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Executive & Director Compensation Reference Guide

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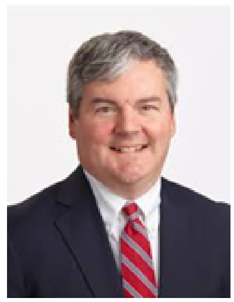

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INTRODUCTION —

There are four statutory clawback mechanisms established under federal law:

- Sarbanes-Oxley § 304; [1]

- Emergency Economic Stabilization Act of 2008 §111(b)(3)(B) (only applicable to entities that receive Troubled Asset Relief Program (TARP) funds); [2]

- Dodd-Frank § 954; [3] and

- Dodd-Frank § 956. [4]

[1] 15 U.S.C. § 7243.

[2] 12 U.S.C. § 5221.

[3] 15 U.S.C. § 78j-4(b).

[4] 12 U.S.C. § 5641.

SARBANES-OXLEY § 304 —

The clawback requirements in § 304 of the Sarbanes-Oxley Act of 2002 (SOX) were passed in response to the same highly publicized financial and business failures that led to the passage of SOX itself. Specifically, Enron and WorldCom manipulated their financial statements in a way that allowed company executives to receive bonuses based on inaccurate financial results and sell their stock at an inflated market price. To deter this financial incentive for executives to manipulate financial statements, § 304 allows the U.S. Securities and Exchange Commission (SEC) to require a company's CEO and CFO to reimburse bonuses, incentive-based, or equity-based compensation received within 12-months prior to the publication or filing of the financial statements at issue and, if the company must prepare an accounting restatement due to noncompliance with any financial reporting requirement under securities laws, any profits realized from the sale of securities of the issuer during that 12-month period. § 304 applies regardless of whether a restatement was caused by the personal misconduct of an issuer's CEO and CFO or by other issuer misconduct.

Use SmartCode to view the latest cases on § 304 clawback requirements.

SOX § 304 defendants are not entitled to a jury trial since the remedy sought is an equitable remedy.[5]

[5] *S.E.C. v. Jasper*, 678 F.3d 1116, 1130 (9th Cir. 2012).

There is no private right of action under § 304.[6]

[6] In re Digimarc Corp. Derivative Litig., 549 F.3d 1223 (9th Cir. 2008); See the Point of Law on this issue

No personal misconduct or scienter requirement exists under § 304.[7]

[7] See the Point of Law on this issue

The SEC may bring an action under § 304 seeking reimbursements for certain compensation within a 12-month period following the first public filing of a financial statement containing material misstatements.[8]

[8] *S.E.C. v. Life Partners Holdings, Inc.*, 854 F.3d 765 (5th Cir. 2017); *S.E.C. v. Mercury Interactive, LLC*, 2009 BL 196600 (N.D. Cal. Sept. 15, 2009); *Sec. & Exch. Comm'n v. AgFeed Indus., Inc.*, 2016 BL 505506 (M.D. Tenn. July 21, 2016); *S.E.C. v. Jasper*, 883 F. Supp. 2d 915, 933 (N.D. Cal. 2010) (explaining that each 10-K report that has to be restated constitutes a new “first filing” that triggers a 12-month forfeiture period).

For a § 304 claim to survive a motion to dismiss, the issuer must be required to file a financial restatement. [9]

[9] *Teachers' Ret. Sys. Of LA v. Hunter*, 477 F.3d 162, 188 (4th Cir. 2007); *In re Cree, Inc. Sec. Litig.*, 2005 BL 24662 (M.D.N.C. Aug. 2, 2005); *S.E.C. v. Shanahan*, 624 F. Supp. 2d 1072 (E.D. Mo. 2008); *Sec. & Exch. Comm'n v. Bardman*, 231 F. Supp. 3d 442, 449 (N.D. Cal. 2017).

At least one circuit court has held that an indemnity agreement between a corporation and its executives for any § 304 is a violation of SOX. [10]

[10] *Cohen v. Viray*, 622 F.3d 188, 195 (2d Cir. 2010).

TARP —

The Troubled Asset Relief Program (TARP) was created in an attempt to stabilize the country's financial system during the 2008 financial crisis and restore economic growth. The U.S. Department of Treasury oversaw the program, which sought to achieve these goals by purchasing troubled companies' assets and stocks. The clawback provisions at 15 U.S.C. § *5221* from the Emergency Economic Stabilization Act of 2008 apply to employees of a TARP recipient company that has not repaid the Treasury Department for financial assistance it received under the program. The top 5 most highly paid executives of a public company along with any of the next 20 most highly-compensated employees could lose any bonus, retention award, or incentive compensation, if statements of earnings, revenues, gains, or other criteria are found to be materially inaccurate. While the Secretary of Treasury may bring an action to enforce these provisions, no private right of action exists under these provisions.

Use Smart code to view the latest cases on TARP.

DODD FRANK § 954 —

Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in response to the 2008 financial crisis. § 954 of Dodd-Frank includes a mandatory clawback provision, which requires companies to develop a clawback policy in certain circumstances. Specifically, § 954 requires publically-listed companies to clawback the compensation of "any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the three-year period preceding the date on which the issuer is required to prepare an accounting restatement." [11]

There are a few notable differences between Dodd-Frank § 954 and Sarbanes Oxley's clawback provision. First, § 954 is backward-looking, requiring clawbacks of incentive-based compensation from the three years before the accounting restatement. This is wider reaching than Sarbanes Oxley, which permitted clawbacks of compensation received during the twelve-month period *following* the filing of the document that later required a restatement. Second, § 954 applies to "*any* executive," not just chief executive officers or chief financial officers, and does not require personal misconduct. This means that companies can clawback incentive-based compensation from lower-level executives, who do not exercise much control over decision making, even if those executives had no role in the accounting restatement. Third, unlike Sarbanes Oxley, which permitted clawbacks by the SEC alone, § 954 creates both a direct cause of action for boards of directors and a derivative cause of action for shareholders.

Although Congress passed Dodd-Frank in 2010, the SEC still has not finalized the regulations that were first published in July 2015. Accordingly, companies are not yet required to implement clawback policies.

DODD FRANK § 956 —

Congress also enacted § 956 of Dodd-Frank, which similarly targets certain incentive-based compensation arrangements. § 956 requires the SEC and other federal regulators to "prescribe regulations or guidelines to require each covered financial institution to disclose to the appropriate Federal regulator the structures of all incentive-based compensation arrangements offered by such covered financial institutions sufficient to determine whether the compensation structure . . . [a] provides an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation, fees, or benefits; or [b] could lead to material financial loss to the covered financial institution." Covered financial institutions include depository institutions, brokers-dealers, credit unions, investment advisors, and mortgage associations. Notably, § 956 differentiates between financial institutions based on the amount of the institution's total consolidated assets. Institutions with $250 billion or more in assets are considered Level 1; institutions with between $50 billion to $250 billion are considered Level 2; and institutions with between $1 billion and $50 billion are considered Level 3.

Clawbacks under § 956 are triggered when "the covered institution determines that the senior executive officer or significant risk-taker engaged in misconduct that resulted in significant financial or reputational harm to the covered institution, fraud, or intentional misrepresentation of information used to determine the senior executive officer or significant risk-taker's incentive-based compensation." [12] The clawback provision of § 956 applies only to Level 1 and Level 2 institutions. Notably, § 956 targets both senior executive officers and significant risk-takers, who are those individuals in the position to put a covered financial institution at risk. The proposed rules for § 956 define "excessive compensation" as any compensation that is "unreasonable or disproportionate to the value of the services performed." Moreover, clawbacks under § 956 are discretionary and enforceable only by the covered financial institution.

Like § 954, the SEC and other federal regulators have not yet finalized the rules and regulations for § 956.

CONTRACTUAL CLAWBACK PROVISIONS —

With the uncertainty of whether the proposed Dodd-Frank clawback regulations will ever be finalized, companies are implementing their own clawback provisions that allow the company or its board to claw back executive incentive compensation for a variety of reasons, including issuance financial restatements (with or without misconduct), fraud or willful misconduct, and/or executive misbehavior in violation of company policy. These are typically contractual provisions that give the company discretion as to whether to enforce them. Contractual clawback policies will likely continue to become more prevalent as shareholders seek to hold executives accountable for misconduct.

The business judgment rule generally applies to demands for clawbacks by shareholders. [13]

[13] *Andersen v. Mattel, Inc.*, 2017 BL 15059 (Del. Ch. Jan. 19, 2017); *Grika v. McGraw*, 57 N.Y.S.3d 675 (N.Y. Sup. 2016); *City of Tamarac Firefighters' Pension Trust Fund v. Corvi*, No. 2017-0341-KSJM, 2019 WL 549938 (Del. Ch. Feb. 12, 2019).