The Business Case for Clawbacks

By Kathryn Neel, Seymour Burchman, and Olivia Voorhis

In the world of corporate governance, a string of recent corporate scandals has highlighted the criticality of effective risk management and the potential financial and reputational harm that can result from inappropriate actions or ineffective oversight (see Figure 1).

The executives of these companies received large pay packages for their stewardship and leadership, largely provided in the form of performance-based compensation under the mantra of "pay for performance."

This raises two questions:

• What should happen if pay is delivered for performance that collapses after the payout is made, and the collapse was a consequence of actions taken when pay was earned?

• Under what conditions is it appropriate to enact a clawback, essentially a reclaiming, of incentive pay, or the cessation or recoupment of severance, and how should it work?

In response to the 2008 financial crisis, the 2010 Dodd-Frank Act tried to address these questions by requiring the recovery of incentive-based compensation when a company must restate its previously issued financial statements due to a material error. However, with two recent Wells Fargo and Equifax scandals the proposed regulations would not have applied, and yet the companies incurred major damage through reputational harm, fines and/or legal settlements.

Accordingly, a strong business case often exists for thinking about clawbacks more broadly than regulators require. This case is derived from the typical objectives for clawback policies: protecting company and shareholder interests in the event of significant damage to the company, avoiding bad optics for the company and the board, and reducing potential motivation for inappropriate actions or decisions by reducing financial gain to be realized by executives.

Many companies already maintain clawback policies that go beyond financial re-statements to cover detrimental conduct more broadly, particularly in industries where the potential for reputational or economic harm is high, such as financial services.

Figure 2 provides four examples of detrimental conduct policies. Some of the triggering factors not found in the typical clawback policy include general fraud or misconduct, gross negligence (even in a supervisory role), and "seriously poor judgement" if the company suffers extraordinary damage.

Accountability in these companies goes beyond intentional actions/decisions to encompass other failures, so that their clawback policies support a broader approach to risk management.

From these examples, and others, arise a set of guiding principles for framing clawbacks:

• Being fair, but also ensuring accountability.

• Penalizing actions/decisions that result in material harm to a company's stakeholders (shareholders, customers, suppliers, employees, or the community) which involve one or more of the following:

- Misconduct, or violation of the company's policies.
- Executive negligence or demonstrated poor judgment or leadership (willful or otherwise).
- Covering up harm that was done, even if poor judgment was not involved in the initial decision or action.

• Having an explicit set of rules governing the use of discretion, given that discretion is invariably required.

How and when should a company evaluate whether its current policy is appropriate or should be expanded? The best way may be in conjunction with a company's annual review of material risks.

In addition to identifying the potential scenarios and major enterprise risks that would seriously harm the company, the board should

Figure 1.

Company	Event	Stock Response[1]	CEO Pay[2]	CEO Response	Direct Costs	Loss in Market Cap[3]
Equifax	2017 breach of over 145 million consumers' personal data	-35% over 1 week	$15.0 million in 2016	CEO stepped down, losing 2017 bonus and severance pay	$87.5 million in Q3 2017[4], with over 240 pending class-action lawsuits and 60 governmental inquiries	-$6.0 billion
Wells Fargo	2016 creation of millions of fraudulent customer accounts	-10% over 2 weeks	$107.5 million between 2011-2016	CEO stepped down and had $69 million forfeited or clawed back[5]	$3.5 billion[6]	Initial $31.6 billion loss; additional $29 billion loss in 2018 after Federal asset cap[7]
Volkswagen	2015 emissions standard scandal; led to millions of recalls, criminal charges against 6 US executives[8]	-39% over 3 weeks	$21.1 million in 2014[9]	Both German CEO and US-subsidiary head stepped down	$30 billion[10]	-$25 billion[11]
GM	2014 faulty ignition switches: recalled 30 million cars, reportedly caused 124 deaths[11]	-12% over 2 months	~$86 million between 2004-2013	CEO retired a month before the scandal broke	Over $5.3 billion[13]	-$6.6 billion

1. Stock prices from Google Finance
2. CEO Pay reflects Total Compensation as reported to the SEC
3. Unless otherwise noted, market cap figures are pulled from FactSet, and represent the loss between the date of the scandal's public announcement and the lowest point of the ensuing price drop
4. "Equifax profits plunge amid breach fallout" (*BBC News*, Nov 10, 2017)
5. "Wells Fargo Board Claws Back $28 Million More from Ex-CEO" (*Bloomberg*, Apr 10, 2017)
6. Includes $190M legal settlement in Sep 2016, and $3.25 billion reserve set aside in Q4 2017 earnings for scandal-related litigation: "Wells Fargo sees no end yet to sales scandal costs, gets tax boost" (*Reuters*, Jan 12, 2018)
7. "Fed Rebuke Costs Wells Fargo About $29 Billion in Lost Market Value" (*The Wall Street Journal*, Feb 5, 2018)
8. "Six VW executives indicted on charges linked to automaker's emissions scandal" (*The LA Times*, Jan 12, 2017)
9. 2014 total pay was €15.9 million, as per Volkswagen's 2014 Annual Report, converted to dollars using 2014 average exchange rate of 1.33
10. "Volkswagen's diesel scandal costs hit $30 billion" (*CNN*, Sep 29, 2017)
11. "Billions wiped off Volkswagen shares by emissions cheating scandal" (*Fortune*, Sep 21, 2015)
12. "Death toll for GM ignition switch: 124" (*CNN*, Dec 10, 2015)
13. "General Motors overcomes huge recall costs to post healthy profit" (*The LA Times*, Oct 21, 2015)

determine whether it would be appropriate to expand compensation policies to allow for clawbacks in situations such as a significant product recall, product malfunction, or data breach.

Broad clawbacks can play a crucial role in sound corporate governance. When coupled with strong leadership, the right culture, strong risk management processes, and effective oversight, they can help deter inappropriate actions and decisions that can cause considerable harm to a company and its key stakeholders. Regardless of government policy, there is indeed a strong business case for a comprehensive clawback policy. ■

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Figure 2.

Company	Policy	Covered Compensation
Cognizant Technology Solutions	• Illegal or improper conduct resulting in significant financial or reputational harm • Knowing of, and failing to report to the board, such conduct • Gross supervisory negligence which allows such conduct	Incentive compensation
Wells Fargo	• Misconduct or commission of a material error that has, or might reasonably be expected to cause reputational, financial or other harm • Improper or grossly negligent failure, including in a supervisory capacity, to identify, escalate, monitor or manage material risks • A material downturn in financial performance or material failure of risk management	Equity awards
Zions Bancorp	• Illegal or improper conduct, gross negligence, or seriously poor judgement resulting in extraordinary financial loss or reputational damage	Incentive compensation
eBay	• Material violation of company code of conduct • Action or omission resulting in material financial or reputational harm • For SVP or higher: supervisory failure resulting in financial restatement	Incentive compensation