SEC Decides Not to Pursue Clawback Actions Against Executives Who Reimbursed Company for Previously Paid Compensation

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In two recent cases, the SEC affirmatively decided not to bring clawback actions under Section 304 of the Sarbanes-Oxley Act ("SOX") against executives who reimbursed their respective companies for compensation they received following the filing of misstated financial statements.

The first case involved an investigation into the accounting practices of Monsanto Company, a St. Louis-based agribusiness company. The SEC found that Monsanto had failed to fully recognize the costs of a rebate program it offered, resulting in "materially misstated" earnings over a three-year period. On February 9, 2016, the SEC announced that Monsanto had agreed to pay an $80 million penalty and hire an independent compliance consultant to settle the charges against it and that three accounting and sales executives also agreed to settle charges in connection with the case. However, the SEC indicated that it would not bring a clawback action against the company's CEO and former CFO. According to the SEC's **press release**, "[t]he SEC's investigation found no personal misconduct by Monsanto CEO . . . and former CFO . . . , who reimbursed the company $3,165,852 and $728,843, respectively, for cash bonuses and certain stock awards they received during the period when the company committed accounting violations." Because Monsanto's CEO and former CFO reimbursed the company, the SEC found that "it wasn't necessary . . . to pursue a clawback action under Section 304 of [SOX]."

The SEC went a step further just a week later. On February 17, 2016, the SEC issued a **press release** announcing that biopesticide company Marrone Bio Innovations had agreed to pay a $1.75 million penalty to settle the SEC's charges that it inflated financial results. Although the SEC also charged Marrone Bio's former COO with accounting fraud, the SEC did not charge the company's CEO or former CFO with any misconduct. However, the SEC filed settled **cease-and-desist proceedings** against former Marrone Bio CFO for his failure to reimburse the company for certain incentive-based compensation he received. Marrone Bio's former CFO consented to the entry of the cease-and-desist order and agreed to reimburse the company $11,789. Notably, the SEC did not bring similar proceedings against Marrone Bio's CEO, likely because she had already reimbursed the company. In its press release, the SEC stated, "[a]s required by Section 304(a) of the Sarbanes-Oxley Act, Marrone Bio CEO . . . has reimbursed the company $15,234 . . . for incentive based compensation [she] received following the filing of Marrone Bio's misstated financial statements" (emphasis added). In deciding to bring proceedings against Marrone Bio's former CFO, but not the company's CEO, the SEC made clear its view that in the event of a financial misstatement covered by Section 304, top executives must reimburse their company for certain compensation, whether they do so voluntarily or as a result of an SEC enforcement action.

Although the **Monsanto** and **Marrone Bio** actions are interesting in that they illustrate the SEC's focus on financial reporting and disclosure and the SEC's willingness to charge individuals believed to be engaged in wrongdoing, what is most noteworthy about these cases is whom the SEC did not pursue in its actions against the companies. These actions appear to signal the SEC's evolving approach to Section 304 enforcement, including an expectation of reimbursement of some forms of compensation, a willingness to forego an enforcement action if reimbursement is made, and a willingness to pursue an enforcement action to compel what the SEC considers appropriate (indeed required) reimbursement.

The Evolution of Clawback Enforcement

Section 304(a) of SOX, "Forfeiture of Certain Bonuses and Profits," empowers the SEC to force CEOs and CFOs of public companies to reimburse their company for bonuses, incentive or equity-based compensation, and profits realized from the sale of the issuer's securities, if the compensation in question was received or realized by the executives during the 12-month period following the issuance of the misstated financial statements. The SEC is permitted to exempt any person "as it deems necessary and appropriate" under Section 304(b); however, the SEC has not provided any meaningful guidance to date regarding the factors for such an exemption.

Although the SEC has had the authority under Section 304 to recover certain compensation from CEOs and CFOs of public companies since 2002, in the first seven years following the passage of the Act, the SEC rarely brought cases under Section 304. Until 2009, the majority of cases where Section 304 was invoked involved executives who allegedly participated in the misconduct at issue, and portrayed those executives as the primary actors of the alleged violations.

Beginning in 2009, however, the SEC expanded the use of Section 304 to proceedings where the defendant executive was not alleged to have been involved in the underlying misconduct. In SEC v. Jenkins, the first action seeking reimbursement under Section 304 where the individual executive was not charged with any wrongdoing, the SEC sought reimbursement from Maynard Jenkins, the former CEO of CSK Auto Corporation, of approximately $4 million in bonus and equity-based compensation. In denying Jenkins's motion to dismiss the SEC complaint on the ground that he had committed no wrongdoing, among other things, the court held that the plain language of SOX 304 "require[s] only the misconduct of the issuer, but do[es] not necessarily require the specific misconduct of the issuer's CEO or CFO."[1]

Following Jenkins, the SEC brought and settled cases against several CEOs and CFOs who were not alleged to have engaged in the underlying misconduct. The SEC's use of Section 304 in so-called "no fault" cases presents a serious risk for executives of public companies because it allows the clawing back of CEO and CFO bonuses or incentive- or equity-based compensation covered by the statute whenever there is a restatement "as a result of misconduct," regardless of the size of the restatement or the culpability of the executive.

On July 1, 2015, the SEC proposed Rule 10D-1 implementing Section 954 of the **Dodd-Frank Act**, which would require executives to reimburse their company in the event there is a finding of material noncompliance by the company in connection with issuing its public filings. While the language of Rule 10D-1 largely tracks Section 304, there are several significant differences, including a broader time period, different types of compensation subject to clawback, no "misconduct" requirement and more employees who are covered. Given these differences, there is an open question as to how Rule 10D-1 would be enforced in conjunction with Section 304, such as on the issue of whether a company's own clawback under Rule 10D-1 would count as a form of credit in a Section 304 enforcement action.

Company Clawback Policies

As the SEC's application of Section 304 has evolved over the years, the prevalence of companies implementing their own clawback policies has increased. Indeed, according to a study by Equilar, a provider of executive compensation data, from 2006 to 2013, the number of Fortune 100 companies with publicly disclosed clawback policies increased from 17.6% to 89.4%. Once Rule 10D-1 is finalized, all companies will be required to have clawback policies that comply with the new rule.

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[1] ***SEC v. Jenkins*, 09-cv-1510 (D. Ariz. June 9, 2010)**.

Furthermore, in recent years, companies—particularly financial institutions—have implemented more robust recoupment policies and provided more detailed information regarding those policies. For example, according to a PricewaterhouseCoopers 2014 Proxy Disclosure Study of 100 large U.S. public companies with disclosed clawback policies, 62% of the companies had clawback policies that apply to all executives and senior management, and 28% of the companies had policies that apply to all employees or participants. Only 9% of companies had policies that apply exclusively to the CEO and CFO.

Even though companies have adopted more robust clawback policies, 73% of the companies surveyed still require evidence that the employee engaged in misconduct or contributed to the false financial reporting before the clawback is triggered. Thus, most companies' clawback provisions would not be triggered in cases, such as Monsanto and Marrone Bio, where the CEO and CFO are not found to have engaged in misconduct.

Implications of Monsanto and Marrone Bio

As described above, since the passage of SOX in 2002, the standard the SEC uses in enforcing Section 304 has evolved from fault-based to strict liability. The Monsanto and Marrone Bio cases make clear the SEC's view that in the event of financial misstatements covered under Section 304, even non-culpable CEOs and CFOs are required to reimburse their companies. However, the SEC's decision to forgo clawback actions against top executives in those cases illustrates a more nuanced approach to the SEC's enforcement of Section 304, in that it suggests that, when faced with a potential SEC enforcement action, companies and executives now have the ability to accomplish the accountability envisioned in Section 304, while avoiding a potentially damaging and costly clawback action. Although the cases indicate that Section 304 enforcement actions against non-culpable CEOs and CFOs can be avoided, they also signal the SEC's general expectation that the compensation covered by Section 304 must be returned.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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