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Ninth Circuit Clarifies Whose "Misconduct" Triggers SOX 304 Disgorgement, But Not What Constitutes "Misconduct"

By Bruce A. Ericson

*Section 304 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. § 7243) requires CEOs and CFOs to repay bonuses, incentive- and equity-based compensation, and profits realized on the sale of securities received in the 12 months after the release of financials that later must be restated. But SOX 304 applies only to restatements resulting from "misconduct"—raising the issue of **whose** "misconduct" is required. For 14 years no appellate court reached the issue. Then, on August 31, 2016, the Ninth Circuit held that SOX 304 requires only "misconduct" on the part of the issuer, and not "misconduct" on the part of the CEO or CFO.*

SOX 304, entitled "Forfeiture of certain bonuses and profits," requires CEOs and CFOs to repay "any bonus or other incentive-based or equity-based compensation received… from the issuer" and "any profits realized from the sale of securities of the issuer" during the 12-month period following the first public issuance or filing with the SEC of financial documents of the issuer, if that financial document was later restated "due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws…." But whose "misconduct"? For years, district courts split, and no court of appeals decided the issue.

In *U.S. Securities & Exchange Commission v. Jensen*, --- F.3d ---, No. 14-55221, 2016 WL 4537377 (9th Cir. Aug. 31, 2016), the issuer, Basin Water, Inc., had restated its earnings, but the district court held that Basin's former CEO, Jensen, and its former CFO, Tekulve, did not violate SOX 304 because "'Basin's misstatement was not issued due to any misconduct on the part of Defendants.'" 2016 WL 4537377, at *10 (quoting the district judge). The SEC appealed this ruling (among others); the Ninth Circuit vacated and remanded. In a matter of first impression at the court of appeals level, the court held (3-0) that both the plain language of SOX and the legislative history allow "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." *Id*. at

*11. Noting that SOX 304 is equitable and not legal, the court explained 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." *Id*. But having so ruled, the court declined "to reach the issue of the meaning of 'misconduct' under SOX 304." *Id*., n.7.

Judge Bea, concurring in the result and generally in the court's analysis, would have reached the issue of the meaning of "misconduct." *Id*. at *13, *16-*17. Noting that neither the court nor the SEC had previously provided such guidance, Judge Bea would have employed the dictionary definition of "misconduct," limiting it to "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." *Id*. at *17.[1]

All three judges also held that CEOs and CFOs may be liable for false certification of financial statements under Exchange Act Rule 13a-14 (17 C.F.R. § 240.13a-14) if they certify "false" financial statements and not merely if they fail to sign or file a certification. *Id.* at *8-*9 (court), *13-*16 (concurrence). But here again, the majority declined "to reach the question of the mental state required for a violation of Rule 13a-14," whereas Judge Bea would have held "that liability for false certification under Rule 13a-14 may lie only where a CEO or CFO acts with knowledge or at least recklessness as to the falsity of a certification." *Id*. at *9, n.6, *13.

So the Ninth Circuit has upped the ante for CEOs and CFOs—but by exactly how much remains to be decided in future cases.

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[1] Although neither opinion mentions it, misconduct as an issue may largely go away if and when the SEC promulgates a rule implementing section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (adding section 10D to the Securities Exchange Act of 1934, 15 U.S.C. § 78j-4). Section 954 creates an incentive compensation clawback of three years (not 12 months) that does not require a showing of "misconduct" but merely a showing that "erroneous data" caused the payment of compensation "in excess of what would have been paid to the executive officer under the accounting restatement." The SEC proposed an implementing rule in July 2015, but has not yet promulgated a final rule. See Exchange Act Release No. 34-75342 (July 1, 2015), published at 80 Fed. Reg. 41144 (July 14, 2015), proposing Exchange Act Rule 10D-1.