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Executive Compensation

Why Executive Compensation Clawbacks Don't Work

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Summary. Clawback provisions are a common feature in executive compensation packages. They are intended to deter executives from boosting their incentive compensation entitlements by taking decisions that could impose legal or reputational costs on the company. But if executives cash in their compensation and then leave the company clawbacks can be almost impossible to enforce. Requiring incentive compensation for executives to be made in restricted stock or option grants whereby the compensation can only be cashed out six to 12 months after the executive has left the company will leave the company in a better position to recover compensation if it needs to. **close**

The executive pay "clawback," an idea that had its debut during the discussion around the passage of the Sarbanes-Oxley Act in 2002, has become an increasingly common provision in executive compensation packages. In theory, clawback policies enable companies to recover incentive pay granted to executives for achieving financial performance targets on the basis of decisions and actions that subsequently turn out to be ethically and legally questionable, and which impose significant monetary and reputational liabilities on the company.

Actually applying the provision turns out to be challenging. In October last year, for example, Goldman Sachs announced that it would use clawbacks to recover $174 million from current and former executives following the Board's approval of a $2.9 billion settlement of claims in respect of its role in the Malaysian 1MDB scandal in 2012-13. Goldman has recovered some of this money through deductions from the 2020 compensation of executives still serving. But others had already cashed in rewards for their decisions related to 1MDB and left the firm, such as former Goldman president Gary Cohn, and so far they have failed to return the money.

There is probably little that Goldman can do about this, though it will no doubt be following with interest the progress of McDonald's attempts to recover through the courts $40 million from former CEO Stephen Easterbrook.

There are two simple reasons for this. First, the legal requirement for recovering monies already paid to an executive typically involve the notion of "cause" — unless convicted of a crime, an executive will argue the company has no legal right to reclaim the cash. Second, and just as important, once the money is out the door, the burden is on the party without the cash to get it back. And, in many circumstances, the money may be spent and basically unrecoverable.

But the fact that the clawback has been largely ineffective thus far does not mean that it cannot be forged into a more useful tool.

As a solution, we propose that the incentive compensation of corporate executives should consist only of restricted equity (restricted stock and restricted stock options) — restricted in the sense that the individual cannot sell the shares or exercise the options for six to 12 months after their last day in office. This would prevent executives from capturing the financial gains from questionable decisions or actions before the longer-term costs of those decisions or actions became apparent. And from the company's perspective, it is clearly easier to simply withhold the stock or options than to attempt to recover cash paid out. Of course, an aggrieved executive can still sue the company, but then the burden would be on the plaintiff to prove their case.

Of course, our proposal imposes some costs. To begin with, if executives are required to hold restricted shares and options, their savings would most likely be under-diversified, with a resulting decrease in their risk-adjusted expected return. In addition, if executives are required to hold restricted shares and options post-retirement, they may be concerned with lack of liquidity.

To address these concerns, we recommend the amounts of equity awarded under our proposal should be increased slightly from current levels in order to bring the risk-adjusted expected return back up. Additionally, managers should be allowed to liquidate, on board approval, a modest and minimal fraction of their awarded incentive restricted shares and options.

It can be argued that incentive schemes along the lines proposed here would encourage young executives to leave companies after a period of good stock performance in order to lock in the gains to their incentive schemes. But any such temptation is likely to be offset by concerns that executives who develop a reputation for early departures from firms will soon find they have fewer high-quality career opportunities.

It is critical to good governance that companies be able to recover compensation from senior executives that has not been fairly and fully earned. What we propose here will enable the clawback provision to live up to its potential.

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