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PERSPECTIVE

Jensen embodied in proposed Dodd-Frank rule

By Neal Potischman and Sarah K. Solum

The possibility that a C-level executive might have his or her compensation "clawed back" after engineering a financial fraud is not new. Many corporate officers, however, may not realize that they could be required to disgorge incentive compensation paid two to three years ago whenever someone else in their organization engages in conduct that triggers a restatement. A number of developments continue to weaken executives' ability to hold onto compensation in these circumstances, effectively subjecting them to a strict liability standard for other employees' behavior.

On Aug. 31, the 9th U.S. Circuit Court of Appeals, in *SEC v. Jensen*, held that Section 304 of the Sarbanes-Oxley Act (SOX 304) allows the SEC to claw back compensation from CEOs and chief financial officers whose companies have restated financial results, "even if the triggering restatement did not result from misconduct on the part of those officers." Although the SEC has taken this position in prior settlements, the 9th Circuit is the first among the Courts of Appeals to endorse the SEC's interpretation of SOX 304.

The case was brought by the SEC against the former CEO and chief financial officer of Basin Water, who were alleged to have engaged in a fraudulent scheme to overstate the company's financial results by failing to comply with generally accepted accounting principles. They were also alleged to have received hundreds of thousands of dollars in incentive-and equity-based compensation during the relevant period.

As to the SEC's compensation clawback claim, the district court held that the defendants had not violated SOX 304 because their company's "misstatement was not issued due to any misconduct on the part" of the defendants. The 9th Circuit reversed. The court agreed with the SEC that 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." In the court-acknowledged issue of first impression among the courts of appeals, the 9th Circuit held that SOX 304 "does not require CEOs or CFOs to have personally engaged in misconduct before they are required to disgorge profits under that statute." The court explained that "disgorgement is merited to prevent corporate officers from profiting from the proceeds of misconduct, whether it is their own misconduct or the misconduct of the companies they are paid to run."

The SEC's support of a strict liability standard for compensation clawbacks, now endorsed by the 9th Circuit, is also embodied in the SEC's proposed Dodd-Frank implementation rule, Rule 10D-1. Announced on July 1, 2015, proposed Rule 10D-1 directs national securities exchanges to prohibit the listing of any security of an issuer that does not have a compensation clawback policy that contains various specified criteria. Among these are provisions that would require companies to seek disgorgement of incentive compensation from current or former executive officers after a restatement due to material noncompliance with any financial reporting requirement under the federal securities laws, even if the officers were not personally involved in any misconduct.

The proposed rule — which requires issuers to seek return of incentive compensation after a restatement except in narrow circumstances, including if the cost of enforcing the recovery would exceed the recoverable amount — has been the subject of extensive commentary. Commentators have noted the potentially draconian impact of the SEC's position, particularly in the case of executives who engaged in no wrongdoing.

In comments submitted earlier this year, the ABA's Business Law Section noted that the proposed rule "is largely inflexible" and that "the virtual absence of issuer discretion … invites problems." The SEC has not yet responded to the cascade of comments it received.

The SEC's focus on penalizing senior executives, despite an executive's lack of personal misconduct, is perhaps not surprising. Many have criticized regulators for their approach regarding senior executives who profited in the years leading up to the financial crisis. Moreover, counterbalancing any temptation to engineer financial results is surely a good thing. Many companies already have adopted clawback policies designed to do just that, frequently based on a showing of executive misconduct. But if the SEC's strict liability enforcement approach becomes mandatory with no room for corporate boards to make exceptions, then even the most conscientious executives will automatically face disgorgement in the event of qualifying restatements.

How can senior executives best position their companies to avoid restatements?

First, revisit internal controls. By and large, NYSE- and NASDAQ-listed public companies have implemented both required procedures and best practices in the internal controls area. These include a disclosure committee that is charged with risk assessment and review of all SEC filings, a subcertification process whereby lower-level executives and employees certify to matters covered by the CEO and CFO certifications, whistleblower hotlines, related-party policies and approval procedures, an internal audit function, an audit committee composed of independent directors with at least one financial expert and an independent external auditor. While great on paper, the effectiveness of these practices can vary. Companies should assess whether existing practices are effective or whether a rubberstamp mindset prevails. For example, is the disclosure committee afforded adequate time to review earnings announcements and quarterly and annual reports? Are audit committee members briefed on alternative accounting treatments and made aware of how the company's practices differ from others in the industry? Are key financial metrics calculated transparently and consistently?

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Second, assess the team. Consider whether the individuals responsible for internal controls are up to the task at this stage of the company's growth. Consider whether additional resources or upgraded talent would be beneficial. For example, has the company grown such that existing finance, accounting or legal teams are so strained that errors are likely to occur? Has the company's business evolved to a level of complexity beyond the expertise of the company's staff? Does the company consult with external lawyers experienced in SEC compliance and disclosure? Do the members of the audit committee actively engage in their oversight role?

Third, set a tone of transparency and assess high-risk restatement areas. Adopt a culture of strong ethics and accountability and talk about the possibility of fraud. Understand that aggressive compensation arrangements tied to aggressive growth strategies may be more likely to result in misconduct. Relatedly, consider whether the mix of salary and incentive compensation (including equity compensation) adequately balances the achievement of valid corporate objectives with the avoidance of unnecessary risk. Beware that restatements can result from normal human error, willful blindness, aggressive accounting treatment or intentional deception. Understand that, in a high-pressure environment, even honest people may turn a blind eye. Use a risk-based approach that focuses greater attention on the financial reporting areas most likely to trigger a restatement, such as revenue recognition. Consult with auditors on the areas most relevant to the company.

Finally, take heart that restatement activity is at a low. The earliest years of the 21st century were marked by significant scandals at Enron, Worldcom, Tyco and HealthSouth, as well as stock options-backdating restatements. Since 2005, restatements have fallen off significantly. Audit Analytics' 2015 Financial Restatements indicates that there were 264 total restatements by larger U.S. companies in 2015, of which approximately 20 percent disclosed that prior financial statements could no longer be relied upon. This compares to 510 total restatements among the same category of companies in 2005, of which 90 percent disclosed that prior financials could no longer be relied upon. While the SEC has not limited proposed Rule 10D-1 to these more severe types of restatements, it is clear that the rule would require disgorgement only for restatements that reflect the correction of errors that resulted from material noncompliance with reporting standards.

While the possibility of restatement cannot be eliminated, conscientious companies and executives can best position themselves to avoid it by following good corporate hygiene and proactively managing risk.

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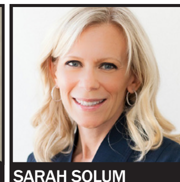
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