To retrieve bonuses paid in error, companies must improve their contracts

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If a company awards a bonus to employees based on financial performance and it later turns out that the results were incorrect, or were achieved by improper means, a clawback clause can be used to retrieve this money.

However, companies need to be more careful about their wording on these clawback clauses, says a study from Nyenrode Business University.

In previous studies, clawbacks have been discussed in a binary way: a firm either does or does not have a clawback. However, there are strong clawbacks and weak clawbacks, the study shows, and firms need to ensure their clawbacks are strong enough.

A weak clawback, for example, might say that the firm can recover bonuses from senior executives whose fraud or misconduct resulted in a significant financial restatement. In this case, not only is fraudulent behaviour extremely difficult to prove, but it also allows for only the recovery of bonuses, not other incentive compensation.

By comparison, a strong clawback might read something like, “The company will use reasonable efforts to recoup any excess incentive-based compensation paid in the three years prior to the restatement to any current or former executive officer”. This clawback policy doesn’t need fraudulent misconduct, nor is it limited to bonus payments. It spans multiple years and covers former executives.

To rank the strength of these clawbacks, the researchers developed an innovative Clawback Strength Index, based on the analysis of nearly 4,500 clawback provisions.

The research has already served as input for a legislative change in SEC regulations in the US. As a result, listed US companies will have to implement and enforce strong clawback clauses from the end of 2023.

Professor Dr Michael Erkens, a researcher on the study, says: “Our research has a major impact on how thousands of companies have to design executive compensation contracts. It also impacts how executives behave, how investors can select 'well' managed companies, how researchers can identify unobservable corporate incentives, and how new legislation is designed.”

For more information, a copy of the paper, or to speak to Dr Erkens contact Chloë Lane at BlueSky Education at chloe@bluesky-pr.com.