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PERSPECTIVE

CEO misconduct not required to clawback pay

By Ethan Dettmer and Noah Stern

Last month, the 9th U.S. Circuit Court of Appeals became the first circuit to hold that CEOs and CFOs may be required to pay back bonuses and other incentive- based pay after restatement of their company's financials, even if the executives did not engage in misconduct leading to the restatement. Though the Securities and Exchange Commission has brought clawback actions against executives not accused of personal misconduct, and most district courts have held such allegations are not necessary, this decision will sharpen the debate over when such clawbacks are appropriate. The court also held, in another issue of first impression, that SEC Rule 13a-14 provides an independent cause of action against executives who falsely certify that their company's financial statements are accurate.

The court's holdings underscore the importance of robust corporate controls designed to ensure GAAP compliant financial reporting to prevent restatements in the first place. Depending on how the law develops, those controls may not be relevant to an executive's defense of an SEC enforcement action. But it is likely that robust controls will not only help avoid such actions in the first place, but in the event they are brought, strong controls should help shape the law appropriately, by demonstrating the unfairness of compensation clawbacks in the absence of fault.

Background

SEC v. Jensen, 2016 DJDAR 9113 (Aug. 31, 2016), is an enforcement action brought against the former CEO and CFO of now-defunct Basin Water, Inc., which manufactured water treatment units used by municipalities to provide clean drinking water. Basin restated its financials in 2009, and the SEC alleged that Basin inflated revenues in violation of GAAP by (1) recognizing revenue from sales that had not been finalized and (2) recognizing revenue from alleged sham transactions with special purpose entities. Among other things, the SEC sought disgorgement of certain executive pay under Sarbanes Oxley (SOX) Section 304. Section 304 requires the CEO and CFO of an issuer that is "required to prepare an accounting restatement ... as a result of misconduct" to reimburse the issuer "any bonus or other incentive-based or equity-based compensation" received during the 12-month period following the public filing that required restatement. The SEC also alleged that defendants violated SEC Rule 13a-14, which requires the CEO and CFO of an issuer to sign certifications about the accuracy of the issuer's financial statements, including those contained in Forms 10-Q and 10-K.

On summary judgment, the district court rejected the SEC's Rule 13a-14 claim, holding that the rule does not create an independent cause of action against CEOs and CFOs that sign false certifications. After a trial, the district court held that SEC could not clawback defendants' pay because the SEC did not prove that the restatement was issued as a result of misconduct by defendants.

9th Circuit Decision

The 9th Circuit reversed and remanded for further proceedings. The court held that Rule 13a-14 contains an implicit truthfulness requirement and that it authorizes the SEC to bring a claim against CEOs and CFOs who falsely certify the accuracy of financial statements. With respect to SOX Section 304, the 9th Circuit sided with the majority of district courts that have recently addressed the issue in holding that "it is the issuer's misconduct that matters, and not the personal misconduct of the CEO or CFO." The court reasoned that SOX Section 304 is focused on "disgorging unearned profits" not "punishing individual wrongdoing."

But the court declined to provide guidance on issues that will arise on remand, specifically (1) whether Rule 13a-14 requires a culpable state of mind and (2) what constitutes "misconduct" under SOX Section 304. Judge Carlos Bea concurred with the majority, but wrote separately to state his view that intentional or reckless conduct is required with respect to both causes of action. To prove a violation of Rule 13a-14, Bea would require the SEC to prove that the CEO or CFO "act[ed] with knowledge or at least recklessness as to the falsity of a certification." And to prove the "misconduct" required by SOX Section 304, Bea would require the SEC to prove "an intentional violation of a law or standard (such as GAAP)." In a passage that will ring true to trial lawyers everywhere, Bea disagreed with his colleagues' decision not to provide guidance, noting the significant resource investment by all parties in the initial trial, and expressing concern that the court's decision virtually guarantees another appeal.

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Analysis

The *Jensen* decision makes clear that CEOs and CFOs of public companies face substantial risk from SEC enforcement actions any time their companies restate their financials. Based on *Jensen*, the SEC will argue that a restatement alone is enough for the SEC to force CEOs and CFOs to repay bonuses and incentive-based pay, including all equity-based compensation, and assert a cause of action under SEC Rule 13a-14.

Judge Bea's concurring opinion, that the SEC should be required to prove culpable conduct under either cause of action, should become the law. In the situation where the CEO and CFO have put robust financial controls in place, and the company is required to restate its financial statements anyway due to no fault of the executives, it is unfair and improper to deprive them of compensation they have earned. Indeed, there are other concerns about the SEC's position that have not been fully tested in the courts: is it constitutional to deprive an executive of property and contractual rights without allegations of fault? Is the executive entitled to customary indemnification? Are clawbacks only appropriate with respect to qualifying compensation that is received as a result of the errors in the financial statement? And how will issuers and the courts address these questions in connection with the SEC's proposed Rule 10-D, which will (if put into effect) require issuers to adopt, publish, and enforce clawback rules with respect to all of their senior executives regardless of fault.

Of course, the best way to avoid such liability is to avoid restatement of the company's financials in the first place. Thus, executives should be even more laser-focused on ensuring their company has robust corporate controls to ensure GAAP-compliant financials. While those controls may prove an ineffective technical defense to an SEC enforcement action, they will decrease the likelihood of a restatement, and, even if a restatement occurs, the deployment of robust corporate controls will decrease the likelihood that the SEC will bring such an enforcement action. And when these legal questions are tested in the courts, the unfairness of clawing back a hard-working executive's pay will be all the more unfair when she has overseen the creating and implementation of robust financial controls that failed due to circumstances beyond her control.

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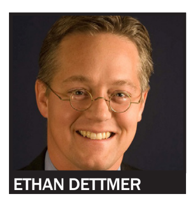
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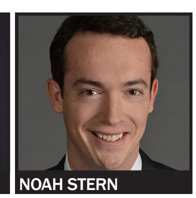
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