Controversial Uses of the “Clawback” Remedy in the Current Financial Crisis

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Current Financial Environment

We are in the midst of a major global economic crisis in which allegations of financial fraud and poor corporate governance have dominated the headlines for the past year or more. Revelations of massive Ponzi schemes of unprecedented size — most notably the Madoff and Stanford cases — and multimillion-dollar bonuses to executives of failing companies have sparked outrage, raised questions about the effectiveness of our financial regulators, and prompted calls for wide-sweeping regulatory reform.

Typically in the wake of a major financial crisis, the regulators and politicians will formulate a quick regulatory response (such as Sarbanes-Oxley in response to the corporate scandals of the early 2000s), and the government enforcers will ramp up their activity and push the enforcement envelope with more aggressive charging decisions and uses of legal remedies. While these rapid actions can help restore investor confidence in the markets and reestablish the credibility of financial regulators in the short term, prosecutorial decisions made in haste on new and/or complex financial matters can have unintended and unfair consequences.

One legal remedy commonly used in cases to redress large financial frauds is the “clawback” — the attempt to recover money that has been paid to third parties in the course of a fraud. Using clawed-back funds, regulators, court-appointed receivers, bankruptcy trustees, corporations, and investors’ counsel attempt to redistribute payments made in the course of the fraud, in either an attempt to make defrauded parties whole or to prevent unjust enrichment.

While the clawback is an established legal remedy under both common law and state and federal statutes, the manner in which this remedy is being used in the current financial scandal has drawn the ire of, ironically, both government regulators and the private bar — along with one circuit court. In the corporate
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fraud context, clawbacks are being used by regulators to recover compensation that innocent corporate officers received from a company engaged in fraud. In the current Ponzi scheme environment, clawbacks are being used by court-appointed private attorneys in an attempt to recover funds that were transferred to investors who redeemed their investment before the scheme’s collapse, or transfers that were made to other innocent third parties, such as unwitting company employees and investment professionals, during the course of the fraud.

Critics argue that these uses of the clawback remedy — both in enforcement actions and private litigation — to seek money from individuals who have engaged in no wrongdoing and, in the case of Ponzi schemes, persons who have already suffered substantial harm from the fraud, are improper. Recent uses of clawbacks to recover Ponzi payments are alleged to be grossly inequitable and inconsistent with existing clawback law.

Just weeks ago, the 5th Circuit struck down the Stanford Receiver’s attempt to pursue clawback claims against hundreds of investors simply by naming them as relief defendants. Similarly, a recent case where the U.S. Securities and Exchange Commission has sought to claw back executive compensation has come under attack as a reflection of poor prosecutorial discretion in the overheated atmosphere surrounding executive compensation and because of ambiguity in the SEC’s executive clawback provision under Sarbanes-Oxley.

As more frauds are uncovered and as regulation of executive compensation becomes more stringent, more lawyers will be involved in providing advice about dealing with the consequences of fraud, whether in reaction to the discovery of a fraud or protecting their client’s interest in the event that a fraud occurs. Lawyers who represent investors, corporate boards and officers, and investment professionals need to be aware of current developments in the law regarding clawbacks in order to advise their clients on potential liability in the event that a fraud is discovered.

Clawback of Executive Compensation

Sarbanes-Oxley §304

What liability does a corporate executive officer face when a fraud or other securities law violation has been uncovered at the executive’s company? In cases where the officer was involved in the illegal activity (e.g., some level of participation and scienter), the SEC may seek disgorgement of the executive’s ill-gotten gains, which may include all compensation attributable to the legal violations (e.g., salary, bonus, stock options, stock sale proceeds). The SEC also may seek civil money penalties and a host of equitable non-monetary remedies against the executive.

Until recently, however, executive officers have not faced financial liability for corporate securities law violations absent an allegation that the officer had engaged in misconduct. This changed in a case filed by the SEC this summer, SEC v. Jenkins, in which the SEC is seeking to claw back incentive-based compensation from Maynard L. Jenkins, the former chief executive officer of a public company that the SEC had previously charged with fraud, without any allegations — either in the current case against Jenkins or the earlier enforcement action against the company — that Jenkins had any involvement in or knowledge of the corporate misconduct.

In seeking to claw back more than $4 million in bonuses and stock sale proceeds that Jenkins received during the period covering the company’s financial restatement, the SEC is relying on a lesser-known provision of Sarbanes-Oxley. Section 304 of Sarbanes-Oxley provides that the chief financial officer and CEO of public companies must reimburse the company for any bonus or equity-based compensation and any profits from sales of the company’s securities received during the relevant period if the company is required to prepare an accounting restatement due to material noncompliance of the issuer with any financial reporting requirement under the securities laws, if such noncompliance resulted from misconduct. Courts that have addressed the issue have uniformly declared that no private right of action exists under this provision.

Prior to Jenkins, the few cases the SEC had brought under this provision were matters involving stock options backdating where misconduct against the executive was alleged. The use of Section 304 to claw back compensation from an executive not accused of wrongdoing has been met with criticism from the securities bar ranging from due process to prosecutorial discretion in the overheated atmosphere surrounding executive compensation and because of ambiguity in the SEC’s executive clawback provision under Sarbanes-Oxley.

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tion concerns. Further, without specificity of the facts or circumstances that led to this charging decision, it is difficult for corporate counsel to discern and advise their clients on appropriate conduct in similar situations.

**TARP and EESA Requirements**

The Emergency Economic Stabilization Act of 2008 (EESA) created the Troubled Asset Relief Program (TARP). Section 111 of EESA, as modified by the American Recovery and Reinvestment Act of 2009 (ARRA), requires all recipients of TARP funds to establish certain executive compensation and corporate governance standards. As part of these standards, TARP recipients must provide a means to claw back “any bonus, retention award, or incentive compensation paid to a senior executive officer and any of the next 20 most highly compensated employees of the TARP recipient based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate.” Senior executive officers are defined as the five most highly compensated executives and those whose compensation is required to be reported.

There are a few notable differences between the clawback provisions of EESA and the clawback provision in Sarbanes-Oxley. The EESA requirement applies to a larger range of employees, to both public and private TARP recipients, and to retention awards, and is not exclusively triggered by an accounting restatement resulting from misconduct, does not limit the recovery period, and covers not only material inaccuracies relating to financial reporting, but also material inaccuracies relating to other performance metrics used to calculate bonus payments. While a plain reading of EESA Section 111 seems to indicate that misconduct is not required to trigger the clawback provision, the U.S. Treasury Department interim final rules state that an employee’s knowing engagement in providing inaccurate information will result in the information being considered materially inaccurate with respect to that employee. The remainder of the rule indicates, however, that information could be considered materially inaccurate even in the absence of such misconduct.

The Treasury Department’s interim final rules implementing the EESA also add a requirement that the TARP recipient must enforce the clawback provisions unless the TARP recipient can show that it would be unreasonable to do so (i.e., if the cost of enforcement exceeds the potential recovery). As noted above, Sarbanes-Oxley does not provide such a private right of action.

Even companies that are not subject to the EESA executive compensation provisions should review their agreements and policies to determine their ability to claw back executive compensation. While the future of executive compensation regulation is unclear, the EESA executive compensation rules for TARP recipients may form the basis for future regulations that are more generally applicable. The TARP clawback rules may be seen by many, perhaps even by the SEC, as best practices, and policies in line with those rules may signal a company’s commitment to good governance procedures.

Further, recent SEC proposals for proxy rule changes requiring additional disclosure of compensation arrangements may force companies to disclose whether they have agreements or policies in place to claw back incentive-based compensation. Executive compensation continues to be an area of concern to shareholders — companies that do not have robust clawback policies and procedures may be vulnerable to shareholder proposals on that topic.

In response to these pressures, many companies have begun including clawback provisions in their employment agreements or incentive plan agreements. For more visibility, some companies have created stand-alone clawback policies or agreements. Even if company policy and contractual provisions do not provide a clawback remedy, common law remedies, such as disgorgement and restitution, may allow corporations to recover performance-based pay in the event that it is determined that the performance measures were fraudulently inflated.

**Ponzi Schemes and Clawbacks**

The public’s attention has been captured by the recent discovery of multiple massive Ponzi-type frauds. The most infamous fraud of recent years is doubtlessly the massive Ponzi scheme that sent Bernard Madoff to prison, which has been estimated to have defrauded investors of $65 billion. In Texas, the SEC and U.S. Department of Justice have accused colorful financier Allen Stanford of operating an $8 billion Ponzi scheme through the sale of CDs through Stanford International Bank.

Insight as to how the laws governing clawbacks may be applied in these schemes may be derived from a lesser-known Ponzi scheme involving a number of hedge funds operated through Bayou Management, L.L.C. (referred to collectively as “the Bayou Funds”). The Bayou Funds sustained heavy losses from their inception, with audits by a fictitious audit firm providing support for false financial statements showing fictitious returns. As with most Ponzi schemes, investors who wished to redeem their investment were paid not from profits, but from the principal contributions of later investors. When the Bayou Funds collapsed in the summer of 2005, more than $250 million in investor principal had vanished, and the Bayou Funds and their related entities filed for bankruptcy.

When a Ponzi scheme is uncovered, the entity through which the fraud was perpetrated often ends up either filing for bankruptcy (the Bayou Funds), in Securities Investors Protection Corporation (SIPC) liquidation in bankruptcy court (Madoff), or in an SEC receivership (Stanford). In many cases, the only asset available to provide any payment to the many investors and other creditors are legal claims to recover sums paid out by the entity before the crash. These legal claims (often called avoidance) generally fall into two categories: preferences and fraudulent transfers (sometimes known as fraudulent conveyances). While avoidance actions for preferences are available only in cases in which the Bankruptcy Code applies, fraudulent transfer claims may be brought either under either the Bankruptcy Code or under state laws governing fraudulent transfers.
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Preferences
The Bankruptcy Code provides that the trustee may avoid payment or transfer to any creditor who has received payment or a transfer within 90 days of the debtor’s bankruptcy filing.51 Payments made in the ordinary course of business, however, are not subject to avoidance.52 Generally, redemption payments to investors are not considered to be in the ordinary course of business, and redemptions within the 90-day period are therefore considered preferential transfers.53 Payments to non-investor creditors, however, may be subject to the ordinary course of business defense.54

Intentional or Actual Fraudulent Transfers
The intentional fraudulent conveyance provision of the Bankruptcy Code, found at 11 U.S.C. §548(a)(1)(A), allows the trustee to recover any funds transferred within two years of the bankruptcy filing if the transfers were made with actual intent to hinder, delay, or defraud any of the debtor’s creditors,55 whether they were creditors at the time or became creditors after the transfer was made.56 Only the debtor’s intent is relevant to determining whether an intentional fraudulent transfer occurred; the intent or knowledge of the transferee is not relevant to whether a fraudulent transfer occurred, but merely to the “good faith” defense under §548(c).57 It is not necessary to prove that the debtor actually did, in fact, hinder, delay, or defraud the transferee or other creditors.58

In Bayou, the bankruptcy court ruled that once the funds owed to investors exceed the funds’ net asset value, all redemptions by investors were made with intent to hinder, delay, or defraud creditors, since failure to redeem in accordance with the investor’s expectation based on inflated account statements would have resulted in the investigation and discovery of the fraud.59 Thus, the debtor had made out a prima facie case that both the principal and the fictitious profits redeemed by investors before the Funds’ collapse were intentional fraudulent transfers, subject to the transferees’ good faith defense.60

Constructive Fraudulent Transfers
Transfers can also be constructive fraudulent conveyances if the debtor received less than a reasonably equivalent value in exchange for the transfer and the debtor was insolvent61 on the date of the transfer.62 In Bayou, the court ruled that investors’ principal contributions were considered reasonably equivalent value for redemptions up to the amount of the investment.63 Thus, the constructive fraudulent transfer claims applied only to the fictitious profits portion of the redemptions.64 The court held that plaintiffs had made out a prima facie case for constructive fraud.65

Good Faith Defense
The fraudulent transfer provisions are subject to the defense that the transferee took in good faith and for value.66 While, in theory, this defense is available to both claims for actual and constructive fraud, the Bayou court held that if a prima facie show-
5th Circuit ruled against the Receiver. The court held that the Receiver cannot recover funds, whether principal or interest, from investors simply by naming them as relief defendants, but that he must establish a claim under fraudulent transfer law.47

Investors who redeemed before the Ponzi scheme was exposed are not the only transferees against whom fraudulent transfer and preference clawbacks are sought. The Madoff Trustee has filed preference and fraudulent transfer claims seeking payments that were made by Madoff’s firm to individuals and companies in exchange for the referral of clients (e.g., feeder funds).48 The Stanford Receiver has requested that recipients of charitable and political contributions from Stanford entities, among others, return the funds to the receiver.49

Conclusion

As governmental entities, court-appointed receivers and trustees, and corporations continue to react to the financial crisis, aggressive use of clawback remedies can be expected. Corporations are beginning to use broad clawback provisions to recover various forms of compensation in instances beyond what may be permitted by EESA and Sarbanes-Oxley. As regulators and shareholders come to expect these more stringent clawback provisions, corporations should carefully consider the adequacy and enforceability of their clawback arrangements. As trustees and receivers attempt to deal with massive Ponzi and other fraudulent schemes, clawback attempts against investors and other innocent recipients of funds will likely continue to be aggressively pursued under a variety of theories.

Notes

10. 74 Federal Register 28399.
11. 74 Federal Register 28414.
12. 74 Federal Register 28414.
13. 74 Federal Register 28394.
16. For examples of incentive plan agreement clawback provisions, see United Technologies, Form DEF 14A, filed on Feb. 22, 2009 (reporting on changes made to clawback provisions of the company’s incentive plan documents); Del Monte Foods Co. Form DEF 14A, filed Aug. 19, 2009. For an example of a clawback policy in an employment agreement, see Time Warner Cable Form 8-K, filed Aug. 6, 2009.
17. For examples of stand-alone policies, see Microsoft Corp., Form DEF 14A filed on Oct. 4, 2006 (Compensation recovery policy adopted by the Executive Compensation Committee), Pfizer, Inc., Form DEF 14A filed on March 16, 2006 (Board of Directors’ Policy granting the Committee the authority to make retroactive adjustments to incentive based compensation paid to certain officers and stating that the Company will seek to recover amounts inappropriately received).
18. For an example of a stand-alone contractual clawback provision see American Express Co., DEF 14A filed on March 22, 2006 (Reporting that approximately 525 executives signed agreements requiring them to forfeit the proceeds from some or all of their long-term incentive award for up to two years before the termination of employment if they engage in conduct that is detrimental to the company).
21. The authors do not maintain that the holdings in the Bayou case constitute the settled law on any aspect of fraudulent transfer jurisprudence. The case is merely used as a recent illustration of how a court may apply certain doctrines and statutory provisions in a Ponzi scheme case.
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25. Id.
26. See, e.g. In re Hedged-Investment Associates, Inc., 48 F.3d 470, 475 (10th Cir. 1995); Henderson v. Buchanan, 985 F.2d 1021 (9th Cir. 1993); But see In re Independent Clearing House Co., 77 B.R. 843, 873–75 (D. Utah 1987) (Holding that trustee had not shown that redemptions within 90 days were not in the course of ordinary business the fact that debtors were operating a Ponzi scheme rather than a legitimate or “ordinary” business does not mean that transfers he makes in the course of that business may not be made in the “ordinary course of business”).
28. Investors in a Ponzi scheme are considered to be creditors, Rosenberg v. Collins, 624 F.2d 659, 664 (5th Cir. 1980) (investors in a Ponzi scheme whose total cash withdrawals were less than their total cash deposits were creditors of the bankrupt); Bayou, 396 B.R. at 831 (Investors were considered to be creditors of the Bayou funds for two reasons: 1) under the terms of the Operating Agreement, each investor had a contractual right to redeem all or part of his account balance in the fund, which consisted of the funds, although not the fictitious profits].
33. Bayou, 296 B.R. at 827, 843 [check pinpoint].
34. In Bayou, the bankruptcy court found that the Bayou funds were insolvent for the entire period in question, since the amounts invested by investors were higher than the net asset value of the funds. Bayou, 96 B.R. at 831. Under this reasoning, a Ponzi scheme will always be considered insolvent from the time that the amount invested exceeds the asset value of the pool and not just when the promoter is no longer able to keep up with redemptions. For a similar conclusion in the 5th Circuit, see In re Ramirez Rodriguez, 209 B.R. 624 (Bkrtcy. S.D. Tex. 1997).
36. Bayou, 396 B.R. at 827, 843. Other Ponzi scheme cases have held that profits or interest may have been for reasonably equivalent value. See e.g. In re Carrozella and Richardson, 286 B.R. 480, 490 (D. Conn. 2002); Lustig v. Weisz & Assoc. Inc. (In re Unified Comm. Capital Inc.), 260 B.R. 343, 353–54 (Bankr. W.D. N.Y. 2001).
38. Bayou, 396 at 843.
40. Bayou, 396 B.R. at 843.
42. V.T.C.A. Bus. & Com. C. §§24.001 to 24.013; Uniform Fraudulent Transfer Act, General Notes. One notable exception, however, is New York, which still applies the earlier uniform fraudulent conveyance statute.
43. Warfield v. Byron, 436 F.3d 551, 558 (5th Cir. 2006).
44. 11 U.S.C. §544.
45. V.T.C.A. Bus. & Com. C. §§24.001 to 24.013; Uniform Fraudulent Transfer Act, General Notes. New York is one of the few states that has not adopted the Uniform Fraudulent Transfer Act and has a six-year look-back period.
47. Receiver's Amended Complaint Naming Relief Defendants, Janevey v. Alguire, Case No. 03:09-cv-0724 (N.D. Tex. July 28, 2009). On Aug. 4, 2009, the judge in the Stanford International Bank case granted the Receiver's motion to freeze the investors' accounts as to the fictitious interest earned on the CDs, but denied the motion as to the principal. Order, Janevey v. Alguire, Case No. 03:09-cv-0724 (N.D. Tex. Aug. 4, 2009). The 5th Circuit lifted the freeze for both interest and principal on the grounds that the Receiver could not pursue claims against the investors by naming them as relief defendants. Janevey v. Alguire, No. 09-10761 (5th Cir., Nov. 13, 2009).

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