

WHITE-COLLAR CRIME

New DOJ and SEC Compensation Clawback Policies—Easier Said Than Done?

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In recent months the Biden administration has demonstrated that clawing back compensation from company executives is at the top of its list of white collar enforcement priorities. Last month the Department of Justice launched a new Pilot Program on Compensation Incentives and Clawbacks (the Pilot Program), effective March 15, which requires that resolutions with any company include compensation-related criteria and provides a fine reduction incentive for companies that claw back, or attempt to claw back, employee compensation. Several weeks earlier, the Securities and Exchange Commission adopted its long-awaited clawback rule—“Rule 10D-1,” effective Jan. 27, 2023—implementing changes to Section 10D of the Securities Exchange Act passed as Section 954 of the Dodd-Frank Wall Street Reform Consumer Protection Act of 2010.

These new programs represent a major broadening in the scope of clawback policies, but at least for publicly held companies, clawback mandates are not new. Since 2002, Section 304 of the Sarbanes-Oxley Act (SOX Section 304) has directed the SEC to enforce the clawback of any bonus, incentive-based pay, or stock sale profits received by a public company’s CEO or CFO that has restated its financials. The new DOJ and SEC



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policies mirror certain elements of this existing clawback regime, while also reflecting some significant differences. Most important, however, is the absence of express statutory authority for these new clawback policies, thereby forcing companies to rely on existing state legal remedies, which may present significant practical hurdles to recovery. As lawmakers such as Massachusetts Sen. Elizabeth Warren call for the clawback of executive compensation to hold individuals accountable for events seen in recent news headlines, such as for the collapse of Silicon Valley Bank and Signature Bank, companies may soon face questions regarding whether or not to participate in the DOJ’s Pilot Program. As companies analyze some of the real world hurdles to clawback, they may find that the costs of participating in the program outweigh its potential benefits.

The DOJ Pilot Program

The aim of DOJ’s Pilot Program is to place the burden on executives and employees, rather than uninvolved shareholders, through two initiatives

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applicable to every company (i.e., public, regulated, private, etc.): (1) any corporate resolution must include “compliance-promoting” criteria related to compensation and bonus structures and (2) companies that fully cooperate and remediate, but nonetheless face enforcement, have the opportunity to receive a fine reduction if the company implements policies and procedures to recover employee compensation. In practice, DOJ anticipates that the Pilot Program will operate so that a resolving company pays the applicable fine amount imposed by DOJ minus a “reserved credit,” which will equal the amount of executive compensation the company intends to claw back from employees. If the company succeeds in recovering the full amount, the company is permitted to keep the compensation and escape the full penalty. If a company is unsuccessful in recouping 100% of the reserved credit, but nonetheless demonstrates a “good faith attempt,” it is eligible for up to a 25% fine reduction.

The decision whether to participate in the Pilot Program or not is left to the resolving company; the Pilot Program creates an incentive to participate, but participation is not mandatory. Assistant Attorney General Kenneth A. Polite Jr. remarked during the announcement of the Program that it functions as “best practice” and “companies should make an assessment about the potential cost to shareholders and prospect of success of clawback litigation” in their calculus of whether to pursue recoupment of employee compensation.

Rule 10D-1

The SEC’s recently adopted Rule 10D-1 directs U.S. stock exchanges and securities associations to require listed companies to adopt and comply with a written clawback policy. The policy must require that any incentive compensation (including both cash and equity compensation) paid to any current or former executive officer is subject to recoupment if: (1) the incentive compensation was calculated based on financial statements that were required to be restated due to material

noncompliance with financial reporting requirements, including all forms of restatements, and (2) that noncompliance resulted in overpayment of the incentive compensation within the three fiscal years preceding the date the restatement was required. The new rule broadly applies to all listed companies, regardless of size.

Rule 10D-1’s enforcement regime is proscriptive and mandatory—companies must seek clawback, unless they determine that the cost of collection will exceed the amount to be recovered. If this exception does not apply and a company fails to comply with the Rule, stock exchanges are instructed to commence delisting proceedings. Corporate officers that do not enforce the policy are subject to civil and criminal penalties. Rule 10D-1 provides that corporations’ clawback procedures are triggered once the board of directors or management discovers, or should have discovered, a material accounting error.

Fault or No-Fault, That Is the Question

The DOJ’s Pilot Program and each of the SEC’s mandates take different approaches to the level of fault required to warrant clawback and which employees are subject to compensation recoupment. The Pilot Program directs that companies seeking a fine reduction recover compensation from “employees who engaged in wrongdoing in connection with the conduct under investigation, or others who both (a) had supervisory authority over the employee(s) or business area engaged in the misconduct and (b) knew of, or were willfully blind to, the misconduct.” The Pilot Program thus applies to any employee, regardless of title or seniority, but takes a fault-based approach.

SOX Section 304, on the other hand, provides that “if an issuer is required to prepare an accounting restatement...as a result of misconduct,” CEOs and CFOs—who have primary legal responsibility for preparing financial statements and for putting in place a system of internal controls over financial reporting and disclosure —“shall” reimburse their company by disgorging incentive compensation

received within the 12-month period following the first public filing of an improper financial statement. 15 U.S.C. § 7243(a)(1). The mandate applies unless the SEC deems that an exemption is “necessary and appropriate.” In the early years following SOX Section 304’s first enactment in 2002, the SEC tended to bring actions only where the CEO or CFO had engaged in, or had direct knowledge of, the misconduct leading to the restatement. Beginning in 2009, however, the SEC began pursuing cases on a strict liability theory, requiring CEOs and CFOs to disgorge compensation even if they were not involved in or aware of the misconduct. In recent years, the SEC has continued applying this “no-fault” approach, and it has withstood judicial scrutiny in federal appellate courts. See, e.g., *S.E.C. v. Jensen*, 835 F.3d 1100, 116 (9th Cir. 2016).

Rule 10D-1 adopts a “no-fault” approach that applies to a wider group of employees than SOX Section 304. Rule 10D-1 requires companies to recoup excess compensation from all current and former executive officers in any case where the company is required to prepare a restatement either correcting a previously filed material error or an error that would result in a material misstatement, regardless of whether the executive officer engaged in misconduct and regardless of fault. An executive officer includes a company’s president, principal financial officer, principal accounting officer or controller, any vice-president of the company in charge of a principal business unit, division, or function, and any other officer or person who “performs similar policy-making functions.”

Reaching the Full Money Pot, or Not?

Each of the three clawback regimes set different standards for what “compensation” is subject to clawback. The DOJ’s Pilot Program does not take a position on which form or how much compensation is to be clawed back, except that the structure incentivizes companies to be aggressive in order to maximize its potential fine reduction.

SOX Section 304 is more focused, providing that the CEO and CFO shall reimburse the company

for “any bonus or other incentive-based or equity-based compensation.” 15 U.S.C. § 7243(a)(1). Legislative history suggests that the purpose of this remedy was to ensure that CEOs and CFOs did not benefit from improperly inflated financial results, with the Senate report noting the equitable nature of SOX Section 304 and indicating that disgorgement should only be applied to compensation in excess of what was properly obtained. See S. Rep. 107-205, at 26 (2002); see also *SEC v. Jensen*, 835 F.3d 1100, 115-16 (9th Cir. 2016) (analyzing legislative history in context of determining “misconduct”). Nevertheless, the SEC has taken the position that SOX Section 304 provides for clawback of all incentive and equity-based compensation obtained during the twelve-month covered period, regardless of whether such compensation still would have been due under the results reported in the restated financial statements. Further, the Second Circuit has held that a company cannot indemnify a covered executive from SOX Section 304 liability. See *Cohen v. Viray*, 622 F.3d 188, 194-96 (2d Cir. 2010).

Rule 10D-1’s compensation reach is the most limited, expressly adopting an “excess compensation” standard, providing that the recoverable amount is “the amount of incentive-based compensation received in excess of the amount that otherwise would have been received” under a proper accounting. Rule 10D-1 also expressly prohibits companies from indemnifying executive officers and from paying premiums for executive officers’ insurance related to their excess compensation.

Real World Hurdles to Implementation

As companies choose to participate in DOJ’s Pilot Program or are directed to comply with Rule 10D-1, they may face significant practical hurdles in clawing back compensation, particularly from former employees. The most important difference in implementation between the two new clawback regimes and SOX Section 304 is that the two new regimes put the onus on companies to take the necessary steps to carry out the clawback,

while SOX Section 304 provides express statutory authority for its form of clawback. Indeed, the Second and Ninth circuits have held that SOX Section 304 creates no private right of action and vests exclusive enforcement authority in the SEC. See Cohen 622 F.3d at 193-94; *In re Digimarc Corp. Derivative Litigation*, 549 F.3d 1222, 1233 (9th Cir. 2008). Once the SEC invokes it, however, SOX Section 304 provides all the legal authority necessary to enforce the clawback.

On the other hand, DOJ's Pilot Program and SEC Rule 10D-1 require companies to use existing legal means, such as state law, to claw back compensation. With respect to employees whose employment continues, companies may have sufficient discretion to reduce or withhold bonuses, depending on the terms of bonus plans and the requirements of any applicable employment contracts.

The prospects for recovery from former employees are much different. New York's labor laws, for example, typically prohibit an employer from recovering compensation or other losses caused by an employee during their course of work, unless the employee's conduct entails fraud or intentional misconduct. In *Charles H. Greenthal Management v. Waldes*, Case No. 653211/2017, 2018 WL 987028 (Sup. Ct. NY County, Feb. 16, 2018), for example, the court held that a real estate management company's suit seeking recovery from a former controller for a series of alleged grossly negligent acts, including succumbing to over \$1 million in internet fraud, was barred by §193 of the New York Labor Law, which prevents employers from taking deductions from employees' wages if the deductions are not expressly authorized by that statute. See Philip M. Berkowitz and Maria Caceres Boenau, *Employee Bad Actors: Can Employers Recover*, *New York Law Journal* (Jan. 8, 2020).

Regardless of employee conduct or employment status, another potential hurdle is that companies may be prohibited from recovering certain types of compensation pursuant to local wage and hour laws. DOJ's Program encourages employers

to recoup "compensation," but state labor laws typically prohibit employers from clawing back wages once earned, and some jurisdictions interpret "wages" broadly. For example, New York Labor Law defines "wages" to include "the earnings of an employee for labor or services rendered, regardless of whether the amount of earnings is determined on a time, piece, commission or other basis." Thus, where an employment agreement suggests that a bonus is predicated on personal productivity, courts have determined that this type of bonus constitutes a protected "wage." See, e.g., *Kolchins v. Evolution Markets*, 31 N.Y.3d 100 (2018). New York courts nevertheless exclude from protected wages certain forms of "incentive compensation" linked to an employer's financial success. See, e.g., *Truelove v. Northeast Capital & Advisory*, 95 N.Y.2d 220, 224 (2000). Distinctions like these exist in other jurisdictions, and foreign law often provides even greater wage protections than those applicable in the United States. Companies that are considering participating in DOJ's Program, particularly those addressing conduct implicating foreign employees, should be mindful of applicable labor laws and other legal doctrines that may circumscribe the types of compensation subject to clawback or otherwise substantially limit prospects of meaningful recovery.

Conclusion

The DOJ's new Pilot Program and SEC's new Rule 10D-1 confirm this administration's commitment to compensation clawback as a means to hold individuals accountable for corporate misconduct. But without the benefit of implementing legislation, companies considering how to proceed regarding the DOJ Program or SEC Rule 10D-1 must take into account that the legal means at their disposal to implement clawback may have limited reach or require lengthy, expensive litigation. When companies consider the real world costs and benefits, the DOJ Program's fine reduction incentive may not really be much of an incentive at all.