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SEC Clawbacks of CEO and CFO Compensation

Posted by John F. Savarese and Wayne M. Carlin, Wachtell, Lipton, Rosen & Katz, on Thursday, September 15, 2016

Editor's note: John F. Savarese and Wayne M. Carlin are partners in the Litigation Department of Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton memorandum. Related research from the Program on Corporate Governance includes Excess-Pay Clawbacks by Jesse Fried and Nitzan Shilon (discussed on the Forum here); and Rationalizing the Dodd-Frank Clawback by Jesse Fried (discussed on the Forum here).

Last week, the U.S. Court of Appeals for the Ninth Circuit affirmed the SEC's interpretation of Section 304 of the Sarbanes-Oxley Act, which authorizes the SEC to seek to claw back performance-based compensation paid to CEOs and CFOs of public companies in certain circumstances. *SEC v. Jensen* (Aug. 31, 2016). The SEC's power to seek clawbacks arises when an issuer has been required to restate previously issued financial statements "as a result of misconduct." A key issue in the interpretation of this provision has been the question whether the "misconduct" must be committed by the person whose compensation the SEC is seeking to recover. The SEC has argued that personal misconduct is not required, but that any misconduct within the corporation—committed by any employee—is a sufficient predicate to claw back compensation from the CEO and CFO.

In *Jensen*, a unanimous Ninth Circuit panel held that Section 304 "allows the SEC to seek disgorgement from CEOs and CFOs even if the triggering restatement did not result from misconduct on the part of those officers." Several district courts had previously addressed this issue and also accepted the argument that misconduct by the corporation is a sufficient basis for clawback relief. See our 2011 posts, Another SEC Clawback Settlement and SEC Claws Back Again. After these initial victories at the trial court level, the SEC continued to seek clawbacks in some, though not all, cases involving restatements. The *Jensen* court is the first appellate court to rule on the issue. While the SEC has not hesitated to pursue this remedy under the previously existing caselaw, this victory at the appellate level may lead the Commission to seek this relief with greater frequency.

The SEC's continued use of the clawback remedy, and the Ninth Circuit's validation of the SEC's reading of Section 304 together reinforce the importance of policies and procedures that are the best defense against possible errors in financial reporting. In recent years, the SEC has devoted greater resources to financial reporting investigations. This added emphasis has coincided with the growth of the SEC's whistleblower program. Throughout the existence of the program, financial reporting matters concerning issuers have consistently been the single largest category of whistleblower complaints. Critical steps for all companies include communicating a strong tone from the top with respect to ethics, compliance and accurate financial reporting; maintaining a robust system of internal controls and periodically assessing the need for updates and

enhancements to those controls; and responding in an appropriate and timely manner to indications of possible financial reporting issues, including internal whistleblower complaints.