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"A successful claim under SOX Section 304 can result in a substantial recovery, commensurate with modern levels of pay for CEOs and CFOs."

SOX SECTION 304 CLAWBACKS FOR BACKDATED OPTIONS

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Sadly, a fair number of shareholders must now be considering what clawback rights a corporation has where it has granted impermissibly backdated stock options. There are a variety of possible grounds for asserting a right to recover such option compensation, including arguments involving contract theories, as well as theories of unjust enrichment, implied right of offset due to disloyalty, and implied forfeiture. Another potentially effective tool with respect to public companies may be the use of Section 304 of the Sarbanes-Oxley Act of 2002 ("SOX"). That section provides that where a public company is required to issue an accounting restatement due to the company's material noncompliance with any securities law financial reporting requirement "as a result of misconduct," the CEO and CFO are required to pay back the bonus and incentive- or equity-based compensation they received over a 12 month period.

SEC Settlement. A successful claim under SOX Section 304 can result in a substantial recovery, commensurate with modern levels of pay for CEOs and CFOs. The Securities and Exchange Commission, for example, has announced in SEC Litigation Release No. 20387, dated December 6, 2007, that it has procured a $468 million settlement in an options backdating case against the former CEO and Chairman of the Board of UnitedHealth Group Inc. The release indicates that this is the SEC's first settlement with an individual under the clawback provision of Section 304.

The Commission alleged that over a 12 year period the former CEO repeatedly caused the company to grant undisclosed, in-the-money stock options to himself and other officers and employees, without recording in the company's books, and disclosing to shareholders, material amounts of compensation expenses as required by applicable accounting rules. The former CEO allegedly did so by looking back over a window of time and picking grant dates for options that coincided with dates of historically low quarterly closing prices for the company's common stock. He then allegedly signed and approved backdated documents falsely indicating that the options had actually been granted on those earlier dates (when the stock price was at or near those low points). The SEC alleged that these inaccurate documents caused the company to understate compensation expenses for stock options, and that the documents were routinely provided to the company's external auditors in connection with their audits and reviews of the company's financial statements.

According to the SEC, the company filed with the Commission quarterly and annual reports, proxy statements, and registration statements that the former CEO knew, or was reckless in not knowing, contained materially false and misleading statements concerning the true grant dates and proper exercise prices of the stock options. The SEC alleged that because of this misconduct investors were misled to believe that the stock options were granted with strike prices not less than the fair market value of the company's stock on the date of grant, and in accordance with the terms of the company's stock option plans. In March 2007, the company restated its financial statements for the 12 years at issue (1994 through 2005), and in doing so disclosed material cumulative pre-tax errors in stock-based compensation accounting totaling $1.526 billion.

The former CEO (a) agreed to disgorge ill-gotten gains of almost $11 million, with $1.7 million in prejudgment interest, (b) pay a $7 million civil penalty, and (c) pursuant to SOX Section 304, reimburse the company for all incentive- and equity-based compensation he received from 2003 through 2006, totaling approximately $448 million in cash bonuses, profits from the exercise and sale of stock, and unexercised options. Under the settlement, all but the $7 million civil penalty will be deemed satisfied by the former CEO's return to the company of approximately $600 million in cash and options pursuant to the terms of a separate settlement agreement with the company, announced the same day, resolving employment claims and shareholder derivative lawsuits filed against the CEO in state and federal courts.

"A number of federal district courts have concluded that . . . there is no private right of action under SOX Section 304."

No Private Cause of Action. The SEC settlement involving the former CEO of UnitedHealth Group raises the question whether a company, for example through a shareholder derivative action, might itself use SOX Section 304 to recover compensation from its CEO or CFO (or, more likely, its former CEO or CFO). A number of federal district courts have concluded that a company may not do so because there is no private right of action under SOX Section 304. Instead, the SEC must bring any such claim. One of the more recent of these decisions is *In re iBasis, Inc. Derivative Litigation*, 2007 WL 4287591 (D. Mass. 2007). In the *iBasis* case, the court listed another half dozen federal district court decisions reaching the same conclusion.

Proxy Statement Allegations. The *iBasis* shareholders also argued, in their derivative action, that a number of the company's directors violated Section 14(a) of the Securities Exchange Act of 1934 by allowing the company to issue false or misleading proxy statements. The plaintiffs presented evidence that several incentive stock option grants were backdated and one grant was spring-loaded (that is, issued prior to the public announcement of positive news), allegedly contrary to the terms of the company's stock incentive plan, which required that the exercise price under the options be not less than 100 percent of the fair market value of the company stock on the date of the grant.

The court dismissed the proxy claims on a couple of grounds. The first was that one of the proxy statements was dated January 31, 2000, while the action was not filed until December 21, 2006. This made the claim untimely. The court explained that for claims under Section 14(a) alleging that a company made false and misleading statements to its shareholders in a proxy statement, there is a limitations period of (a) one year after a plaintiff discovers the facts constituting the violation, or (b) three years after the violation, whichever is earlier. The one year limitations period functions as a statute of limitations, while the three year period functions as a statute of repose. As a statute of repose, tolling principles do not apply to the three year period.

The plaintiffs also made allegations relating to an April 13, 2005 proxy, but the court concluded that the plaintiffs failed to show a causal nexus between any alleged injury to the company and the transactions approved in that proxy. Importantly in this regard, all of the allegedly backdated options were issued prior to the date of the 2005 proxy statement. Although the plaintiffs alleged that the proxy contained proposals that the shareholders (a) vote to approve an increase in the number of shares and options awardable under the stock incentive plan, and (b) reelect three directors who allegedly previously engaged in stock grant timing manipulation, the court concluded that where there was no allegation that further violations occurred after the date of the proxy, the plaintiffs could not

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"Where . . . there is an SEC investigation underway, the threat of Section 304 liability may help a company in its private clawback litigation by offering a former CEO or CFO the opportunity to have monies repaid to the company in one action do double duty in the other . . .."

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show the necessary causal nexus between any alleged injury to the company and the transactions approved in the proxy.

In reaching this causation conclusion, the court distinguished a federal district court decision in *In re Zoran Corp. Derivative Litigation*, 511 F.Supp.2d 986 (N.D. Cal. 2007), which also concerned stock option grant manipulation. The i*Basis* court said the "transactional causation" in *Zoran* involved a three-step process. First, there was a stock option grant manipulation that pre-dated a proxy statement. Second, there was a false or misleading proxy statement that led to approval of the recommended action, which was the reelection of directors and amendment of the company's stock option plan. Importantly to the court in *iBasis*, there was, finally, a third step, under which the reelected directors granted additional manipulated stock options. In contrast, the plaintiffs in *iBasis* failed to establish the required transactional causation linking a vote in favor of the April 13, 2005 proxy statement with any new injury to *iBasis*, because they did not allege that any bad act occurred subsequent to the date of the proxy statement.

Conclusion. The weight of the early authority is that there is no private right of action to recover compensation from a company's CEO or CFO under Section 304 of SOX. The right to bring such a claim belongs exclusively to the SEC. Where, however, there is an SEC investigation underway, the threat of Section 304 liability may help a company in its private clawback litigation by offering a former CEO or CFO the opportunity to have monies repaid to the company in one action do double duty in the other, such as appears to have been the case in the UnitedHealth Group settlement announced by the SEC.

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