BETSY PISIK
333 E 9TH STREET
NEW YORK, NY 10003

(212) 539-1911
BPISIK@GMAIL.COM
WWW.BETSYPISIK.PRESSFOLIOS.COM
LINKEDIN.COM/IN/BETSYPISIK

IS SALARY DISGORGEMENT LEGAL?

BETSY PISIK EXAMINES THE LATEST CASES OF ENFORCED COMPENSATION DISGORGEMENT – AND FINDS THE SEC MAY BE EXCEEDING ITS POWER TO RECLAIM EXECUTIVE PAY

Corporate Secretary
June 1, 2005
Byline: Betsy Pisik

When retired poultry kingpin Don Tyson recently agreed to pay $700,000 in fines for failing to properly disclose his compensation, he and Tyson Foods were implicitly conferring authority on a controversial passage in Sarbanes-Oxley that puts executive base pay under new scrutiny.

Directors of the Arkansas-based meat processor agreed to pay an additional $1.5 mn in connection with the case, although the company rejected accusations of wrongdoing by the SEC.

The Tyson case is one of many to attract uneasy attention from senior officers, directors and their corporate lawyers, who are watching closely to get a feel for a little-known and ambiguously written Sox article that could, in theory, make it easier for the SEC to seek forfeiture of ill-gotten salaries and bonuses.

Although, technically, the SEC did not seek disgorgement of a portion of Tyson's salary, observers note, the settlement amount on the non-disclosure was akin to what the commission could have sought as unfair enrichment.

In the two years since Sox, including Article 304, was passed, the SEC has sought voluntary disgorgement of salaries from executives at more than half a dozen corporations, with varying and sometimes surprising results. Executives at Adelphia, Lucent Technologies, Tyco International and others have agreed to forfeit portions of their base pay to shareholders after they were implicated in misconduct or serious non-compliance with securities law.

But many are wondering how contracted salary – often a relatively small and straightforward aspect of executive compensation – came under scrutiny. Even though millions of dollars have been forfeited and will eventually be passed back to shareholders, it's far from clear whether the SEC has the authority to seek it at all.

Even supporters of salary disgorgement agree that the language of Article 304, drafted by a Congress in a hurry during 2002, is ambiguous. Its terms have not yet been upheld by a court of law, nor even faced a court challenge. But nearly everyone agrees the impact could be far-reaching.

'You read the tea leaves and there is no question that case law will catch up to this,' says Michael O'Brien, a partner at Bingham McCutchen LLP who specializes in securities and corporate areas. He predicts that Article 304 will contribute to the curbing of ever-expanding executive compensation, as well as force a more transparent disclosure of the amounts and terms of wider compensation packages.

Ambiguous terms

The threat of forfeiture under 304 has already lent weight to unrelated shareholder lawsuits challenging excessive salaries in poorly managed companies. Lawyers opposed to the article point out that the text allows the SEC to seek forfeiture of bonuses, profits and additional compensation, but does not explicitly mention salary. They further note that forfeiture requires no formal finding of guilt. Wrongdoing appears to be limited to the chief executive and financial officers. The wording is vague and, most curiously, the text does not explicitly mention base pay.

'It's a cryptic little statute, 304,' acknowledges O'Brien, who is wary of it. 'There are more ambiguities than you might expect, and the SEC has not adopted any language to clarify those issues. We don't even know exactly what constitutes misconduct.'

Where O'Brien sees ambiguity, lawyer Thomas Sjoblom sees an attack on corporate officers that exceeds SEC authority – and one that will not survive a legal challenge. 'The SEC does not have the power to seek forfeiture of base pay,' states Sjoblom, a partner at Chadbourne & Parke LLP in New York and a former SEC trial lawyer who recently represented HealthSouth founder Richard Scrushy against accusations of fraud and other charges. 'Practically speaking, it pushes the envelope to say that every minute of every hour of every day of every week contributes, somehow, to fraud. If congress had wanted or meant to take base salary, it would have said so. It doesn't. It limits it to incentives and bonuses.'

But Joseph Franco, a law professor at Boston's Suffolk University Law School, disagrees. He says the SEC has always had the statutory authority to seek disgorgement of executives' salary in cases of wrongdoing, and believes 304 formally codifies its reach.

'There is no doubt the SEC has the broad equitable right to seek disgorgement; it's set forth in statute and it has had that right for 50 years,' explains Franco, himself a former assistant general counsel to the SEC. 'Disgorgement is a general equitable remedy relating to any unjust enrichment.'

He does acknowledge, however, that historically the commission rarely went after base compensation because it was so difficult to show that it was the direct result of unlawful or unethical conduct.

Increased scrutiny

In the post-Enron world, of course, investigators and shareholders are looking harder, and they're finding a lot that disturbs them. And now they've got a little more leverage in trying to reclaim for shareholders what they see as unjust spoils or outright fraud.

In North Virginia in March, Jeffrey Steiner, chairman and CEO of Fairchild Corp, voluntarily reduced by 20 percent his base salary and agreed to reimburse the motorcycle and aerospace parts manufacturing firm $1.5 mn in legal fees to settle a shareholder lawsuit alleging excessive compensation. His son, Eric, the company's president and a board member, accepted a 15 percent pay cut. The board of directors was also sued for breach of loyalty and fiduciary duties and waste of corporate assets, largely in relation to contracts and myriad payments to members of the Steiner family.

What makes the Fairchild case so interesting is that executives and directors never even went to court, settling instead with shareholders just four months after the civil suit was filed. The SEC was not involved in this particular civil suit, but observers say the recent enforcement actions may have added pressure to the executives to address the claims, rather than fight them.

Sjoblom sees this is as part of a troubling trend. 'The SEC is not in litigation but in extraction,' he notes. 'It is saying, If you want out of this case, you're going to have to settle. If someone does litigate it, the SEC would lose.'

O'Brien says that when corporate officers are faced with the full force of SEC pressures – such as the threat of civil or criminal suits, a ban from running public companies or serving on boards, fines and penalties, and the endless expense of legal challenges – many executives are willing to negotiate settlements just to be able to walk away. He believes the commission's willingness to go after lower level executives – those he describes as 'small fry with $600,000 in savings' – is far more troubling.

But the courts have a history of allowing SEC precedents to become law, by upholding innovations long after they've been in use. Special boards, special investigators and receivers all emerged out of SEC practice and were later upheld by courts. In a recent ruling, a US circuit court allowed the commission to freeze millions of dollars in contested bonuses negotiated by the outgoing executives of Gemstar-TV Guide International, even before they were proven guilty. The Gemstar decision sets a relevant precedent, according to Franco, even if it has no direct bearing on base salary.

Unless a court knocks down Article 304, experts say, the threat of salary disgorgement is yet another threat that officers – and, by extension, their boards – must face.

Serious ramifications

Companies are going to have to be more diligent about disclosing the true nature and amount of executive compensation, including salary, benefits and bonuses, consistent with other aspects of Sox. Disgruntled shareholders, emboldened by the Disney lawsuits as well as the accumulating corporate settlements, have begun to seek partial disgorgement from executives.

As a result of all this, O'Brien suggests, senior executives may begin to notice a gradual flattening of the salary spikes they've come to expect since the mid-1980s. Franco agrees. 'Ordinary compensation is an unlikely subject for disgorgement,' he says. 'But let's face it, we've seen some extraordinary compensation in recent years.'

For directors of public companies, the message from 304 is clear: even if the SEC has not demonstrated a legal authority to review base salaries, there is still a pressing need to make sure that companies disclose and even justify the sums, Franco adds.

Boards of directors will have to write clearer contracts, stipulating exactly which aspects of compensation are salary and which are dependent on performance or other factors. 'Directors' own pocketbooks are at risk,' O'Brien warns, noting that directors' and officers' (D&O) insurance will not cover penalties related to wrongdoing – unless, of course, the SEC begins to back away from, rather than pursue, disgorgement efforts.

Stephen Cutler, the SEC's aggressive director of enforcement, announced this spring that he would be returning to the private sector. Cutler, several experts noted, was involved in ten of the dozen largest settlements in SEC history, and has negotiated more than $6 bn in disgorgements and penalties from corporate wrongdoers. Until his replacement is named and a course set, it is unclear how aggressive the SEC's enforcement office will be.

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