

Bad Boys (and Girls) Get Clawed Back

Richard E. Wood

The following are the dramatic words of Senator Charles Schumer as he proposed an amendment to the then proposed legislation that ultimately was enacted into law as the Sarbanes-Oxley Act of 2002 (SOA).

It is my hope that by revealing the few bad apples at the bottom of the barrel, and punishing these individuals for their immoral behavior, we can save the rest of the industry and restore confidence in our markets.¹

Senator Schumer's amendment, which became SOA Section 304, requires the chief executive officer (CEO) and chief financial officer (CFO) of a public company to reimburse the company for certain incentive compensation they receive and profits they realize on the sale of company securities during the 12-month period following the issuance by the company of a financial report that, due to misconduct, is materially noncompliant with the federal securities laws.

Whether Senator Schumer knew it or not, he was legislating a "bad boy provision" with a "clawback." Among compensation professionals, a "bad boy provision" represents a condition set forth in a compensation arrangement that causes a forfeiture of, or other penalty with respect to, compensation otherwise payable to a person who has engaged in prohibited conduct (in Senator Schumer's parlance, a "bad apple"). A "clawback" is a particular form of bad boy provision that requires a person who has engaged in bad conduct to disgorge (repay to the company) compensation previously paid to that person.

Bad boy provisions were found in compensation plans and agreements long before the enactment of SOA. The 2000 stock plan design and administration survey issued by the National Association of Stock Plan Professionals (NASPP) indicated that 23.8 percent of the companies surveyed in 2000 had stock option plans containing noncompete forfeiture provisions. The convergence of two factors, however, has resulted in an increase in the use of bad boy provisions. First, such provisions are most commonly used in bonus, incentive, stock option, and similar performance-based plans, and since the early 1990s, public companies have increasingly utilized such plans in order to better

Richard E. Wood is a partner in the law firm Kirkpatrick & Lockhart Nicholson Graham LLP. He gratefully acknowledges the assistance of Rahmond Staggars and David Teigman, associates with K&LNG, with the research for this article.

align the financial interests of executives with those of the company's shareholders. Second, the spate of highly publicized corporate scandals in recent years has focused attention on bad boy provisions as a possible weapon in the arsenal of proponents of good corporate governance. This column reviews the design of bad boy and clawback provisions and briefly explores issues relating to the enforceability of such provisions.

Purpose and Design of Bad Boy and Clawback Provisions

Before companies began to regularly include bad boy provisions in their compensation plans, they were not necessarily without recourse in the event of an executive's misconduct. For example, the common law has long recognized that an employee is obliged to exercise the utmost good faith in his dealings with the employer and that the employee may forfeit the right to compensation if he or she does not live up to that standard of conduct:

If the agent does not conduct himself with entire fidelity toward his [employer], but is guilty of taking a secret profit or commission in regard to the matter in which he is employed, he loses his right to compensation on the ground that he has taken a position wholly inconsistent with that of agent for his employer, and [that] gives his employer, upon discovering it, the right to treat him so far as compensation, at least, is concerned, as if no agency had existed. This may operate to give the principal the benefit of valuable services rendered by the agent, but the agent has only himself to blame for that result.²

In addition to providing that the miscreant employee may lose his right to compensation, the common law has also provided employers with a noncontractual clawback right under certain circumstances. Restitution and disgorgement are well-established equitable remedies that may permit recovery from a wrongdoer in some situations. While these terms are sometimes used interchangeably, restitution and disgorgement are distinct legal concepts. Restitution is intended to make an injured party whole while disgorgement is intended to divest the wrongdoer of amounts he or she has been unjustly awarded.³ In general, an employer may recover salary, bonus, or other compensation paid to an employee if it is determined that payment of the compensation was induced by the employee's fraud or that during the course of his employment, the employee violated his express or implied obligations to the employer by fraud or disloyalty. Courts, however, will refuse to require restitution of compensation, even in clear cases of breach of trust by corporate officers, where it would be inequitable to do so.

Corporate officers not only have potential exposure under the common law, but they also have statutory duties of loyalty, prudence, and good faith to their companies and may be subject to civil liability for breach of these statutory obligations.⁴ This liability may include, for example, accountability to the corporation for profits made in breach of the officer's duty of loyalty.⁵ SOA Section 304, discussed further below, offers an additional statutory remedy to public companies under limited circumstances.

An increasing number of companies, however, are choosing not to rely on these somewhat limited common law theories and statutory provisions and are seeking to protect themselves contractually. Bad boy forfeiture and disgorgement provisions are intended to discourage executives from engaging in specified conduct against the employer's interest and to provide the company a clear contractual remedy in the event of a breach of the stated standard of conduct.

A number of different approaches can be taken to the design of bad boy clauses and clawback provisions as part of compensation plans and arrangements. The following are some of the key considerations in drafting such provisions.

Compensation Arrangements Typically Covered

Executive compensation packages are often viewed as consisting of three basic components: (1) base salary, (2) short-term incentives, and (3) long-term incentives. For the purposes of this analysis, a fourth compensation category, executive severance benefits, will be considered. Bad boy provisions commonly may be found in all of these categories of executive compensation other than base salary. While it is conceivable that base salary could be made contractually subject to forfeiture or repayment in the event of executive misconduct, such contractual arrangements are rare. It is not unusual, however, for a company to seek repayment of base salary as an equitable remedy in a lawsuit involving allegations of serious acts of misconduct or disloyalty on the part of an executive, and it is possible that broader bad boy provisions covering salary will be found in executive employment agreements of the future.

Short-term incentive arrangements, such as annual bonus plans, are often structured to condition eligibility for payment on some measure, among other things, of the executive's conduct. For example, a bonus plan might require an executive to achieve an individual performance rating of "satisfactory" or above for one year in order to be eligible for an annual bonus for that year. Such requirements are less common in plans for executive officers than in plans for lower-ranking employees. Contractual clawback provisions, requiring the repayment of bonuses already received by an executive in the event of the executive's misconduct, have sometimes been included in executive

bonus plans and can be expected to be used more frequently in the future, especially if reports of large executive bonuses “earned” on the basis of faulty financial data continue to proliferate.

Bad boy provisions and clawbacks have most commonly been used in long-term incentive plans, such as stock options, performance awards, and restricted stock programs. Such plans are potentially very lucrative for executives and participation in such programs is commonly viewed as a special privilege that should not be extended to those who have engaged in misconduct at the company’s expense.

Executive severance plans and agreements often provide for payment of severance benefits over a specified period of weeks, months, or years, and the eligibility of an executive to receive such benefits is frequently conditioned on his or her compliance with a specified standard of conduct, such as an agreement not to compete with or to not disparage the company. Some companies include additional conditions on severance payments, such as a requirement that the executive has not committed fraud or otherwise violated the federal securities laws.

Conduct Prohibited

The following are types of conduct prohibited under the compensation arrangements discussed.

Competition or Other Disloyal Conduct

Many companies enter into restrictive covenant agreements with executives that obligate the executives to protect the company’s confidential information and prohibit the executive from competing with or disparaging the company or soliciting the company’s employees or customers. Such covenants apply during the entire term of employment and often for a stated period of time after the end of the employment term. Confidentiality and nondisparagement covenants typically continue to apply indefinitely following termination of employment while noncompete and nonsolicitation covenants generally continue for a fixed period of time, usually from one to three years after termination of employment.

In many cases, the company’s preferred remedy for a violation of such a restrictive covenant is specific enforcement, i.e., an injunction against the executive or former executive restraining him or her from engaging in the prohibited conduct. In addition, compensation entitlements may be conditioned on compliance with such covenants. As discussed below, however, it is not clear that such dual remedies can peacefully co-exist in all circumstances.

Fraud or Other Securities Law Violations

Serious misconduct on the part of corporate officers can take a variety of other forms, including but not limited to fraud, negligent or intentional misrepresentations, malfeasance, misappropriation or diversion of corporate assets or business opportunities, acts of disloyalty, and the commission of illegal acts. Forfeiture and clawback provisions in compensation plans can be designed to cover any and all such acts.

Other Conduct Detrimental to the Company

Occasionally bad boy provisions include a “catch-all” category for any conduct not in the company’s best interests. Given its somewhat subjective nature, such a provision should be carefully drafted in order to avoid inequitable results.

Forfeiture or Disgorgement

The consequence of an executive’s violation of a contractual bad boy provision may be forfeiture of as yet unpaid compensation, an obligation to disgorge (repay) compensation previously received (a clawback), or both forfeiture and clawback. While forfeiture provisions may be more defensible than clawbacks on equitable grounds, the presence of a forfeiture clause may not be particularly helpful as a practical matter if the detrimental conduct remains undiscovered for a period of time. Alternatively, the forfeiture provision may merely postpone the detrimental conduct for a period of time until the compensation is paid. In contrast, a clawback provision may actually give pause to a departed executive who is considering joining a competitor or engaging in other prohibited conduct, and, in the event of an actual breach, provide the company with a possible remedy where bad conduct that occurred during employment comes to light only after the executive’s termination or if the conduct does not begin until after termination.

Time Period When the Restriction Applies

As suggested above, forfeiture conditions apply only if the prohibited conduct occurs and is discovered before the compensation is paid. While clawback provisions can potentially be applicable for an indefinite period of time, as a matter of fairness it is typical for such provisions to apply for a period of one to three years following termination of the executive’s employment. Even the disgorgement provisions of SOA Section 304, about which more is said below, apply only

to incentive compensation paid and profits on the sale of company securities realized during the 12-month period following the issuance by the company of a noncompliant financial report.

The Legality and Enforceability of Bad Boy Provisions

Courts tend to view compensation plans and arrangements as contractual in nature even if they are not formally documented as contracts. Under contract law, courts generally have a duty to construe and enforce the meaning and intention of the parties to a contract. If a bad boy provision is included in a compensation contract, then the courts should give full effect to that provision—subject, of course, to the usual defenses to the enforcement of contracts, such as fraud, duress, mistake, and unconscionability. Many such defenses are dependent on the facts of the particular case, however, and may not be broadly applicable in litigation with respect to bad boy provisions. The discussion below addresses some of the defenses that may be applicable in the context of an employer's attempt to enforce a bad boy provision in a compensation contract.

Waiver

In the course of negotiating the terms of an executive's separation from employment, companies are frequently asked by the departing executive or his or her legal counsel to agree to release the executive from any claims the company and its shareholders may have against the executive (just as the company requests, almost invariably, that the executive release the company from all claims, including those for various forms of employment discrimination). Any such release by the company may limit the remedies the company might otherwise have had under a contractual clawback provision in a compensation contract as well as any common law remedies of the company in the event it is determined that the executive engaged in serious misconduct. It appears, however, that such a release would not be effective with respect to any claims the company may have against the former executive under SOA Section 304.⁶

Illegality and Violation of Public Policy

Several courts have considered whether bad boy provisions in compensation contracts could be invalidated as being opposed to public policy either by operation of an express statutory prohibition or by operation of common law.

Restraint of Trade

One important public policy that may be implicated by restrictive provisions in compensation contracts is the prohibition against restraints of trade. For many centuries, contracts that restricted a party's ability to find gainful employment were held to be illegal per se as restraints of trade. Under the modern rule, however, the legality of restrictive covenants generally hinges on whether the particular restraint is reasonable under the facts and circumstances of the particular case. A noncompete or similar restriction in a compensation contract could be considered an illegal restraint of trade if it is not reasonable in scope and is ancillary to an otherwise enforceable agreement.

The legality of a clawback tied to a noncompete obligation was one of several issues explored in *International Business Machines Corp. v. Bajorek*.⁷ Dr. Christopher Bajorek was an executive at IBM for over 25 years. During his employment, Bajorek received stock options from IBM as part of his compensation. The applicable stock option agreement contained a noncompete clause that required Bajorek to repay any option gain to IBM in the event that he worked for a competitor within six months of exercising the options. The option contract also contained a New York choice of law provision. Bajorek exercised his stock options, realizing a gain in excess of \$900,000, and within six months of the option exercise he left his employment with IBM and began to work for a competitor. IBM notified Bajorek that his options were canceled and that he was obligated to repay the related option gain to IBM.

Bajorek filed an action in California, his state of residence, seeking a declaratory judgment that the noncompete provision in his option contract was not enforceable under California law. IBM filed an action in New York state court for breach of contract and fraudulent misrepresentation. The actions were transferred and consolidated in the District Court for the Northern District of California. That court applied California law and entered judgment on the pleadings for Bajorek and dismissed the claims of IBM. The court held that California statutory law precludes an employer from reclaiming wages already paid to an employee and prohibits noncompete agreements such as the one in Bajorek's contract.⁸

The Court of Appeals for the Ninth Circuit vacated that decision. The Ninth Circuit held that New York law should have been applied to the case because that was the law chosen by the parties in their contract and because the application of New York law would not be contrary to any fundamental policy of California law. In reaching this conclusion, the court considered Bajorek's argument that two statutory provisions in California blocked the enforcement of the noncompete provision: (1) California's wage payment law that generally pro-

hibits an employer from taking wages back from an employee, and (2) California's Business and Professions Code that bars any restraint of trade. With respect to the wage payment law claim, the Ninth Circuit found that stock options are not "wages" as defined by the California wage payment statute because they fluctuate in value and are incentives not deferred compensation. See the further discussion below of state wage payment laws. Regarding the restraint of trade argument, the Ninth Circuit determined that the noncompete provision of Bajorek's agreement was not in violation of California law because of the limited scope of the restriction. The court stated that Bajorek "was free to work in his profession and in the same industry and keep the money, so long as he did not work for a competitor" and "he could work for a competitor if he gave up what was paid in part for his promise not to."⁹

In a later case also involving IBM and another of its departed executives, *Lucente v. International Business Machines Corporation*,¹⁰ the Second Circuit examined the enforceability of noncompete clawback provisions that permitted IBM to cancel the former executive's restricted stock or stock options if he went to work for a competitor after leaving IBM. Lucente did choose to leave IBM and work for Northern Telecom. IBM told Lucente, however, that Northern Telecom would not be deemed an IBM competitor, thereby ensuring that Lucente would keep his IBM restricted stock and stock options while working there. Two years later, however, Lucente left Northern Telecom to go to work for Digital Equipment Corporation, a competitor of IBM. At that point, IBM decided to cancel Lucente's restricted stock and stock options. The Second Circuit held that the cancellation did not violate New York law because of the "employee choice doctrine." Under that doctrine, a restrictive covenant is enforceable without regard to its reasonableness if "the employee has been afforded a choice between not competing (and thereby preserving his benefits) or competing (and thereby risking forfeiture)."¹¹ It should be noted that the employee choice doctrine is inapplicable to an employee whose employment has been terminated involuntarily.

Unlike the Second Circuit in *Lucente*, in *Tatom v. Ameritech Corp.*,¹² the Seventh Circuit, applying Illinois law, found it necessary to inquire into the reasonableness of a noncompete forfeiture provision contained in a stock option plan. The court stated, however, that a provision calling for "the forfeiture of a bonus in the form of stock options does not strike us as an unreasonable restraint on competition."¹³ The court also cited several cases for the proposition that "[f]ederal cases draw a distinction between provisions that prevent an employee from working for a competitor and those that call for a forfeiture of certain benefits should he do so."¹⁴

In *Olander v. Compass Bank*,¹⁵ the Fifth Circuit confronted a different type of noncompete forfeiture provision. While he was employed by Compass Bank, Gary Olander received stock options pursuant to an agreement that contained noncompete restrictions that purported to be enforceable by injunctive relief. The agreement also contained a clawback requiring the return to the bank of both the stock and the profits earned on the stock if the restrictive covenants were found invalid or unenforceable. Olander exercised his options and then left Compass Bank to work for a competitor. He sought to have the noncompete declared unenforceable under Texas law because it was not “ancillary to or a part of an otherwise enforceable agreement.” He prevailed in this argument on the grounds that his rights under the option agreements were illusory because he was an at will employee whose stock option rights could be extinguished at any time by Compass Bank’s termination of his employment. Olander’s victory was far from complete, however, because the Fifth Circuit found the clawback provision to be enforceable and ordered Olander to return to Compass Bank the nearly \$225,000 in profits he earned by exercising his options.

Restraint on Alienation

Under the common law, a contractual provision that forbids a party from transferring property may be invalid as against public policy if it is determined to constitute an unreasonable restraint on alienation.¹⁶ In yet another case involving IBM, *International Business Machines Corporation v. Martson*,¹⁷ the ex-IBM employee argued that a clawback provision in his option contract was unenforceable because it constituted an unreasonable restraint on alienation. In quickly disposing of Martson’s argument, the District Court for the Southern District of New York stated that the clawback provision in Martson’s option contract did not forbid Martson from selling his stock. According to the court, the clawback was a restraint, but it did not restrain the sale of the stock. It restrained Martson’s ability to work for a competitor. Therefore, the clawback was not unenforceable as an unreasonable restraint on alienation.¹⁸

Choice of Remedy

In contrast to the contract involved in the *Olander* case, that set forth alternative remedies of an injunction or a clawback, some employers design restrictive covenants in compensation contracts with the intent of providing dual remedies against the employee of both (1) an injunction to specifically enforce the covenant *and* (2) forfeiture or clawback of the compensation payable or paid under the

contract. A potential concern with the dual remedy approach is that the forfeiture or clawback provision might be viewed as the equivalent of a liquidated damages clause that obviates the need for specific enforcement of the covenant. In some states, a liquidated damages clause for breach of a restrictive covenant may be viewed as providing an “adequate monetary remedy” that precludes injunctive relief to enforce the covenant.¹⁹

Bad boy provisions are certainly not intended, at least by the employer, to be a measure of the damages the employer would suffer from an executive’s breach of restrictive covenants. Instead, the purpose of a bad boy clause is to avoid the unjust enrichment of an executive who has breached his or her covenants. There is no fundamental inconsistency between an employer’s enforcement of a bad boy provision and an action by the employer for actual damages and/or injunctive relief so long as it is clear that the employer is not recovering twice for the same element of breach. In general, courts will limit a plaintiff to monetary damages specified in the contract only if the parties’ intent is that the specified amount be the plaintiff’s exclusive remedy. While some courts may be reluctant to both enjoin a former employee from competing with his former employer and give effect to a noncompete forfeiture provision or clawback, in many circumstances there may be no justification for such reluctance.²⁰

State Wage Payment Laws

As noted above, in the *Bajorek* case, the Ninth Circuit rejected the former employee’s argument that California’s wage payment law precluded the enforcement of a clawback provision. Similarly, in the *Martson* case, the court held that New York’s wage payment law did not bar enforcement of a clawback. In both of these cases, it was determined that for purposes of the wage payment laws of California and New York, the term “wages” does not include stock options and other forms of stock compensation.

Like California and New York, most states have wage payment laws requiring an employer to pay terminated employees their full wages on their last day of work or shortly afterward. Employers that do not comply with these statutory obligations may subject themselves and their officers to civil and criminal liability. Not all state laws, however, have been construed as narrowly as California’s and New York’s. For example, although the statutory definition of “wages” under Pennsylvania’s wage payment law is identical to the statutory definition in New York, the Pennsylvania case law is far more inclusive than the New York case law in determining what constitutes “wages.” Pennsylvania courts have determined that most types of payments by an employer to an employee will be within the definition of “wages.”

Under this broad analysis, the following types of compensation have been found to be wages: bonus payments, equity interests, stock options, and other equity-based plans.²¹

Employee Retirement Income Security Act

The Employee Retirement Income Security Act of 1974, as amended, (ERISA) is the primary federal law protecting pensions and other employee benefits. ERISA applies to two classes of benefit plans: (1) employee pension benefit plans and (2) employee welfare benefit plans. ERISA broadly preempts state law from being applied to employee benefit plans that are subject to ERISA. Among ERISA's substantive requirements for pension plans are prohibitions on alienation and forfeiture of pension benefits. Thus, for example, ERISA would prohibit a bad boy provision that causes an employee to forfeit any portion of his or her vested benefit under a tax-qualified 401(k) plan or defined benefit pension plan if the employee has met the minimum vesting requirements of ERISA.²² If a plan contains a vesting schedule that is more rapid than ERISA requires, however, then a bad boy provision may be enforceable if it results in the forfeiture only of the portion of a participant's benefit that is not yet vested under ERISA's minimum vesting schedule.²³ Despite the fact that certain types of bad boy provisions in tax-qualified plans may be legally defensible, there does not appear to be a widespread practice among employers to include such provisions in their plans.

ERISA is not applicable to many types of executive compensation programs, such as stock option and restricted stock plans, because most such plans fall outside of the definitions of ERISA-covered pension and welfare benefit plans. Some other types of executive compensation programs, such as deferred compensation and supplemental retirement programs, may be considered ERISA-covered pension plans. There is an important exception, however, from ERISA's prohibition on anti-alienation and forfeiture for so-called "top hat" plans. A top hat plan is an unfunded employee benefit plan for a select group of management or highly compensated employees.²⁴ While top hat plans are subject to some ERISA requirements, ERISA's prohibitions on alienation and forfeiture of benefits do not apply to such plans. In *Bryan v. The Pep Boys—Manny, Moe, and Jack*, the District Court for the Eastern District of Pennsylvania observed that the exclusion of top hat plans from ERISA's nonforfeitability provisions "is the result of a deliberate decision to let executives use their positions of power to negotiate . . . protection for their plans on their own" and that the "federal common law may not be used to create forfeitability protection under ERISA."²⁵ Accordingly, the court in the Bryan case strictly enforced a noncompete forfeiture provision contained in an executive

supplemental pension plan without any inquiry into the reasonableness of the noncompete.

A Further Word About SOA

As discussed briefly above, SOA Section 304 is a statutory form of bad boy provision. Section 304 presents numerous interpretive questions that will have to be resolved by SEC regulation and/or litigation. Perhaps the most critical issue concerns the definition of the types of “misconduct” that can trigger the application of the SOA Section 304 penalties to the CEO and the CFO. From the face of the statutory provision, it would appear that any misconduct, including that of an accountant or other professional who assisted in the preparation of financial reports, could potentially subject the CEO and CFO to liability. SOA Section 304 does not expressly require as a condition of liability that the CEO and the CFO know of or be involved in the misconduct. One commentator has estimated that neither the CEO nor the CFO were personally culpable in approximately one half of all misconduct-driven restatements.²⁶

An interpretation of SOA Section 304 that results in vicarious liability without any defense could be inequitable in many cases, and executives can be expected to challenge such a literal application of the statute where it is established that the CEO or the CFO could not have discovered or controlled the conduct in question. Such a strict liability concept would seem to be inconsistent with other provisions of SOA, such as the financial certification requirements of SOA Sections 302 and 906, which do not require corporate officers to take outright responsibility for the accuracy and completeness of periodic reports.²⁷ Needless to say, a broad interpretation of SOA Section 304 could have a chilling effect on performance-based compensation and motivate executives to demand that their compensation be moved toward more fixed pay.

Congressman Barney Frank has proposed legislation that would greatly expand the scope of SOA Section 304 with respect to stock option income realized by a company’s directors and five of the most highly compensated executive officers. The Executive Stock Option Profit Recapture Act (H.R. 4208) would limit gains on the exercise of options to the lesser of (1) the gain realized on the date of exercise or (2) the gain that would have been realized if the option had been exercised at the end of a one year period following exercise if the company’s stock price declines by a “material amount” within that year. The director or executive would have to reimburse the issuer for any option gains that exceed the permissible amount. Unlike the current provisions of SOA Section 304, Representative Frank’s proposed legislation would apply to directors and executives whether or not they engaged in any misconduct or their companies were in compli-

ance with law—even if a market decline is attributable solely to factors that are not company specific, such as interest rate increases.

SOA Section 304 is not the only provision that may affect the payment of compensation to executives. SOA Section 1103 gives the Securities and Exchange Commission (SEC) the authority to request a federal court to order a temporary freeze on “extraordinary payments” to company executives (and certain other parties).²⁸ If such an order is obtained, the payments can be escrowed for 45 days pending a hearing on whether violations of law have occurred. The escrow period may be extended by the court for good cause for not longer than 45 additional days. If the issuer or the person whose payments are frozen is charged with any violation of the federal securities laws before the expiration of the escrow period, then the escrow will continue until the conclusion of any related legal proceedings.

While there are no reported cases where an issuer or the SEC has sought disgorgement under SOA Section 304,²⁹ there have been a few instances where the SEC has used SOA Section 1103 as an enforcement tool. The most notable of these cases is *SEC v. Yuen*,³⁰ which involves former executives of Gemstar-TV Guide International Inc., a magazine publisher that had overstated its revenues by \$40 million. Upon discovery of the overstatement, Gemstar negotiated severance arrangements with its CEO and chief financial officer (CFO). The CEO’s severance package consisted of a termination fee of approximately \$22.4 million in addition to restricted stock and other benefits and the CFO had a similar package including a termination fee of nearly \$6.9 million. At the request of the SEC, the District Court for the Central District of California ordered that the executives’ severance payments be escrowed as “extraordinary payments” under SOA Section 1103.

On appeal, the Ninth Circuit initially reversed the lower court’s decision, holding that the payments could not be considered “extraordinary” simply because they were so large. Subsequently, the Ninth Circuit heard the case *en banc* and affirmed the lower court’s decision. In affirming the lower court’s decision, the *en banc* Ninth Circuit agreed with the lower court that the payments to the CEO and CFO were “anything but ordinary.”³² In reaching this conclusion, the *en banc* Ninth Circuit reasoned that, among other things, the severance packages to the executives were five and six times greater than their salaries and that the amounts paid to them were different from the amounts due to them under their employment agreements.

Conclusion

Bad boy provisions will undoubtedly continue to be broadly used in the executive compensation plans and programs of public companies in order to provide a disincentive for executive misconduct and

ensure that executives who engage in misconduct do not enjoy the benefits of such plans and programs. Those who draft such compensation plans and programs must be keenly aware not only of the best practices in the design of bad boy provisions but also of the legal pitfalls awaiting those who wish to enforce such provisions against alleged breaches of the established standard of conduct. Variations in state wage payment statutes and laws regarding restraints on trade should be considered, and contractual choice of law and remedies provisions should be carefully written to present the company with the best opportunity for a favorable outcome.

Notes

1. 107 Cong. Rec. S7361 (2002).
2. *Raymond v. Davies*, 199 N.E. 321, 323 (Mass. 1936) quoting *Little v. Phipps*, 94 N.E. 260, 261 (Mass. 1911).
3. See SEC, Report Pursuant to Section 308(c) of The Sarbanes-Oxley Act of 2002, at p. 19 (2003) available at <http://www.sec.gov/news/studies/SOA308creport.pdf> (last visited Feb. 24, 2005).
4. See, e.g., N.Y. Bus. Corp. Law §§ 715, 720 (Consol. 2004).
5. See, e.g., *Seaboard Indus. v. Monaco*, 276 A.2d 305 (Pa. 1971).
6. See 15 U.S.C. § 78cc(a) (2005).
7. 191 F.3d 1033 (9th Cir. 1999).
8. No. C96-20806 RMW (PVT) (N.D. Cal. Apr. 16, 1997).
9. 191 F.3d at 1041.
10. 310 F.3d 243 (2d Cir. 2002).
11. *Id.*, at 254.
12. 305 F.3d 737 (7th Cir. 2002).
13. *Id.*, at 745.
14. *Id.*, at 744.
15. 363 F.3d 560 (5th Cir. 2004).
16. See *Rafe v. Hindin*, 288 N.Y.S.2d 662 (1968).
17. 37 F. Supp. 2d 613 (S.D.N.Y. 1999).
18. *Id.*, at 618.
19. See *Ed Bertholet & Assoc., Inc. v. Stefanko*, 690 N.E.2d 361 (Ind. 1998); but see *Washel v. Bryant*, 770 N.E.2d 902 (Ind. 2002) (distinguishing the *dicta* in *Stefanko* and holding that a liquidated damages clause does not preclude injunctive relief because money damages will not remedy an ongoing violation of a covenant not to compete).
20. See *Dobbs Law of Remedies*, § 12.9 (2d Ed. 1993).

21. *Scully v. U.S. WATS, Inc.*, 238 F.3d 497 (3d Cir. 2001); *Gautney v. Amerigas Propane, Inc.*, 107 F. Supp. 2d 634 (E.D. Pa. 2000); *but see Kafando v. Erie Ceramic Arts Co.*, 764 A.2d 59 (Pa. Super. Ct. 2000) (holding that amounts paid under the employer's gainsharing program were not "wages" because the bonuses were dependent entirely on the employer's earnings and were not related to any work performed by the employees).
22. *See Noell v. Am. Design, Inc.*, 764 F.2d 827 (11th Cir. 1985).
23. *Clark v. Lauren Young Tire Ctr. Profit Sharing Trust*, 816 F.2d 480 (9th Cir. 1987).
24. 29 U.S.C. §§ 1051(2), 1081(a)(3), 1101(a)(1) (2005).
25. No. CIV.A.00-1525, 2001 WL 752645 (E.D. Pa.).
26. J.P. Kelch, "Section 304 of the Sarbanes-Oxley Act of 2002: The Case for a Personal Culpability Requirement," 59 *Bus. Law.* 1005, 1014 (2004).
27. *Id.*, at 1028.
28. 15 U.S.C. § 78u-3(c) (2005).
29. As of the date of this writing, the only reported cases mentioning SOA Section 304 involved brief and inconclusive analyses of whether a private right of action exists under SOA Section 304. *See In re Cree, Inc. Sec. Lit.*, 333 F. Supp. 2d 461 (M.D.N.C. 2004); *Karpus v. Borelli*, No. 02 Civ.6527(DLC), 2004 WL 2397190 (S.D.N.Y. Oct. 26, 2004).
30. No. 03-56129, 2005 U.S. App.
31. 367 F.3d 1087 (9th Cir. 2004).
32. 2005 U.S. App. Lexis 4617, at *36.