Ninth Circuit Issues SOX Opinion—Approves Compensation Clawback Even for Executives Not Engaged in Misconduct

August 31, 2016

Today, the Ninth Circuit issued an opinion in [SEC v. Jensen](). The court held that Rule 13a-14 of the Securities Exchange Act confirms that the SEC has a cause of action against CEOs and CFOs who sign false or misleading certifications. (Op. at 5, 24.) Importantly, the court also held that Section 304 of the Sarbanes-Oxley Act ("SOX 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*." (Op. at 28 (emphasis added).) Although the SEC has taken this position in prior settlements, the Ninth Circuit is the first Court of Appeals to endorse the SEC's interpretation.

The case was brought by the SEC against the former CEO and CFO of Basin Water, who were alleged to have engaged in a scheme to fraudulently overstate the company's financial results by failing to comply with GAAP. (Op. at 4, 6-7.) They were also alleged to have received hundreds of thousands of dollars in incentive- and equity-based compensation during the period they were allegedly causing the company to fraudulently inflate its revenues. (Op. at 7.) As to Rule 13a-14, the district court granted summary judgment to the defendants on the SEC's claim that defendants' certification of false financial statements violated the rule. The rule requires that certain reports—including 10-Qs and 10-Ks—must include a certification from each principal executive and principal financial officer of the issuer as to the accuracy of the financial statements. (Op. at 20-21.) The defendants argued, successfully in the district court, that the rule only applies to executives who refuse to file the requisite certifications. The Ninth Circuit disagreed, concluding that the rule includes an "implicit truthfulness requirement" and applies to executives who file false or misleading certifications. (Op. at 21-24.)

As to the SEC's claim for disgorgement of compensation pursuant to SOX 304, the district court conducted a bench trial and held that the defendants had not violated that section because their company's "misstatement was not issued due to any misconduct on the part" of the defendants. (Op. at 25-26.) The Ninth Circuit reversed this holding as well, agreeing 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*." (Op. at 26.) In what the court acknowledged was an issue of first impression among the Courts of Appeals, the Ninth 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," explaining 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." (Op. at 27-29.)

Judge Carlos Bea filed a concurrence to "clarify the intended scope of the new legal rules" announced in the court's decision. (Op. at 32-47.) With respect to Rule 13a-14, he emphasized that "not every inaccurate certification is 'false' within the meaning of the rule," and stated that he would hold that liability for false certification under the rule "may lie only where a CEO or CFO acts with knowledge or at least recklessness as to the falsity of a certification." (Op. at 32-33, 40.) With respect to SOX 304, he observed that neither the Ninth Circuit nor the SEC has previously explained what qualifies as "misconduct" necessary to trigger disgorgement, and indicated his view that such "misconduct" requires "an intentional violation of a law or standard (such as GAAP) on the part of the issuer, which can be shown by evidence that any employee of the issuer (not only the CEO or CFO), acting within the course and scope of that employee's agency, intentionally violated a law or corporate standard." (Op. at 41-42.) Thus, he concluded that SOX 304 is meant to impose liability on CEOs and CFOs by making them subject to disgorgement if they have committed "mismanagement," insofar as their internal controls fail to prevent or detect "intentional wrongdoing by any authorized agent of the issuer." (Op. at 43.)

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