

## Outside Counsel

# Limiting, Clawing Back Executive Pay In the Wake of Financial Bailout

## Expert Analysis

Shareholders and the general public are livid that former executives of failed companies received, or continue to receive, exorbitant pay and bonuses in the aftermath of the implosion of the subprime mortgage market and the consequent bailout of Wall Street firms and other financial companies. The public outcry is changing the legal landscape relating to executive compensation.

While current compensation numbers are staggering, especially when juxtaposed with unparalleled business losses, the situation is far from unprecedented.

Earlier this decade, exposure of fraud at companies like Enron and WorldCom highlighted the inadequacy of the system to recoup inappropriately paid-out executive compensation. In response to the recent economic downturn, there is renewed momentum coming from governmental watchdogs, shareholders, and business groups to reform the rules relating to executive pay.

As the government becomes increasingly more entangled in securing the financial footing of struggling companies, it may try to use several legal options that arose post-Enron, including the Sarbanes-Oxley Act, civil enforcement actions, and fines provided by criminal statutes, to recoup or “claw-back” unearned performance-based pay.



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This article analyzes the success of past recoupment actions and discusses what options may be available in the future.

Most claw-back provisions provide for recoupment of all performance-based compensation in the event of a restatement of financial results due to misconduct on the part of the executive officer.

### Existing Legal Options

Congress enacted Sarbanes-Oxley in part to provide the Securities and Exchange Commission (SEC) with greater enforcement power and to compensate shareholders for losses incurred due to executive mismanagement.<sup>1</sup> Section 304 of the act provided, for the first time, a compensation-oriented disgorgement remedy for violations of federal securities law. Under this provision, performance-based compensation that is artificially inflated as a result of executive misconduct can be disgorged.<sup>2</sup>

From its inception, however, §304 has been hamstrung by a number of limitations. For example, courts have held that §304 is only enforceable by the SEC, and does not establish a private cause of action by an aggrieved company or its shareholders.<sup>3</sup> Also, the provision allows recoupment only from the CEO or CFO, and thus disallows the SEC from bringing suit against other high-level executives. Finally, §304 fails to define the meaning of the term “misconduct.” Perhaps because of these limitations, §304 was not used successfully as a disgorgement remedy until just recently, when it was used against several executives for their roles in stock-option backdating scandals.<sup>4</sup>

Although the current political climate may result in a more expansive reading and use of the statute, its recent applications suggest that the SEC will only seek to use its disgorgement provision in cases where the CEO or CFO was personally involved in the misstated financials. Moreover, a federal district court recently ruled that the provision applies only when an accounting restatement is actually filed, not simply when the accounting discrepancies are discovered.<sup>5</sup> It remains to be seen how broadly courts will interpret the mandate of §304 going forward, but this ruling could potentially chill the SEC from using the claw-back provision in similar cases.

In addition to exposure under federal securities laws, officers and directors of companies face potential recoupment efforts by shareholders in civil actions for breach of fiduciary duty and by government

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officials seeking novel applications of traditional civil remedies. The business judgment rule has traditionally shielded corporate directors' compensation decisions; however, shareholders seeking equitable rescission and restitution via derivative suits have been successful in recovering ill-gotten gains, even in the absence of compelling proof of personal impropriety on behalf of the unjustly enriched executives.<sup>6</sup>

### State Laws

State corporate governance laws also have been used recently, with mixed results, to recoup executive compensation. Although ultimately unsuccessful, *People v. Grasso*, 11 NY3d 64 (2008), is an example of state law regulators invoking a state law remedy in their attempts to claw-back executive pay. In *Grasso*, the New York State attorney general invoked New York's non-profit law and state common law in his effort to recoup a \$187 million compensation package that was paid to former New York Stock Exchange Chairman Richard Grasso, a compensation package that then-Attorney General Eliot Spitzer argued was unreasonably large.

The New York Court of Appeals concluded, in part, that while some sections of New York non-profit law gave the attorney general authority to bring an action against Mr. Grasso, the government's attempt to ascribe liability based on the size of the compensation package was incompatible with the statutory scheme.<sup>7</sup> The court's reluctance to rule on the reasonableness of Mr. Grasso's compensation is not surprising given that courts have generally declined to be the arbiters of what constitutes reasonable executive compensation.<sup>8</sup>

More recently, New York State Attorney General Andrew Cuomo successfully used New York's fraudulent conveyance law to compel AIG to recover bonuses from its former executives.<sup>9</sup> In October 2008, Mr. Cuomo threatened legal action if AIG did not rethink its executive compensation packages to executives

like former CEO Martin Sullivan and Joseph Cassano, former president of AIG's financial products division. Mr. Cassano's division racked up \$11 billion in losses from trading on risky credit-default swaps, yet he received \$34 million in bonuses and continued to receive \$1 million a month in consulting fees from the company.<sup>10</sup> As a result of Mr. Cuomo's demand letter, AIG agreed to freeze salaries and eliminate bonuses for top executives, and promised to recover bonuses and other compensation, including money paid to Mr. Cassano, cancel perks, and institute compensation reforms.<sup>11</sup>

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In addition to civil enforcement options, both the state and the federal government have used criminal prosecutions to impose fines and restitution payments on executives that improperly enriched themselves at the expense of their companies. For example, in 2005, former Tyco executives Dennis Kozlowski and Mark Swartz were prosecuted and convicted under New York State's grand larceny statute for looting \$150 million from the company. In addition to imprisonment, the judge ordered Mr. Kozlowski and Mr. Swartz to pay nearly \$240 million in fines and restitution under a provision of the statute that allows imposition of gain-based fines.

In the prosecution of the former CEO of Computer Associates (CA), Sanjay Kumar, for accounting fraud, federal prosecutors attempted to recover millions of dollars in performance-based compensation. Mr.

Kumar eventually pleaded guilty and, as part of his plea agreement, paid a multi-million-dollar fine and made restitution payments to CA. The judge later approved a restitution agreement, by which Mr. Kumar was ordered to pay \$798.6 million to the victims of the fraud, with \$52 million to be paid by liquidating assets, including luxury cars and a yacht.

Post-Enron, criminal investigations and prosecutions in the areas of securities and finance have increased dramatically. Through powerful prosecutorial tools like the Mail and Wire Fraud Statutes, 18 U.S.C. §§1341, 1343, the government can impose enhanced criminal fines and penalties upon a finding of liability. It is safe to assume that this trend will continue and that the financial meltdown will lead to increased investigations and criminal prosecutions of those responsible for wrongdoing. It is also likely that any plea or settlement agreements that come out of these investigations will include restitution payments directed at unjustified compensation.

### Internal Self-Regulation

Many companies have taken a proactive approach to the problem of excessive executive compensation by adopting claw-back policies as part of their corporate governance. During the 2008 proxy season, almost 300 companies adopted some form of claw-back provision, a stark contrast to four years ago, when only 14 of the world's major corporations had such policies in place.<sup>12</sup> Although the terms of these policies differ, a recent study found that most of them provide for recoupment of all performance-based compensation in the event of a restatement of financial results due to misconduct on the part of the executive officer.<sup>13</sup> And, in contrast to the limited scope of §304 of Sarbanes-Oxley, these claw-back measures apply to all high-ranking executives, not just to the CEO and CFO.

The recent financial crisis has increased the pressure on companies to adopt and to enforce these types of provisions.

In early 2007, as news of Fannie Mae's financial troubles became public, the company announced it would enforce a long-dormant claw-back provision to recoup \$44.1 million in performance bonuses from its top executives, a move that garnered some badly-needed public favor.<sup>14</sup>

### Going Forward

With taxpayers increasingly buying a stake in bailed-out corporations, the debate over executive pay has fundamentally changed from a shareholders' issue to a taxpayers' issue. This change allows the federal government to assume a central role in the efforts to reign in executive compensation.

For example, when Congress drafted the \$700 billion financial bailout bill, it attempted to limit Wall Street executive pay by including processes for reviewing executive compensation and recovering bonuses based on unrealized earnings, as well as prohibitions against "golden parachutes," and penalties for violations of these provisions. Although Congress modified the executive compensation provision just before the bill was passed, effectively creating a loophole that allows companies to circumvent the restrictions on executive pay, senators on the Finance Committee are considering whether they should amend the law to close the loophole.<sup>15</sup>

The Emergency Economic Stabilization Act is not the only avenue for the federal government's involvement in this debate. Because the federal government became a stakeholder in many of these companies, it may try to follow Attorney General Andrew Cuomo's lead and seek to recover executive compensation using state law remedies similar to the New York fraudulent conveyance statute invoked by Mr. Cuomo in his conflict with AIG. The success of this tactic may encourage creditors to pursue recoupment from highly paid executives whose companies face financial insolvency.

Efforts to institute internal reforms are also growing within companies. Claw-back provisions are currently

being adopted as company policies, but in the future they will likely become part of employment agreements in order to provide companies with a contractual basis for enforcement.

Notably, Barclays, UBS and Goldman Sachs have announced moves to re-examine their pay models and halt bonus payouts for top executives in 2008.

UBS was the first large European lender to introduce a radical overhaul of its executive pay system.<sup>16</sup> Under its new, more transparent, system, top managers' bonuses will be held for at least three years, instead of being paid immediately, and executives will receive variable pay, as warranted by UBS' results. UBS' high-level executives, shamed by disastrous results, have also agreed to retroactive claw-backs of previous years' bonuses totaling tens of millions of dollars. Other CEOs are also showing restraint—Merrill Lynch Chairman and CEO John Thain and Morgan Stanley CEO John Mack have requested no bonuses in 2008 from their respective compensation committees.

Other shareholder-empowerment measures, such as "say on pay" proposals, which require that shareholders be permitted to offer at least an advisory opinion on the propriety of compensation packages offered to company executives, are emerging as well. While the opinions offered by shareholders would technically be nonbinding, compensation committees could only ignore them at their peril.<sup>17</sup>

### Conclusion

Regardless of whether any of these new avenues prove to be useful tools for controlling executive compensation and recovering payouts deemed excessive or improper, it is clear at least that in the current political climate federal and state regulators will continue to push the limits of governmental regulatory authority in order to recoup performance-based compensation payouts from corporate executives who did not earn them.

2. Sarbanes-Oxley Act of 2002 §304, 15 U.S.C.A. §7243 (2002) ("If 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 first occurs) of the financial document embodying such financial reporting requirements; (2) any profits realized from the sale of securities of the issuer during that 12-month period.")

3. See, e.g., *In re BISYS Group Inc.*, 396 F.Supp.2d 463 (S.D.N.Y. 2005); *Kogan v. Robinson*, 432 F.Supp.2d 1075 (S.D. Cal. 2006); *Neer v. Pelmo*, 389 F.Supp.2d 648 (E.D. Pa. 2005).

4. The SEC reached its first settlement in a §304 disgorgement action in 2007, when former UnitedHealth Group CEO William McGuire agreed to a \$468 million settlement that included a \$7 million civil penalty and reimbursement to the company for incentive and equity based compensation. See "United Health Group CEO/Chairman Settles Stock Options Backdating Case," Sarbanes Oxley Act Release No. 20387, 2007 SEC LEXIS 2837 (Dec. 6, 2007). Since the McGuire settlement, the SEC has also sought disgorgement under §304 in cases involving misappropriation of company funds and alleged manipulation of profit margins. See, e.g., *SEC v. Brooks*, No. 07-61526 (S.D. Fla. filed Oct. 25, 2007).

5. *SEC v. Shanahan*, No. 4:07-cv-1262, 2008 WL 5211909 (E.D. Mo. Dec. 12, 2008).

6. For example, in *Scrushy v. Tucker*, 955 So.2d 988 (Ala. 2006), a derivative action against Chairman and CEO Richard M. Scrushy for breach of fiduciary obligations stemming from a \$2.7 billion accounting fraud. The Alabama court ordered Mr. Scrushy to repay the company nearly \$48 million in bonuses, finding that he was "unjustly enriched," even though the bonuses did not result from personal wrongdoing by Mr. Scrushy.

7. See Grasso, 11 NY3d at 72 ("[E]ach of the challenged causes of action against [Mr.] Grasso seeks to ascribe liability based on the size of his compensation package. The Legislature, however, enacted a statute requiring more. The attorney general may not circumvent that scheme, however unreasonable that compensation may seem on its face. To do so would tread on the Legislature's policy-making authority.")

8. See, e.g., *In re The Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 350 (Del. Ch. 1998) ("[N]ature does not sink a ship merely because of its size, and neither do courts overrule a board's decision to approve and later honor a severance package, merely because of its size.")

9. Letter from Attorney General Andrew M. Cuomo to American International Group Board of Directors, Oct. 15, 2008.

10. See Gretchen Morgenson, "Behind Insurer's Crisis, Blind Eye to a Web of Risk," N.Y. TIMES, Sept. 28, 2008, at A1; Jonathan D. Glater & Vikas Bajaj, "Cuomo Seeks Recovery of Bonuses at A.I.G.," N.Y. TIMES, Oct. 16, 2008, at B1.

11. David S. Hilzenrath, "AIG Limits Pay of Its Top Executives," WASH. POST, Nov. 26, 2008, at D01.

12. Gretchen Morgenson, "Pay It Back If You Didn't Earn It," N.Y. TIMES, June 8, 2008, B1.

13. Paul Hodgson, 2008 Proxy Season Foresights #11: Clawback Policies, The Corporate Library, June 2008.

14. Press Release, Sen. Chuck Hagel, "Senator Hagel Applauds Fannie Mae Plan to Recoup \$44.1 Million in Bonuses From Executives" (Feb. 20, 2007) ("This decision is an appropriate one. The Fannie Mae executives who received regulators, Congress, and their own shareholders must be held accountable for their actions.")

15. Amit R. Paley, "Executive Pay Limits May Prove Toothless," WASH. POST, Dec. 15, 2008, at A01.

16. Jason Rhodes & Lisa Juca, "UBS adopts new exec pay model, axes 2008 bonuses," REUTERS, Nov. 17, 2008.

17. Christopher Keller & Michael Stocker, "Executive Compensation's Role in the Financial Crisis," NAT'L L.J. (Nov. 18, 2008).

1. See generally Nader H. Salehi & Elizabeth A. Marino, "§304 of Sarbanes-Oxley Act: New Tool for Disgorgement?," 239 NYLJ 4 (2008).