DIRECTORS' AND OFFICERS' LIABILITY DEVELOPMENTS IN 2009: SENIOR CORPORATE OFFICERS BEWARE OF THE SEC'S NEW AGGRESSIVE POLICY ON SARBANES-OXLEY CLAWBACKS

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Congress enacted the Sarbanes-Oxley Act of 2002 (SOX) to protect investors by improving the reliability and accuracy of public company financial disclosures. SOX Section 304, the "clawback" provision, provides that where a corporation 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 (CEO) and chief financial officer (CFO) "shall reimburse" the corporation for "any bonus or other incentive-based or equity-based compensation" or "any profits realized from the sale of the securities" during the 12-month period preceding the filing of the misstated financial statements.[1]

Section 304 has had relatively little impact since its enactment, for two reasons. First, although it provides for reimbursement to the corporation, the courts have uniformly held that enforcement power is vested exclusively in the U.S. Securities and Exchange Commission (SEC) and that neither the corporation nor its shareholders may enforce Section 304.[2] Second, until very recently, the SEC pursued Section 304 clawbacks only as one of several remedies against targeted officers alleged to have been involved personally in misconduct that caused misstated financial statements, and in cases where the SEC alleged substantive violations of other securities laws.[3]

Recently, however, the SEC has pursued a new, more aggressive approach. In two recent cases, the SEC has asserted that, where there has been a restatement as a result of misconduct by someone at the company, a Section 304 clawback may be obtained from a CEO or CFO who is not alleged to have had any involvement in the improper conduct. In July 2009, the SEC sued the former CEO of CSK Auto Corporation (CSK), alleging that under Section 304, he must repay $4 million to CSK, even though he was not alleged to have participated in, condoned, or negligently failed to detect the purported fraud.[4] Moreover, the SEC is pursuing all bonus compensation and stock profits received, without alleging that all or part of those amounts were attributable to artificial inflation of CSK's stock price due to misstated financial statements. A few months later, on November 13, 2009, the staff of the SEC sent a Wells Notice to the CEO of Beazer Homes, Inc., informing him that the staff had preliminarily determined to recommend that the SEC bring a similar action against him, even though the staff did not allege "any lack of due care by [the CEO] in connection with [Beazer Homes'] financial statements or other disclosures."[5]

The SEC's new approach highlights the key ambiguity at the heart of Section 304. The trigger for a Section 304 clawback is "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."[6] As commentators noted when SOX was passed, the critical question is *whose* misconduct is required to trigger the clawback: Must it be the misconduct of the CEO or CFO, or is misconduct of other management sufficient?[7] Put differently, does Section 304 establish a standard of strict liability for CEOs and CFOs whose companies have issued restated financial statements? And does it permit the clawback of bonuses, incentive-based compensation, or stock sales proceeds not alleged to have been tied to, or affected by, the misstatements?

Acceptance of the SEC's new approach necessarily requires acceptance of the conclusion that, in enacting Section 304, Congress intended two dramatic departures from existing law: First, to alter the well-established relationship between the federal securities laws, which were enacted to protect investors and the integrity of the securities markets, and state corporation law, which regulates the internal operation and governance of corporations; and second, to create a new, retrospective strict liability scheme. There is no persuasive evidence that Congress intended such dramatic changes.[8] Moreover, there are significant policy objections to the SEC's new interpretation of Section 304.

Corporate Governance Standards Established by State Law

Corporate governance has long been recognized to be a matter primarily of state regulation. In *Business Roundtable*, the D.C. Circuit vacated an SEC "one vote/one share" rule because, among other reasons, it would "overturn or at least impinge severely on the tradition of state regulation of corporate law."[9] "As the Supreme Court has said, 'corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to *stockholders*, state law will govern the internal affairs of the corporation.'"[10] Carefully examining the Securities Exchange Act, the D.C. Circuit concluded that there is an "intelligible conceptual line excluding the Commission from corporate governance."[11]

Delaware, whose law applies to the CSK situation, has well-developed law establishing both substantive corporate governance standards and enforcement procedures.[12] Delaware recognizes that officers owe fiduciary duties to the corporation, including duties of care and loyalty.[13] Breach of the duty of care occurs where the officer engages in misconduct rising at least to the level of gross negligence,[14] and breach of the duty of loyalty requires bad faith or similar conduct, such as conversion of corporate assets or "intentionally act[ing] with a purpose other than that of advancing the best interest of the corporation," or "demonstrating a conscious disregard for his duties.[15] Breach of the "oversight" duty requires essentially bad faith, where an officer "(a) utterly fail[s] to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously fail[s] to monitor or oversee its operations thus disabling themselves from being informed of the risks or problems requiring their attention."[16] These high thresholds for liability reflect Delaware's recognition that management of a corporation necessarily requires reliance upon subordinates.

Delaware law also entrusts the corporation's board of directors with responsibility for governing it.[17] The board's authority extends to evaluating claims that management has violated its fiduciary duties. Thus, for example, if a corporation is required to restate its financial statements, and a shareholder brings a derivative suit alleging breach of duty by management in connection with issuing the original financial statements, the board (or, in some cases, a special committee of disinterested directors)[18] will evaluate the claims and, exercising its business judgment, determine whether it is in the corporation's best interest to pursue them.[19] In exercising its business judgment, the board (or special committee) may consider the likelihood of success as well as the potential cost to the corporation in terms of litigation expense, distraction of management, and reputational harm.[20]

Strict Liability Interpretaion Gives SEC Unilateral Discretion

The SEC's "strict liability" interpretation of Section 304 effectively arrogates to the SEC the unilateral right to require innocent CEOs and CFOs to pay to the corporation board-approved compensation that was not affected by the financial statement misstatements. The SEC views Section 304(a)'s "shall reimburse" language as mandatory, tempered only by the SEC's unilateral authority under Section 304(b) to "exempt any person" from Section 304(a) "as it deems necessary and appropriate."[21] Thus, the SEC interprets Section 304 to authorize the SEC to make the ultimate judgment about a clawback.

The SEC claims that in so doing, it is acting "in the right of the corporation"[22]—that is, that the SEC is exercising the sort of right normally reserved to the board of directors. Yet, because there is no private right of action to enforce Section 304, the SEC is exercising a "right of the corporation" that the corporation itself cannot enforce.[23] And, even more ironically, in theory, the SEC could require such reimbursement even where there is no officer misconduct and the board believes that reimbursement is contrary to the corporation's best interest—for example, because it will harm the relationship between the corporation and its executives. That is, the SEC can pursue a "right of the corporation" that the board does not believe the corporation should pursue.

Beyond the Scope of Prior Prophylactic "Strict Liability" Securities Law Remedies

The SEC asserts that its position is not novel, citing securities law provisions establishing prophylactic rules requiring individuals to pay over funds to the corporation, even where no culpable state of mind is alleged.[24] However, those rules are materially different from SOX Section 304 as interpreted by the SEC in two critical respects. First, they provide clear advance notice of the circumstances under which conduct will result in payment so that the officer or director can avoid that conduct. Second, they are limited prophylactic rules designed to mitigate the risk of trading on inside information to the detriment of the corporation or other shareholders and, as such, protect the integrity of the markets.

Thus, for example, the SEC cites Section 16(b) of the Exchange Act, the "short swing profits" provision. That section requires public company insiders to disgorge "short swing" profits from any purchase and sale within a six-month period, irrespective of the insider's intent.[25] The insider can easily avoid liability simply by paying attention to the calendar and abstaining from the statutorily prohibited conduct. The insider can similarly avoid liability under SOX Section 306, which provides for mandatory repayment of stock sale profits from insiders who traded during a retirement plan "blackout period," irrespective of the seller's intent, by abstaining from such sales during the publicly announced blackout period.[26]

These prophylactic rules operate very differently from SOX Section 304 as now interpreted by the SEC. In the case of, for example, a restatement resulting from misconduct that the CEO and CFO were not involved in and did not know (or were affirmatively deceived) about, they cannot have known in advance that a restatement would occur and consequently could not order their conduct to avoid running afoul of the clawback. Moreover, no risk of trading on inside information existed because, in this hypothesis, they were unaware of any accounting irregularity or financial statement misstatement. Thus, the SEC's interpretation of Section 304 creates a unique, retrospective "strict liability" standard. Moreover, it does so even with respect to compensation that is not alleged or proven to have been affected in any way by the financial statement misstatements.

Legislative History

Nothing in SOX or its legislative history suggests that Congress intended broadly to displace Delaware law regarding the fiduciary obligations of corporate officers or boards' governance authority. To the contrary, SOX provides that violations under the act should be treated "in the same manner as a violation of the Securities Exchange Act of 1934." Thus, the logic of *Business Roundtable*, which decided that the SEC's role does not extend to the regulation of corporate governance, still applies.[27] If Congress wanted the SEC to enter this corporate governance space, one would have expected Congress to say so both expressly and clearly. It did not.

To the extent SOX imposes specific duties on officers and/or directors, it does so in only limited instances, all of which are clearly tailored to protect the integrity of the financial markets and the information provided to them by issuers. Thus, SOX requires the issuer's CEO and CFO to certify that, "based on the officer's knowledge," the financial report does not contain any untrue statement of material fact or a material omission;[28] requires statements with respect to internal controls;[29] prohibits trading during blackout periods;[30] and governs the filing deadlines of Forms.[31] None of these duties are designed to supplant corporate governance standards. Even the SOX Section 302 certification provision does not directly impact corporate governance standards, as it requires only that the signing officer review the report and certify that based on the officer's knowledge, "the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading."[32] If in fact the certifying official knew or suspected that the financial statements were materially misleading, the officer clearly would be in violation of both state corporate governance laws and pre-SOX federal securities laws. Notably, Section 302, with which Section 304 must be construed as part of the entire SOX statute, specifically refers to the officer's state of mind.

Nothing in the legislative history clearly reflects congressional intent to federalize governance standards and impose strict liability on innocent officers. In fact, the legislative history makes clear that Congress viewed the reimbursement contemplated by the statute as tantamount to "disgorgement," a term of art that consistently has been construed to mean profits *wrongfully* acquired as a result of violation of law.[33] The Senate Committee that discussed the version of Section 304 incorporating the language that "the chief executive officer and chief financial officer of the issuer shall *reimburse* the issuer"[34] repeatedly described this reimbursement as disgorgement. The Senate Report stated,

> Recent events have raised concern about *management benefitting from unsound financial statements*, many of which ultimately result in corporate restatements. The President has recommended that "CEOs or other officers should not be allowed to profit from erroneous financial statements," and that "CEO bonuses and other incentive-based forms of compensation should be *disgorged in cases of accounting restatement and misconduct*."[35]

The italicized language, which is reiterated in the committee's discussion of the bill,[36] suggests that Congress intended a disgorgement remedy (i.e., only benefits obtained through wrongful conduct and demonstrably tied to misstated financial statements could be at risk under Section 304). The SEC's interpretation eliminates those state-of-mind and causation requirements.

SEC's Interpretation Is Unnecessary

The SEC's claim that its interpretation "obviously serves to foster greater corporate responsibility and deter fraud"[37] is unconvincing. The SEC's interpretation is not necessary—or even helpful—to prevent restatements. Other provisions of SOX already require management to provide certifications with respect to the company's internal financial controls.[38] Any additional deterrent value provided by the SEC's interpretation is at best redundant.

Indeed, the SEC's theory can lead to perverse results. Under the SEC's theory, if a CEO or CFO suspects problems and advocates and implements more stringent controls that uncover a fraud and result in a restatement, he risks being punished for his diligence. Moreover, if the SEC's position is that the compensation to be clawed back need not be tied to or inflated by the misstated financial statements, this would either severely punish proactive and non-culpable officers, or leave the punishment decision completely within the SEC's discretion.[39]

The SEC's new interpretation of SOX Section 304 gives the SEC a powerful—and powerfully tempting—new enforcement tool because it effectively eliminates key elements of the SEC's case. A strict liability standard eliminates the element of scienter that is required to establish most securities law violations[40] or even the good faith required to defend Securities Act Section 11 claims.[41] Moreover, eliminating any requirement that the compensation to be clawed back be proven to have resulted from the misstatement effectively eliminates the normal requirements of showing a nexus between the alleged misconduct and ill-gotten gains sufficient to support disgorgement.[42] Thus, as a practical matter, the SEC's approach, if accepted, would provide the SEC a simpler enforcement device than traditional securities fraud claims.

Conclusion

In the wake of the stock market meltdown of 2008 and the Madoff scandal, the SEC faces extraordinary pressure for more vigorous enforcement. We respectfully suggest, however, that more vigorous enforcement of the securities laws is not the same thing as a more aggressive interpretation of them. If the goal is to obtain more timely, effective remedies against those who have violated the securities laws or otherwise engaged in misconduct, interpreting SOX Section 304 to assert claims against officers who are not alleged to have engaged in any misconduct under either the securities laws or state corporate law, to force them to return bonuses that are not alleged to be related to any misstatements, appears to us to be a misguided effort. It is hard to identify any additional deterrent effect: It will not enhance the reliability of corporate disclosures because there is nothing officers can do to eliminate absolutely any risk of misconduct that could result in a restatement. It could hamper the ability of corporations to retain qualified CEOs and CFOs generally, and particularly in circumstances where new management is needed to guide a troubled company. And it does so in derogation of the traditional role of boards of directors, as defined by state law, to monitor management's performance and pursue remedies for any breach of duties.

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1. 15 U.S.C. § 7243.
2. *See, e.g., In re* Digimarc Corp. Deriv. Litig., 549 F.3d 1223, 1232 (9th Cir. 2008); Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Raines, 534 F.3d 779, 793 (D.C. Cir. 2008); *In re* iBasis, Inc. Deriv. Litig., 532 F. Supp. 2d 214, 224–25 (D. Mass. 2007).
3. *See, e.g.*, SEC Charges Hurricane Restoration Company and Executives in Post-Katrina Accounting Fraud; Four Individuals Settle, Litigation Release No. 21314 (Nov. 30, 2009), *available at* www.sec.gov/litigation/litreleases/2009/lr21314.htm (charging current and former CEOs with having "engaged in a series of revenue-inflation schemes, booking millions of dollars of bogus revenue by invoicing and recording receivables on work that never occurred" and seeking "reimbursement of bonuses and stock sale profits under Section 304."); SEC Settles With Microtune Inc. and Sues Former Microtune Officers In Stock Option Backdating Scheme, Litigation Release No. 20633 (July 1, 2008), www.sec.gov/litigation/litreleases/2008/lr20633.htm (charging CEO and former CFO/General Counsel with perpetrating an options backdating scheme that awarded them and other employees millions of dollars of undisclosed compensation and seeking reimbursement of their stock sale profits under Section 304).
4. *See generally* Complaint ¶¶ 1–2, 42, 44–48, Sec. & Exch. Comm'n v. Jenkins, Case No. 2:09-cv-01510-JWS (D. Ariz.) (filed July 22, 2009) (Jenkins Complaint).
5. Beazer Homes USA, Inc., Form 8-K (Nov. 16, 2009).
6. 15 U.S.C. § 7243 (emphasis added).
7. *See, e.g.*, John Patrick Kelsh, *Section 304 of the Sarbanes-Oxley Act of 2002: The Case for a Personal Culpability Requirement*, 59 Bus. Law 1005 (May 2004) (arguing that CEO or CFO culpability should be required); John C. Coffee Jr., *Leading Issues Under Sarbanes-Oxley*, N.Y.L.J., Volume 228 (Sept. 19, 2002) (highlighting ambiguity); Rachael E. Schwartz, *The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean*, 64 Bus. Law 1 (2008) (arguing no CEO or CFO culpability should be required).
8. As a general rule, when statutory language is ambiguous, courts will defer to the interpretation of the statute by the agency charged with administering it as long as "the agency's answer is based on a permissible construction of the statute." Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842–43 (1984). If the "text of the statute will [not] reveal an actual intent of Congress," the Court looks to the legislative history to ascertain congressional intent and whether the agency's interpretation is consistent. *Id.* at 861–63. "But the presence of some [statutory] uncertainty does not expand *Chevron* deference to cover virtually any interpretation of the [relevant] Act" by the agency. *See* Cuomo v. Clearing House Ass'n, L.L.C., 129 S. Ct. 2710, 2715 (2009).
9. The Bus. Roundtable v. Sec. & Exch. Comm'n, 905 F.2d 406, 412 (D.C. Cir. 1990).
10. *Id.* (*quoting* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977) (emphasis in original)).
11. *Id.* at 413.
12. Delaware is the most common state of incorporation, and most states' corporate laws are substantially similar with respect to the issues discussed herein.
13. Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009).
14. *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369 (Del. 2006) (approving standard articulated in *In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996)).
15. *Id.* at 369. (*quoting In re* Walt Disney Co. Deriv. Litig., 906 A.2d 27, 67 (Del. 2006)).
16. *Id.* at 370.
17. *See* 8 Del. Code Ann. Tit. 8, 141(a) (2006); *see also Stone*, 911 A.2d at 366 (quoting the statute).
18. *See, e.g.*, Zapata Corp. v. Maldonado, 430 A.2d 779, 786 (Del. 1981).
19. *See, e.g.*, Del. Ch. Ct. R. 23.1; Brehm v. Eisner, 746 A.2d 244, 255 (Del. 2000). Not only are boards thus entitled to evaluate demands and control any ensuing litigation, but also their decisions to refuse such demands are entitled to deference under the business judgment rule. *See, e.g.*, Spiegel v. Buntrock, 571 A.2d 767, 775–76 (Del. 1990). These sorts of derivative claims have occurred frequently in connection with restatements. *See, e.g., In re* Am. Int'l. Group, Inc., 965 A.2d 763, 775, 778 (Del. Ch. 2009); Saito v. McCall, Civ. A. 17132-NC, 2004 WL 3029876, *7 & n.71 (Del. Ch. Dec. 20, 2004).
20. *See, e.g., Zapata*, 430 A.2d at 784; *Brehm*, 746 A.2d at 255.
21. SEC Opp. to Mot. to Dismiss at 17 n.13, SEC v. Jenkins (filed Oct. 15, 2009) (SEC Br.); 15 U.S.C. § 7243.
22. SEC Br. at 17 n.13; *id.* at 14.
23. *Id.*
24. *See* SEC Br. at 16–17 (citing 15 U.S.C. § 78p(b)).
25. 15 U.S.C. § 78p(b) (cited at SEC Br. at 16–18).
26. 15 U.S.C. § 7244.
27. *Business Roundtable*, 905 F.2d 406.
28. 15 U.S.C. § 7241(a)(2); 18 U.S.C. § 1350.
29. 15 U.S.C. § 7262.
30. 15 U.S.C. § 7244(a).
31. 15 U.S.C. § 78p.
32. 15 U.S.C. § 7241(a)(2).
33. *See* Def. Mot. To Dismiss at 17, SEC v. Jenkins (filed Sept. 15, 2009); *see also*, *e.g.*, SEC v. First Pac. Bancorp, 142 F.3d 1186, 1191 (9th Cir. 1998) ("Disgorgement is designed to deprive a wrongdoer of unjust enrichment."); SEC v. Blatt, 583 F.2d 1325, 1335 (5th Cir. 1978) (defendant could be compelled only to disgorge profits and interest wrongfully obtained).
34. *See* Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 2673, S. Rep. No. 107-205.
35. *Id.* at 26 (emphasis added).
36. *Id.* at 53 (emphasis added) ("In the case of accounting restatements that *result from material non-compliance with SEC financial reporting requirements*, CEOs and CFOs must *disgorge* bonuses and other incentive-based compensations and profits on stock sales, *if the non-compliance results from misconduct*.").
37. SEC Br. at 16.
38. *See supra* p. 8 & nn.33–37.
39. *See* 15 U.S.C. § 7243(b).
40. *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 US 185, 193 (1976) (scienter is an element of a claim under 10(b) of the Securities Exchange Act of 1934 and Exchange Commission Rule 10b-5 requires an allegation of scienter).
41. 15 U.S.C. 77k(b).
42. *See generally* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 347 (2005) (causation).