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EXECUTIVE COMPENSATION

An Executive's Guide to Defeating the SOX 304 Clawback (Part I)




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Recent investigations and scandals have directed attention to the behavior of individual corporate executives. The common reaction to misconduct is to look to the people at the top; like it or not, corporate management is expected to accept responsibility and make appropriate amends if something goes wrong. Making amends may include paying back any incentive-based bonuses or profits from stock sales that benefitted from inflated financial reporting.

Not surprisingly, the Securities and Exchange Commission (SEC) increasingly has focused on executives whose compensation benefitted from inflated numbers, whether the executives were involved in the underlying misconduct or not. Section 304 of the Sarbanes-Oxley Act (also known as ''SOX'') grants the SEC the discretion to claw back the incentive-based compensation and stock sales of chief executive officers (CEO) and chief financial officers (CFO) after a restatement resulting from corporate misdeeds. *See* Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

In this article, we examine possible arguments and responses to an SEC investigation of alleged SOX 304 violations. In our next article, we will discuss the SEC's burden of proof in litigation and possible defenses to a SOX 304 proceeding.

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I. Section 304: Legislative History and Statutory Text

Prompted by the Enron scandal, Congress passed the Sarbanes-Oxley Act to induce a comprehensive reform of business practices in the hopes of curtailing corporate fraud. A stated purpose of SOX was to ''require[] CEOs and CFOs to certify their companies' financial reports, outlaw[] fraud and deception by managers in the auditing process [and] *prevent[] CEOs and CFOs from benefitting from profits they receive as a result of misstatements of their company's financials.*'' Pub. L. No. 107-204, Senate Report at 107-205 (emphasis added). More specifically, the clawback was ''designed to prevent CEOs or CFOs from making large profits by selling company stock, or receiving company bonuses, while management is misleading the public and regulators about the poor health of the company,'' so that,

when malfeasance occurs, ''CEOs and CFOs must disgorge bonuses and other incentive-based compensation and profits on stock sales.'' *Id*.

Section 304(a) provides that a CEO and CFO shall disgorge (1) any bonus or other incentive-based or equity-based compensation, and (2) any profits realized from the sale of securities of the company, during the 12-month period following the first public issuance or filing of the restated financial document, if the company was required to prepare an accounting restatement due to material noncompliance with SEC financial reporting requirements, and the noncompliance was the result of ''misconduct.'' The SEC also has discretion to exempt individuals from clawbacks under Section 304(b). The text of the statute leaves open many ambiguities, such as what is meant by ''misconduct,'' how profits on stock sales should be fairly measured, and whose misconduct triggers the clawback.

Under its current enforcement of the rule, the SEC often has sought far beyond what many consider to be reasonably required by SOX 304.

The few courts that have addressed issues relating to SOX 304 have answered the last question by holding that the SEC may pursue clawbacks against executives who were not personally aware of or involved in misconduct; rather, misconduct by the issuer or company is sufficient, whether the executive was aware of it or not, apparently based on the CEO's or CFO's certification of adequate internal controls. *See SEC v. Jenkins*, 718 F. Supp. 2d 1070, 1074 (D. Ariz. 2010). This reasoning contradicts Section 304's legislative history, which characterizes the aim of Section 304 as the return of ill-gotten gains. Instead, this interpretation renders the clawback more akin to a strict liability penalty, rather than disgorgement or unjust enrichment, and can prompt inequitable results. Given the significance and impact of this issue, a closer examination of recent court interpretations of Section 304 will be addressed in a forthcoming Part II to this article.

Under its current enforcement of the rule, the SEC often has sought far beyond what many consider to be reasonably required by SOX 304. The key to combatting an overbroad application is to consider carefully the text of the statute and its legislative history, as applied to the facts at hand. To assist with the challenge, this article will outline several practical arguments to counter an attempt to aggressively enforce SOX's clawback provisions. In an effort to meaningfully scale Section 304 back to Congress's original purpose, executives and their counsel can minimize, in a logical and equitable way, the amount of compensation that is exposed to clawback.

II. Argument 1: Certification by the Executive is Required

The SEC may only pursue a clawback against a CEO or CFO based on the executive having certified a filing that was later restated. Indeed, Section 304 should apply only to executives who fail to comply with their obligations under Section 302, which requires a CEO and CFO to certify that a company's financial filings are correct and its internal controls are adequate. Accordingly, one of the purposes of Section 304 is to incentivize CEOs and CFOs to be diligent in their review of financial filings and internal controls before certifying such filings by attaching liability to their certification. *See* Isaac U. Kimes, *Unfettered Clawbacks - Why Section 304 of the Sarbanes-Oxley Act Requires a Personal Misconduct Standard*, 42 U. Mem. L. Rev. 797, 823-25 (2012). As such, Section 302 and Section 304 are considered two sides of the same coin. *See id*. at 826.

Section 304 can be reasonably viewed as an individual remedy tied back to an executive's individual responsibilities. Therefore, if an executive did not certify one or more financial filings that were later restated, the coordinating incentives in the interplay between Section 302 and 304 are not triggered and the time period for clawback exposure should be adjusted accordingly. As an example, if a company issued three restatements relating to three accounting periods due to misconduct but an executive only certified one of these filings, the executive should only be responsible for the single financial filing that he or she certified. Even where an executive has certified a financial filing that is later restated, a further prerequisite to clawback eligibility exists that is worth analyzing.

III. Argument 2: Restatement Must be Due to Misconduct by Issuer

The statute expressly provides that no basis exists for a clawback without ''misconduct by the issuer.'' Sarbanes–Oxley Act of 2002 § 304, 15 U.S.C. § 7243. Therefore, the restatement of a financial filing certified by the executive is a necessary but not sufficient predicate to invoke Section 304. Rather, misconduct by the issuer is a further requirement that limits what kind of restatements may trigger clawbacks.

It is not unusual for companies to use restatements to clean up accounting issues. By reviewing SEC public filings regarding a restatement, one may be able to identify which filings were restated for reasons other than misconduct—such as good-faith reliance on auditors, changes in accounting policies, and innocent errors—and thereby remove those corresponding time period(s) from consideration. For example, if an executive certified three years of filings that were later restated, but two years were restated due to innocuous accounting changes, only the compensation attributable to the single filing restated due to misconduct should be subject to clawback. Another frequent example involves quarterly filings; it is common to restate the year-end financials without restating each individual quarter. Moving forward, scrutinizing the type of compensation also may reduce the eligible clawback amount.

IV. Argument 3: Eligible Compensation for Clawback Must be Performance-Based

Only incentive-based or performance-based compensation should be subject to clawback, given that Section 304 was drafted to prevent executives from profiting from inflated company financials, not to require them to forfeit all compensation earned. If an executive receives compensation that was not due to company perfor-

   ISSN 2330-6300

mance but was provided for retention, promotion, or the achievement of personal goals not tied to financial results, such compensation should be immune from clawback. Similarly, if an executive receives stock awards that are not tied to company financial performance, these awards likewise should be exempt. The purpose of specific cash and stock awards may be gleaned from SEC public filings that include specific details about CEO and CFO compensation and more broadly the company's compensation programs.

Moreover, although the statute refers to ''any profits realized from the sale of securities of the issuer during that 12-month period,'' applying this subpart on its own without taking into account the statute's overarching context may produce inequitable results. Based on the purpose and structure of the statute, a strong argument can be made that profits from stock sales should be subject to clawback under Section 304(a)(2) only if both (a) the related award of stock or options and (b) the sale of stock occurred within the eligible time period. More specifically, subpart (1) refers to ''equity-based compensation'' received within the 12-month period and subpart (2), joined by the conjunctive ''and,'' provides a further possibility for clawback if such equity-based compensation is also sold within this 12-month period. Read any other way, Section 304 would be impermissibly broad and would allow the SEC to pursue profits from stock granted for reasons that are wholly independent of the erroneous filings.

The SEC's counterargument to this point may be that any stock sold within the 12-month period would be artificially inflated due to the misstated filings. Under that view, however, the SEC should only be able to pursue any incremental increase that occurred in the relevant 12-month period rather than the entire sales price of the stock. Otherwise, the SEC would not be fairly accounting for increases that independently occurred before Section 304 was triggered and would unjustly deprive the executive of compensation rightly earned based on results unrelated to the alleged misconduct.

V. Argument 4: An Executive Should Only Reimburse Excess Compensation

Given that the purpose of Section 304 is to prevent executives from profiting by misleading the public about the poor health of the company, *see* Pub. L. No. 107-204, Senate Report at 107-205, there is no basis for a clawback in the case of a ''positive'' restatement. A positive restatement occurs where an executive would have received a higher bonus under the restated filings when compared to what was received under the original filings because the restated filings reflect company performance that is better than what was reflected in the original misstated filings. A positive restatement can occur more frequently than one might presume, given the varying metrics used by companies in connection with financial reporting and awarding compensation. This argument is supported by the text of the statute, as well as the subtitle of Section 304, ''Additional Compensation,'' and reasonably can be interpreted to refer to only that portion of compensation that an executive otherwise would not have received under the original numbers. It cannot equitably be read to extend to the portion of compensation that an executive would have received under the revised filings.

This argument also loops back to the Act's legislative history, which defines the clawback as ''disgorgement'' to prevent unjust enrichment. If an executive would have received an even greater bonus under the restated numbers, but in fact did not, then there were no ill-gotten gains to be forfeited. Under these circumstances, any such clawback would be unjust and illogical. This reasoning also is mirrored in Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires an issuer that has restated its financials to recover ''incentive-based compensation'' in ''excess of what would have been paid to the executive under the accounting restatement.'' 15 U.S.C. § 78j-4(b).

A positive restatement also may knock out the ''misconduct'' prerequisite of the statute. Section 304 was designed to curtail accounting fraud; its purpose was not to punish an executive of a company that unwittingly understates the financial health of that company. Accordingly, a positive restatement begs the question of whether any misconduct exists, and whether Section 304 should be triggered at all.

One could reasonably argue based on the legislative purpose of Section 304 that an executive should only reimburse the ''excess portion'' of compensation.

It also follows that the eligible clawback amount may be reduced in the case of a ''negative'' restatement. A negative restatement occurs when an executive's bonus under the restated numbers would be lower than what was originally received. One could reasonably argue based on the legislative purpose of Section 304 that an executive should only reimburse the ''excess portion'' of compensation, or the amount that the executive received beyond what he or she otherwise would have received under the restated figures. For example, if the executive received $500,000 incentive-based compensation prior to the restatement, but would have received $350,000 under the restated numbers, the portion of such compensation subject to clawback should be limited to $150,000—the amount he or she would not have received under the restated numbers.

VI. Arguing to the Discretion of the Commission

Also, keep in mind that the SEC has discretion not to apply Section 304, particularly in cases where the executive was not aware of or involved in the misconduct that led to the restatement. Strong equitable arguments may persuade the SEC to either forgo enforcement altogether or pursue a much smaller clawback. Such arguments include that the executive added real value to the company by spearheading compliance or other efforts, that the executive relied in good faith on an auditor's or lawyer's advice, or that the executive only sold stock after the restatement was announced or at the bottom of the market, thereby minimizing any ''inflation'' due to the restatement. If the internal controls complied with existing best practices, and the executive

exercised due diligence and did his or her best to comply with SOX 302, it can be argued that a substantial clawback is unjustified. Indeed, as we will discuss in our next article, SOX 304 would seem to require some level of scienter and cannot be applied in a just manner on a strict liability basis.

Other factors also may appeal to the commission's discretion. For example, the nature and importance of any initiative taken by the executive to identify the need for and to implement a restatement, or his or her cooperation during any subsequent SEC investigation, may factor into the SEC's exercise of discretion. Additionally, as discussed below, the commission has declined to enforce clawbacks against executives who reimburse the company without an SEC order.

In practice, the SEC has liberally exercised its discretion by accepting Section 304 settlements for less than the full amount of the bonus or stock sales under the appropriate circumstances. Specifically, the SEC has previously accepted Section 304 settlement offers from executives that comprise a small percentage of total compensation potentially eligible for clawback. *See, e.g.*, https://www.sec.gov/news/pressrelease/2016-74.html.

VII. Other Practical Considerations

One should also bear in mind the following practical considerations in grappling with how to minimize Section 304 exposure:

■ **Chronology of Employment.** Given that Section 304 is only applicable to CEOs and CFOs, pay careful attention to the timeline and progression of the executive's employment with the company. The SEC may pursue the broadest interpretation of the Section 304 time period, so ensure that it is accurately defined based on the facts. For example, if the executive did not continuously hold the position of CEO or CFO during the relevant 12-month period, the compensation attributable to the executive's time in other positions would be exempt from clawback.

■ **Stock Grants vs. Stock Options.** On a technical note, when reviewing the SEC's calculations for eligible compensation, confirm whether stock awards were grants or options, as that impacts the profit analysis. If the stock awards are options, not grants, the profits should be calculated based on the difference between the exercise price and sales price. Moreover, many grants are net awards made after the company has withheld taxes. Accordingly, any clawback should be on a net basis.

■ **Voluntary Reimbursements.** Another approach, which may minimize references in press releases and public filings (and in subsequent Google searches), is for the executive to voluntarily reimburse the company. *See* https://corpgov.law.harvard.edu/2016/03/02/accountability-and-the-pursuit-of-sec-clawback-actions/. In such cases, no SEC order was issued, and the press releases issued in connection with the company settlements merely stated that the executive did not engage in any misconduct and had reimbursed the company certain amounts. *See, e.g.*, https://www.sec.gov/news/pressrelease/2016-32.html. These reimbursements, without an SEC order, underscore the flexibility of the SEC in exercising its discretion under SOX 304. Given that an executive likely will be focused on minimizing both reputational damage and the monetary clawback amount, this approach may successfully address both concerns.

■ **Indemnification.** As a final point, indemnification by the company of an executive's clawback payment may not be available. In *Cohen v. Viray*, the U.S. Court of Appeals for the Second Circuit overturned a lower court order approving a settlement which, among other things, permitted indemnification of the clawback. The Second Circuit held that the order permitting the corporate indemnification of a CEO or CFO against liability arising under Section 304 was contrary to the statute, which rested that discretion in the SEC, and noted that doing so would ''frustrate the power of a federal agency to pursue the public's interests in litigation'' and ''[fly] in the face of Congress's efforts to make high ranking corporate officers of public companies directly responsible for their actions that have caused material noncompliance with financial reporting requirements.'' *Cohen v. Viray*, 622 F.3d 188, 195 (2d Cir. 2010). The SEC also typically requires the settling respondent to assure the commission in writing that he or she will not be seeking indemnification of the settlement amounts. In this regard, however, the SEC does not appear to take a position regarding the use of insurance. Accordingly, making a claim under applicable insurance to recover an executive's out-of-pocket costs may be an option worth pursuing, depending on the policies involved.

VIII. Conclusion

Executives facing SEC investigations of alleged SOX 304 violations should be fully apprised of the potential legal and equitable arguments at their disposal, particularly given the SEC's enforcement of the clawback against innocent executives coupled with its broad discretion in determining settlement amounts. As described above, these points range from the legislative purpose of the Sarbanes-Oxley Act to the statutory text of Section 304 to the technicalities of how the clawback amount should be fairly calculated. All things considered, by appealing to reasonable legal and commonsense arguments that comport with the original purpose of the Act, executives and their counsel may be able to bend the arc of the SEC's overbroad enforcement into a more just shape.

Moving forward, in the upcoming second part of this series, we will examine the SEC's burden of proof in SOX 304-related litigation and potential defenses to a SOX 304 proceeding.

   ISSN 2330-6300