Featured Article

Restating Financials? Forfeiting Bonuses and Profits to the SEC Now a Real Threat

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The Securities and Exchange Commission (SEC) announced that it has used a provision of the Sarbanes-Oxley Act for the first time to recover almost $450 million of stock profits and other compensation in an options-backdating case. Enacted in 2002, Section 304 of Sarbanes-Oxley provides for the repayment of bonuses and profits from chief executive officers and chief financial officers when an issuer restates its financial statements as a result of "misconduct."[1] Until now, the prospect of such a remedy remained an unrealized, but daunting, weapon in the SEC's arsenal. On December 6, 2007, the SEC announced its first settlement with an individual under the "clawback" provision of Section 304.[2] Without admitting or denying the allegations, the former CEO of a leading healthcare provider entered into a settlement with the SEC over option backdating allegations that included the reimbursement under Section 304 of a whopping $448 million in cash bonuses, profits from the exercise and sale of stock and unexercised stock options, as well as the payment of an additional $20 million in penalties and disgorgement.

The SEC's recent action did little to explain some of the textual ambiguities of Section 304. In particular, the language of Section 304 fails to explain what constitutes "misconduct" or whose misconduct is relevant. Because the SEC's recent application of Section 304 was settled rather than litigated, these terms still have not received judicial interpretation. These uncertainties, combined with potentially aggressive SEC enforcement activity, exacerbate the already alarming prospect that chief executive officers and chief financial officers may be required to repay millions of dollars in bonuses and profits simply because they were derived during the time financial statements were restated.

Unlike the SEC, shareholder plaintiffs have not been successful in trying to invoke Section 304 to assert private actions to recover on behalf of shareholders or derivatively on behalf of the issuer. Courts have routinely dismissed those actions on the ground that Section 304 does not create a private right of action.

Despite the size of this record-setting settlement, it remains unclear whether the SEC's newfound use of Section 304 will mean more aggressive tactics towards executives facing a restatement. Nevertheless, given the number of executives who opt for equity-based compensation, the SEC's action in this area merits renewed focus.

Section 304 "Forfeiture of Certain Bonuses and Profits"

Section 304 provides in the event an issuer is required to file an accounting restatement due to its material noncompliance with any financial reporting requirements, "as a result of misconduct," the chief executive officer and the chief financial officer *shall* reimburse the issuer for any incentive-based or equity-based compensation, bonuses, or profits realized from securities sales during the 12-month period following the public issuance or filing of financial statements that are later restated.[3] As the statute makes clear, although invoked by the SEC, repayment is made to the issuer who paid the compensation in the first place.

The level of misconduct required to trigger forfeiture is unclear. The provision is silent as to whether the misconduct must be negligent, reckless, or intentional. Legislative history provides little guidance. A House of Representatives Committee Report suggests the provision should only be used when the SEC can prove "extreme misconduct."[4] Looking to other provisions of the Sarbanes-Oxley Act for comparison, liability for filing a false certification is limited to actions that are deemed willful or with actual knowledge.[5] Liability for a violation of the antifraud provisions in Section 10(b) of the Exchange Act requires intentional

or reckless conduct.[6] In this context, it is likely that at least reckless conduct is required for disgorgement under Section 304.

Another complication is that Section 304 does not clarify whether only the personal misconduct of chief executive officers or chief financial officers is relevant. Can the misconduct of a lower level employee require executives to disgorge their bonuses and profits under Section 304, or is the executive required to participate personally in the misconduct? Would aiding and abetting a securities law violation suffice? Most commentators believe the provision requires misconduct by the respective executive.[7] A more expansive reading of Section 304 to include disgorgement based on the misconduct of lower level employees seems unduly harsh. Until Section 304 is tested in the courts, however, the scope of its application will remain uncertain.

Factors Triggering Forfeiture Under Section 304

The SEC's announcement of its first disgorgement under Section 304 did little to explain the reasoning behind the determination. The SEC alleged that over a 12-year period, the defendant caused the company to grant large quantities of in-the-money stock options to himself and others without recording the appropriate compensation expense.[8] The SEC also claimed documents were falsified and the company's external auditors were deceived. The SEC indicated that the former executive would not have received certain bonuses during the restated period but for the company's failure to record compensation expense. The accounting errors purportedly resulted in a restatement of approximately $1.5 billion in pre-tax stock-based compensation. SEC Enforcement Chief Linda Thomsen said "[t]he $468 million settlement in this case, including the largest penalty assessed against an individual in an options backdating case, reflects the magnitude and scope" of the alleged misconduct.[9]

Other recently filed SEC actions also seek disgorgement of executive bonuses and profits.[10] All of these actions were filed during 2007 and involve similar allegations of stock option backdating or insider trading by chief executive officers or chief financial officers. Based on a review of these matters, the SEC likely is focused on the presence of the following conditions in deciding to bring a disgorgement action under Section 304: (1) restatements of a significant magnitude covering several financial periods; (2) reckless or intentional conduct; (3) conduct by executives resulting in individual profits or other financial benefits; (4) deception of external auditors or alteration of financial records; and (5) personal involvement by the executives in the misstated financials requiring restatement.

After lying dormant for nearly four years following their enactment, the revival of Section 304 remedies in recent SEC actions appears likely to continue.

No Private Right of Action

In contrast to the SEC's only recent employment of Section 304, shareholder plaintiffs have tried repeatedly to assert private actions against executives under the provision. Plaintiffs' lawyers argue that language in Section 304 indicating that executives "shall reimburse the issuer" for bonuses and profits they received supports the private right to sue for reimbursement on behalf of the issuer. To date, courts have rebuffed plaintiffs' attempts to read a private right of action into Section 304.

The leading decision in the Ninth Circuit, *Kogan v. Robinson*, rejected plaintiff's efforts to imply a private right of action for disgorgement.[11] Paul Hastings' attorneys, on behalf of certain former officers of Ligand Pharmaceuticals, were successful in obtaining a dismissal with prejudice of a shareholder's purported derivative claim under Section 304. The District Court found "Congress did not intend to create an implied [private] right of action in Section 304." The Court held that while "Section 304 creates a right in favor of issuers, it does not create a private remedy." The Court also pointed to the SEC's explicit power to exempt persons from the statute as inconsistent with the concept of a private right of action under the provision.

Following the *Kogan* decision, in the *Digimarc Corporation Derivative Litigation*, the District of Oregon similarly held that an implied private right of action did not exist under Section 304.[12] The *Digimarc* decision is currently on appeal before the Ninth Circuit.

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[1] 15 U.S.C. § 7243.
[2] SEC Litigation Release No. LR-20387 (Dec. 6, 2007).
[3] In its entirety, Section 304 provides:
(a) Additional compensation prior to noncompliance with commission financial reporting requirements. If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for –

(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and

(2) any profits realized from the sale of securities of the issuer during that 12-month period.

(b) Commission exemption authority. The Commission may exempt any person from the application of subsection (a), as it deems necessary and appropriate.
[4] *See* H.R. Rep. No. 107-414 (2002).
[5] 15 U.S.C § 7241 (Sarbanes-Oxley Section 302); 18 U.S.C. § 1350 (Sarbanes-Oxley Section 906).
[6] 15 U.S.C. § 78j; *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).
[7] John P. Kelsh, *Section 304 of the Sarbanes-Oxley Act of 2002: The Case for a Personal Culpability Requirement*, 59 Business Lawyer 1005 (Nov. 2004); John J. Huber and Thomas J. Kim, *The Response to Enron: The Sarbanes-Oxley Act of 2002 and Commission Rulemaking*, PLI Corporate Practice Course Handbook Series No. 1375, at 517, n.82 (2002).
[8] SEC Press Release No. PR-2007-255 (Dec. 6, 2007).
[9] *Id.*
[10] *See SEC v. Brooks*, No. 07-CV-61526 (S.D. Fla. filed Oct. 25, 2007), SEC Litigation Release No. LR-20345 (Oct. 25, 2007); *SEC v. Schroeder*, No. 07-CV-3798 (N.D. Cal. filed July 25, 2007), SEC Litigation Release No. LR-20207 (July 25, 2007); *SEC v. Shanahan*, No. 07-CV-1262 (E.D. Mo. July 12, 2007), SEC Litigation Release No. LR-20193 (July 12, 2007); *SEC v. Mercury Interactive LLC*, No. 07-CV-2822 (N.D. Cal. filed May 31, 2007), SEC Litigation Release No. LR-20136 (May 31, 2007); *SEC v. Jasper*, No. 07-CV-6122 (N.D. Cal. filed Dec. 4, 2007).
[11] 432 F. Supp. 2d 1075 (S.D. Cal. 2006).
[12] *In re Digimarc Corp. Derivative Litig.*, No. 05-CV-1324 (D. Or. Aug. 11, 2006).