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EXECUTIVE COMPENSATION

An Executive's Guide to Defeating the SOX 304 Clawback (Part 2)




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In the first part of this series, we discussed Section 304 of the Sarbanes-Oxley Act of 2002 (SOX) in the context of an SEC investigation of alleged SOX 304 violations. In this second part, we examine the SEC's burden of proof in SOX 304-related litigation and possible defenses.

The application of ''no-fault'' clawbacks in SOX 304 cases represents a serious risk for executives, because any time a restatement occurs ''as a result of misconduct,'' an executive's compensation is at risk of being clawed back--even if the executive has done nothing wrong. Invoking strict liability in SOX 304 cases establishes an unprecedented legal standard that punishes executives for misconduct of which they were unaware and not involved. It also threatens to reshape the SOX 304 remedy from its original purpose of disgorgement of ill-gotten gains into a penalty that may have many unintended consequences.

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1. Recent Judicial Interpretations of SOX 304

The few courts that have addressed SOX 304 generally have held that the SEC may enforce clawbacks against executives who were not personally aware of or involved in the misconduct that led to the company's restatement. *See SEC v. Jenkins*, 718 F. Supp. 2d 1070 (D. Ariz. 2010); *SEC v. Jensen*, 835 F.3d 1100, 1114 (9th Cir. 2016). In this section, we will discuss the courts' reasoning in those cases. Then, we will examine the strong legal and equitable arguments establishing that an executive who is diligent and adheres to a reasonable standard of care should not be so penalized.

(a) *SEC v. Jenkins*

In *SEC v. Jenkins*, the SEC filed a complaint against Maynard Jenkins, the former CEO of CSK Auto Corp., and sought to claw back more than $4 million in bonuses, incentive compensation, and stock profits. The SEC did not claim that Jenkins was aware of the fraud or that he was negligent in failing to uncover the fraud. The defendant moved to dismiss the SEC's complaint, arguing that the SEC was ''attempting to force a novel 'vicarious strict liability' interpretation'' of Section 304 that would result in the imposition of a ''[d]raconian

penalty on an admittedly innocent person.'' *See* Def. Jenkins' Mot. to Dismiss at 1 (Dkt. #17), *SEC v. Maynard L. Jenkins*, Case No. CV-09-1510-PHX-GMS (D. Ariz. Sept. 15, 2009).

In a case of first impression, the U.S. District Court for the District of Arizona held that SOX 304 does not require personal misconduct by the executive to trigger the clawback. *Jenkins*, 718 F. Supp. 2d at 1070. Rather, a restatement caused by the misconduct of any officer, agent or employee acting within the scope of his or her employment would be sufficient to require the CEO or CFO to disgorge funds under SOX 304. *Id*.

The court also drew a connection between SOX 302 and SOX 304. SOX 302 requires each CEO and CFO to certify the accuracy of the issuer's quarterly and annual financial reports, as well as ''the existence, design, and operation of effective internal controls that provide assurances as to the accuracy of the issuer's financial statements.'' *See* Sarbanes-Oxley Act of 2002 § 302; *Jenkins*, 718 F. Supp. 2d at 1077. The court determined that SOX 304 ''provides an incentive for CEOs and CFOs to be rigorous in their creation and certification of internal controls by requiring that they reimburse additional compensation received during periods of corporate non-compliance,'' and that ''[t]o the extent that the statute is designed to promote vigilance in such officers, it would appear that it might have aspects that could be described as either remedial or punitive, or both.'' *Jenkins*, 718 F. Supp. 2d at 1077. As articulated by the court in *Jenkins*, SOX 304 is more akin to a strict liability penalty rather than disgorgement or unjust enrichment.

(b) *SEC v. Jensen*

In *SEC v. Jensen*, 835 F.3d 1100 (9th Cir. 2016), a case with similar facts, the defendants were not accused of misconduct. Nevertheless, the U.S. Court of Appeals for the Ninth Circuit adopted an expansive view of SOX 304 liability.

The district court ruled that the defendants ''did not act with scienter or negligence in preparing the financial documents that were restated,'' and accordingly declined to order the defendants to forfeit compensation pursuant to a claw back. *SEC v. Jensen*, Case No. 11-CV-05316 (C.D. Cal. Dec. 10, 2013). On appeal, however, the SEC argued that ''this conclusion was legally erroneous because SOX 304 is concerned not with individual misconduct on the part of the CEO and the CFO, but rather with the misconduct of the issuer.'' *SEC v. Jensen*, 835 F.3d 1100, 1114 (9th Cir. 2016). The Ninth Circuit agreed, reasoning that ''the clause 'as a result of misconduct' modifies the phrase 'the material noncompliance of the issuer,' suggesting that it is the issuer's misconduct that matters, and not the personal misconduct of the CEO or CFO.'' *Id*. The *Jensen* court also looked to SOX's legislative history, and noted that an earlier version of the bill provided for disgorgement if the CEO or CFO ''engaged in misconduct resulting in, or made or caused to be made in, the filing of a financial statement,'' but this version of the bill was not ultimately passed. *Id*. The court therefore concluded that Congress chose not to limit the disgorgement remedy to cases of personal misconduct by an officer or director.

(c) *SEC v. Life Partners*

In *SEC v. Life Partners*, the SEC alleged that a financial services firm and three executives were involved in disclosure violations and improper accounting, and sought, *inter alia*, SOX 304 clawback of compensation, even though there was no finding of misconduct by the executives. *SEC v. Life Partners Holdings, Inc.*, 71 F. Supp. 3d 615 (W.D. Tex. 2014). The district court held that to seek reimbursement under SOX 304, the SEC must demonstrate by a preponderance of evidence that (1) the company was required to prepare an accounting restatement due to material noncompliance with financial reporting requirements; (2) the noncompliance was caused by misconduct within the company; and (3) the defendant-executive received bonuses, incentive-based or equity-based compensation, or profits from sales of the company's securities during the 12 month period after the first improper public issuance of filing. *Life Partners*, 71 F. Supp. 3d at 625. Although the court agreed that the SEC had fulfilled the first and third requirements, it held that there was ''insufficient evidence'' that the company's restatement was caused by misconduct. *Id*. The court supported its reasoning by stating that the SEC never argued (1) that the company's auditors conspired with the company to mislead the public, (2) that the company did not rely on its external auditors in good faith, or (3) that the company misled its auditors. Accordingly, the court concluded that the defendant-executive was not required to pay anything back under SOX 304.

The court carved out a higher standard for what constitutes ''misconduct'' by creating a good faith defense of reliance on its auditors.

In essence, the court carved out a higher standard for what constitutes ''misconduct'' by creating a good faith defense of reliance on its auditors. The SEC has appealed this decision and the case is now scheduled to be heard in the Fifth Circuit.

These recent decisions, in which courts have interpreted that a company's misconduct is sufficient to enforce an individual penalty against an innocent executive, strike a chord of unfairness and ambiguity. More specifically, the following questions arise: Where should this line equitably be drawn? What if the CEO and CFO followed standard business practices and were reasonably diligent in ensuring that proper accounting principles were followed and that no fraudulent conduct occurred? Are these executives still fair game under SOX 304?

2. Strict Liability Doctrine

As a rule of statutory interpretation, a mens rea requirement for a crime is inferred unless the legislature clearly and explicitly rejects such requirement. *See, e.g.*, *Morissette v. United States*, 342 U.S. 246, 250-51 (1952) (applying common law presumption of mens rea to federal embezzlement statute); *United States v. Gypsum Co.*, 438 U.S. 422, 437-38 (1978) (applying presumption against strict liability crimes to Sherman Act offence and noting that ''far more than the simple omission of the appropriate phrase from the statutory definition is necessary to justify dispensing with an intent

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requirement.''). As the Supreme Court stated in *Morissette v. United States*, ''[c]onsequences of a general abolition of intent as an ingredient of serious crimes have aroused the concern of responsible and disinterested students of penology. Of course, they would not justify judicial disregard of a clear command to that effect from Congress, but they do admonish us to caution in assuming that Congress, without clear expression, intends in any instance to do so.'' *Morissette*, 342 U.S. at 255 n.14. In other words, Congress must speak clearly when imposing criminal sanctions if a strict liability penalty is the intended remedy. If the legislature does not clearly delineate a crime as strict liability, the courts should therefore interpret that some level of intent must be proven.

Although the SEC cannot impose a criminal sanction, this rule of interpretation is appropriate, given the severity of the strict liability offenses in other fields of the law. In tort law, for example, strict liability is reserved for activity that is so ultra-hazardous and contrary to the public welfare that legislators seek explicitly to deter it through the use of strict liability statutes. Not surprisingly, some scholars are wary of the over-application of strict liability, as strict liability imposes punishment without considering core principles: the defendant's state of mind, mitigating circumstances, and good faith efforts. *See, e.g.,* Laurie L. Levenson, *Good Faith Defenses: Reshaping Strict Liability Crimes*, 78 Cornell L. Rev. 401 (1993). These principles have equal application in the context of a statutory scheme, such as federal securities laws, that requires scienter.

(a) Application to Federal Securities Laws

Federal securities laws generally require proof of mens rea. For example, Section 10b-5 of the Securities Exchange Act of 1934 requires proof of scienter. *Ernst v. Hochfelder*, 425 U.S. 185 (1976). Section 17(a) of the Securities Act of 1933 also requires proof of at least negligence. *See Aaron v. SEC* , 446 U.S. 680, 696-97 (1980); *SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999); *Pagel Inc. v. SEC*, 803 F.2d 942, 946 (8th Cir. 1986).

Even for federal securities law provisions that approach strict liability, such laws generally contain exceptions and good faith defenses. For example, Section 11 of the Securities Act of 1933 provides for strict liability for all issuers and near-strict liability, *see Herman v. Huddleston*, 459 U.S. 375, 382 (1983), for all directors, officers, underwriters, and experts who make material misstatements or omissions in a registration statement for publicly offered securities. Notably, however, there is an exception by which directors, officers, underwriters, and experts may escape liability if they had no knowledge of the misstatement or omission and they conducted reasonable due diligence. *See also* Rule 508, 17 C.F.R. § 230.508 (1991) (carving out a limited good faith defense by providing that a failure to comply with a term, condition, or requirement of the exemptions from the registration requirements of Section 5 would not result in the loss of the exemption, if the person relying on the exemption shows, *inter alia*, that a ''good faith and reasonable attempt was made to comply[.]'').

(b) Application to SOX 304

Turning to SOX 304, as the *Jenkins* court noted, provisions requiring proof of scienter were included in early House versions of the bill, but then were eliminated prior to final passage. Legislative silence on the issue of scienter, however, does not equate to confirming strict liability. Rather, if Congress intended to enact a strict liability standard through SOX 304, it should have explicitly stated so in the rule. *See Morissette*, 342 U.S. at 255 n.14.

Further, strict liability does not correspond with the case of an executive who is leading a public company and certifying financial statements according to a reasonable standard of care, and who also may be a victim of the misconduct. Notably, the financial stakes under SOX 304 are high, as clawback dollar amounts can easily rise into the millions of dollars, because restatements can span multiple years and typically are imposed years after the fact. For example, one company's CEO and CFO forfeited $3.7 million and $2.1 million, respectively, pursuant to SOX 304. https://www.sec.gov/news/pressrelease/2016-283.html.

In the securities law realm, liability typically requires some level of scienter, and rules that approach strict liability are balanced with good faith exceptions or defenses. Recent court interpretations of SOX 304, however, do not leave room for equitable escapes from the severe penalties faced by corporate executives and also are contrary to long-established principles, such as the business judgment rule.

3. Application of Business Judgment Rule

In corporate law, courts have long recognized the ''business judgment'' rule, which presumes that corporate directors and officers acted on an informed basis with an honest belief that business decisions were taken in the best interests of the company. The business judgment rule sets forth that an officer or director of a corporation is not liable for acts of mere negligence, but may be liable for acts of gross negligence or bad faith. *See In re Citigroup Inc. S'holder Derivative Litig.*, 942 A.2d 106, 125 (Del Ch. 2009). This rule strikes a balance between holding executives accountable and understanding that high-level executives often make difficult, multi-layered decisions concerning the company, which courts should not second-guess absent good reason. The business judgment rule is a particularly useful analog to SOX 304 because the latter provision is exclusively aimed toward CEOs and CFOs. Courts in the SOX 304 context are similarly ill-equipped to second guess good faith decisions made by CEOs and CFOs, absent some proof that they were involved in the wrongdoing and acted with scienter.

Using the business judgment rule as a guide for the level of scienter that should be required under SOX 304 would strike a fair and reasoned balance.

As discussed above, under several courts' interpretations of SOX 304, executives are given no such leeway. This perspective may be inconsistent with good business management and effective delegation of duties. For example, many corporations have multiple subsidiaries and business units, making it impractical (if not impossible) for CEOs and CFOs to scrutinize every

transaction or financial entry. Instead, it is necessary for them to rely on sub-certifications and reports from lower-level officers and employees, internal compliance personnel, and external auditors. In such circumstances, imposing strict liability clawbacks makes no sense where the executive acted prudently and engaged in reasonable due diligence.

Consistent with the business judgment rule, a long-established principle, Section 304 liability should require proof of a departure from the standard prudent practices of an executive in similar circumstances. Using the business judgment rule as a guide for the level of scienter that should be required under SOX 304 would strike a fair and reasoned balance, and would be consistent with the knowledge requirement embedded in Section 302.

4. Looking to Section 302: Knowledge as the Most Appropriate Level of Intent

The legislative history of SOX, as well as the related case law, draws an inherent connection between Section 302, which articulates an executive's responsibility to certify company financial statements, and the Section 304 clawback. The two sections should be read together because Section 304 is the remedy for an executive's failure to diligently certify the financial statements. Therefore, the scienter requirements of Section 302 and Section 304 should match.

Notably, Section 302 imposes responsibilities based on the officer's personal knowledge at the time of certification, requiring the officer to certify that ''(1) the signing officer reviewed the report; (2) ***based on the officer's knowledge***, the report does not contain'' untrue or misleading statements of material fact or omit statements of material fact; (3) ''***based on such officer's knowledge***, the financial statements, and other financial information presented in the report fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report.'' Sarbanes-Oxley Act § 302 (a)(1)-(3), 15 U.S.C. § 7241(a)(1)-(3) (emphasis added). Accordingly, Section 304 should likewise contain an identical knowledge requirement.

Given the interplay between these closely-linked statutory sections and the reasoning in *Life Partners*, executives who do not employ a reasonable standard of care and certify financial statements despite knowing that such statements include untrue or misleading information should be exposed to the SOX 304 clawback. If, however, an executive is diligent in reviewing and certifying financial statements under Section 302 and the executive has no knowledge of the misconduct that triggered the restatement, he or she should not be required to forfeit compensation under Section 304 because he or she has done what Section 302 requires. Further, recognizing the mirroring requirements of Sections 302 and 304 and setting knowledge as the appropriate level of intent may bolster the overall statutory coherence of the Sarbanes-Oxley Act and strike a more appropriate balance between corporate law's adherence to the gross negligence standard in the business judgment rule and the legislature's intent to enhance the accountability of public companies and executives.

5. Comparison to Rule 206(4)-7

In the same way that SEC officials are reconsidering the SEC's enforcement of Rule 206(4)-7, which mandates compliance programs for investment companies and investment advisers, and threatens strict liability for legal and compliance officers who act in good faith, the current application of SOX 304 should be re-evaluated. Echoing the words of these officials, the SEC and the courts should not be permitted to play ''Monday morning quarterback'' to good-faith and well-meaning business decisions, particularly where executives ''performed their responsibilities diligently, in good faith, and in compliance with the law.''

Recent statements by SEC officers regarding the enforcement of Rule 206(4)-7 are instructive. For example, in 2015, then-SEC Commissioner Daniel Gallagher noted that two recent settlements ''illustrate a Commission trend toward strict liability for CCOs [chief compliance officers] under Rule 206(4)-7,'' and that these actions are ''undoubtedly sending a troubling message . . . that CCOs should opt for less comprehensive policies and procedures with fewer specified compliance duties and responsibilities to avoid liability when the government plays Monday morning quarterback.'' Comm'r Daniel M. Gallagher, Statement on Recent SEC Settlements Charging Chief Compliance Officers With Violations of Investment Advisers Act Rule 206(4)-7 (June 18, 2015), *available at* https://www.sec.gov/news/statement/sec-cco-settlements-iaa-rule-206-4-7.html. The Commissioner concluded:

> The Commission must take a hard look at Rule 206(4)-7 and consider whether amendments, or at a minimum staff or Commission-level guidance, are needed to clarify the roles and responsibilities of compliance personnel under the rule so that these individuals are not improperly held accountable for the misconduct of others. The status quo simply will not do. As it stands, the Commission seems to be cutting off the noses of CCOs to spite its face. *Id*.

Furthermore, in 2014, then-director of the SEC Division of Enforcement Andrew Ceresney clarified that the appropriate scope of bringing such actions against legal and compliance officers should be limited to cases where a CCO affirmatively participates in misconduct, helps to mislead regulators, or when he or she has a clear responsibility to implement compliance programs and wholly fails to carry out that obligation. Director Ceresney emphasized, ''At the end of the day, though, legal and compliance officers who perform their responsibilities diligently, in good faith, and in compliance with the law are our partners and need not fear enforcement action.'' Andrew Ceresney, Keynote Address at Compliance Week 2014 (May 20, 2014), *available at* https://www.sec.gov/News/Speech/Detail/Speech/1370541872207.

6. Possible Creation of Unintended Consequences and Perverse Incentives

On a practical note, over-application of SOX 304 clawbacks against innocent executives may stir up perverse incentives that cut against the original purpose of the statute. For example, executives who are aware of the SOX 304 risk may insist on compensation that is immune to clawback by asking for salary-rich payouts rather than bonuses and stock grants tied to perfor-

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mance. This compensation shift may create tax complications for the business (for example, Section 162(m) of the tax code limits the amount of deductible compensation that a company can pay to the CEO and top four other most highly paid officers to $1 million annually), and also undermine one of the main purposes for incentive-based bonuses and stock grants, which is to tie the executive's personal compensation to the company's success. If executives and companies adopt this stance, the important incentives embedded in SOX 304 to increase executives' vigilance about the accuracy of companies' financial statements may be circumvented. If the SEC and the courts narrow the enforcement of SOX 304 against only those executives who have not exercised reasonable care in certifying financial statements, the objectives of SOX would be more acutely achieved.

The current trend towards strict liability for SOX 304 also has important implications for a defendant's choice of venue, jury trial right, and likelihood of success.

7. Strict Liability Penalty May Implicate Jury Trial Right

If SOX 304 is interpreted to punish executives regardless of their involvement or awareness in misconduct, a strong legal argument can be made that SOX 304 enforcement actions must take place in federal district court where the defendant's jury trial right attaches, rather than in administrative court.

The Seventh Amendment guarantees a right to a jury trial to determine liability when the SEC brings a legal claim for civil penalties. *See Tull v. United States*, 481 U.S. 412, 414 (1987). If SOX 304 is interpreted to require strict liability then it resembles a penalty, rather than equitable disgorgement, and the SEC could not present its case before an administrative law judge. As U.S. District Court Judge Jed Rakoff has remarked, the SEC success rate in its administrative courts far exceeds its success rate in federal court. Nate Raymond, *U.S. Judge Criticizes SEC Use of In-house Court for Fraud Cases*, Reuters, Nov. 5, 2014, *available at* http://www.reuters.com/article/2014/11/05/us-sec-fraud-rakoff-idUSKBN0IP2EG20141105.

One could reasonably argue that the current application of SOX 304 against innocent executives is more akin to a penalty than equitable disgorgement. As the court in *SEC v. Microtune*, noted: ''[T]his very case highlights the difference between Section 304's statutory reimbursement remedy and equitable disgorgement—Section 304 contains no personal wrongdoing element, in contrast to disgorgement, that would require scienter or misconduct on behalf of the officers in order to trigger reimbursement.'' *Microtune*, 783 F. Supp. 2d at 886-87. Equitable disgorgement, after all, involves the return of ill-gotten gains due to a wrongdoer's personal misconduct, which is a stance that some courts have explicitly rejected in the context of SOX 304. *See Jenkins*, 718 F. Supp. 2d at 1070; *Jensen*, 835 F.3d at 1114; *see also* Russell G. Ryan, *The Equity Facade of SEC Disgorgement*, Harv. Bus. L. Rev. Online (Nov. 15, 2013), *available at* http://www.hblr.org/2013/11/the-equity-facade-of-sec-disgorgement.

8. Statute of Limitations

The law regarding the statute of limitations for SEC enforcement actions will be better settled in the near future, and could significantly shape SOX 304-related considerations. On Jan. 13, 2017, the Supreme Court granted certiorari to review *SEC v. Kokesh*, 834 F.3d 1158 (10th Cir. 2016), in order to resolve a circuit split regarding which types of SEC enforcement actions are limited by the five-year statute of limitations in 28 U.S.C. § 2462. Under Section 2462, a five-year limitations period exists for the ''enforcement of any civil fine, penalty, or forfeiture.'' Further, the Supreme Court has held that this five-year period is measured from when the violation occurred rather than when it was discovered. *See Gabelli v. SEC*, 133 S. Ct. 1216, 1220 (2013).

Lower courts have disagreed, however, over whether this limitations period applies to commonly-sought injunctive relief and disgorgement, including the SOX 304 clawback. Some circuits have held that disgorgements and injunctions are not subject to the five-year statute of limitations because they are remedial and not punitive. *Kokesh*, 834 F.3d at 1164-67; *Riordan v. SEC*, 627 F. 3d 1230 (D.C. Cir. 2010) (specifically considering obey-the-law injunctions); *SEC v. Tambone*, 550 F. 3d 106 (1st Cir. 2008); *SEC v. Rind*, 991 F.2d 1486 (9th Cir. 1993). The D.C. Circuit, however, has held that injunctive suspension or bars for past behavior are ''punishment'' subject to those limitations. *See Johnson v. SEC*, 87 F. 3d 484 (D.C. Cir. 1996). Further, the Eleventh Circuit has held that disgorgement is also subject to Section 2462 because it is a ''forfeiture.'' *See Gabelli*, 133 S. Ct. at 1220. While the Supreme Court may resolve this issue in *Kokesh*, it is clear that a SOX 304 strict liability penalty will be subject to the five-year statute of limitations. Thus, the characterization of SOX 304 as a penalty or as equitable disgorgement may affect the limitations time period.

9. Conclusion

When SOX 304 is considered within the broader legal context, it becomes clear that imposing this clawback against innocent executives who had no knowledge of misconduct does not comport with the principles of statutory interpretation, the scienter requirements of the federal securities laws, the Section 302 knowledge requirement, and long-standing corporate principles. Overbroad enforcement of SOX 304 also may create unwanted consequences by punishing well-meaning and diligent executives, an outcome that is not only unjust but also unwise. In a SOX 304 proceeding, therefore, the SEC should be required to prove that the executive, in certifying the financial statements pursuant to Section 302, departed from the standard prudent practices of an executive in similar circumstances.