacks like the pending tax bill to attempt to recover bonus payments made to AIG executives, the tax bill is problematic because it must contend with existing contractual rights to such bonuses, not to mention overcoming the concomitant constitutional

²¹⁵ See Appendix A, *infra*.

²¹⁶ See *supra* Part II(A).

rights.²¹⁷ In contrast, introducing prospective clawbacks will mean that such contractual rights are modified automatically under the specified circumstances of unfair enrichment to allow for the recovery of the unfair restitution as represented by the bonuses.²¹⁸

Thus, the very nature of clawbacks indicates that prospective rather than retroactive clawbacks will in general prove to be the more effective tool for addressing the unfair enrichment at issue. So far, this section has concentrated on defining the term “clawback,” and arguing that prospective clawbacks will be a far more effective way of addressing the various unfair enrichment concerns that arise in executive compensation and Ponzi schemes. We turn in the next section to a slightly different question — what impact would clawback provisions have on other concepts within contract law doctrine?

C. Implications of Clawbacks for Contract Doctrine

1. Reconciling the Doctrine

Clawback provisions could be categorized in varying ways within existing contract doctrine. One such “doctrinal home” for clawbacks would be the realm of conditions. Under the definition in the Restatement (Second) of Contracts, a condition only refers to a contract that already exists. Further, the Restatement (Second) limits a condition to an event that must occur before a duty of performance arises.²¹⁹ However, prior common law tradition did recognize “an event that extinguishes a duty that has already arisen,” in the form of what was known as a condition subsequent.²²⁰ While the Restatement (Second) has eliminated conditions subsequent as they are considered “unusual,” and refers only to “conditions,” this terminology and analytical framework may be useful for our present purposes.²²¹

To illustrate how a clawback provision could be categorized as a condition subsequent, consider an example from the executive compensation context. A hypothetical contract between the corporation and the executive might provide a certain level of bonus. The obligation to pay out the bonus to the employee would be conditioned on the company’s stock price reaching a particular level. Reaching that performance goal would therefore be a condition precedent to payment of the bonus or grant

²¹⁷ See *supra* note 73, and accompanying text.

²¹⁸ *Id.*

²¹⁹ E. ALLEN FARNSWORTH, *CONTRACTS* 523 (3rd ed. 1999).

²²⁰ *Id.*

²²¹ *Id.* Although the *Restatement (Second) of Contracts* has moved away from distinguishing a condition precedent and condition subsequent, it would appear that the distinction may have some vitality for our current purposes. See *RESTATEMENT (SECOND) OF CONTRACTS*, § 230 & § 224, Reporters’ Note.

of stock. Once that performance goal has been reached, a legal obligation to pay the bonus attaches. However, let us also assume that the original contract additionally included a clawback provision that is triggered in the event that the financial benchmarks were later found to have been reached through fraudulent accounting, in the form of a material restatement of financial results.²²² Such a clawback provision would then operate as a condition subsequent. Even though the legal duty to pay the bonus had technically arisen when the stock price was reached, it would be extinguished by the “trigger” to the clawback, which would be the restatement of financial results.

Another way to think about the role of clawback provisions within contract doctrine would be to see them as a form of stipulated damages. Parties may agree in advance to an amount of money payable in the event of breach of contract. In essence, this allows the parties to re-write the default rules for contract damages by prior agreement. An important limitation on stipulated damages, however, is that they cannot be so large that they have an *in terrorem* effect, lest they be classified as a penalty.²²³ If a clause is “condemned as a penalty,” a court will hold that the provision is unenforceable.²²⁴

One way this view of clawbacks as stipulated damages might play out can be illustrated by the example of a contractual clawback provision that is triggered in the event that an executive engages in misconduct.²²⁵ Let us assume in this instance that performance benchmarks are met, and the bonus is paid to the employee. Unfortunately in prior weeks, the executive had “invested” millions of dollars gambling the company’s money away in Las Vegas, a result that would doubtless be deemed “misconduct.” At that point, the misconduct creates a breach and requires activation of the clawback provision to recover the bonus that had been paid. In this example, the stipulated damages amount is the amount of the bonus.²²⁶ If this result is too harsh or draconian, it may be challenged and held unenforceable, in the same way that a penalty clause might be challenged and invalidated under the standard doctrinal dichotomy of liquidated damages versus penalties.

²²² See *infra* Appendix A (categorizing various clawback in executive compensation contracts based on triggering events, one of which might be material restatement of financial results).

²²³ FARNSWORTH, *supra* note 219 at 841-3.

²²⁴ *Id.* at 843.

²²⁵ See *infra* Appendix A (categorizing various clawback in executive compensation contracts based on triggering events, one of which might be material restatement of financial results).

²²⁶ Of course, one could argue that the company could turn around and sue its agent for fraud, and that if the company was unwilling to do so, a shareholder could bring a derivative action to force the company to act. However, bringing a tort action, especially one for fraud (requiring a pleading with particularity) and scienter, is more difficult to bring than a straight contract claim.

Ultimately, clawback provisions could have an effect on many of the other significant doctrinal areas that concern the allocation of risk within contracts. Some of the more salient areas that might be affected would be conditions more generally, as well as defenses, including mistake,²²⁷ impracticability, and frustration of purpose, the application of which would all depend on notions of allocation of the risk.

2. Relational Contract Theory and Executive Compensation

Clawback provisions may also impact contract doctrine on a more theoretical level. Such provisions in the context of executive compensation lend support to the relational contract theory as opposed to, say, the classical model of contracting. The classical model of contracting views the behavior of contracting as involving a series of discrete contracts between rational actors in a competitive marketplace who employ contracts as a way to allocate risks. Under this model, the contract may specify which party bears the risk of the occurrence (or non-occurrence) of particular events, and sophisticated parties bargain in order to place a risk upon that party that is the least-cost avoider.²²⁸

In contrast, relational theory, as described by Professors Ian MacNeil²²⁹ and Stewart Macaulay²³⁰ seeks to put the contracting parties' interactions into a larger social context. Instead of seeing contracts as one-off discrete transactions, relational theory describes patterns of reciprocal behavior, often over a period of years, between repeat players.²³¹

Clawback provisions in executive compensation contracts, through their very structure, rule out the possibility of a short-term relationship. Because certain events that could occur at time in the future may trigger the reclamation of the benefit conferred, a contract with a clawback provision by its nature cannot be a one-off transaction.²³² A contract with a clawback term serves to link the parties to each other and to incentivize executives to

²²⁷ RESTATEMENT (SECOND) OF CONTRACTS § 154 (1981).

²²⁸ For a thorough treatment of the classical model of contract, as well as other theoretical perspectives on contracts, see Kojo Yelapaala, *Legal Consciousness and Contractual Obligations*, 39 MCGEORGE L. REV. 193, 209-13 (2008).

²²⁹ See, e.g. Ian R. MacNeil, *Relational Contract Theory: Challenges and Queries*, 94 NW. U. L. REV. 877, 881 (2000); Ian R. MacNeil, *Relational Contract: What We Do and Do Not Know*, 1985 WIS. L. REV. 483 (1985).

²³⁰ See, e.g., Stewart Macaulay, *Relational Contracts Floating on a Sea of Custom? Thoughts About the Ideas of Ian MacNeil and Lisa Bernstein*, 94 NW. U. L. REV. 775, 793 (2000).

²³¹ See, e.g., *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d 772 (9th Cir. 1981) (context important in long-term contractual relationship where parties in effect acted as partners); *Columbia Nitrogen Corp. v. Royster Co.*, 451 F.2d 3 (4th Cir. 1971) (context important in determining terms where Royster had been a purchaser and then became seller).

²³² Of course, one could argue that the actual performance period under a clawback is simply an extension of the original time period; and that in fact, the clawback is just one more way of extending the period for performance. However, as discussed in the portion on conditions subsequent, *supra* notes 219-222 and accompanying text, the fact is that most of these contracts contemplate a time period after one of the parties has already finished rendering their obligations under the agreement.

perform over longer periods of time.

From these questions of contract doctrine, we turn now to a final question, which is how these prospective clawback measures might be implemented. In addressing this question, the following section considers whether their adoption will be wholly voluntary or alternatively achieved with the assistance of the legislature, administrative agencies, or courts.

D. Bottom-Up or Top-Down Approaches to Clawbacks?

In the aftermath of the financial crisis, renewed calls for government regulation have already ensued. Professor Joseph Grundfest analogizes the process of lawmaking in the securities area as a reactive pattern that he likens to the evolutionary biology theory of punctuated equilibrium.²³³ In evolutionary biology, sudden and drastic changes take place in response to a “high pressure” event.²³⁴ Grundfest likens the Great Depression and the Enron failure to extreme events that forced securities law to evolve at a rapid pace.²³⁵ In the case of the Great Depression, the regulatory response to the stock market crash created our system of public reporting and disclosure. As a response to several massive accounting frauds, Congress passed the Sarbanes-Oxley Act, much of which directly responds to events at Enron.²³⁶

Certainly, the financial crisis of Fall 2008 is of such magnitude that one wonders whether a top-down regulatory solution is needed in order to prevent the vicissitudes of the financial cycle — both those gyrations that are irrationally exuberant as well as their converse, the inevitable troughs. At the same time, we should not fall into the trap of only regulating in response to scandal.²³⁷ Solutions and policy policies should be contemplated and analyzed *before* problems arise. Analysts have not had time yet to react to the financial crisis — or to think through fully any of its root causes. For now, it is enough to say that we are in more of a “reactive” position in responding to the financial crises in general, not just the current situation.

One alternative, which we have discussed throughout this Article, is to write clawback provisions directly into contracts on a prospective basis. As we have described extensively throughout this Article, attorneys for

²³³ Joseph Grundfest, *Punctuated Equilibria in the Evolution of United States Securities Regulation*, 8 STAN. J. L. BUS. & FIN. 1, 2 (2002).

²³⁴ *Id.*

²³⁵ *Id.*

²³⁶ *Id.*

²³⁷ Rosen, *supra* note 48, at 2910 (describing initial dialogue about propriety and desirability of regulating in response to scandal).

investors have been trying to cobble these types of clawback remedies together *retroactively* based on equitable principles. Obviously, it would be easier for attorneys to implement these types of remedies if they were clearly written *prospectively* into the investment contract, in the context of hedge funds, or if clawback provisions were clearly written into the contract between the corporation and the executive. This is more of a “bottom up” approach to reform,²³⁸ with incremental changes in individual contracts, which then generate a body of law surrounding clawback provisions, their substance, their interpretation, and their enforcement.

In contract law, specialized clauses like the clawback we discuss here serve important functions. The more a particular clause is used, the more likely it is to be included in “standard” boilerplate, and to have a body of doctrine and particular modes of judicial interpretation. One example would be the humble (yet heroic) “force majeure” clause, which allocates risk between the parties upon the instance of a catastrophic event.²³⁹ Major casebooks include a discussion of force majeure clauses, normally including them as part of their discussion of frustration of purpose or commercial impracticability.²⁴⁰ Other examples of such specialized provisions include merger and integration clauses (normally included in discussion of the parol evidence rule), indemnification clauses, and provisions relating to warranties. In all of these instances, the clauses acquire particular meanings as they become more commonplace and routine.

It may be that investors will begin demanding these types of protections independent of any regulation. On the other hand, we have seen all too frequently the principal-agent problem manifesting itself in the corporate context. The gap between the shareholders and the board of directors can, all too often, result in a lack of accountability for the board and the managers of the publicly traded company.²⁴¹ Between the public outcry over executive bonuses, and the motivation this proxy season to write clawbacks into executive compensation contracts going forward, it is entirely possible that there will be sufficient momentum present to solve the problem.

²³⁸ See generally Jeffrey J. Rachlinski, *Bottom-Up Versus Top-Down Lawmaking*, 73 U. CHI. L. REV. 933, 933 (2006) (“Democratic legal systems make law in one of two ways: by abstracting general principles from the decisions made in individual cases (from the bottom up); or by declaring general principles through a centralized authority that are to be applied in individual cases (from the top down)”); Frederick Schauer, *Do Cases Make Bad Law?*, 73 U. CHI. L. REV. 883, 891 (2006).

²³⁹ Often the performance of both parties will be called off under the force majeure clause if the event in question is triggered. See *Kama Rippa Music, Inc. v. Schekeryk*, 510 F.2d 837 (2d Cir. 1975) (interpreting force majeure clause).

²⁴⁰ See, e.g., E. ALLEN FARNSWORTH, ET AL., *supra* note 219, at 842-4.

²⁴¹ Calls for regulation are completely justified in the hedge funds, the failure of oversight, the failure of gatekeepers — attorneys and accountants — to spot the Madoff fraud is shocking and justifies reform. Similarly, the idea that former executives who took extreme — and perhaps unjustified risks — could profit while ordinary shareholders and taxpayers had to absorb massive losses — seemed offensive, and again, provide a justification for additional top-down regulation.

It is also possible that legislative or administrative action by the SEC is required in order to ensure the inclusion of clawbacks in executive compensation arrangements. This is not an unusual proposal; there are many laws (securities related and otherwise) that mandate particular disclosures, or specific language in a contract in order to comply with a statute. For example, mandatory disclosures are required in certain real estate transactions.²⁴² But one need not even stray that far from the corporate context in order to find such examples of mandatory disclosures. For example, in the sale of stock in a private placement, the contract for such sale must disclose particular limitations on resale of the securities, with particular legends informing the purchaser that the stock is restricted.²⁴³ At this point, these provisions are well-accepted, and indeed, expected in this context. With so many disclosures already part of the “landscape of contract” in the securities arena, mandating an additional set of prospective contract terms concerning clawback provisions is eminently achievable.

CONCLUSION

This Article has described, in detail, the use of contractual clawbacks in two different scenarios — executive compensation and Ponzi schemes. In both of these situations, we have analyzed the gap in the remedies currently available and remarked that the gap leads to a continuing problem of unfair enrichment. As we have described, writing clawbacks prospectively and directly into contracts can provide a ready avenue for recovery. In the context of executive compensation, it forces executives to align their interests with that of the long-term growth of the company. In the context of Ponzi schemes, clawbacks present an opportunity to equalize “winning” and “losing” investors. In tandem, these remedies provide an important way of prospectively changing the legal landscape to further the protection of shareholders and investors.

²⁴² 9 THOMPSON ON REAL PROPERTY § 78.08(b)(3) (David A. Thomas ed., 2nd ed. 1999) (California law mandating disclosures in real property as to condition of land, airport location, and public utilities).

²⁴³ Securities and Exchange Act, Rule 144A, 17 C.F.R. § 230.144A (2008).

APPENDIX A: CATEGORIES OF CLAWBACKS
IN EXECUTIVE COMPENSATION CONTRACTS

The following is a categorization of clawback provisions regarding executive compensation, which are triggered in the event of employee bad faith, misconduct or fraud, or a restatement of financial results. These exemplars of clawbacks have been culled from the filings of publicly-traded companies. Compensation arrangements are typically disclosed in a company's Compensation Discussion and Analysis (CDA), a portion of the company's definitive proxy statement (Form 14A-DEF), as filed with the Securities and Exchange Commission. While the content of a "clawback" may vary widely with the language of any particular contract, these categories seem to reflect the most common "triggering" events for recoupment. The first category, "bad faith," would likely be ineffectual, while the last category, which would allow for a clawback in the event of a material financial restatement, would probably have the most impact.

A. "Bad Faith" Conduct

1. McKesson Corp., Form DEF 14A, (June 23, 2008), at 32.

Clawback Policy. As described in the Company's standard award documentation, the Compensation Committee may seek to recoup any economic gains from equity grants from any employee who engages in conduct which is not in good faith and which disrupts, damages, impairs or interferes with the business, reputation or employees of the Company or its affiliates.

2. Ford Motor Corp., Form DEF 14A, (April 4, 2008), at 71-2.

The Plan has certain conditions which must be met prior to the distribution of any award in order for a participant to receive an award following termination of employment. These conditions include continuing employment with the Company or a subsidiary or, if termination was for a reason other than death, being available to consult and supply information to the Company. In addition, the participant must refrain from competitive activity, unless the Company approves the activity. A participant also may forfeit an award, including deferred amounts, for conduct contrary to the best interests of the Company.

*Cherry & Wong**B. Fraud or Misconduct*

1. General Motors Corp., Form DEF 14A (April 25, 2008), at 35.

In October 2006, the GM Board adopted and announced a policy regarding the recoupment of unearned compensation, applicable to incentive compensation paid to executive officers after January 1, 2007 and unvested portions of awards previously granted, in situations involving financial restatement due to employee fraud, negligence, or intentional misconduct. In conjunction with this, the Committee charter was modified to reflect the new policy and the revised charter and policy were published on GM's Web site. In addition, we added provisions to all executive incentive and deferred compensation plans to reference Board policies affecting compensation, and require that the compensation of all executives covered by this policy be subject to this recoupment clause.

2. American Express Co., Form DEF 14A, (March 14, 2008), at 32.

Policy Regarding Recoupment of Incentive Compensation. To protect the shareholders' interests, we have a policy pursuant to which we will, to the extent practicable, seek to recover performance-based compensation from any executive officer and certain other members of senior management in those circumstances where (i) the payment of such compensation was based on the achievement of financial results that were subsequently the subject of a restatement, (ii) in the Board's view the employee engaged in fraud or misconduct that caused or partially caused the need for the restatement, and (iii) a smaller or no payment would have been made to the employee based upon the restated financial results.

Detrimental Conduct. To help protect our competitive position, we have a "detrimental conduct" policy, covering approximately 540 executives (including the NEOs). Each covered executive is required to sign an agreement that requires him or her, among other provisions, to forfeit the pre-tax proceeds from some or all of his or her compensation received under the 1998 Plan and the 2007 Plan, including RSAs (and dividends paid), NQSOs, RSUs (and dividend equivalents paid), PGs awarded under either plan and, in the case of executive officers, all of his or her AIAs that were received up to two years prior to employment termination if he or she engages in conduct that is detrimental to the Company following employment termination. Detrimental conduct includes, for example, working for certain competitors, soliciting our customers or employees, or

disclosing our confidential information. The detrimental conduct policy is in addition to the obligations arising under our Code of Conduct.

C. Restatement of Financial Results

1. Cisco Systems, Inc., Form DEF 14A, (September 25, 2008), at 28.

Following the Compensation Committee's recommendation in March 2008, the Board of Directors adopted a recoupment policy for cash incentive awards paid to executive officers under Cisco's annual cash incentive plan, the EIP. In the event that there were a restatement of incorrect financial results, this policy would enable the Compensation Committee, if it determined appropriate and subject to applicable laws, to seek reimbursement of the incremental portion of EIP awards paid to executive officers in excess of the awards that would have been paid based on the restated financial results. Cisco's variable cash incentive and long-term, equity-based incentive award plans also generally provide for forfeiture if a named executive officer participates in activities detrimental to Cisco or is terminated for misconduct. Additionally, consistent with statutory requirements, including the Sarbanes-Oxley Act of 2002, and the principles of responsible oversight, and depending upon the specific facts and circumstances of each situation, the Compensation Committee would review all performance-based compensation where a restatement of financial results for a prior performance period could affect the factors determining payment of an incentive award.

2. Dell Inc., Form DEF 14A, (June 2, 2008), at 71-72.

Recoupment Policy for Performance Based Compensation. If Dell restates its reported financial results, the Board of Directors will review the bonus and other awards made to the executive officers based on financial results during the period subject to the restatement, and to the extent practicable, Dell will recover or cancel any such awards based on having met or exceeded performance targets that would not have been met under the restated financial results.

3. Exxon Mobile Corp., Form DEF 14A, (April 10, 2008), at 32.

Should the Corporation's reported financial or operating results be subject to a material negative restatement within five years, the Board would seek to obtain from each executive officer an amount corresponding to any incentive award or portion thereof that the Board determines would not

Cherry & Wong

have been granted or paid had the Corporation's results as originally reported been equal to the Corporation's results as subsequently restated.