

## EQUITABLE CLAWBACK: AN ESSAY ON RESTORATION OF EXECUTIVE COMPENSATION

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### I. INTRODUCTION

In the current global recession, resulting in part from managerial failures to fulfill fiduciary responsibilities at many of the world's largest financial institutions, a popular fervor has emerged leading to demands that officers at these companies return their bonuses to their respective corporate treasuries. To be sure, many of the more recent demands have not necessarily been based on alleged breaches of fiduciary duties owed by those officers and their companies' boards of directors, but rather on the understandable outrage of using federal bail-out funds to award the very officers who managed these failed or failing businesses.<sup>1</sup> This is not to say, however, that these officers, as leaders of their respective companies, sufficiently fulfilled their fiduciary duties of care, loyalty, good faith, and disclosure in accordance with applicable standards. Given the rapid implosion of many of these companies, probabilities certainly suggest fiduciary failure.

Following Enron's collapse in 2001, a similar populist hue and cry led Congress to enact so-called *clawback provisions* as some of its Sarbanes-Oxley Act reforms.<sup>2</sup> These provisions require certain corporate officers, namely chief executive and chief financial officers, to return bonuses and related performance-based compensation but not base salaries in the event

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1. See, e.g., Randall Smith & Liam Plevin, *Some Will Pay Back AIG Bonuses*, WALL ST. J., Mar. 19, 2009, at A1 (reporting on public protests demanding that AIG employees return retention bonuses).

2. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745, 778 (2003) (codified at 15 U.S.C. § 7243 (2005)).

their misconduct has caused subsequent restatements of their corporate employers' financial results.<sup>3</sup> However, the statute did not expressly provide any private remedy to corporate employers or shareholders, and the courts thus far have refused to imply one.<sup>4</sup> Although not required by the Sarbanes-Oxley Act, Securities and Exchange Commission (SEC) rules or exchange listing standards, many publicly held corporations have voluntarily adopted clawback provisions as part of their executive compensation policies, enabling those companies to recover performance-based compensation to the extent their boards later determine that the performance goals were not actually met, whether due to restatements of financial results or other causes.<sup>5</sup> However, these corporate clawback provisions generally do not cover all executive officers' base salaries, retirement agreements, or other non-performance-based compensation, and are not necessarily triggered by any prior breach of the covered officer's fiduciary duties.

Fortunately, the common law of fiduciary duty applicable to all corporate officers as agents and the equitable remedies that arise from its breach have long provided a remedy that might be appropriately termed *equitable clawback*. This restitutionary remedy, like others based on principles of unjust enrichment, is generally referred to as *restoration* of compensation or *forfeiture* of compensation, terms often used interchangeably. In the agency context, the principles underlying this remedy are generally referred to collectively as the *faithless servant doctrine*. The doctrine establishes a mandate that an agent who engages in activities that breach his fiduciary duties to his principal is not entitled to and must forfeit any compensation for services rendered during the period of his breach even though part of those services may have been properly

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3. *Id.* See generally John P. Kelsh, *Section 304 of the Sarbanes-Oxley Act of 2002: The Case for a Personal Culpability Requirement*, 59 BUS. LAW. 1005, 1010 (2004) (contending that "section 304 should not be interpreted to impose liability in the absence of a finding that the defendant is liable" but "should rather be interpreted as a remedy provision, providing a clear statutory basis for disgorgement of benefits"); Rachael Schwartz, *The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean*, 64 BUS. LAW. 1, 3 (2008) (arguing that a requirement that "the officer from whom a clawback is sought to have personally engaged in the misconduct that led to the restatement" should not be read into section 304 of the Sarbanes-Oxley Act).

4. See, e.g., *Kogan v. Robinson*, 432 F. Supp. 2d 1075, 1082 (S.D. Cal. 2006) (holding that "[i]n light of the text and structure of Section 304 and the Sarbanes-Oxley Act, this Court declines to imply a private right of action" to seek reimbursement from officers for bonuses); *Neer v. Pelino*, 389 F. Supp. 2d 648, 657 (E.D. Pa. 2005) (holding that Section 304 does not imply a private right to seek disgorgement of bonuses from corporate officers).

5. See, e.g., *Compensation Experts See Momentum, Challenges with Including Clawback Provisions in Corporate Policies*, Corporate Counsel Weekly (BNA) No. 36, at 288 (Sept. 21, 2005) (discussing the various ways that boards of directors and compensation committees can approach implementation of clawback provisions).

performed.<sup>6</sup> In other words, the agent's failure to satisfy fiduciary obligations that supplement and relate to the scope of his contractual obligations generally precludes even a *quantum meruit* recovery against his employer.<sup>7</sup> This remedy was not developed to simply compensate the injured beneficiary for its losses, but to provide recovery of all ill-gotten gains of the breaching fiduciary as well as his salary and other compensation after the breach. Like all other fiduciary remedies, the equitable clawback remedy was developed to serve a prophylactic function, deterring fiducial misbehavior through the imposition of a risk of forfeiture that could far exceed the proceeds, if any, derived from the fiduciary's misconduct.

Unfortunately, the restoration of compensation remedy has not been fully utilized, at least not in shareholder derivative and other class actions. Both plaintiffs and defendants have typically settled breach of fiduciary duty and related fraud claims against the corporate agent's enterprise, the corporate principal, rather than the individual agents who actually committed the underlying breach, acting alone or in concert with their colleagues. Settlements of these claims have been generally funded by the defendant corporation and by directors' and officers' liability insurance coverage, the premiums on these policies having been paid by the corporation. In addition, the SEC and other federal agencies have generally imposed financial sanctions on the offending corporation and not its individual wrongdoers. Consequently, the shareholder-owners of the corporate principal suffer not only from the breaches of the corporate agents' fiduciary duties, but also from damages and penalties related to those breaches. This accomplishes what one distinguished scholar has

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6. See, e.g., *Enstar Group, Inc. v. Grassgreen*, 812 F. Supp. 1562, 1570 (M.D. Ala. 1993) (noting the role of corporate directors under Alabama's laws). After reiterating the fiduciary duties of corporate officers and directors, the court restated the doctrine under Alabama law:

[A] corporate officer is not entitled to compensation for services during a period in which that officer engages in activities constituting a breach of the officer's duty of loyalty to the corporation. Accordingly, an officer who is found to have engaged in such conduct may be required to forfeit all compensation which he received during such time, including salary and bonuses.

*Id.* at 1571. The court then held that the defendant, who had misappropriated commitment fees in directing the company's investments, was required to forfeit all compensation received from the time of his initial disloyal act through the time of his forced resignation, an amount in excess of \$5,000,000. *Id.* at 1575. In addition, the court upheld a punitive damages award of \$10,000,000, reducing a larger amount previously awarded by the jury. *Id.* at 1582.

7. See, e.g., *Blackburn & Co. v. Park*, 357 F.2d 525, 527 (2d Cir. 1966) (holding that there can be no recovery in *quantum meruit* for an agent who has breached fiduciary duties owed to the principal).

referred to as “double victimization.”<sup>8</sup> Notwithstanding the continual debate over whether individual liability should be accorded primacy over entity liability in private and public enforcement actions,<sup>9</sup> the restoration of compensation remedy has often been overlooked as a viable method to achieve payment of damages directly from the individual duty-breaking agent to his employer-victim.

This essay briefly addresses the equitable remedy of restoration of compensation paid by corporate principals to officers and other agents who have breached their fiduciary duties. It does not focus directly on issues of *excessive* compensation even though the actions taken to award or accept that excess may separately constitute a breach of fiduciary duty.<sup>10</sup> Moreover, this essay will not directly assess the issue of fraud in the inducement of employment, retirement and other agreements that contain various compensation provisions.<sup>11</sup> Instead, this essay is intended to

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8. Donald C. Langevoort, *On Leaving Corporate Executives “Naked, Homeless and Without Wheels”*: Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability, 42 WAKE FOREST L. REV. 627, 632 (2007).

9. See, e.g., Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1489 (1996) (arguing that instead of class-based damage awards, “a regulatory sanction—in effect, a schedule of civil penalties enforceable by private litigation—would provide superior deterrence at a lower cost for claims involving publicly traded securities”); Jennifer Arlen & William Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 694 (1992) (finding that “agent liability probably achieves superior deterrence” compared to enterprise liability in cases of Fraud on the Market); John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1585 (2006) (advocating eliminating the corporation as a defendant in order to “force the true adversaries—plaintiffs’ attorneys and individual corporate defendants—to litigate for real”).

10. In a recent analysis of “executive overcompensation” at publicly held companies, Judge Richard Posner, recognizing the problem to be more serious than he had previously believed, concluded that neither boards of directors nor competition in the corporations’ product markets have been effective in constraining managerial greed. Richard A. Posner, *Are American CEOs Overpaid, and, If So, What If Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1013 (2009). Judge Posner, while defending efficient market theory as having “substantial explanatory value,” acknowledges the “profound . . . implications” of behavioral finance on executive overcompensation issues. *Id.* at 1036. See generally LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004) (examining the dynamics between corporate directors and managers, and the resultant problematic effects on executive compensation). Obviously, the debate over excessive compensation is far from over. See, e.g., Jenny Anderson, *Goldman Sachs Alters Its Bonus Policy to Quell Uproar*, N.Y. TIMES, Dec. 10, 2009, at B1 (noting the company’s decision to pay executive bonuses in stock, rather than cash); Graham Bowley and Eric Dash, *Goldman Chief’s \$9 Million Bonus Seen by Some as Show of Restraint*, N.Y. TIMES, Feb. 6, 2010, at B1 (reporting that the CEO’s bonus was relatively modest compared to CEO bonuses at other banking companies); Ben Casselman, *Chesapeake Holders Denounce CEO’s Pay*, WALL ST. J., Apr. 28, 2009, at B1 (reporting that the Chief Executive of Chesapeake Energy Corporation was paid \$112 million in 2008 “even as the company’s stock price tumbled”).

11. See, e.g., *Wal-Mart Stores, Inc. v. Coughlin*, 255 S.W.3d 424, 426 (Ark. 2007)

explore and clarify the traditional restoration of compensation remedy, permitting employer-beneficiaries to claw back compensation paid or otherwise payable to their employee-fiduciaries during periods of time when those employee-fiduciaries were acting in breach of their fiduciary duties. The essay concludes that the continued use of this remedy will constructively advance the laudable, although often elusive, goals of compensation and deterrence, strengthening the link between executive wealth and executive responsibility.

## II. THE TRADITIONAL CLAWBACK REMEDY: A SWORD AND A SHIELD

The restoration of compensation remedy (which, as previously noted, could be termed *equitable clawback*) arises from a breach of the fiduciary duty of loyalty owed by all fiduciaries to their beneficiaries.<sup>12</sup>

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(reporting that Wal-Mart entered into a retirement agreement, which included a general release of claims known and unknown, under which agreement its executive vice president, Thomas Coughlin, was to receive millions of dollars in retirement and other benefits). Subsequently, Wal-Mart learned that Coughlin had conspired with subordinates to misappropriate Wal-Mart assets through various fraudulent schemes, and, the company decided to suspend payment of Coughlin's retirement benefits. The court concluded that Coughlin's failure, as a fiduciary, to disclose his misconduct, could void both the retirement agreement and the general release. *Id.* at 430-31. Wal-Mart subsequently settled this litigation, reducing its potential payout to Coughlin by over \$10 million. *See Roehm v. Wal-Mart Stores, Inc.*, No. 07-10168, 2007 WL 1650701, at \*1 (E.D. Mich. June 4, 2007) and related pleadings (noting that after discharging its chief marketing officer for breach of fiduciary duties—including an alleged affair with a subordinate—Wal-Mart terminated the executive's salary, restricted stock options, and other equity compensation, which prompted Roehm to bring an action to recover these benefits that was ultimately dismissed under a choice of forum clause in the employment contract mandating suit in Arkansas courts); Form 8-K, Wal-Mart Stores, Inc., Aug. 21, 2008 (noting Coughlin initially sought \$17 million and Wal-Mart settled for \$6.75 million); Matthew Malone, *Fired Wal-Mart Ad Executive Loses Round in Michigan*, PORTFOLIO.COM, Aug. 22, 2007, <http://www.portfolio.com/views/blogs/daily-brief/2007/08/22/fired-wal-mart-ad-executive-loses-round-in-michigan/> (discussing the *Roehm* proceedings); *see also* Hadden v. Consolidated Edison Co., 382 N.E.2d 1136, 1139 (N.Y. 1978) (holding that an executive's misrepresentation voided the corporation's waiver of the right to discharge the executive before he retired on a pension). Recently, the Delaware Chancery Court, in *Xu Hong Bin v. Heckman Corp.*, cited *Coughlin*, as a restatement of the majority rule that "a fiduciary owes a duty of full disclosure when entering into a transaction with the fiduciary's corporation and . . . the fiduciary's failure to disclose material facts relating to a mutual release of claims between the parties is sufficient to set aside the release." *Xu Hong Bin v. Heckman Corp.*, No. 4637-CC, 2009 WL 3440004, at \*7 (Del. Ch. Oct. 26, 2009) (citing *Coughlin*, 255 S.W.3d at 429). The *Xu Hong Bin* court also noted the established exception to this rule where the general release is negotiated amid suspicions or allegations of fraud or other misconduct, in which case the accused fiduciary would not have a fiduciary duty to disclose his wrongful acts before executing the release. *Id.* (citing *Alleghany Corp. v. Kirby*, 333 F.2d 327, 333 (2d Cir. 1964)).

12. *See generally* *Pepper v. Litton*, 308 U.S. 295, 307-10 (1939) (authorizing equitable remedies to prevent or repair harms caused by an executive's breach of fiduciary duty);

The remedy also is clearly available for a breach of the fiduciary duty of good faith,<sup>13</sup> which may be subsumed by the duty of loyalty,<sup>14</sup> a breach of the fiduciary duty of disclosure,<sup>15</sup> and for a willful breach of an employment contract.<sup>16</sup> Recently, the remedy was invoked by an accounting firm against one of its senior accountants for insider trading in the securities of the firm's corporate clients.<sup>17</sup> However, the clawback remedy generally may not be invoked for a fiduciary's breach of the duty of care, including errors of judgment and other activities that do not rise to the level of gross or wanton misconduct.<sup>18</sup> The remedy is available where

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Meinhard v. Salmon, 164 N.E. 545, 548-49 (N.Y. 1928) (providing equitable remedies for a partner's breach of fiduciary duty); Globe Woolen Co. v. Utica Gas & Electric Co., 121 N.E. 378, 379-80 (N.Y. 1918) (applying fiduciary duty principles to dealings between trustees and beneficiaries). The duty of loyalty generally prohibits self-dealing, and, consequently, restrains agents and other fiduciaries from taking opportunities that rightfully belong to their principals, from engaging in competition with their principals, and from misappropriating or exploiting for their personal use the assets, including information, of their principals. See Hunter v. Shell Oil Co., 198 F.2d 485, 488-89 (5th Cir. 1952) (discussing exploitation of the principal's information); Banks v. Bryant, 497 So. 2d 460, 463 (Ala. 1986) (involving usurpation of corporate opportunities); Steelvest Inc. v. Scansteel Service Ctr., Inc., 807 S.W.2d 476, 483 (Ky. 1991) (exploring competition with one's principal). Indeed, an agent's misappropriation of his principal's confidential information has become integral to enforcement of federal insider trading prohibitions. See U.S. v. O'Hagan, 521 U.S. 642, 651-52 (1997) (holding that misappropriation can give rise to federal criminal liability).

13. See, e.g., Neely v. Wilmore, 187 S.W. 637, 638 (Ark. 1916) (barring an agent from recovering compensation if the agent is found guilty of fraud, dishonesty or unfaithfulness in connection with his agency); Lamdin v. Broadway Surface Advertising Corp., 5 N.E.2d 66, 67 (N.Y. 1936) (finding that an agent who proves disloyal to his principal may forfeit the right to compensation).

14. See Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (finding that the duty to act in good faith is a condition of the fundamental duty of loyalty).

15. See, e.g., Usaco Coal Co. v. Carbomin Energy, Inc., 85 F.3d 630, 630 (6th Cir. 1996) (affirming the grant of a preliminary injunction intended to prevent defendants from concealing assets during the pendency of the litigation); Lawson v. Baltimore Paint and Chemical Corp., 347 F. Supp. 967, 977 (D. Md. 1972) (declaring that Maryland law provides for denial of compensation if an agent breaches his fiduciary duty by way of fraudulent concealment); Craig v. Parsons, 161 P. 1117, 1118 (N.M. 1916) (holding that a real estate broker who fraudulently represents the price of a parcel of land is liable for the commission received from the transaction).

16. See, e.g., Breen v. Larson College, 75 A.2d 39, 42 (Conn. 1950) (finding that radical unfaithfulness or gross misconduct on the part of a servant in contract can result in forfeiture of all compensation rights); see also *infra* notes 30 and 34 and accompanying text.

17. Deloitte LLP v. Flanagan, C.A. No. 4125-VCN, 2009 WL 5200657, at \*7 (Del. Ch. Dec. 29, 2009).

18. See, e.g., Baldwin v. Prince, 578 S.W.2d 240, 243 (Ark. 1979) (noting that a breach of agency contract, absent willfulness, is insufficient grounds for forfeiture of compensation); Rochester v. Levering, 4 N.E. 203, 210 (Ind. 1886) (holding that absent gross neglect or disregard of duty, mere errors of judgments are insufficient to invoke the restoration remedy); Nutrition Found., Inc. v. Gitzen, 403 N.Y.S.2d 748, 749 (N.Y. App. Div. 1978) (explaining that negligence does not establish a duty of repayment absent fraud

the agent's performance does rise to the level of gross negligence or has otherwise been so unskillful that it has no value or results in absolute loss to the principal.<sup>19</sup> Certainly, in the agency context, the vast majority of the cases reviewed have arisen from a breach of the duty of loyalty. Termed the *general fiduciary principle*, Section 8.01 of the American Law Institute's Restatement (Third) of Agency states that "[a]n agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship."<sup>20</sup> The Reporter's Comment states that this "general fiduciary principle requires that the agent subordinate the agent's interests to those of the principal and place the principal's interests first as to matters connected with the agency relationship."<sup>21</sup> The Comment further states that this fiduciary principle is deemed to *supplement* all directions given to the agent, thus obviating any requirement that the principal provide the agent with any explicit qualifications or prohibitions.<sup>22</sup> The agent's liability to the principal for breach of this fiduciary duty of loyalty stems from principles of restitution and unjust enrichment from the agent's duty to account to the principal and from general tort law.<sup>23</sup> The Reporter's Comment subsequently sets forth and briefly discusses, under remedies for breach of fiduciary duty, the remedy of restoration or forfeiture of compensation:

An agent's breach of fiduciary duty is a basis on which the agent may be required to forfeit commissions and other compensation paid or payable to the agent during the period of the agent's disloyalty. The availability of forfeiture is not limited to its use as a defense to an agent's claim for compensation.<sup>24</sup>

In application, courts in a vast majority of jurisdictions have generally afforded restoration or forfeiture of compensation both as an affirmative remedy to recover compensation previously paid to an agent and as a defense to an agent's claim for compensation not yet paid. The various judicial opinions discussing the remedy reflect a divergence of views on how harshly it should be applied.

Courts in a majority of jurisdictions have come to apply a strong form

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or breach of the duty of loyalty).

19. See, e.g., *Hansen v. Barnard*, 270 F. 163, 166 (2d Cir. 1920) (holding that an employer may recover wages when an employee has committed fraud or negligent work is valueless); *Bessman v. Bessman*, 520 P.2d 1210, 1215 (Kan. 1974) (noting that recovery of compensation is allowable where an employee commits gross misconduct, assault, fraud or embezzlement); *Libhart v. Wood*, 1841 WL 4079, at \*3 (Pa. May, 1841) (finding an employer may recover compensation where an agent engaged in criminal misconduct).

20. RESTATEMENT (THIRD) OF AGENCY § 8.01 cmt. b (2006).

21. *Id.*

22. *Id.*

23. *Id.*

24. *Id.* § 8.01 at cmt. d(2).

version of the forfeiture remedy, which is exemplified by the Reporter's illustration.<sup>25</sup> These courts have adopted a bright line rule that the agent must forfeit all compensation paid or payable over the entire period of the agent's disloyalty, presuming, in effect, that the agent's misconduct tainted or otherwise permeated his entire relationship with his principal from the original point of the breach going forward. Some courts have been somewhat more lenient, considering the egregiousness of the agent's breach to evaluate whether the agent's breach tainted all of the agent's work or only specific conflicted transactions.<sup>26</sup> Regardless of whether the strong form rule is applied, courts generally have not allowed the agent to offset against forfeitable compensation the value of any benefits the agent's work may have provided the principal.<sup>27</sup> This view, of course, is consistent with fiduciary principles of voidability that allow the beneficiary complete discretion to accept or reject each conflicted transaction, denying the breaching fiduciary any offsetting or netting benefits.<sup>28</sup> Finally, the Reporter's Comment reaffirms the universal principle that the principal's forfeiture remedy against the agent is available no matter whether the principal has suffered any damage or has actually enjoyed profits as a result of the conflicted transactions.<sup>29</sup>

The traditional remedy is best understood by reviewing several representative cases in which it has been applied. Perhaps one of the decisions more often cited is the Tenth Circuit's opinion in *Wilshire Oil Company of Texas v. Riffe*,<sup>30</sup> interpreting Oklahoma law applicable to

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25. See *id.* (identifying *Phansalkar v. Andersen Weinroth & Co.*, 344 F.3d 184 (2d. Cir. 2003) as the factual basis for a hypothetical illustration of the application of the forfeiture of compensation remedy).

26. See, e.g., *Burrow v. Arce*, 997 S.W.2d 229, 232 (Tex. 1999) (finding that attorneys who breach their fiduciary duty to clients must forfeit their fees); *Williams v. Queen Fisheries, Inc.*, 469 P.2d 583, 590 (Wash. Ct. App. 1970) (finding that a trial court has discretion over whether an employee who breaches fiduciary duty must forfeit compensation); *Hartford Elevator, Inc. v. Lauer*, 289 N.W.2d 280, 287 (Wis. 1980) (concluding that a court must consider all relevant circumstances when deciding a forfeiture amount to avoid unjust enrichment of either party).

27. See RESTATEMENT (THIRD) OF AGENCY § 8.01 cmt. d(2) (2006) (stating that although cases have permitted a disloyal agent to show that, on balance, he aided his principal "the better rule does not allow an agent to offset amounts otherwise forfeitable to the principal by showing benefits gained by the principal through the agent's work").

28. Generally, an agent who has violated his fiduciary duties in a number of distinct transactions is not permitted to net gains against losses in any determination of damages for his breach, and the principal has complete discretion to rescind certain transactions and to affirm other transactions tainted by the breach. See RESTATEMENT (SECOND) OF AGENCY § 407 cmt. b (1958) ("If an agent engages in a number of distinct transactions, the principal can elect to receive what the agent obtained as a result of some of them and the value of any of the principal's property disposed of by the agent in others of them.").

29. RESTATEMENT (THIRD) OF AGENCY § 8.01 cmt. d(2) (2006) (citing *Tarnowski v. Resop*, 51 N.W.2d 801 (Minn. 1952)).

30. 406 F.2d 1061 (10th Cir. 1969).

corporate officers as fiduciaries. In *Wilshire Oil*, the plaintiff corporation brought suit against a former corporate officer, who had participated in the business of a competitor and had pocketed commissions related to his employer's construction projects.<sup>31</sup> The corporate principal sought to recover not only the former officer's profits earned from his work with the competitor and the secret commissions but also all compensation paid to the officer during the time of his association with the competitor.<sup>32</sup> The court essentially adopted the forfeiture of compensation rule reflected in the Restatement (Second) of Agency, § 469.<sup>33</sup> The court restated the doctrine as follows:

When a corporate officer engages in activities which constitute a breach of his duty of loyalty, or if it is a willful breach of his contract of employment, he is not entitled to compensation for services during such a period of time although part of his services may have been properly performed.<sup>34</sup>

The court then adopted the Reporter's Comment to this section of the Restatement: "An agent, who, without the acquiescence of his principal, acts for his own benefit or for the benefit of another in antagonism to or in competition with the principal in a transaction is not entitled to compensation which otherwise may be due him."<sup>35</sup> Reversing the lower court, the Tenth Circuit concluded that the defendant must forfeit all compensation, including his salary from the date the fiduciary failure commenced through the date of his termination.<sup>36</sup>

In another frequently cited opinion, *American Timber & Trading Co. v. Neidermeyer*,<sup>37</sup> the Oregon Supreme Court ruled similarly in favor of the corporate employer against its former president. The defendant engaged in a litany of misconduct, including substituting his separately owned corporation in place of his corporate employer on a supply contract with a third party and then selling the supplies acquired to his corporate employer at inflated rates.<sup>38</sup> In addition, the defendant manipulated his corporate employer's revenues in order to inflate its value for securing loans, entered a one-sided exchange agreement for corporate assets, and leased his vacation homes to the corporation.<sup>39</sup> And as if that were not enough, the defendant arranged for payment to himself of increasingly larger bonuses

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31. *Id.* at 1061.

32. *Id.*

33. *Id.* at 1062.

34. *Id.*

35. *Id.*

36. *Id.*

37. 558 P.2d 1211 (Or. 1976).

38. *Id.* at 1217.

39. *Id.*

and salary and of reimbursements for personal living expenses.<sup>40</sup> In effect, he engaged in the looting of corporate assets, leading the corporate auditors to conclude that he was “trying to steal the company blind.”<sup>41</sup>

Among other successfully asserted remedies, the employer corporation sought to recover the salaries paid to the defendant over some five years.<sup>42</sup> While the court conceded that the salaries were reasonable and had even been ratified by the corporation through acquiescence, it nevertheless concluded that the defendant should be required to refund those salaries given his numerous breaches of fiduciary obligations.<sup>43</sup> The court, citing *Wilshire Oil*, the Restatement (Second) of Agency, and a host of other authorities, applied the following general rule:

The general rule . . . is that a corporate officer who engages in activities which constitute either a breach of his duty of loyalty or a willful breach of his contract of employment is not entitled to any compensation for services rendered during that period of time even though part of those services may have been properly performed.<sup>44</sup>

Although the court determined that application of the remedy of restoration of compensation is dependent upon the individual facts of each case, it concluded that the facts in this case provided no reason to make an exception.<sup>45</sup>

In *Zakibe v. Ahrens & McCarron*,<sup>46</sup> the Missouri Court of Appeals addressed the use of the forfeiture of compensation principle as a defense rather than as a remedy for restoration of compensation. In this case, the plaintiff, while serving as a corporate officer of the defendant corporation, invested in a separate corporation and caused the defendant employer, among other things, to extend substantial credit to the separate corporation, resulting in substantial write-offs to the defendant.<sup>47</sup> After his termination, the officer sought recovery of bonuses and severance pay under his employment contract.<sup>48</sup> The court, citing *Neidermeyer* with approval, stated that the plaintiff was subject to the general rule that “a corporate officer forfeits all rights to compensation which might otherwise be due when the officer engages in activities that breach the officer’s fiduciary duty of loyalty to the corporation.”<sup>49</sup> According to the court, the “agent’s

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40. *Id.*

41. *Id.*

42. *Id.* at 1223.

43. *Id.*

44. *Id.* at 1223.

45. *Id.*

46. 28 S.W.3d 373 (Mo. Ct. App. 2000).

47. *Id.* at 378-80.

48. *Id.* at 380.

49. *Id.* at 385.

claim for compensation accruing after the beginning of the agent's wrongdoing is not valid or enforceable, and the agent's breach of fiduciary duty is a defense to an action for compensation."<sup>50</sup> The court stated that forfeiture applies "[r]egardless of contract terms,"<sup>51</sup> which strongly suggests that remedial and other contractual limitations that would vitiate the forfeiture remedy and the faithless servant doctrine's principles would be unenforceable, presumably for being counter to public policy. Clearly, allowing an agent to retain or recover compensation despite his breach of fiduciary duties would run roughshod over established corporate statutory and common law principles of officer responsibility.<sup>52</sup>

This discussion of the traditional remedy of restoration or forfeiture of compensation would be remiss if it did not provide a case illustrating circumstances where the corporate employer goes over the top "to extract a pound of flesh."<sup>53</sup> In *Bank of Tokyo-Mitsubishi, Ltd. v. Malhotra*, the court, applying Illinois law, emphasized the discretionary nature of the equitable remedy of forfeiture of compensation.<sup>54</sup> In this case, the defendant, a former bank officer, had entered a guilty plea to a charge of bank fraud, which resulted in a restitution order requiring him to repay the bank almost \$600,000, as "the total amount of his fraudulent deprecations."<sup>55</sup> The bank sought to recover compounded prejudgment interest on the restitution amount, totaling over \$200,000, as well as a forfeiture of the roughly \$500,000 of compensation and fringe benefits the bank had paid the defendant over nine years of employment.<sup>56</sup> While the court awarded the interest claim, it exercised its discretion by limiting restoration of compensation to bonuses paid by the bank during the time it was "the

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50. *Id.*

51. *Id.* at 386.

52. *See* Langevoort, *supra* note 8, at 647-48 (stating that Delaware law allows companies to seek restitution from executives for violations of their duty of loyalty). These principles not only would include the corporate officer's common law fiduciary duties, but also his statutory duties. *See, e.g.*, MODEL BUS. CORP. ACT § 8.42 (1984) (detailing the standards to which officers are held). *See generally* Lyman Johnson, *Having the Fiduciary Duty Talk: Model Advice for Corporate Officers (and Other Senior Agents)*, 63 BUS. LAW. 147, 147 (2007) (stating that there is a lack of legal materials on fiduciary duties of corporate executives). Professor Langevoort also notes the challenges posed in shareholder derivative suits should the corporation, through the vehicle of a special litigation committee, seek to protect the corporate officer from a forfeiture claim by recommending dismissal of the action. *See* Langevoort, *supra* note 8, at 646-47 (noting the benefits to a company gained from the board protecting an executive from litigation). *See also* BEBCHUK & FRIED, *supra* note 10, at 45-48 (arguing that litigation is not an efficient means to constrain executive compensation arrangements).

53. *Bank of Tokyo-Mitsubishi, Ltd. v. Malhotra*, 131 F. Supp. 2d 959, 962 (N.D. Ill. 2000).

54. *Id.* at 961.

55. *Id.* at 960.

56. *Id.* at 962.

unwitting victim of his fraudulent activity.”<sup>57</sup> The court acknowledged that the Illinois faithless servant doctrine would support forfeiture of base salary and fringe benefits as well but added, “Bank’s counsel are guilty of overstatement in attempting to convert that doctrine from a discretionary one to a mandated result.”<sup>58</sup> In the court’s view, it would be “extraordinarily punitive” to deny the defendant all compensation for almost the full decade of his life at the bank, resulting in nearly a 100% penalty on the fraudulent gains he has already been ordered to repay.<sup>59</sup> Basically, it appears that the court simply concluded that the former bank employee had been punished enough.

The foregoing discussion of representative cases highlights the utility of the faithless servant doctrine, whether employed as a sword to claw back or as a shield to deny payment of compensation otherwise due. Although the majority rule has been previously noted,<sup>60</sup> the case law from state to state follows a graduated intensity scale from a relatively harsh application to application of total forfeiture only in egregious circumstances.<sup>61</sup> Courts in New York,<sup>62</sup> California<sup>63</sup> and the District of Columbia<sup>64</sup> have adopted very strict positions, holding that an employee must forfeit all compensation that he has earned after his first act of disloyalty. This variance among state laws obviously raises challenging

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57. *Id.*

58. *Id.* at 961.

59. *Id.*

60. *See supra* note 24 and accompanying text (stating that agents are not generally allowed to keep compensation they obtained during the period in which they violated their duty of loyalty).

61. *See, e.g.,* Wallace v. Odham, 579 So. 2d 171 (Fla. Dist. Ct. App. 1991) (discussing the origins of the forfeiture of compensation remedy).

62. *See, e.g.,* Phansalkar v. Andersen Weinroth & Co., L.P., *infra* note 66, at 188 (holding that the defendant was required to forfeit all his compensation after the date his disloyalty began); Royal Carbo Corp. v. Flameguard, Inc., 645 N.Y.S.2d 18, 19 (N.Y. App. Div. 1996) (holding that the corporation forfeited its right to compensation because it failed to show a duty of loyalty); Murray v. Beard, 7 N.E. 553, 555 (N.Y. 1886) (holding that “the broker could not recover commissions from the defendant because he fraudulently suppressed material facts in making the contracts”). In *Murray*, the New York Court of Appeals succinctly summarized the faithless servant doctrine: “An agent is held to *uberrima fides* in his dealings with his principal; and if he acts adversely to his employer in any part of the transaction, or omits to disclose any interest which would naturally influence his conduct in dealing with the subject of the employment, it amounts to such a fraud upon the principal, as to forfeit any right to compensation for services.” *Id.* at 554; *see also* Aramony v. United Way Replacement Benefit Plan, 191 F.3d 140, 155-56 (2d Cir. 1999) (holding that a corporation can only recover compensation for the limited period where the defendant is disloyal).

63. *See, e.g.,* J.C. Peacock v. Hasko, 196 Cal. App. 2d 353, 354 (Cal. Ct. App. 1961) (holding that an employee is not entitled to bonuses when he is disloyal to his corporation).

64. *See, e.g.,* Riggs Inv. Mgmt. Corp. v. Columbia Partners, LLC, 966 F. Supp. 1250, 1274 (D.D.C. 1997) (requiring the forfeiture of salary for violation of duty of loyalty).

choice of law issues. These would include whether the internal affairs doctrine would govern, applying the law of the state of incorporation to the fiduciary duties of corporate officers, or whether other choice of law rules would be applicable.<sup>65</sup> Resolution of these issues, while beyond the scope of this essay, could obviously affect the end result in any pursuit of the clawback remedy.

### III. THE REINVIGORATION OF THE TRADITIONAL REMEDY

The restoration or forfeiture of compensation remedy, despite variance in the intensity of its application among jurisdictions, has continually been revalidated over the last century. That being said, one case (although from a jurisdiction according the remedy one of its strictest applications) was immediately regarded as a shocking reminder of the remedy's power. Generally referred to by New York courts as the faithless servant doctrine, the remedy was reinvigorated by the Second Circuit in *Phansalkar v. Andersen Weinroth & Co., L.P.*,<sup>66</sup> which further developed a bright line rule for application of the remedy as a form of equitable clawback whenever a corporate officer has breached his duty of loyalty to his employer.

In *Phansalkar*, the employee, Robit Phansalkar, was a nominal partner in a limited partnership, Andersen Weinroth & Co., L.P., a small merchant banking firm.<sup>67</sup> The firm's income was primarily cash and securities derived from its investments in various businesses, including compensation, whether in the form of cash fees or stock options, earned by its personnel for serving on the boards of directors of those businesses.<sup>68</sup> Under the firm's compensation policy, Phansalkar was to receive \$250,000 per year in salary, and (as determined in the sole discretion of the general partners) "[p]artner [a]llocations" of investment securities that vested over three years and awards of "investment opportunities."<sup>69</sup>

During his year and a half at the firm, Phansalkar worked on four transactions, took advantage of three investment opportunities, and sat on the board of three companies as the firm's representative.<sup>70</sup> After Phansalkar resigned his position to become chief executive officer of a company in which the firm had invested, the firm learned that Phansalkar had received stock options and fees that he had failed to disclose to the firm

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65. See *Greenspun v. Lindley*, 330 N.E.2d 79, 81 (N.Y. 1975) (illustrating the difficulty in resolving choice of law issues).

66. 344 F.3d 184 (2d. Cir. 2003).

67. *Id.* at 187.

68. *Id.* at 189.

69. *Id.* at 190.

70. *Id.*

while serving on the boards of two companies.<sup>71</sup> Disturbed by Phansalkar's conduct, the firm transferred back to the "actual partners" shares of a company, Millenium Cell, which they had previously awarded to Phansalkar as an investment opportunity under the firm's compensation policy.<sup>72</sup>

Soon after discovery of Phansalkar's acts of disloyalty, the firm sued him for breach of fiduciary duty, among other things, alleging that he had been a disloyal employee for his last nine months with the firm and had taken property and opportunities that belonged to the firm.<sup>73</sup> Phansalkar then filed his own action against the firm, alleging, among other things, conversion, breach of contract, and *quantum meruit*.<sup>74</sup> The trial court, while concluding that Phansalkar had breached his fiduciary duty by not disclosing fees and options earned for his services at the two companies, held that he had not acted disloyally with respect to the firm's investment in Millenium Cell.<sup>75</sup> Consequently, the court granted Phansalkar's \$4,000,000 conversion claim regarding the Millenium Cell shares and limited forfeiture of compensation to his distributions from the two companies to which his disloyalty related.<sup>76</sup> The trial court essentially took the position that under its view of New York's faithless servant doctrine, Phansalkar's disloyalty required him to forfeit only compensation derived from transactions in which he had been disloyal, based in large part on its findings that Phansalkar had not engaged in a fraudulent scheme and that his "isolated misdeeds did not permeate his entire employment relationship."<sup>77</sup>

The Second Circuit acknowledged that, under New York law, two different standards not yet reconciled had been applied to determine whether an employee's misbehavior warrants forfeiture.<sup>78</sup> The first, the weaker standard, would require acts demonstrating "substantial" disloyalty, which would be lacking where the disloyalty consisted of only a single act of misconduct or where the employer knew about and tolerated the faithless conduct.<sup>79</sup> The stronger second standard would impose a strict rule against any limitation on a faithless servant's forfeiture whenever the misconduct amounts to a breach of the duty of loyalty.<sup>80</sup> The court then concluded that

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71. *Id.* at 194.

72. *Id.* at 196.

73. *Id.* at 197.

74. *Id.*

75. *Id.*

76. *Id.* at 198.

77. *Id.* at 188.

78. *Id.* at 201.

79. *Id.* at 201-02. This standard was enunciated in *Turner v. Kouwenhoven*, 2 N.E. 637, 639 (N.Y. 1885).

80. *Phansalkar*, 344 F.3d at 202. This standard was enunciated in *Murray*, *supra* note

Phansalkar's conduct clearly violated both standards.<sup>81</sup> Applying the weaker standard, the court held that he must forfeit his compensation because his disloyal conduct occurred repeatedly, and thus "substantially" violated the terms of his contract of service.<sup>82</sup> Applying the stricter standard, the court held that he must forfeit his compensation because both his failure to disclose various interests and opportunities and his withholding of income that belonged to his employer constituted breaches of his duty of loyalty.<sup>83</sup> The court rejected Phansalkar's argument that forfeiture should require intent to defraud, which the trial court found lacking in this case.<sup>84</sup> The court stated, "[w]e find nothing in New York law to suggest that a specific intent to defraud is necessary to render misconduct sufficient to warrant forfeiture."<sup>85</sup>

The Second Circuit then addressed the question of the extent or measure of forfeiture once the applicability of the forfeiture remedy has been determined under either of the two standards discussed above.<sup>86</sup> It noted that the earlier New York decisions held that disloyal agents should forfeit all compensation without any limitations.<sup>87</sup> The court noted that in several later decisions forfeiture of compensation had been limited to compensation paid or payable only during the period of disloyalty, excluding from forfeiture compensation already paid to the employee prior to his disloyalty.<sup>88</sup> The Second Circuit then reiterated two of its own decisions, *Musico v. Champion Credit Corp.*<sup>89</sup> and *Sequa Corp. v. GBJ Corp.*,<sup>90</sup> in which the court had further relaxed the forfeiture remedy in those limited circumstances where: (1) the employee's contract itself allocated compensation among tasks, e.g., a commission on each sale or a fee for each successful transaction; (2) the employee engaged in no misconduct at all with respect to other tasks; and (3) the employee's disloyalty corrupting certain tasks did not taint or interfere with the tasks the employee handled loyally.<sup>91</sup> Accordingly, under these limited circumstances, a court might exercise its discretion to limit the measure of forfeiture to compensation related to the employee's *tainted tasks*.<sup>92</sup>

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62, at 508.

81. *Phansalkar*, 344 F.3d at 202.

82. *Id.*

83. *Id.* at 203.

84. *Id.* at 204.

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.* at 205.

89. *Musico v. Champion Credit Corp.*, 764 F.2d 102 (2d Cir. 1985).

90. *Sequa Corp. v. GBJ Corp.*, 156 F.3d 136 (2d Cir. 1998).

91. *Phansalkar*, 344 F.3d at 205.

92. *Id.* at 205-06.

The court, noting the “tenuous posture” and the “relatively generous” approach taken in *Musico* and *Sequa*, respectively, refused to expand the tainted task rule beyond the trio of limited circumstances set forth above.<sup>93</sup> Its reluctance was based largely on its recognition that New York courts had never mentioned, much less followed, the *Musico* and *Sequa* decisions and, in fact, had never confronted the question whether forfeiture should be limited, not just to the time period of disloyalty, but to tainted tasks within that period of disloyalty.<sup>94</sup> Given that lack of endorsement by any New York court, the Second Circuit concluded that “New York courts have given us no reason to retreat from, or to expand, our holding in *Musico*.”<sup>95</sup> The court, taking a harder look at *Musico* and *Sequa*, where transaction-by-transaction compensation was actually structured by contractual agreement, concluded that its tainted task rule should never be applied in cases where the employee is paid a salary or is awarded compensation derived from transactions on which he did not work.<sup>96</sup> According to the court, this distinction has the practical advantages of “drawing a clear line” and “not embroiling courts in deciding how much general compensation should be forfeited.”<sup>97</sup> The Second Circuit, in effect, established two distinct forfeiture measures: (1) a broad rule for generally compensated employees who are salaried and otherwise compensated in the discretion of their employers, and (2) a tainted task rule for employees who are compensated by commissions or other task-by-task or transaction-by-transaction remuneration applicable only in the limited circumstances delineated.

The court then applied these principles to Phansalkar, whose compensation plan included a salary, together with partnership allocations and investment opportunities awarded solely in the discretion of the firm’s

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93. *Id.* at 206.

94. *Id.*

95. *Id.* at 207. The author has located no decision by any New York court that has adopted a *tainted task* rule, i.e., limiting forfeiture by a disloyal agent solely to tasks disloyally performed. Instead, as the Second Circuit noted, except for one lower federal court, the only reported decisions applying “transaction-by-transaction” limitations on forfeiture were its own in *Musico* and *Sequa*. *Id.*

96. *Id.* at 208.

97. *Id.* at 207. The Second Circuit’s “clear line” did not resolve how forfeiture might be measured in circumstances where the employee’s compensation structure included both salary and transaction-by-transaction commissions. In *Design Strategy, Inc. v. Davis*, 469 F.3d 284 (2d Cir. 2006), the court held that the general rule enunciated in *Phansalkar* should be applied to forfeit the faithless servant’s salary during the period of disloyalty, but, finding no tainted tasks, held that the tainted task rule protected the employee’s commissions from untainted transactions during the period of his disloyalty. Given the harsh view of disloyalty taken by most courts, it is unlikely that the court’s leniency in these limited circumstances will hold sway in other contexts. In the author’s view, corporate officers who would betray their corporate employers should never be permitted to avoid forfeiture by using their compensation structure as a shield against the penalty for their betrayal.

actual partners.<sup>98</sup> Clearly, his compensation was not structured as fees or commissions on a transaction-by-transaction basis.<sup>99</sup> The court concluded “that forfeiture cannot appropriately be limited to only some transactions in these circumstances, where the agreement calls for general compensation, and does not limit compensation to specific amounts paid for the completion of specific tasks.”<sup>100</sup> Consequently, the court required Phansalkar to forfeit all compensation awarded to him after his first act of disloyalty in which he received stock options that he did not report to the firm.<sup>101</sup> This forfeiture included his salary and partnership allocations during the ensuing period of his employment as well as the approximately \$4,000,000 Millenium Cell and other investment opportunity awards.<sup>102</sup> Phansalkar’s \$4,500,000 rebuke for disloyal behavior to his firm, to the extent publicized by the press and communicated to clients by their legal counsel, should work to make a corporate officer think twice before engaging in disloyal conduct.

The Second Circuit’s decision in *Phansalkar* certainly illustrates, to use Professor Deborah DeMott’s words, the “ferocious” power of the forfeiture of compensation remedy.<sup>103</sup> Although the court’s decision has been criticized by one lawyer as making “indentured servants out of employees,”<sup>104</sup> most experts would agree that the remedy, as applied, serves the goals of compensation and deterrence. The equitable clawback achieved by the remedy restores to the employer-beneficiary the compensation paid or otherwise payable to the disloyal agent-fiduciary. That specter of clawback then serves to deter corporate officers and other agents from committing acts of disloyalty given the risk of forfeiture of all compensation and not just that portion that relates to misconduct. Regrettably, few of the reported decisions reviewed involved litigation brought by publicly held companies to recover compensation paid to disloyal officers. Although the stakes were high for Phansalkar, they pale by comparison to the compensation paid to the officers of the nation’s largest publicly held corporations. The corporation’s recovery rights

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98. *Phansalkar*, 344 F.3d at 207-208.

99. *Id.*

100. *Id.* at 208.

101. *Id.*

102. *Id.*

103. Deborah A. DeMott, *Disloyal Agents*, 58 ALA. L. REV. 1049, 1059 (2007). According to Professor DeMott, the forfeiture remedy is “geared to deterrence and to assuring that some remedy will be available against a disloyal agent even when the agent has realized no material benefit for which the agent must account.” *Id.* at 1060. Moreover, it “represents an entitlement on the part of the principal to loyal service from an agent that operates independently of contract law norms.” *Id.* at 1061.

104. Stacey Stowe, *Executive Life: Was He Disloyal? Millions at Stake*, N.Y. TIMES, Nov. 9, 2003, at BU12 (quoting Hillary Richard, a New York employment lawyer).

constitute a significant asset that should not be wasted by ignorance or indifference. Equitable clawback surely has a larger role to play.

#### IV. CONCLUSION

This essay has briefly surveyed the remedy of restoration or forfeiture of compensation, known in the agency context as the faithful servant doctrine, permitting employer-principals to claw back compensation previously paid to employee-agents who have breached their fiduciary obligations. The Second Circuit in *Phansalkar* followed the traditional view that the remedy was intended to be applied strictly and harshly, imposing forfeiture of all compensation from the moment when employees begin to conduct themselves in breach of their fiduciary duties to their employers. In interpreting New York law, the court determined, in effect, that the doctrine and the interests of the beneficiaries it protects should not be subjected to further relaxation. In various forms, the equitable clawback remedy has been adopted and followed in the vast majority of common law jurisdictions. The focus of the remedy has and continues to be the purest form of full compensation to the beneficiary and a strong form of deterrence for corporate officers and other agents tempted to breach their fiduciary duties. The consequences of fiduciary misconduct are forfeitures of compensation that could greatly exceed the amounts of the fiduciary's gains, if any, and the beneficiary's losses, if any, attendant to that misconduct. Indeed, much of a corporate officer's personal wealth may be derived from past, present and future compensation paid or payable by the corporate employer. By posing a substantive threat to executive wealth, the equitable clawback remedy, if stringently applied, should secure a higher level of executive responsibility. Given the fiduciary failure of corporate leadership in recent years, it is a remedy that should be universally pursued.