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Client Alert

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A Tale of Two Clawbacks: The Compensation Consequences of Misstated Financials

Section 304 of the Sarbanes-Oxley Act of 2002 (SOX) gave the Securities and Exchange Commission the power to recover certain restatement-related compensation and stock profits from Chief Executive Officers and Chief Financial Officers of public companies, in the event the restatement was caused by misconduct. In recent years, the Commission has made increasingly aggressive use of that clawback tool, seeking recovery from executives even if they were not personally charged with misconduct, and this June, a federal court validated the SEC's more aggressive approach.

Now Congress has enacted, in Section 954 of the Dodd-Frank Act, another restatement-related clawback provision that is meant to apply even more broadly. Together, these two provisions have radically changed the landscape of executive compensation in the event that public company financial statements are found to contain material misstatements due to error or accounting irregularity. Such events are by no means rare. From 2002 through 2009, there were over 2,900 negative restatements of net income by listed public companies.[1]

"Together, these two provisions have radically changed the landscape of executive compensation."

This *Alert* covers what public companies need to know about how the SOX 304 and Dodd-Frank 954 clawback provisions operate, both individually and together.[2]

The SOX 304 Clawback

Section 304 of the Sarbanes-Oxley Act of 2002 is short and direct. The statute states that, in the event an issuer is required to prepare an accounting restatement caused by "misconduct," the CEO and the CFO "shall" reimburse the company for any bonus or other incentive-based or equity-based compensation, and any profits from the sale of the issuer's securities, received during the year following the issuance of the misstated financial statements. In the seven years following passage of Sarbanes-Oxley, Section 304 reimbursements were relatively rare. The courts decided that only the Securities and Exchange Commission could bring SOX 304 clawback actions,[3] and the Commission used SOX 304 only when the CEO or CFO was alleged to be involved in the misconduct. Subsequently, however, the Commission promised to make greater use of SOX 304, and then followed through on that promise.[4]

Use of the SOX 304 Clawback against Uncharged CEOs and CFOs

The Commission's more aggressive approach includes a recent action in which the Commission sought to require a former CEO not accused of misconduct to disgorge bonuses and stock sale profits. In that action, Maynard Jenkins, the former CEO of CSK Auto Corporation, moved to dismiss the SEC's clawback claim on several grounds, including that a clawback from a person not alleged to have engaged in misconduct would constitute a "grossly excessive" punishment in violation of the Eighth Amendment. The court denied Jenkins' motion to dismiss, ruling that SOX 304 does not require any misconduct on the part of the CEO or CFO subject to the clawback.[5] The court left the constitutional question partially open, however, by suggesting that if the facts as later developed in the Jenkins matter showed that the clawback amount was a "severe and unjustified deprivation to the Defendant," clawing that amount back from him could violate the Constitution.[6]

SOX 304 Issues for Companies to Consider

Despite the fact that SOX 304 was enacted more than eight years ago, several important questions regarding the application of that provision remain:

- What misconduct counts as SOX 304 misconduct? Must there be conduct with "scienter" — that is, intentional or reckless misconduct — by someone? Or can negligence on anyone's part that leads to a restatement provide the predicate for a SOX 304 clawback?
- Do fiduciary or similar duties require the board of directors to seek repayment, or require the CEO or CFO to repay? Does it matter whether the CEO or CFO engaged in misconduct?
- Even if not required by fiduciary or similar duties, should the company request repayment by the CEO or CFO without waiting for an SEC action, given that the company is the recipient of compensation disgorged pursuant to SOX 304? Again, does it matter whether the CEO or CFO engaged in misconduct?
- Should the company's employment agreements with the CEO and CFO require repayment under SOX 304? Should such a requirement turn on whether the CEO or CFO engaged in misconduct?
- What are the CEO's and CFO's obligations if the SEC or its staff thinks a restatement is required, but management disagrees? What if new management thinks a restatement is required, but previous management disagrees? What if the new auditor thinks a restatement is required, but the previous auditor disagrees?

The benefits to the company of interjecting itself into what ordinarily would be an issue between the officer and the SEC include the ability to obtain faster repayment and the possible elimination of the need for an SEC action against the CEO or CFO, thereby potentially saving the company the considerable expense it would incur via its indemnification and advancement obligations. On the other hand, the company could prefer that any legal action to claw back SOX 304 compensation/profits be taken — and paid for — by the SEC, although a litigated enforcement proceeding could still impose significant costs on the company. In many cases, a company with customary indemnification and advancement obligations will likely be obligated to reimburse the officer for litigation expenses incurred in any investigation and action brought by the SEC. But these costs may not be reimbursed under the company's directors and officer insurance policy if the policy contains the standard exclusion for suits seeking recovery

of unearned compensation. It is not inconceivable that these indemnification costs could outstrip any potential recovery. The best interests of the company also may suggest that it not take action concerning potential misconduct while an SEC investigation or civil litigation is pending. Moreover, companies considering adding repayment obligations to employment agreements should keep in mind that the existence of a contractual right to recover could be interpreted as creating a duty to exercise that right.

Because courts have held that SOX 304 does not permit shareholder derivative suits seeking disgorgement, it is perhaps more likely, now, that shareholder plaintiffs and their attorneys will seek creative ways to force SOX 304-style clawbacks. For example, an aggressive shareholder could allege that directors breached their fiduciary duties by not considering whether the company should try to claw back compensation/profits using equitable remedies. Similarly, a shareholder could contend that the CEO and CFO breached their fiduciary duties by not voluntarily reimbursing the company for incentive-based compensation/profits following financial restatements based on misconduct. This is because, under Delaware law, corporate officers have the same fiduciary duties of care and loyalty as corporate directors.[7] Proving such a breach of duty, and identifying real damage to the company, should be difficult tasks in such suits. However, a suit such as this would still cost the company money and time.

With these risks in mind, boards of directors should make a thoughtful decision on whether and how to respond to any SOX 304 issue that arises. Such a decision presumptively will be entitled to business judgment rule protections,[8] which would not be the case if the board did not consider the issue at all.

The Dodd-Frank 954 Clawback

Section 954 of the new Dodd-Frank Act adds to the Securities Exchange Act of 1934 a new Section 10D that (like SOX 304) deals with clawbacks in the event of a restatement. This new provision co-exists with SOX 304 but differs from it in a number of ways.

Perhaps most importantly, Dodd-Frank 954 puts the onus to force the clawback on the issuer rather than the SEC. It does this by requiring the Commission to promulgate rules that require issuers "to develop and implement a policy providing:

> (1) for disclosure of the policy of the issuer on incentive-based compensation that is based on financial information required to be reported under the securities laws; and
>
> (2) that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement."[9]

Dodd-Frank 954 also requires the SEC's new rules to direct the securities exchanges not to list an issuer's security if the issuer fails to develop and implement such a policy.[10]

The scope of Dodd-Frank 954 also differs from SOX 304 in four other respects. First, SOX 304 applies only to CEOs and CFOs, while Dodd-Frank 954 requires reimbursement from all current and former "executive officers." Second, SOX 304 reaches *all* incentive-based and equity-based compensation, plus stock profits, while Dodd-Frank 954 claws back only excess incentive-based compensation. Third, the period of receipt of money or options or equity subject to clawback under SOX 304 is the *year following issuance of a financial statement* that was misstated, while Dodd-Frank 954 covers the *three years preceding the date on which the company was required to file the restatement*. Fourth, SOX 304's application is limited by the requirement that the restatement triggering the clawback must have been caused by misconduct, while Dodd-Frank 954 contains no such limitation.

Uncertainty in Interpreting Dodd-Frank 954

The statutory language creating this new clawback mechanism gives rise to a number of questions, some of which might be answered when the SEC adopts the rules contemplated by Dodd-Frank 954. The following uncertainties arising from the text of the new provision suggests that it will be a challenge for the Commission to interpret and implement:

- On what date is a restatement "required" to be prepared, so that the end of the three-year clawback period can be ascertained? If there was a financial irregularity (that is, an *intentional* material "error"), is it the date the misstated financials were issued, because at that point the issuer had already "discovered" the error and was required to prepare a restatement?[11] If so, the same date that *begins* the 304 one-year period *ends* the 954 three-year period, and there will generally be no 954 compensation to claw back, because incentive-based compensation is generally paid *after* issuance of the relevant financial statements. If, on the other hand, the error was unintentional, is the date that ends the three-year clawback period the date on which management *discovered* the error? The date on which management *should have discovered* the error? The date on which the issuer *determined the error to be material*? Or the date management *should have determined that the error was material*? In any of these events, if the trigger date happens to occur more than three years after the executives received the excess compensation, there will again be no compensation to claw back under Dodd-Frank 954.[12]
- Who determines the amount of "excess" compensation, and how? Determining the amount of incentive-based compensation paid "based on the erroneous data" could be relatively easy if the compensation was based on objectively determinable financial performance targets, as is often the case for annual bonuses or long-term incentive payments. But how will this apply to stock options, specifically mentioned in the statute, which are generally discretionary and not granted based on past "data"? Are they and other discretionary compensation, or compensation determined based on non-financial performance measures, exempt from recovery because such compensation was not "based on the erroneous data"?
- What steps must be taken to "implement" the clawback policy? Presumably implementation means expressly conditioning new grants and awards of incentive compensation on the policy, in order to bolster the enforceability of the policy in the event of a covered restatement. Are companies required to attempt to amend existing award agreements to condition prior awards of compensation on the policy? What if the executive officer refuses to reopen

his or her agreements? What is a company to do? What is its exposure to criticism and litigation if others think it did not do enough?
- What steps must an issuer take to "recover" excess compensation? Must the issuer exhaust all potential means? Will the issuer be required to obtain, and try to enforce, a judgment against a former executive who does not have the ability to repay? If a current or former executive officer has not repaid excess compensation, is the issuer required to withhold the amount from future payments to that person, if any?

To the extent the SEC rulemaking process does not resolve these and other open issues under Dodd-Frank 954 (as well as SOX 304), the unresolved issues should be considered by public companies in developing the required policy on "incentive-based compensation that is based on financial information required to be reported under the securities laws."

Because the new provision contemplates that issuers will pursue reimbursement, it may arm shareholder plaintiffs and shareholder activists with a major new weapon. We will not be surprised to see shareholder plaintiffs bring derivative suits challenging the implementation of the company's clawback policy and attempting to exercise the company's rights to repayment. Whether such suits will find any measure of success and how often they will be filed is difficult to predict.

Finally, we ask, as a practical matter, will all of these uncertainties and risks create unintended (or not expressly intended) consequences? Will companies design incentive compensation that is not based on financial targets? Will the risks to companies of being second-guessed with respect to their efforts to implement or enforce clawback policies cause them to adopt compensation holdbacks, earnouts or other policies that would make it easier to enforce, or avoid the need for, actual clawbacks?

Conclusion

Dodd-Frank 954 does not preempt SOX 304. They coexist. To recap:

SOX 304 requires reimbursement of *all* incentive-based and equity-based compensation, plus stock profits, received by CEOs and CFOs in the year following issuance of a financial statement that was misstated *due to misconduct* and later is restated (unless, arguably, "all" would be a "severe and unjustified deprivation" to the CEO or CFO and thus unconstitutional). Dodd-Frank 954 requires reimbursement of *excess* incentive-based compensation received by *any* executive officer in the *three* years preceding the date on which the company was required to file the restatement (whenever that may be).

The SEC's recent aggressive use of its clawback authority under SOX 304 may presage a similarly aggressive interpretation of Dodd-Frank 954. US public companies would do well to consult promptly with counsel experienced in this area for advice on how to respond to these developments.

Endnotes

[1] See Audit Analytics, 2009 Financial Restatements, A Nine Year Comparison, at 14.

[2] In addition, companies that are Troubled Asset Relief Program (TARP) recipients should be aware that yet another clawback provision applies to them. A TARP recipient must ensure that any bonus payment made to a senior executive officer (SEO) or the next 20 most highly compensated employees during the TARP period is subject to clawback if the bonus payment was based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria. The TARP recipient must exercise its clawback rights except to the extent it demonstrates that it is unreasonable to do so, such as, for example, if the expense of enforcing the rights would exceed the amount recovered. See 31 CFR § 30.8.

[3] *See, e.g., In re Digimarc Corp. Derivative Litig.*, 549 F.3d 1223, 1238 (9th Cir. 2008) ("[T]here is no private right of action under section 304 of the Sarbanes-Oxley Act.").

[4] In March 2010, SEC Director of Enforcement Robert Khuzami noted that the SEC had used

SOX 304 to obtain reimbursement from fourteen officers in 11 cases over the previous 30 months. Robert Khuzami, Speech to the Society of American Business Editors and Writers (Mar. 22, 2010), *available at* http://www.sec.gov/news/speech/2010/spch031910rsk.htm [*hereinafter* "Khuzami Speech"]. *See also* Latham & Watkins, *Client Alert: Senior SEC Enforcement Staff Describes Changes at the Division, Reflects on 2009 Performance, and Highlights Priorities for 2010* (Dec. 10, 2009), *available at* http://www.lw.com/upload/pubContent/_pdf/pub2917_1.pdf.

[5] S*ecurities and Exchange Commission v. Jenkins*, 2010 WL 2347020 (D. Ariz. June 9, 2010).

[6] *Id*. Reportedly, two of the five SEC Commissioners voted against the enforcement action against Jenkins and generally oppose SOX 304 actions against CEOs or CFOs not alleged to have engaged in misconduct. *See* Jesse Westbrook, *SEC Rift on When to Claw Back Bonus May Leave Policy in Limbo (August 6, 2010), available at* http://www.bloomberg.com/news/2010-08-06/u-s-regulators-said-to-debate-when-it-s-appropriate-to-claw-back-bonuses.html.

[7] *See Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

[8] *See Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 205 (Del. Ch. 2006) (board decision protected by business judgment rule); *David B. Shaev Profit Sharing Account v. Armstrong*, 2006 WL 391931, at *1 (Del. Ch. Feb. 13, 2006) ("When a board rationally makes a decision, its actions are protected by the business judgment rule.").

[9] Although this passage, read closely, does not say exactly what should be recovered (maybe the drafters meant to say *the excess*?), the Commission staff writing the rules will have no trouble inferring what the provision is driving at, which is, as the legislative history puts it, "to recover money erroneously paid." H.R. Rep. No. 111-517, at 873 (2010) (Conf. Rep.).

[10] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 954, 124 Stat. 1376.

[11] *Cf.* Financial Accounting Standards Board, *Statement of Financial Accounting Standards—Accounting Changes and Error Corrections*, at 10 ¶ 25 (2008), *available at* http://www.fasb.org/pdf/aop_FAS154.pdf ("Any error in the financial statements of a prior period discovered subsequent to their issuance shall be reported as a prior-period adjustment by restating the prior-period financial statements.").

[12] If the date of discovery, or determination of materiality, ends the 954 period, in some cases the 954 and 304 periods will overlap and both provisions will cover a particular receipt of incentive-based compensation. Because greater than 100 percent reimbursement makes no sense, perhaps the Commission's rules will make clear that such a result is not required.

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