

Second Circuit Bars Company Indemnification of Sarbanes-Oxley “Clawback” Liability

In a case of first impression, the U.S. Court of Appeals for the Second Circuit has held that a company may not indemnify its CEO or CFO against liability under Section 304 (the “clawback” provision) of the Sarbanes-Oxley Act of 2002.

Section 304(a) of the Sarbanes-Oxley Act provides that “[i]f an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for – (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever occurs first) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period.”

The recent Second Circuit decision involved DHB Industries, Inc. (“DHB,” since renamed Point Blank Solutions, Inc.), a manufacturer of body armor. Following product-defect allegations and a late 2005 decline in DHB’s stock price, derivative lawsuits were brought against the former CEO David Brooks, former CFO Dawn Schlegel, and other former officers. In June 2008 and over objections by the government and others, the District Court approved a settlement under which DHB would have been required to indemnify Brooks and Schlegel from Section 304 liability. Prior to approval of the settlement, DHB had filed restated financial statements for 2003, 2004, and the first three quarters of 2005, Brooks had been indicted, Schlegel had pleaded guilty to criminal charges of conspiracy to commit securities and tax fraud, and the SEC had brought a civil action against Brooks seeking disgorgement of \$186 million under Section 304.

The Court of Appeals for the Second Circuit held that the settlement’s indemnification provision violated Section 304. The *DHB* case is an important part of a developing body of Section 304 case law. (For Ropes & Gray’s Alert on another Sarbanes-Oxley development this spring, the *Jenkins* case, see [Court Says Sarbanes-Oxley Allows “Clawbacks” of Executive’s Bonuses](#)). The *DHB* case confirms for the first time that executives and companies cannot contract around the disgorgement provisions of Section 304 of the Sarbanes-Oxley Act. The *DHB* holding may also have significant implications for the clawback provisions contained in Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The Second Circuit also joined several other Circuits in holding that Section 304 does not provide for a private right of action.

If you would like to discuss the *DHB* case and its potential impact on your business, please contact any member of Ropes & Gray’s [Executive Compensation](#) practice group or your usual Ropes & Gray advisor.