ENFORCING THE CLAWBACK PROVISION: PREVENTING THE EVASION OF LIABILITY UNDER SECTION 954 OF THE DODD-FRANK ACT

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> And even as we seek to revive this economy, it's also incumbent on us to rebuild it stronger than before. We don't want an economy that has the same weaknesses that led to this crisis. And that means addressing some of the underlying problems that led to this turmoil and devastation in the first place. Now, one of the most significant contributors to this recession was a financial crisis as dire as any we've known in generations—at least since the '30s. And that crisis was born of a failure of responsibility—from Wall Street all the way to Washington—that brought down many of the world's largest financial firms and nearly dragged our economy into a second Great Depression.[1]

I. INTRODUCTION

In the fall of 2008, the world financial system was sent into the worst crisis since the Great Depression.[2] As major financial institutions faced liquidity problems and stock prices dropped severely, the crisis began to have widespread economic repercussions in the United States and around the world.[3] With mounting fears that the Unit-

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[1] President Barack Obama, Remarks by the President on Wall Street Reform at Cooper Union, New York, N.Y. (Apr. 22, 2010), *available at* http://www.whitehouse.gov/the-press-office/remarks-president-wall-street-reform.

[2] John Hilsenrath et al., *Worst Crisis Since '30s, with No End Yet in Sight*, WALL ST. J., Sept. 18, 2008, http://online.wsj.com/article/SB122169431617549947.html.

> The U.S. financial system resembles a patient in intensive care. The body is trying to fight off a disease that is spreading, and as it does so, the body convulses, settles for a time and then convulses again. The illness seems to be overwhelming the self-healing tendencies of markets. The doctors in charge are resorting to ever-more invasive treatment, and are now experimenting with remedies that have never before been applied.

Id.

[3] *See Timeline: Global Economy in Crisis*, COUNCIL ON FOREIGN RELATIONS, http://www.cfr.org/publication/18709/timeline.html (follow "Meltdown (2007-

ed States was facing the possibility of a depression, the federal government took drastic steps aimed at preventing further economic decline with the passing of the Troubled Assets Relief Program (TARP) legislation and the Federal Stimulus Bill.[4]

In response to the financial crisis and what Congress perceived as its root causes, the Obama Administration pushed for the passage of a financial regulatory overhaul bill.[5] Congress approved the financial reform bill known as the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") in July 2010.[6] The financial reform bill was aimed at preventing the practices and events that led to the 2008 crisis.[7] Within the Dodd-Frank Act were a number of provisions that created new regulations for executive compensation, including what is known as the clawback provision.[8] The clawback provision requires publicly held companies to recover com-

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Present)" hyperlink; then follow hyperlinks in the timeline for the fall of 2008) (last modified Jan. 4, 2010) [hereinafter *Timeline*].

> In fall 2008 the Dow Jones Industrial Average plunged dramatically, banks became unwilling or unable to lend to one another, and the once highly liquid and low-risk commercial paper market evaporated. This was followed by massive government bailouts of commercial banks, investment banks, and other financial institutions that on a worldwide basis exceeded $2 trillion.

JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 15 (6th ed. 2009).

[4] *See* Sheryl Gay Stolberg & Adam Nagourney, *Partisan Fight Endures as Stimulus Bill Signed*, N.Y. TIMES, Feb. 18, 20099, at A17; Greg Hitt & Deborah Solomon, *Historic Bailout Passes as Economy Slips Further*, WALL ST. J., Oct. 4, 2008, http://online.wsj.com/article/SB122304922742602533.html?KEYWORDS=troubled+asset+relief+program.

[5] Matt Spetalnick, *Obama Pushes Wall Street Reform with Populism*, REUTERS (May 15, 2010, 6:05 AM), http://www.reuters.com/article/2010/05/15/us-financial-regulation-obama-idUSTRE64B50I20100515 (quoting President Obama as saying that "[w]e'll make our financial system more transparent by bringing the kinds of complex, back room deals that helped trigger this crisis into the light of day [and w]e'll prevent banks from taking on so much risk that they could collapse and threaten our whole economy").

[6] Pub. L. No. 111-203, 124 Stat. 1376 (2010); *see also* Binyamin Appelbaum & David M. Herszenhorn, *Financial Overhaul Signals Shift on Deregulation*, N.Y. TIMES (July 15, 2010), http://www.nytimes.com/2010/07/16/business/16regulate.html?adxnnl=1&ref=financial_regulatory_reform&adxnnlx=1284934684-Ea8YFikIeLLs0O5a4h+3Cw.

[7] *See* Appelbaum & Herzenhom, *supra* note 6. "That era of hands-off optimism was gaveled to an end on Thursday as the Senate gave final approval to a bill that reasserts the importance of federal supervision of financial transactions." *Id.*

[8] Joseph Alley, Jr. et al., *Executive Compensation and Governance Provisions of the Dodd Frank Act*, BUS. ETHICS (July 22, 2010), http://business-ethics.com/2010/07/22/1640-executive-compensation-and-corporate-governance-provisions-of-the-dodd-frank-act/.

pensation from their executive officers under certain circumstances.[9] The inclusion of the clawback provision in the Dodd-Frank Act reflects the earlier inclusion of another clawback provision in the Sarbanes-Oxley Act of 2002.[10] Congress passed the Sarbanes-Oxley Act in response to a wave of corporate scandal and corruption.[11] Based on the similarities and the differences in the two provisions, the interpretation, implementation, and enforcement of the Sarbanes-Oxley provision may have important implications for the future of the Dodd-Frank provision.

While the clawback provision of the Dodd-Frank Act aimed to help avoid a repeat of the financial crisis, its effectiveness may depend on the how it is interpreted, implemented, and enforced. This is especially relevant in regard to whether executive officers are able to escape personal liability for money owed. The uncertainty surrounding the clawback provision of the Dodd-Frank Act raises a number of interesting and important legal issues. Part II of this Comment will examine the global financial crisis, including the contributing factors, the American public's reaction, and the federal government's response. Part III will review the two relevant clawback provisions—one found in the Dodd-Frank Act and the other in the Sarbanes-Oxley Act. It will examine the requirements of each provision, the differences and similarities of the provisions, and the interactions between the provisions. Part IV will analyze the steps that executive officers may take to try to avoid liability for money owed under the Dodd-Frank provision, including indemnification, director and officer insurance, and personal bankruptcy. It will examine the manner in which courts might prevent executive officers from using these methods to avoid liability. Part V will explain why courts should prevent executive officers from escaping liability under the Dodd-Frank provision by using these various methods. Such rulings will effectuate Congress's policies behind implementing the Dodd-Frank Act. Specifically, the author will argue that the interpretation, implementation, and enforcement of the clawback provision of the Dodd-Frank Act may have significant effects on how companies operate and how executive officers behave going forward. These issues

[9] Dodd-Frank Wall Street Reform and Consumer Protection Act § 954, 124 Stat. at 1904; *see also* Alley, Jr. et al., *supra* note 8.

[10] *See* Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (2006); *see also* Rachael E. Schwartz, *The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean*, 64 BUS. LAW. 1, 1 (2008).

[11] Schwartz, *supra* note 10, at 1.

surrounding the clawback provision are so important because of their potential economic impact.

II. THE GLOBAL FINANCIAL CRISIS: THE CAUSES, THE PUBLIC OUTCRY, AND THE FEDERAL GOVERNMENT'S RESPONSE

Often referred to as "The Great Recession,"[12] the financial crisis, and the economic downturn that followed, have their origins in a number of different places.[13] Dating back to 2007, a combination of economic and financial factors came together and pushed the world economy to the brink of disaster.[14] While there has been no consensus as to the exact causes of the crisis,[15] most experts agree that certain factors played a role in triggering the crisis, including the mortgage bubble, excessive leverage, and deregulation of the financial industry.[16] The presence of incentives for risk-taking by management at financial institutions is often cited as one of the factors that played an important role in the crisis.[17] The compensation structure for executives and managers incentivized risk-taking by placing a large amount of their pay in performance based bonuses.[18] This compensation structure encouraged executives and managers to take high risks because the structure rewarded short-term success. As a result, executives were tempted to pursue short-term gains, even where the action could hurt the company's long term stability and health.[19] As

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12 Courtney Schlisserman, *"Great Recession" Gets Recognition as Entry in AP Stylebook*, BLOOMBERG (Feb. 23, 2010), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ayojB2KWQG4k.

13 *See* MARK JICKLING, CONG. RESEARCH SERV., R40173, CAUSES OF THE FINANCIAL CRISIS 1 (Apr. 9, 2009).

14 *Id.*

15 Even the Financial Crisis Inquiry Commission did not provide a completely definitive analysis of the reasons for the financial crisis even though it produced three separate reports. M.V., *The Financial-Crisis Commission Fails to Solve the Whodunit*, ECONOMIST (Jan. 27, 2011, 4:03 PM), http://www.economist.com/blogs/newsbook/2011/01/americas_financial-crisis_commission (noting that the Financial Crisis Inquiry Commission was unable reach a consensus on the causes of the financial crisis and stating that "the result is an unfortunate loss of credibility and, confusingly, three competing narratives").

16 JINKLING, *supra* note 13, at 5–8.

17 *Id.* at 6.

18 *Id.*

19 Jian Cai et al., *Compensation and Risk Incentives in Banking and Finance*, FED. RESERVE BANK CLEV. (Sept. 14, 2010), http://www.clevelandfed.org/research/commentary/2010/2010-13.cfm ("[C]ompensation structures that heavily reward short-term performance (for example, through bonuses) may encourage managers to take opportunities that would

part of its final report, the majority of the Financial Crisis Inquiry Commission concluded that the compensation systems and the incentives that the compensation structures created played a role in the financial crisis.[20] These systems encouraged going after the big bet, without properly considering the long term consequences.[21] Often, the "big bets" involved a large amount of leveraging by the financial institutions, which left them "vulnerable to financial distress or ruin if the value of their investments declined even modestly."[22]

The collapse of the financial giant Lehman Brothers is one of the most prominent examples of the results that excessive risk-taking can have on a company's stability and the economy in general.[23] Ex-

boost immediate profitability but risk future financial health."). As early as 2005, there were warnings about the perverse incentives that the compensation structures of investment managers created. *See* Raghuram Rajan, *Has Financial Development Made the World Riskier?* 2–3 (Nat'l Bureau of Econ. Research, Working Paper No. 11728, 2005), *available at* http://www.nber.org/papers/w11728.pdf?new_window=1. The perverse incentives were thought to have the potential to create the conditions for a major crisis in the financial system. *Id.*

[20] FIN. CRISIS COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT at xvii–xix, *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf. The international community also recognized the role that compensation and its incentives played in the global financial crisis, with the leaders of the G20 stating that strong international standards for compensation must be implemented to reduce excessive risk-taking. LEADERS' STATEMENT: THE PITTSBURGH SUMMIT para. 17 (2009), *available at* http://www.pittsburghsummit.gov/mediacenter/129639.htm.

[21] FIN. CRISIS COMM'N, note 20, at xix.

[22] *Id.*

[23] *See Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner: Hearing Before the H. Financial Serv. Comm.*, 111th Cong. 179 (2010) (prepared statement of Mary Shapiro, Chairman, U.S. Sec. & Exch. Comm'n) (stating that the collapse of Lehman Brothers reflected larger problems in the financial system, including incentives for excess risk-taking and insufficient risk management). Between 2000 and 2008, the top executives at Lehman Brothers received an estimated $1 billion from cash bonuses and equity sales. Lucian Bebchuk, et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008*, 27 YALE J. ON REG. 257, 257 (2010). During the same period, the top executives at Bear Stearns received over $1.4 billion from cash bonuses and equity shares. *Id.* The near collapse and emergency sale of Bear Stearns is another example of consequences of excessive risk-taking by financial institutions. Yalman Onaran, *JPMorgan Surges After Striking Deal for Bear Stearns*, BLOOMBERG (Mar. 17, 2008, 4:02 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aK2pw3mrmCUQ. "[The] fire-sale to JPMorgan cap[ped] an eight-month slide in the company's fortunes that began [in] July [2007] with the collapse of two of its hedge funds, which invested in securities linked to subprime mortgages." *Id.* With the signs of the coming financial crisis mounting in 2007, the seven largest Wall Street firms paid $122 billion in total compensation and benefits, even as their net revenues fell. Tomoeh Murakami & Renae Merle, *The Bonuses Keep Coming*, WASH. POST, Jan. 29, 2008, at D1. These firms included Lehman Brothers, Goldman Sachs, J.P. Morgan Chase, Merrill Lynch, Bear Stearns, Morgan Stanley, and Citigroup. *Id.* These pay packages came

ecutives at Lehman Brothers undertook risk-taking activities, such as investing in subprime mortgages and mortgage backed securities, which eventually helped lead to the company's collapse in the fall of 2008.[24] Management's excessive risk-taking in the major financial institutions and large corporations was indicative of a larger, systemic risk-taking, which was allowed to occur primarily due to deregulation of the financial industry.[25] This systemic risk-taking was one of the major factors that plunged the global economy into crisis.[26]

The deregulation of the financial industry occurred over the past few decades, as the federal government relied on the self-regulation of the market rather than on government oversight and enforcement.[27] For example, in 1999, Congress passed the Gramm-Leach-Bliley Act, which repealed the Glass-Steagall Act of 1933.[28] The Glass-Steagall Act had restricted the co-ownership of commercial banks, which undertake everyday banking activity, and investment banks, which underwrite securities.[29] At the time of the repeal of the Glass-Steagall Act, many lawmakers and officials believed that it would

in a year during which the firms reported $55 billion in mortgage-related losses and shareholders suffered $200 billion in lost value. *Id.*

[24] *Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner: Hearing Before the H. Financial Serv. Comm.*, 111th Cong. 181 (2010) (prepared statement of Mary Shapiro, Chairman, U.S. Sec. & Exch. Comm'n).

[25] JICKLING, *supra* note 13, at 6. The collapse of Washington Mutual in 2008 is a strong example of the risk-taking by financial institutions and the lack of regulation by government authorities. *See* Floyd Norris, *Eyes Open, WaMu Collapsed Just the Same*, N.Y. TIMES, Mar. 25, 2011, http://www.nytimes.com/2011/03/25/business/25norris.html?_r=1&scp=3&sq=wamu&st=cse#. Prior to the 2008 crisis, top executives at Washington Mutual forecasted the coming problems with the housing market. *Id.* Despite recognizing the high risk involved in the housing market, the bank continued to take on large amounts of bad mortgage loans. *Id.* Regulators, specifically the Office of Thrift Supervision, were made aware of the problems at Washington Mutual but failed to take any significant action in response. *Id.* In the end, Washington Mutual collapsed and became one of the largest bank failures in American history. *Id.*

[26] JICKLING, *supra* note 13, at 6.

[27] *See Timeline*, *supra* note 3 (follow "Regulation & Deregulation (1880-Present)" hyperlink; then follow hyperlinks in timeline from 1990 to 2010); Anthony Faiola et al., *What Went Wrong*, WASH. POST (Oct.15, 2008), http://www.washingtonpost.com/wp-dyn/content/article/2008/10/14/AR2008101403343.html?sid=ST2008101403344.

[28] Gramm-Leach-Bliley Act, Pub. L. No 106-102, 113 Stat. 1338 (1999) (codified at 15 U.S.C. §§ 6801–6809 (2006); *see also* Cyrus Sanati, *10 Years Later, Looking at the Repeal of Glass-Steagall*, N.Y. TIMES: DEALBOOK (Nov. 12, 2009, 3:45 PM), http://dealbook.nytimes.com/2009/11/12/10-years-later-looking-at-repeal-of-glass-steagall/.

[29] Sanati, *supra* note 28.

allow American financial institutions to compete against foreign institutions in a globalized economy by removing what they perceived as antiquated Depression-era restrictions that were holding back the U.S. financial system.[30] Ten years after the repeal, many experts believe that the repeal of Glass-Steagall contributed to the financial crisis of 2008 because "the huge banks born out of the revocation of Glass-Steagall, especially Citigroup, and the insurance companies that were allowed to deal in securities, like the American International Group, would not have run into trouble had the law still been in place."[31]

The American public responded to the imprudent and risky behavior of the financial industry with anger and disapproval. According to a Pew Research Center report from 2010, a large majority of Americans have a negative view of financial institutions and banks, with only twenty-two percent of Americans saying that they view these institutions positively.[32] The actions of the large financial institutions created a feeling of disconnection between "Main Street" and "Wall Street" within the American public. This perception of "Wall Street" culture is fueled by the fact that companies handed out billions of dollars in bonuses, while the rest of the country was facing high unemployment and tough economic choices.[33] In fact, a report from

[30] Stephen Labaton, *Congress Passes Wide-Ranging Bill Easing Banking Laws*, N.Y. TIMES, Nov. 5, 1999, at A1. Interestingly, the lawmakers who opposed the repeal of the Glass-Steagall Act predicted "that the deregulation of Wall Street would someday wreak havoc on the nation's financial system." *Id.*

[31] Sanati, *supra* note 28. The financial crisis of 2008 has been viewed as a vindication of those lawmakers and experts who opposed the repeal of the Glass-Steagall Act and predicted that it would cause financial disaster. Sam Stein, *Glass-Steagall Act: The Senators and Economists Who Got It Right*, HUFFINGTON POST (June 11, 2009, 5:12 AM), http://www.huffingtonpost.com/2009/05/11/glass-steagall-act-these_n_201557.html.

[32] *Distrust, Discontent, Anger, and Partisan Rancor: Overview*, PEW RES. CTR. FOR PEOPLE & PRESS (Apr. 18, 2010), http://people-press.org/report/606/trust-in-government. The Pew Center research found that twenty-two percent of those surveyed believe that banks and other financial institutions have a positive effect on the way things are going in the country. *Id.* In the same survey, seventy-one percent of respondents believed that small businesses have a positive effect on the country. *Id.*; *see also 47%—Public Shows Wariness about Wall Street*, PEW RES. CTR. THE DATABANK, http://pewresearch.org/databank/dailynumber/?NumberID=1345 (last visited Apr. 21, 2012). A May 2011 survey found that forty-seven percent of respondents believe that Wall Street hurts the U.S. economy more than it helps. *Id.*

[33] Frank Ahrens, *Admiration Turns to Anger as Wall St. Bosses Feather Nests*, WASH. POST (Jan. 31, 2009), http://www.washingtonpost.com/wp-dyn/content/article/2009/01/30/AR2009013003665.html. As the profits of financial institutions have returned, so have the compensation packages for the institutions' top executives. *See* Eric Dash & Susanne Craig, *Big Paydays Return with Big Prof-*

the New York comptroller stated that Wall Street firms gave out $18.4 billion in bonuses for 2008, despite the fact that it was "one of the worst years ever on the Street."[34] The backlash against bonuses was compounded by the wide-spread perception that the taxpayers are funding them through federal bailout funds.[35]

Early in its term, the Obama Administration responded to the outrage of the American public and put forward its proposal for an overhaul of the financial regulatory system.[36] The wide-ranging proposal was the most sweeping overhaul since the reforms enacted in

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its at Wall St. Banks, N.Y. TIMES: DEALBOOK (Jan. 21, 2011, 9:11 PM), http://dealbook.nytimes.com/2011/01/21/big-paydays-return-with-big-profits-at-wall-st-banks/?partner=rss&emc=rss. Similarly, another writer remarks,

> So far, this recovery has not trickled down. After two relatively lean years, C.E.O.'s in finance, technology, energy and beyond are pulling down multimillion-dollar paychecks. What many of these executives aren't doing, however, is hiring. Unemployment, although down from its peak, stood at 8.8 percent in March. And few economists predict the jobless rate will drop substantially anytime soon.

Daniel Costello, *The Drought is over (At Least for C.E.O.'s)*, N.Y. TIMES, Apr. 10, 2011, at BU1. In 2010, the three highest-paid CEO's earned $84.5 million, $76.1 million, and $70.1 million, respectively. *Id.* The compensation packages were not as lucrative in 2011, with Wall Street's bonuses falling twenty-five percent from the previous year. John Gralla, *Wall Street Bonuses Fell 25 Percent in 2011*, REUTERS (Mar. 6, 2012, 4:15 PM), http://www.reuters.com/article/2012/03/06/us-wallstreet-bonuses-idUSTRE8241FJ20120306.

[34] Ahrens, *supra* note 33. In 2008 alone, Merrill Lynch paid out $209 million in bonuses to ten of its highest-paid executives despite suffering a net loss of $27.6 billion. *Merrill's Top Earners Took $209 Million in 2009, Report Says,* N.Y. TIMES: DEALBOOK (Mar. 4, 2009, 7:19 AM), http://dealbook.nytimes.com/2009/03/04/merrills-top-earners-took-209-million-in-2008-report-says/. In response to the outrage over bonuses, Congress included within the Federal Stimulus Bill a number of limitations on bonuses for executives at financial institutions that had received government assistance. Tomoeh Murakami Tse, *Congress Trumps Obama by Cuffing Bonuses on CEOs*, WASH. POST, Feb. 14, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/02/13/AR2009021303288.html?sid=ST2009021302017.

[35] *See* Ahrens, *supra* note 33. As President Obama remarked,

> Now, Americans don't begrudge anybody for success when that success is earned. But when we read in the past, and sometimes in the present, about enormous executive bonuses at firms—even as they're relying on assistance from taxpayers or they're taking huge risks that threaten the system as a whole or their company is doing badly—it offends our fundamental values.

President Barack Obama, Remarks by the President on Wall Street Reform at Cooper Union, New York, N.Y. (Apr. 22, 2010), *available at* http://www.whitehouse.gov/the-press-office/remarks-president-wall-street-reform.

[36] Helene Cooper, *Obama Pushes Financial Regulatory Overhaul*, N.Y. TIMES, June 21, 2009, at A20.

response to the Great Depression.[37] As the Administration pushed for the passage of the financial reform bill, President Obama expressed his anger with the behavior of the financial industry and attempted to appeal to the American public's frustration and anger.[38] After two years of debate, Congress finally approved the financial reform bill, and President Obama signed it into law in July of 2010.[39] Known as the Dodd-Frank Act, the legislation is aimed at preventing another major financial crisis by regulating the behaviors, instruments, and practices that are seen as having facilitated the collapse.[40] Many proponents of the legislation argued that the overhaul was long overdue as the regulatory system had failed to keep pace with the innovations and changes in the financial markets.[41]

The Dodd-Frank Act covers a wide range of areas within the financial industry, with provisions that regulate credit cards, consumer protection, mortgages, credit rating agencies, and derivatives.[42] Within the Dodd-Frank Act, there are numerous provisions that created new regulations for executive compensation, including a "Say on Pay" provision, a "Compensation Committees" provision, and an "Executive Compensation Disclosure" provision.[43] These provisions are part of a larger objective to strengthen corporate governance in order to

[37] *Obama's Financial Reform Plan: The Condensed Version*, WALL ST. J. WASH. WIRE (June 17, 2009, 2:14 PM), http://blogs.wsj.com/washwire/2009/06/17/obamas-financial-reform-plan-the-condensed-version/.

[38] *See* Jeff Zeleny, *As the Public Simmers, Obama Lets Off Steam*, N.Y. TIMES, Mar. 20, 2009, at A9.

[39] Appelbaum & Herszenhorn, *supra* note 6.

[40] *See id.*

[41] *Id.*

[42] *See also* Jill Jackson, *Wall Street Reform: A Summary of What's in the Bill*, CBS NEWS (June 25, 2010, 11:48 AM), http://www.cbsnews.com/8301-503544_162-20008835-503544.html.

[43] Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 951–57, 124 Stat. 1376, 1889–1907 (2010) (to be codified at in scattered sections of 15 U.S.C.); *see also* Alley Jr. et al., *supra* note 8 (describing the provisions and labeling them by their commonly used nicknames). For example, in 2011, the Securities and Exchange Commission (SEC) proposed rules under Section 956 of the Dodd-Frank Act. *SEC Proposes Rules on Disclosure of Incentive-Based Compensation at Financial Institution*, U.S. SEC. & EXCHANGE COMMISSION (Mar. 2, 2011), http://sec.gov/news/press/2011/2011-57.htm. Section 956 calls for federal regulators to require "covered financial institutions" to disclose information on the structure of the institutions' incentive-based compensation arrangements and to prohibit compensation arrangements that regulators determine encourage excessive risk. Dodd-Frank Wall Street Reform and Consumer Protection Act § 956.

avoid the oversight issues that occurred prior to the crisis.[44] The intent behind the provisions is to provide shareholders with better oversight and more involvement in the regulation and formation of a company's executive compensation.[45] As part of the new regulations on executive compensation, Congress included a provision entitled "Recovery of Erroneously Awarded Compensation."[46] This provision is Section 954 of the Dodd-Frank Act[47] and it is most commonly referred to as the clawback provision.[48] This provision mandates that publicly traded companies institute policies that would require executive officers to return compensation in certain situations.[49] Congress enacted this provision to discourage executives from making high-risk decisions that would have short-term gains but eventually hurt the stability and strength of the company.[50] Congress anticipated that this would deter executives from making these high-risk decisions because, in the end, the executives could be forced to return a part of their compensation.[51] Congress also determined that it would be unfair to shareholders if executives were allowed to keep compensation that they had been rewarded erroneously.[52] The following parts will examine Section 954 of the Dodd-Frank Act provision and the legal issues surrounding its implementation and enforcement.

III. THE CLAWBACK PROVISION OF THE DODD-FRANK ACT

A. *Section 954 of the Dodd-Frank Act*

In the Dodd-Frank Act, Section 954 falls under "Subtitle E—Accountability and Executive Compensation," and it places new regulations on the governance of executive compensation within compa-

[44] THE INVESTORS' WORKING GROUP, U.S. REGULATORY REFORM: THE INVESTOR'S PERSPECTIVE, at 22 (2009), *available at* http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors%27%20Working%20Group%20Report%20%28July%202009%29.pdf.

[45] *See* S. REP. NO. 111-176, at 133–36 (2010).

[46] Dodd-Frank Wall Street Reform and Consumer Protection Act § 954, 124 Stat. at 1904.

[47] *Id.*

[48] Alley, Jr. et al., *supra* note 8.

[49] Dodd-Frank Wall Street Reform and Consumer Protection Act § 954, 124 Stat. at 1904; *see also* Alley, Jr. et al., *supra* note 8.

[50] THE INVESTORS' WORKING GROUP, *supra* note 44, at 23.

[51] *See id.*

[52] S. REP. NO. 111-176, at 136.

nies.[53] Section 954 amends the Securities Exchange Act of 1934 by adding Section 10D.[54] Under Section 954, the Securities and Exchange Commission (SEC) is required to put in place rules that require any company that is listed on a national securities exchange to develop and implement a policy providing

> for disclosure of the policy of the issuer on incentive-based compensation that is based on financial information required to be reported under the securities laws; and
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> that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.[55]

Section 954 thus requires the SEC to put the burden on the companies listed on national securities exchanges to create and enforce clawback policies.[56] These policies would require companies to recover portions of incentive-based compensation from executive officers; incentive-based pay includes not only bonuses but also stock options that were given as compensation.[57] The clawback policy will come into play when a company is required to prepare an accounting restatement as a result of the company's material noncompliance with any financial reporting requirements under securities laws.[58] In that event, the company is required to recover the portion of the incentive-based pay that is in excess of what the executive would have been paid under the accounting restatement.[59] This requirement covers the incentive-based pay that was rewarded during the three-year period prior to the date when the accounting restatement was required.[60] Section 954 also requires that the SEC create rules that or-

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[53] Dodd-Frank Wall Street Reform and Consumer Protection Act § 954, 124 Stat. at 1904.

[54] *Id.*

[55] *Id.*

[56] *See id.*

[57] *Id.*

[58] *Id.*

[59] *Id.*

[60] *Id.*

der the national securities exchanges to prohibit the listing of any company that does not develop and implement a proper clawback policy.[61]

With the language that is in place, Congress has delegated power to the SEC to fill in the specifics of the rules that will govern the clawback policy.[62] The SEC has yet to promulgate these rules but it is expected to have them in place by June of 2012.[63] There are a number of questions left open for the SEC to answer when writing these rules. On what date does the triggering event of a restatement occur so that the three-year period can be calculated? Who is considered an executive officer? What must a company do to "implement" the clawback policy? How does a company "recover" the "excess" compensation? And how is the "excess" compensation calculated?[64] These are all important questions that the SEC must consider when it is promulgating the new rules pursuant to Section 954. As of the writing of this Comment, the SEC had not proposed rules pursuant to Section 954. While the rules will most likely address important unresolved issues, their implementation is not likely to affect the analysis in this Comment because the rules are not likely to address the issues discussed in this Comment.

B. Section 304 of the Sarbanes-Oxley Act

In order to better understand Section 954 and the provision's future implementation, it may be helpful to examine the clawback provision enacted and enforced prior to the Dodd-Frank Act. In the aftermath of high-profile corporate scandals, which resulted in the

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[61] *Id.* § 954.

[62] Deborah Lifshey, et al., *Summary of Clawback Policies Under Dodd-Frank Reform Act*, BOARDMEMBER.COM (July 23, 2010), https://www.boardmember.com/Print.aspx?id=5146.

[63] *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, U.S. SEC. & EXCHANGE COMMISSION, http://sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml#08-12-11 (last modified Apr. 18, 2012). The SEC stated that it planned to propose and adopt rules pursuant to Section 954 sometime between January and June of 2012. *Id.* Originally, the SEC stated that the rules for Section 954 would be proposed and adopted by the end of 2011. *SEC Delays Implementation of Dodd-Frank Executive Compensation Requirements*, CLEARY GOTTLIEB STEEN & HAMILTON LLP (Aug. 1, 2011), http://www.cgsh.com/sec_delays_planned_implementation_for_dodd-frank_executive_compensation_requirements/.

[64] William R. Baker III et al., *A Tale of Two Clawbacks: The Compensation Consequences of Misstated Financials*, LATHAM & WATKINS LLP (Aug. 10, 2010), http://www.lw.com/Resources.aspx?page=FirmPublicationDetail&office=2&publication=3662.

collapse of major corporations, Congress responded by enacting the Sarbanes-Oxley Act of 2002.[65] These scandals involved companies such as Enron, WorldCom, Tyco, and Global Crossing.[66] The amount of corporate fraud and corruption was shocking to many Americans and resulted in a loss of investor confidence in the system.[67] The Sarbanes-Oxley Act was aimed at improving accountability, integrity, and transparency in the accounting and financial practices of major corporations.[68] The objective was for investors to have more accurate knowledge when considering whether to invest in a corporation and to make investors more confident that their investments would be safe from fraud and corruption.[69] The overarching goal behind the Sarbanes-Oxley Act was to prevent the wide-ranging negative consequences that followed corporate scandals.[70]

Within Section 304 of the Sarbanes-Oxley Act, Congress included a clawback provision.[71] Under Section 304, in the event that an issuer of stock is required to prepare an accounting restatement as a result of misconduct, the CEO and CFO of the issuer are to reimburse the issuer for

> 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 requirement; and

[65] *See* Schwartz, *supra* note 10, at 4.

[66] Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1153 (2004).

> Sarbanes-Oxley would not have been enacted if Enron had been an isolated event. Enron's bankruptcy was soon followed by the financial collapse of approximately a dozen large public companies where there was also strong evidence of reporting violations and audit failures even more egregious than that which occurred in Enron.

COX ET AL., *supra* note 3, at 10.

[67] *See* Johnson & Sides, *supra* note 66, at 1153.

[68] J. Brent Wilkins, *The Sarbanes-Oxley Act of 2002: The Ripple Effects of Restoring Shareholder Confidence*, 29 S. ILL. U. L.J. 339, 343 (2005).

[69] *See* Allison List, Note, *The Lax Enforcement of Section 304 of Sarbanes-Oxley: Why is the SEC Ignoring Its Greatest Asset in the Fight Against Corporate Misconduct?*, 70 OHIO ST. L.J. 195, 197–98 (2009).

[70] *See id.* at 198 ("The concern became that investors had lost confidence in the market and would pull their money out of the market, leading to an economic downturn if something was not done to fix the problem.").

[71] Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (2006).

> any profits realized from the sale of securities of the issuer during that 12-month period.[72]

Because of the similarities between this provision and Section 954 of the Dodd-Frank Act, it may be instructive to compare the two provisions and consider how they interact with each other.

C. The Interaction Between Section 954 of the Dodd-Frank Act and Section 304 of the Sarbanes-Oxley Act

The provision set forth in Section 954 of the Dodd-Frank Act expands on the provision set forth in Section 304 of the Sarbanes-Oxley Act. The two clawback provisions co-exist, as Section 954 does not preempt or replace Section 304.[73] While the provisions complement each other, they overlap in many ways.[74] Specifically, the two provisions call for very similar actions in very similar situations. Both provisions call for executive compensation to be returned to the company in circumstances in which the company is required to prepare an accounting restatement because of material noncompliance with any financial reporting requirement under the securities laws.[75] The general aim of both provisions is similar—they both attempt to discourage certain types of behavior by executive officers.[76] Section 954 is intended to discourage excessive risk-taking by executive officers, while Section 304 is intended to improve corporate management to discourage fraudulent or wrongful conduct by executive officers.[77]

While the overall requirements of the provisions are similar, there are a number of important differences between them. One of the most important differences is that Section 304 is only triggered when the accounting restatement resulted from misconduct, while Section 954 does not require any such misconduct.[78] Another important difference is that Section 304 covers only the CFOs and CEOs of a company, while Section 954 applies to all current and former "executive officers."[79] Also, Section 304 requires repayment of all in-

[72] *Id.*

[73] Baker III et al., *supra* note 64.

[74] *Id.*

[75] *Id.*

[76] S. REP. NO. 111-176, at 136 (2010); *see* Schwartz, *supra* note 10, at 8.

[77] S. REP. NO. 111-176, at 136; *see* Schwartz, *supra* note 10, at 8.

[78] *Compare* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376, 1904 (2010) (to be codified at 15 U.S.C. § 78j-4), *with* Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (2006); *see also* Baker III et al., *supra* note 64.

[79] *Supra* note 78; *see also* Baker III et al., *supra* note 64.

centive-based and equity-based compensation, along with all stock profits, while Section 954 only requires the repayment of incentive-based compensation, including stock options awarded as compensation, that are in excess of what should have been granted.[80] Finally, Section 304 covers compensation received in the year following the issuance of a misstated financial statement, while Section 954 covers compensation received in the three years before the date on which the company was required to file the restatement.[81] The overall effect of these differences is that Section 304 is a narrower provision than Section 954, because it applies in fewer circumstances than Section 954. The wider scope of Section 954 may make it more effective than Section 304.

D. Enforcement of Section 304 of the Sarbanes-Oxley Act and the Implications for the Future Enforcement of Section 954 of the Dodd-Frank Act

Due to the similarities between the clawback provisions of both the Dodd-Frank Act and the Sarbanes-Oxley Act, the manner in which the clawback provision of the Sarbanes-Oxley Act has been interpreted, implemented, and enforced may have significant implications for the clawback provision of the Dodd-Frank Act. Based on the language of the clawback provision of the Sarbanes-Oxley Act, courts have held that only the SEC can bring an action against a company under Section 304.[82] This means that the provision does not create a private right of action under which individuals can bring suit against a company.[83] The courts have reasoned, based on the plain language of the text and the legislative intent, that there is no private right of action because the statute does not expressly or implicitly create one.[84] For example, the Ninth Circuit in *In re Digimarc Corp.* held that "Section 304 does not explicitly create a private right of action because nothing the text of the section makes any mention of a cause of

[80] *See* Baker III et al., *supra* note 64.

[81] *Id.*

[82] *See In re* Digimarc Corp., 549 F.3d 1223, 1238 (9th Cir. 2008); *In re* iBasis, Inc. Deriv. Litig., 532 F. Supp. 2d 214, 223 (D. Mass. 2007); *In re* BISYS Grp. Inc., 396 F. Supp. 2d 463, 464 (S.D.N.Y. 2005); Neer v. Pelino, 389 F. Supp. 2d 648, 651 (E.D. Pa. 2005).

[83] *See In re Digimarc*, 549 F.3d at 1230–31; *In re iBasis*, 532 F. Supp. 2d at 224; *In re BISYS*, 396 F. Supp. 2d at 464; *Neer*, 389 F. Supp. 2d at 652–58.

[84] *See In re Digimarc*, 549 F.3d at 1230–31; *In re iBasis*, 532 F. Supp. 2d at 224; *In re BISYS*, 396 F. Supp. 2d at 464; *Neer*, 389 F. Supp. 2d at 652–58.

action."[85] The court also held that Section 304 does not implicitly create a private right of action "[b]ecause the text and the structure of the Sarbanes-Oxley Act do not demonstrate an intent to create a private right of action under [S]ection 304."[86]

Since there is no private right of action under Section 304, the enforcement of the provision falls solely on the SEC.[87] For the first seven years after the Sarbanes-Oxley Act, the SEC did not exercise its power under Section 304 very frequently.[88] This trend has changed recently as the SEC has stepped up its enforcement of Section 304 and brought actions against company executives.[89] According to the SEC Director of Enforcement, Robert Khuzami, the SEC took action against fourteen executive officers in eleven cases from 2008 to 2010.[90] The most prominent case of SEC enforcement of Section 304 is *SEC v. Jenkins*.[91] There, the SEC brought an independent action based on its power under Section 304 against the CEO of an auto-parts company.[92] The SEC sought reimbursement of four million dollars in incentive-based pay and profits made from the sale of stock.[93] The action was based on accounting restatements made by the company due to "pervasive accounting fraud."[94] The defendant challenged the action, arguing that Section 304 did not apply because the SEC had not alleged misconduct on the defendant's part.[95] The court disagreed and held that Section 304 allows the SEC to seek reimbursement of executive compensation even when the defendant is

[85] *In re Digimarc*, 549 F.3d at 1230.
[86] *Id.* at 1233.
[87] *See* Baker III et al., *supra* note 64.
[88] *Id.*
[89] Thomas P. Cimino, Jr. et al., *SEC Uses Section 304 to Claw Back Incentive-Based Compensation from "Innocent" Executives*—SEC v. O'Dell *&* SEC v. Jenkins, NAT'L L. REV. (Sept. 9., 2010), http://www.natlawreview.com/article/sec-uses-section-304-to-claw-back-incentive-based-compensation-innocent-executives. The SEC settled a suit against the CEO of Beazer Homes for $6.5 million in March 2011, which was brought under Section 304. *SEC Obtains Settlement with CEO to Recover Compensation and Stock Profits He Received During Company's Fraud*, U.S. SEC. & EXCHANGE COMMISSION (Mar. 3, 2011), http://www.sec.gov/news/press/2011/2011-61.htm.
[90] Richard Khuzami, Director, U.S. Sec. & Exch. Comm'n, Speech to the Society of American Business Editors and Writers (Mar. 19, 2010), *available at* http://www.sec.gov/news/speech/2010/spch031910rsk.htm.
[91] *See* Cimino, Jr. et al., *supra* note 89.
[92] SEC v. Jenkins, 718 F. Supp. 2d 1070, 1072–73 (D. Ariz. 2010).
[93] *Id.* at 1073.
[94] Cimino, Jr. et al., *supra* note 89.
[95] *Jenkins*, 718 F. Supp. 2d at 1075.

not alleged to have committed misconduct.[96] The court also held that only misconduct by the company is required for an action under Section 304.[97] By allowing the SEC to bring an action against an executive who has not been accused of misconduct, this case permits the SEC to pursue action against a larger group of executives.[98] It remains to be seen if the SEC will take advantage of this power.

The enforcement under Section 304 may have important implications for the future enforcement of Section 954, as the SEC and the courts may treat Section 954 and Section 304 in a similar manner. First, the SEC will most likely be able to bring action against an executive whose company is required to prepare an accounting restatement because otherwise there would be no way to enforce the provision in case that companies fail to enforce their clawback policies on their own. While a non-compliant company may be delisted from the national securities exchanges, this will not help with reimbursement of the compensation that was erroneously awarded.[99] Second, the SEC will most likely be aggressive in its enforcement of Section 954, as the SEC considers clawback provisions to be an important tool in its enforcement of corporate governance.[100] This eagerness to exercise the power of clawback provisions is evidenced in the recent increase in suits that the SEC has brought under Section 304.[101] Third, courts will have to determine whether there is a private right of action under Section 954 that would allow individuals to bring suits against companies that are not in compliance. Based on the *In re Digimarc Corp.* court's analysis, the court will only find a private right of action if it was expressly or implicitly granted by the statute.[102] Although Section 954 does not explicitly provide for a private cause of action, courts may find that the language implicitly grants a private right of action by requiring that companies "implement" the claw-

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[96] *Id.* at 1074.

[97] *Id.* at 1074–75.

[98] *See id.* For example, the SEC brought a "clawback" suit against the CEO of Beazer Homes, even though he was not personally charged with misconduct. *SEC Obtains Settlement with CEO to Recover Compensation and Stock Profits He Received During Company's Fraud*, U.S. SEC. & EXCHANGE COMMISSION (Mar. 3, 2011), http://www.sec.gov/news/press/2011/2011-61.htm. Despite not being implicated in the fraud that took place at Beazer, Ian J. McCarthy agreed to reimburse the company for his compensation in 2006, totaling around $6.5 million. *Id.*

[99] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376, 1904 (2010) (to be codified at 15 U.S.C. § 78j-4).

[100] *See* Khuzami, *supra* note 90.

[101] *See id.*

[102] 549 F.3d 1223, 1230 (9th Cir. 2008).

back policy.[103] This language seems to imply that the enforcement of the provision rests on the companies.[104] If the courts do hold that there is a private right of action, this could give shareholders an important new weapon and could result in shareholder derivative suits to enforce companies' clawback policies.[105] A number of factors will influence the future enforcement of Section 954, which remains an open question.

IV. POSSIBLE METHODS OF ESCAPING LIABILITY UNDER SECTION 954

The effectiveness of future enforcement of Section 954 may face another possible challenge, in addition to the issues involved in how the provision is enforced in the future. Executive officers may attempt to escape liability for money owed under Section 954 by employing a number of different tactics. The means by which executive officers may try to avoid liability could include indemnification, director and officer insurance, and personal bankruptcy. All three of these methods could present executive officers, who were ordered to return compensation to their companies, with the opportunity to circumvent the personal liability that Section 954 imposes. If executive officers are allowed to use these methods to avoid liability, the effectiveness of Section 954 will be significantly reduced.

A. Indemnification

Indemnification is one of the most reliable corporate protections afforded to directors and officers.[106] Indemnification is the method by which a corporation agrees to "reimburse any agent, employee, officer, or director for reasonable expenses for losses of any sort arising from any actual or threatened judicial proceeding or investigation."[107] Most states have indemnification provisions within their corporate statutes that allow for both mandatory indemnification rights and elective indemnification rights.[108] In order for a corporation to indemnify a director or an officer, most corporate stat-

[103] Dodd-Frank Wall Street Reform and Consumer Protection Act § 954, 124 Stat. at 1904.
[104] *See id.*
[105] Baker III et al., *supra* note 64.
[106] WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 243 (5th ed. 2009).
[107] *Id.*; *see, e.g.*, CAL. CORP. CODE § 317 (West 2011); DEL. CODE ANN. tit. 8, § 145 (2011); N.Y. BUS. CORP. LAW § 722 (McKinney 2011).
[108] ALLEN ET AL., *supra* note 106, at 243.

utes require that the losses result from good-faith conduct on behalf of the corporation and that the losses not result from a criminal conviction.[109] The policy reasoning behind these statutory requirements is "to encourage capable people to serve as corporate employees, officers and directors by permitting corporations to shield them from liability for their official activities."[110] Indemnification rights also provide corporate officials with the ability to defend themselves against suits brought against them in their official capacity.[111]

Executive officers who face liability under Section 954 may attempt to have their losses indemnified by the corporation in order to be reimbursed for the compensation that they are required to return. This attempt, however, may not be successful. A recent court decision, for instance, prevented the indemnification of executive officers who faced liability under Section 304 of the Sarbanes-Oxley Act.[112] In *Cohen v. Viray*, the dispute focused on a settlement agreement in a shareholders' derivative suit, which included provisions that released and indemnified the CEO and the CFO of the corporation against all liability under Section 304.[113] The Department of Justice (DOJ) and the SEC objected to the approval of the settlement agreement based on the inclusion of those provisions.[114] While the district court was considering whether to approve the settlement agreement, the SEC brought a separate action against the former CEO seeking the return of $186 million under Section 304.[115] After the district court approved the settlement agreement, the DOJ, with consultation from the SEC, appealed the district court's decision, arguing that the provisions of the settlement agreement that released and indemnified the CEO and the CFO nullified the SEC's ability to enforce Section 304.[116] Ultimately, the court held that the settlement agreement

109 *Id.*

110 *In re* Miller, 290 F.3d 263, 267 (5th Cir. 2002). "No corporation can be a success unless led by competent and energetic officers and directors. Such individuals would be unwilling to serve if exposed to the broad range of potential liability and legal costs inherent in such service despite the most scrupulous regard for the interests of stockholders." Hermelin v. K-V Pharm. Co., No. 6936–VCG, 2012 WL 395826, at *1 (Del. Ch. Feb. 7, 2012).

111 *In re Miller*, 290 F.3d at 267 (citing VonFeldt v. Stifel Fin. Corp., 714 A.2d 79, 87 (Del. 1998)).

112 *See* Cohen v. Viray, 622 F.3d 188 (2d Cir. 2010).

113 *Id.* at 190.

114 *Id.*

115 *Id.* at 192.

116 *Id.* at 194.

could not include provisions that release and indemnify the CEO and CFO for liability under Section 304.[117] The court reasoned that these provisions would frustrate the power of the SEC to pursue the public interests in litigation and would "fly . . . in the face of Congress's efforts to make high ranking corporate officers of public companies directly responsible for their actions that have caused material non-compliance with financial reporting requirements."[118] According to the court, if the settlement agreement was allowed to stand, the CEO and CFO would be able to pass their liability onto the corporation and "would suffer no penalty at all."[119]

Based on the Second Circuit's decision in *Cohen*, a company may not be able to indemnify its executive officers for liability under Section 954.[120] Due to the similarities between Section 954 and Section 304, the court's reasoning would most likely apply to liability under Section 954 as well. If executive officers could be indemnified for their losses under Section 954, this would nullify the provision and would frustrate the legislative intent behind the provision. Indemnification would allow executive officers to simply pass the liability onto their companies, effectively allowing executive officers to escape any penalty for their actions. This would prevent Section 954 from serving the public interest and from ensuring "the integrity of the financial markets."[121] Allowing for indemnification of liability under Section 954 would permit executive officers to escape responsibility for their actions and decisions, an outcome that courts are not likely to be comfortable with.

B. Director and Officer Insurance

Director and officer (D&O) liability insurance has become an important tool for large corporations.[122] Almost all large companies

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[117] *Id.* at 195.

[118] *Cohen*, 622 F.3d at 195. "The SEC's decision to pursue § 304 relief is not solely intended to reimburse a company; it also furthers important public purposes. The § 304 remedy is an enforcement mechanism that ensures the integrity of the financial markets." *Id.* Based on similar reasoning, the Second Circuit has held that an underwriter is not entitled to indemnification by an issuer for violations of federal securities laws because it would be against the public policy embodied by the federal securities laws and would encourage flouting of federal securities laws. Globus v. Law Research Serv. Inc., 418 F.2d 1276, 1288. (2d Cir. 1969).

[119] *Cohen*, 622 F.3d at 195.

[120] *See id.*

[121] *Id.*

[122] Michael Sousa, *Making Sense of the Bramble Filled Thicket: The "Insured vs. Insured" Exclusion in the Bankruptcy Context*, 23 EMORY BANKR. DEV. J. 365, 366 (2007). Many

maintain D&O liability insurance as a way of protecting their directors and officers from liability stemming from actions that are connected to their corporate positions.[123] While every insurance policy is different, most policies have some standard provisions that define the terms of the policy and outline what is covered by the policy and what is not.[124] Most standard D&O liability insurance policies include Insurance Agreement A, also known as "A-Side Coverage," which provides direct coverage for directors and officers for losses that result from actions taken against them for "wrongful acts" committed in their corporate capacity.[125] This means that the insurance provider will cover the monetary award or settlement that the director or officer is obligated to pay.[126] The "A-Side Coverage" applies when the corporation cannot or does not indemnify its directors and officers.[127]

If courts disallow indemnification for the money owed under Section 954, then executive officers may attempt to have the loss covered by their companies' D&O liability insurance. The ability of the executive officers to have their losses covered by insurance will depend largely on the insurance policy of the individual company.[128] But there are several arguments why the money owed under Section 954 are not be recoverable under D&O insurance policy, at least in the policy's most common form.

There are three main reasons why such losses may not be covered. First, coverage under most D&O liability insurance policies is only be triggered by a claim involving a "wrongful act" committed by the insured executive officer.[129] This "wrongful act" requirement will most likely not be met by a claim under Section 954, because the pro-

states' corporation laws permit corporations to purchase director and officer insurance. *See, e.g.*, DEL. CODE ANN. tit. 8, § 145 (2011); N.Y. BUS. CORP. LAW § 726 (McKinney 2011).

[123] *See* Sousa, *supra* note 122, at 366 ("Presently, as many as ninety-five percent of Fortune 500 companies maintain directors and officers liability insurance.").

[124] *See* WILLIAM P. BILA & TIFFANY S. SALTZMAN-JONES, WALKER WILCOX MATOUSEK LLP, D&O POLICY BASICS "WHAT YOU SHOULD KNOW" 1 (2005), *available at* http://www.wwmlawyers.com/images/uploads/00004683.pdf.

[125] *Id.*

[126] *Id.*

[127] *Id.*

[128] *Id.*

[129] Kevin LaCroix, *Sarbanes-Oxley Act and D&O Insurance*, THE D&O DIARY (June 14, 2010), http://www.dandodiary.com/2010/06/articles/d-o-insurance/sarbanesoxley-act-clawbacks-and-do-insurance/.

vision does not require that there be a showing of "misconduct."[130] Under Section 954, liability can occur based only on the filing of an accounting restatement due to material noncompliance with filing requirements under the securities laws.[131] Based on the language of the provision, it does not seem that a clawback claim will most likely involve any "wrongful act" and, therefore, would most likely not trigger coverage under most D&O insurance policies.

The second reason why the award under Section 954 would not be covered by a company's D&O liability insurance is that "liability insurers regularly refuse to cover restitutionary and disgorgement amounts."[132] For example, most insurers will not cover awards that result from insider trading actions taken under Section 11 of the Securities Act of 1933 and Section 20A of the Securities Exchange Act of 1934.[133] The insurers' refusal to cover these liabilities is based on several court rulings which hold that restitutionary and disgorgement amounts do not fall within the meaning of "loss" under companies' D&O policies.[134] In *Level 3 Communications, Inc. v. Federal Insurance Co.*, the Seventh Circuit held that the settlement award from a securities fraud suit was not a "loss" under the D&O liability insurance policy.[135] The court agreed with the insurance provider that "a 'loss' within the meaning of an insurance contract does not include the restoration of an ill-gotten gain."[136] In *Conseco, Inc. v. National Union Fire Insurance Co.*, the court stated that "[i]t is axiomatic that insurance cannot be used to pay an insured for amounts an insured wrongfully acquires and is forced to return."[137] This reasoning may apply to monetary awards under Section 954 as well, since these awards can be classified as disgorgements of the executive officers' compensation. The incentive-based compensation that the executive officer is required to return to the company may be considered an "ill-gotten gain" because it was received based on inaccurate account-

[130] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376, 1904 (2010) (to be codified at 15 U.S.C. § 78j-4).

[131] *Id.*

[132] BILA & SALTZMAN-JONES, *supra* note 124, at 3.

[133] *Id.*

[134] *Id.* (citing Level 3 Commc'ns, Inc. v. Fed. Ins. Co., 272 F.3d 908 (7th Cir. 2001); Conseco, Inc. v. Nat'l Union Fire Ins. Co., No. 49D130202CP000348, 2002 WL 31961447 (Ind. Cir. Ct. Dec. 31, 2002); Bank of the West v. Superior Court, 833 P.2d 545 (Cal. 1992)).

[135] *Level 3 Commc'ns, Inc.*, 272 F.3d at 910.

[136] *Id.*

[137] *Conseco, Inc.*, 2002 WL 31961447, at *6.

ing statements.[138] Thus, the executive officer is being forced to return the compensation because he or she was erroneously awarded that money, even if there was an absence of "misconduct."[139] Since the compensation being disgorged under Section 954 can be considered an "ill-gotten gain," courts could hold that it cannot be covered by D&O liability insurance policies. Therefore, if courts follow the rationales on which they have relied for denying insurance reimbursement for Section 307 claw backs, executive officers who face personal liability under Section 954 would similarly not be reimbursed by their company's insurance providers.

Finally, the third reason why the award under Section 954 would probably not be covered by D&O liability insurance is that most policies have conduct-based exclusions to coverage.[140] Within these conduct-based exclusions, most policies exclude "coverage for any loss based on a claim for any 'profit or advantage' to which the insured is not legally entitled."[141] Courts that have interpreted the term "profit or advantage" have held that it is a broad term, which should apply to any benefit received by directors or officers.[142] The relevant cases involved various violations of federal and state law by directors and officers.[143] In *TIG Specialty Insurance Co. v. Pinkmonkey.com Inc.*, the Fifth Circuit stated that "a defendant is not legally entitled to an advantage or profit resulting from his violation of law if he could be required to return such profit."[144] Based on this interpretation of the "profit or advantage" exclusion, money owed under Section 954 would probably not be covered by D&O liability insurance policies because it is a profit to which the executive officer is not entitled. The executive officer is not entitled to the compensation because he or she received it based on erroneous data and would not have been awarded that amount of money if the original accounting statement was accurate. Since the money owed under Section 954 could fall within the "profit or advantage" exclusion, courts could hold that insurance providers

[138] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 954, 124 Stat 1376, 1904 (2010) (to be codified at 15 U.S.C. § 78j-4).

[139] *Id.*

[140] Bila & Saltzman-Jones, *supra* note 124, at 3.

[141] LaCroix, *supra* note 129.

[142] *See* TIG Specialty Ins. Co. v. Pinkmonkey.com Inc., 375 F.3d 365, 370 (5th Cir. 2004); Nat'l Union Fire Ins. Co. v. U.S. Bank, Nat'l Ass''n, No. 4:07-CV-1958, 2008 WL 2405975, at *6 (S.D. Tex. 2008).

[143] *See TIG Specialty Ins. Co.*, 375 F.3d at 368; *Nat'l Union Fire Ins. Co.*, 2008 WL 2405975, at *6.

[144] *TIG Specialty Ins. Co.*, 375 F.3d at 370.

do not need to reimburse the executive officers for the returned compensation. When an executive officer is required to return a portion of his or her compensation under Section 954, this portion of the compensation will likely fall within the exclusion because the executive officer is not legally entitled to that money.

All three of these arguments why illustrate why D&O liability insurance may not cover the money that executive officers owe under Section 954.

C. Personal Bankruptcy

One of the most common forms of bankruptcy is Chapter 7, which is also known as the United States Bankruptcy Code's "liquidation chapter" and is often referred to as "straight bankruptcy." When this procedure is undertaken, a third party liquidates the debtor's assets and distributes the proceeds to the debtor's creditors.[145] Under bankruptcy law, the debtor is allowed to discharge his or her old debts.[146] Discharge means that he or she is no longer personally liable for his or her pre-bankruptcy debt.[147] If a creditor is owed a debt, it only receives a pro rata share of the assets of the debtor's bankruptcy estate, which is usually only cents on the dollar.[148] The most important policy goal of Chapter 7 bankruptcy is allowing a "fresh start" to a debtor so that he or she has the opportunity to start anew unhindered by the burden of preexisting debt.[149] In *Grogan v. Garner*, the U.S. Supreme Court recognized that the central purpose of bankruptcy is "to provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy 'a new opportunity in life with a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.'"[150] Despite of the "fresh start" policy goal of bankruptcy, there are several exceptions to dischargeability[151] which are found in § 523 of the

[145] Lucian Murley, Note, *Closing a Bankruptcy Loop-Hole or Impairing a Debtor's Fresh Start? Sarbanes-Oxley Creates a New Exception to Discharge*, 92 KY. L.J. 317, 319 (2003).
[146] *Id.*
[147] *Id.*
[148] *Id.*
[149] Keith N. Sambur, Note, *The Sarbanes-Oxley Act's Effect on Section 523 of the Bankruptcy Code: Are All Securities Laws Debts Really Nondischargeable?*, 11 AM. BANKR. INST. L. REV. 561, 563 (2003) (citing Grogan v. Garner, 498 U.S. 279, 286 (1991); Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934)).
[150] *Grogan*, 498 U.S. at 286 (quoting *Local Loan Co.*, 292 U.S. at 244).
[151] *Id.*

Bankruptcy Code.[152] These exceptions usually involve some type of culpable conduct on the part of the debtor.[153]

While it may seem extreme for executive officers to declare personal bankruptcy in order to discharge debt owed for Section 954 liability, this may be a possibility considering the amount of money that could be at stake. For example, in *Cohen*, the SEC sought to disgorge $186 million from the executive officer under Section 304 of the Sarbanes-Oxley Act.[154] In another Section 304 matter, a former CEO agreed to return more than $400 million to his former company as part of a settlement agreement.[155] In light of potential awards or settlements of this size, there is a possibility that executive officers would declare bankruptcy if they cannot afford to reimburse their companies. In order to prevent discharge of debt owed under Section 954, the debt would have to fall within one of the exceptions enumerated in § 523 of the U.S. Bankruptcy Code because the general rule is that most debt is dischargeable.[156] There are two exceptions within § 523 that may apply when an executive officer is attempting to discharge debt owed under Section 954.

The first possible exception is found in § 523(a)(19).[157] This provision allows an exception from dischargeability if two conditions are met: first, the plaintiff must show that the debt was the result of a securities law violation or for fraud in connection to the purchase or sale of a security, and, second, the debt must be set forth in a judicial

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152 11 U.S.C. § 523 (2006).

153 Sambur, *supra* note 149, at 564.

154 Cohen v. Viray, 622 F.3d 188, 192 (2d Cir. 2010).

155 Schwartz, *supra* note 10, at 13.

156 Sambur, *supra* note 149, at 564.

157 11 U.S.C. § 523(a)(19) (2006). Under Section 523(a)(19) of the Bankruptcy Code, there is an exception to dischargeability for debt that

> is for: the violation of any of the Federal securities laws (as that term is defined in section 3(a)(47) of the Securities Exchange Act of 1934), any of the State securities laws, or any regulation or order issued under such Federal or State securities laws; or common law fraud, deceit, or manipulation in connection with the purchase or sale of any security; and results, before, on, or after the date on which the petition was filed, from any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding; any settlement agreement entered into by the debtor; or any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor.

Id.

or administrative order or settlement agreement.[158] The Corporate and Criminal Fraud Accountability Act of 2002 added this provision of § 523 to the Bankruptcy Code as part of the Sarbanes-Oxley Act.[159] In enacting this provision, Congress intended to make judgments and settlements arising from securities law violations to be non-dischargeable.[160] This was done to help defrauded investors recover their losses by closing a perceived "loophole" in bankruptcy law, which had allowed wrongdoers to discharge their debt from securities law violations.[161]

Based on the language of this provision, debt owed under Section 954 could fall within this exception and, therefore, could be non-dischargeable. In order for it to fall within this exception, two requirements must be met, however. First, courts would have to find noncompliance with Section 954 to constitute a violation of securities law. This may be likely because Section 954 has been added to the Securities Exchange Act of 1934 as Section 10D.[162] Therefore, there is a very strong argument that Section 954 falls within the definition of "securities law" required by § 523 because that definition includes the Securities Exchange Act of 1934.[163] Second, the debt owed under Section 954 would have to be memorialized in a judicial or administrative order or a settlement agreement. This would most likely apply to actions that the SEC brings against executives and, if courts were to allow private causes of action,[164] it would likely apply to actions against executives by either the company or shareholders. But it would probably not apply to internal actions within companies. In addition, there would have to be a showing that the alleged violations actually occurred. For example, a settlement agreement that does not concede fault or liability on part of the debtor may not satisfy this requirement.[165] If these prerequisites are met and based on the legislative intent behind the exception in § 523(a)(19) of the Bankruptcy

[158] *In re* Jafari, 401 B.R. 494, 496 (Bankr. D. Colo. 2009).

[159] Murley, *supra* note 145, at 318.

[160] S. REP NO. 107-146, at 12 (2002).

[161] *Id.* at 10.

[162] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376, 1904 (2010) (to be codified at 15 U.S.C. § 78j-4).

[163] 4 COLLIER ON BANKRUPTCY P 523.27 (Alan N. Resnick et al. eds., 15th ed. rev. 2009).

[164] While this Comment has argued that private causes of action will most likely not be permitted under Section 954, there is still the possibility that a court will find that Section 954 provides individuals with the right to private causes of action.

[165] *See In re* Tills, 419 B.R. 444 (Bankr. S.D. Cal. 2009).

Code, it seems that debt owed under Section 954 would be non-dischargeable. An executive or former executive who is trying to discharge Section 954 debt is attempting to take advantage of the exact "loophole" that Congress wanted to close by enacting § 523(a)(19).[166] If debt owed under Section 954 was dischargeable, it would frustrate the policy reasoning for Section 523(a)(19).

The second possible exception is found in § 523(a)(4).[167] Under § 523(a)(4) of the Bankruptcy Code, there is an exception to dischargeability for any debt that is "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny."[168] Defalcation while acting in a fiduciary capacity involves the misappropriation or failure to account for funds.[169] The federal courts have reached different interpretations of what constitutes defalcation while acting in a fiduciary capacity because some disagree about the requisite level of intent that the fiduciary must have when committing the defalcation for the exception to apply.[170] One group of circuit courts has held that negligence or innocent mistake by the fiduciary is enough for the exception to apply.[171] Another group of circuit courts has held that there needs to be something more than negligence or mistake on the part of the fiduciary, such as willful negligence or recklessness.[172] A third group of circuit courts has held that extreme recklessness or conscious misbehavior by the fiduciary is required for the exception to apply.[173]

Based on the circuit split over the meaning of defalcation while acting in a fiduciary capacity, it is difficult to determine whether or not debt owed under Section 954 would be non-dischargeable under § 523(a)(4). Depending on which interpretation a court adopts, debt incurred under Section 954 could fall within the § 523(a)(4) exception. Under the view that only negligence or mistake is required, debt owed under Section 954 would most likely be non-dischargeable. Executive officers owe the same fiduciary duties to the

[166] S. REP NO. 107-146, at 10 (2002).
[167] *See* 11 U.S.C. § 523(a)(4) (2006).
[168] *Id.*
[169] *In re* Baylis, 313 F.3d 9, 18 (1st Cir. 2002).
[170] *See generally* Matthew W. Knox, Note, *Persistent Confusion: The Circuit Split Over the Exception to Discharge for Defalcation Under 11 USC § 523(a)(4)*, 2008 COLUM. BUS. L. REV. 1078 (2008) (discussing the circuit split in detail).
[171] *Id.* at 1086–87.
[172] *Id.* at 1091.
[173] *Id.* at 1099.

company and its shareholders as board members do, such as the duty of loyalty and the duty of care.[174] Therefore, executive officers are acting within a fiduciary capacity.[175] Material noncompliance with the financial reporting requirements under the securities laws that require a company to prepare an accounting restatement could be considered defalcation because it could be seen as a failure to account for funds. Under this standard, it would not be necessary to show that the executive officers intentionally caused the material noncompliance but only that they were negligent in discharging their duties to avoid such noncompliance.[176]

Under the interpretations of the other groups of circuit courts, however, it may be harder to find that debt owed under Section 954 is non-dischargeable. For a court to hold a debt dischargeable under the two alternative interpretations, it would have to find that the executive officer was not merely negligent but rather the officer was reckless, extremely reckless, or conscious in causing the noncompliance.[177] If these higher standards were applied, executive officers would be able to escape liability under Section 954 more easily through the process of personal bankruptcy.

As between the two exceptions, it seems that the securities law exception is more suitable for debt owed under Section 954. Based on the wording of the provision and the legislative intent in enacting it, a court is more likely to find that this provision applies to debt owed under Section 954. It seems less likely that a court would find debt owed under Section 954 to fall under the fiduciary duty exception because of the differing interpretations of when the exception applies.

V. EXECUTIVE OFFICERS SHOULD NOT BE ALLOWED TO ESCAPE LIABILITY UNDER THE CLAWBACK PROVISION

Congress had two policy reasons in mind when it included the clawback provision in the Dodd-Frank Act.[178] First, Congress wanted to deter executives from making high risk decisions that will have short term gains but will eventually hurt the stability and strength of

[174] *See* Michael Follet, Note, Gantler v. Stephens*: Big Epiphany or Big Failure? A Look at the Current State of Officers' Fiduciary Duties and Advice for Potential Protection*, 35 DEL. J. CORP. L. 563, 575 (2010).

[175] *Id.*

[176] Knox, *supra* note 170, at 1086.

[177] *Id.* at 1091.

[178] S. REP. NO. 111-176, at 136 (2010).

the company.[179] This provision acts as a deterrent against this risky behavior by forcing executives to reimburse the company for compensation that is erroneously received.[180] Second, Congress wanted to promote fairness to shareholders because executives should not be allowed to keep compensation that is received erroneously when the company would otherwise use the money for other purposes.[181]

If executives are allowed to escape liability under Section 954 through indemnification, D&O liability insurance, or personal bankruptcy, the policy rationale behind the provision will be frustrated. Executives will not face personal liability for excess compensation owed under Section 954 and, therefore, will not be deterred from making high-risk decisions. Instead, either the company or an insurance provider will reimburse the executive, through indemnification or D&O liability insurance, respectively. In the event that neither indemnification nor D&O insurance is applicable, executive officer could attempt to discharge the debt incurred under Section 954 in Chapter 7 personal bankruptcy proceedings. Based on past case law and statutory interpretation, there are strong arguments against allowing the use of these methods to escape liability under Section 954. When considering Section 954 liability, courts should follow these holdings and interpretations, in order to ensure the effectiveness of Section 954. Also, the "fairness to shareholders" reasoning will not be served if executives avoid liability in any of these three ways. Under any of these circumstances, the company and its shareholders will suffer because the company will foot the bill of the executive officer and not be able to put the money to better use.

Based on the large amount of money that may be at stake, it is highly likely that executive officers that are required to return compensation under Section 954 will attempt to avoid repayment.[182] As more and more companies adopt and implement clawback policies in anticipation of the proposal of rules pursuant to Section 954,[183] there will likely be an increase in instances in which executives are required to return certain parts of their compensation. With this increase,

[179] *Id.* (citing THE INVESTOR'S WORKING GROUP, *supra* note 44).
[180] *Id.*
[181] *Id.*
[182] *See supra* Part IV.
[183] *See* Erik Krusch, *Corporate Governance: Dodd-Frank's Compensation Tremors*, COMPLINET.COM (Feb. 23, 2011), http://www.complinet.com/dodd-frank/news/analysis/article/corporate-governance-dodd-franks-compensation-tremors.html.

there will be more executives searching for methods to avoid the liability imposed by the clawback policies. Recently, companies and executives have looked for ways to get around other recent reforms,[184] and Section 954 enforcement will likely be no different. In order for the enforcement of Section 954 to be fully effective, courts should not allow executive officers to escape liability under Section 954 by employing these methods.[185] Just as the courts' interpretations of Section 304 in *Jenkins* and *Cohen* allowed enforcement of that provision, courts should interpret Section 954 to provide for the full enforcement of its mandates.[186] Based on the similarities in both purpose and effect between Section 304 and Section 954, courts should apply the interpretations of Section 304 to the enforcement of Section 954. While these two sections are not identical, their similarities are significant enough to justify similar enforcement. By applying the prior interpretations of Section 304 to the enforcement of Section 954, courts will provide for the broadest possible application of the two sections and ensure their effectiveness going forward. This will allow Section 954 to have the impact that Congress intended it to have.

VI. CONCLUSION

In the aftermath of the worst financial crisis since the Great Depression, the federal government took action to help the economy recover and to help prevent a similar crisis in the future. As part of the federal government's response, Congress passed the Dodd-Frank Act, which made sweeping reforms to the regulation of the financial industry. Included within the Dodd-Frank Act was Section 954, which

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[184] *See* Eric Dash, *Stock-Hedging Lets Bankers Skirt Efforts to Overhaul Pay*, N.Y. TIMES: DEALBOOK (Feb. 5, 2011, 5:04 PM), http://dealbook.nytimes.com/2011/02/05/stock-hedging-lets-bankers-skirt-efforts-to-overhaul-pay.

[185] There have been critics of the executive compensation provisions of the Dodd-Frank Act who have questioned whether the provisions will actually be effective in preventing future financial crises. *See* Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II* 25–35 (UCLA School of Law, Law-Econ Research Paper No. 10–12, Sept. 7, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1673575. As part of what Professor Bainbridge termed "Quack Federal Corporate Governance," he criticizes Section 954 as being both over-inclusive and under-inclusive because it reaches innocent executives but at the same time does not reach other individuals who may pose a risk to the stability of a company. *Id.* at 27. Also, the provision may have unintended consequences, such as companies increasing fixed-salary compensation and decreasing incentive-based compensation. *Id.*

[186] *See* Cohen v. Viray, 622 F.3d 188, 192 (2d Cir. 2010); SEC v. Jenkins, 718 F. Supp. 2d 1070 (D. Ariz. 2010).

mandates that companies listed on the national securities exchanges develop and implement clawback policies. These policies require executive officers to reimburse the company for incentive-based compensation in certain situations. The clawback provision of the Dodd-Frank Act has a number of similarities to the clawback provision of the Sarbanes-Oxley Act, which makes the Sarbanes-Oxley provision instructive on how the Dodd-Frank provision may be implemented and enforced. While there are still many open questions as to how the clawback policies will be implemented and enforced, the congressional intent in enacting Section 954 is clear: to deter risky behavior by executive officers and to promote fairness to shareholders. In order for these policy goals to be met, executives should not be able to avoid responsibility for debt incurred under Section 954 through indemnification, D&O insurance, or personal bankruptcy. Thus, courts should use the interpretations of Section 304 of the Sarbanes-Oxley At as a guide for the implementation of Section 954. These interpretations would allow the courts to thoroughly enforce liability under Section 954 and would allow Section 954 to have the effect that Congress intended.