

WSGR ALERT

SEPTEMBER 2011

SEC CONTINUES TO USE SARBANES-OXLEY TO CLAW BACK INCENTIVE COMPENSATION

Background: *SEC v. O'Leary*

On August 30, 2011, the Securities and Exchange Commission (SEC) announced a settlement with James O'Leary, the former chief financial officer of Beazer Homes USA, to recover approximately \$1.4 million in cash bonuses, incentive and equity-based compensation, and profits from his sale of Beazer stock during the period of time that the SEC alleged an individual at Beazer—but not O'Leary—was committing “accounting misconduct.”¹ The SEC's complaint alleged that Beazer engaged in accounting misconduct by (i) artificially establishing and maintaining certain reserve accounts and (ii) recognizing revenue and income from a sale-leaseback arrangement in a manner that was not compliant with generally accepted accounting principles (GAAP). The SEC's complaint further alleged that this accounting misconduct was reflected in Beazer's 2006 financial statements filed with the SEC. Beazer was required to file accounting restatements of its 2006 financial statements.

The SEC's complaint did not allege that O'Leary participated in the misconduct, but rather pursued the action against O'Leary under Section 304 of the Sarbanes-Oxley Act of 2002. Section 304 provides that the chief executive officer (CEO) and chief financial officer (CFO) shall reimburse a company for any bonus or other incentive-based or equity-based compensation as well as any profits from company stock sales received in the 12-month period following the filing of a financial report that is materially non-compliant with financial reporting requirements due to company misconduct, and that requires the company to prepare an accounting restatement.

This is the fourth enforcement action arising from Beazer's alleged misconduct in its financial reporting. In March 2011, the SEC also pursued an action under Section 304 against Beazer's then-CEO, Ian McCarthy. The SEC entered into a settlement with McCarthy that required him to reimburse Beazer with approximately \$6.5 million for certain

compensation and stock profits he had received during the periods covering the misstatements.² The SEC also settled an enforcement action with Beazer in late 2008.³ Litigation proceedings stemming from charges that the SEC brought against Beazer's former chief accounting officer are still ongoing.⁴

History of SEC's Use of Clawbacks under Section 304

After the adoption of the Sarbanes-Oxley Act in 2002, the SEC used Section 304 to claw back CEO or CFO compensation when the CEO or CFO was individually alleged to have been involved with misconduct.⁵ Beginning in 2009, however, the SEC began using Section 304 to claw back CEO or CFO compensation in situations where accounting misconduct had occurred, but not from the actions of the CEO or CFO.⁶ The O'Leary case is merely the latest example of the SEC using Section 304 in this manner, and there is no reason to believe that the SEC will narrow its use of Section 304 in the future.

¹ *SEC v. O'Leary*, Case No. 1:11-cv-2901 (N.D. Ga.); Litigation Release No. 22074 (Aug. 30, 2011) (available at <http://www.sec.gov/litigation/litreleases/2011/lr22074.htm>).

² *SEC v. McCarthy*, Case No. 1:11-CV-667-CAP (N.D. Ga.); Litigation Release No. 21873 (Mar. 4, 2011) (available at <http://www.sec.gov/litigation/litreleases/2011/lr21873.htm>).

³ *In re Beazer Homes USA, Inc.*, Rel. No. 33-8960 (Sep. 24, 2008) (available at <http://www.sec.gov/litigation/admin/2008/33-8960.pdf>).

⁴ *SEC v. Rand*, Civil Action No. 1:09-CV-1780 (N.D. Ga.); Litigation Release No. 21114 (Jul. 1, 2009) (available at <http://www.sec.gov/litigation/litreleases/2009/lr21114.htm>).

⁵ See, e.g., *SEC v. McGuire*, Civil Action No. 07-CV-4779-JMR/FLN (D.Minn. 2007) and SEC Litigation Release No. 20387 (Dec. 6, 2007) (option backdating); *SEC v. Brooks*, Civil Action No. 07-61526-CIV-Altonaga/Turnoff (S.D.Fl. 2007) (fraud and misappropriation of corporate funds).

⁶ *SEC v. Jenkins*, Case 2:09-cv-01510-JWS (D. Ariz. July 23, 2009) (available at <http://sec.gov/litigation/complaints/2009/comp21149.pdf>).

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Dodd-Frank Will Further Expand the SEC's Clawback Authority

As we have discussed previously,⁷ the Dodd-Frank Act of 2010 will expand the SEC's authority to claw back executive compensation beyond the already broad scope of Section 304 of the Sarbanes-Oxley Act. Dodd-Frank directs the SEC to issue rules prohibiting the listing on any national securities exchange of any company that does not adopt a policy for: (i) the disclosure of the issuer's policy on incentive-based compensation related to financial information required to be reported under the securities laws and (ii) the recovery of any incentive-based compensation (including stock options) awarded to current or former executive officers during the three-year period prior to an accounting restatement resulting from material noncompliance of the issuer with financial reporting requirements. This clawback policy would require the recovery of incentive compensation awarded in excess of the incentive-based compensation that would have been paid under the accounting restatement. The Dodd-Frank Act will have far greater implications and reach than the current Sarbanes-Oxley Act clawback

provisions, which, among other things, apply only to a company's CEO and CFO, and require the recovery of compensation only if the accounting restatement results from misconduct. The Dodd-Frank Act does not impose a deadline on such SEC rulemaking; under the SEC's current announced timeline,⁸ such rules would be proposed late this year and would be adopted in the first half of next year.

What You Should Do Now

In light of these matters, it is more important than ever that CEOs and CFOs, as well as other executive officers, set an appropriate tone at the top of their organizations, regularly evaluate the appropriateness and effectiveness of internal controls over financial reporting and disclosure controls and procedures, and work effectively with the company's internal audit function and independent registered public accounting firm.

For any questions or for more information on these or any related matters, please contact your regular Wilson Sonsini Goodrich & Rosati contact, or any member of the firm's corporate and securities practice or securities litigation practice.



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⁷ Learn more in this WSGR Alert: http://www.wsgr.com/WSGR/Display.aspx?SectionName=publications/PDFSearch/wsgralert_dodd_frank2.htm.

⁸ See the SEC's timeline at <http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml>.