

CLIENT ALERT

Navigating Compensation Governance

High Court Strikes Down Chevron Deference

In a landmark decision overruling its prior precedent that courts should defer to a federal agency's reasonable interpretation of an ambiguous statute, the Supreme Court overruled the Chevron doctrine.

Executive agencies will no longer be able to resolve statutory ambiguities or gaps through rulemaking.

The High Court's decision could put in legal jeopardy hundreds of agency-issued rules and regulations, including certain rules relating to pay and governance disclosures.

In a 6 to 2 opinion, the Supreme Court overturned its own 4 decades old rule under which a federal agency's reasonable statutory interpretation was afforded deference by the courts, as long as the agency's interpretation was not inconsistent with the clear statutory language (even if a court would have arrived at a different interpretation). This deference has allowed federal agencies to implement rules that some have argued expanded the reach of these agencies beyond the intent of Congress. The elimination of Chevron deference may place in legal jeopardy hundreds of agency issued rules and regulations and separately incent (i) Congress to be more fastidious in drafting legislation and (ii) federal agencies to adopt rules and regulations that adhere to unambiguous statutory language.

Background: What is Chevron Deference?

First, a quick (and basic) primer on executive agency rulemaking. Generally, an executive agency may only issue rules and regulations in accordance with (i) an authorizing statute and (ii) the requirements of the Administrative Procedures Act (APA). For example, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") empowered certain federal banking agencies to write rules regulating the financial markets of derivative financial instruments. Among other things, the APA requires these banking agencies to publish rules in proposed form, to allow for and consider public comment on proposed rules and to publish final rules in the federal register.

Issues arise in rulemaking when an authorizing statute includes ambiguous provisions or gaps. **Fundamentally, can a federal agency resolve an ambiguity or fill in gaps through rulemaking?** This would require an agency to construe the meaning of an ambiguous statute through a process referred to as statutory construction. Prior to the creation of Chevron deference in 1984, generally federal courts (not federal agencies) would engage in such statutory construction to determine whether an agency rule was consistent with the court determined meaning of an authorizing but ambiguous statute (or statutory provision). However, courts could and sometimes would defer to reasonable agency interpretations, which was ultimately formalized in the Chevron case.

In 1984, this changed when the Supreme Court created Chevron deference in a case involving certain EPA regulations. The relevant authorizing statute was ambiguous with respect to the subject matter of the contested EPA regulations. The High Court ruled that the court should defer to the EPA's rulemaking if the agency offered "a

permissible construction of the [authorizing] statute.” The ruling had the effect of shifting the responsibility for statutory construction of an ambiguous statute from the courts to federal agencies.¹

Why Did the Court Strike Down Chevron Deference?

The Supreme Court found that Chevron deference was an unlawful delegation of judicial authority (i.e., to construe the meaning of statutes) to executive agencies. The basis of the Court’s decision was twofold. Since the earliest days of the Republic, the Court noted that the judiciary has been and is the sole branch of government with the power to resolve legal questions. Further, the Court noted that the APA codified this long-standing practice and specifies that “courts, not agencies, will decide ‘all relevant questions of law’ arising on review of agency action – even those involving ambiguous laws. It prescribes no deferential standard for courts to employ in answering those legal questions.”

However, the Court did not entirely bar courts from using agency interpretations for guidance, ruling that although an agency’s interpretation of a statute cannot bind a court, it may be “especially informative” to the extent it rests on areas within the agency’s expertise.

The Court rejected the Government (and dissent’s) contention that “Congress must generally intend for agencies to resolve statutory ambiguities because agencies have subject matter expertise regarding the statutes they administer; because deferring to agencies purportedly promotes the uniform construction of federal law; and because resolving statutory ambiguities can involve policymaking best left to political actors, rather than courts.” The Court found that none of these considerations justifies Chevron’s “sweeping presumption of congressional intent” to shift statutory interpretations from the courts to federal agencies.

How Does the Court Decision Impact Prior Cases Decided by Chevron Deference?

The Supreme Court decision leaves undisturbed **prior cases** where Chevron deference supported a finding for a governmental agency. The Court noted that a prior case holding’s “mere reliance on Chevron cannot constitute a “special justification” for overruling such a holding.”² Of course, litigants could seek to overturn prior holdings on other grounds.

How Does the Court Decision Impact Previously Issued Agency Rules?

The Supreme Court did **not** grandfather from its decision already issued rules and regulations by executive agencies. In fact, the Court’s decision overturning Chevron deference related to rules adopted by the Secretary of Commerce regarding fishery management plans under the Magnuson-Stevens Fishery Conservation and Management Act, aimed at preventing overfishing and promoting conservation. Therefore, any existing (and future) executive agency rules are fair game for potential challenge when such rules relate to ambiguous (or silent) authorizing statutes (subject to any applicable statute of limitations). This could result in litigation challenging hundreds of rules issued by dozens of federal agencies. Rules subject to future litigation may survive legal challenge but will need to do so based on traditional methods of statutory interpretation rather than being supported by a presumption or deference to an agency’s interpretation.

Could SEC Disclosure Rules Fall Due to Elimination of Chevron Deference?

We have not tallied up the number of SEC (or other agency) rules relating to executive pay and governance matters that might be ripe for challenge due to the fall of Chevron deference. However, some agency rules may not survive legal scrutiny based on the Court’s ruling. A case in point is the SEC’s rulemaking under the Section 954 of Dodd-Frank which requires companies to adopt mandatory clawback policies that meet the following requirements:

¹ Employing this new test, the Supreme Court concluded that Congress had not addressed the question at issue with the necessary “level of specificity” and that EPA’s interpretation was “entitled to deference.”

² However, the dissent was less sanguine than the majority on this point and believes that overturning prior case holdings that applied Chevron deference may still be possible under certain circumstances.

“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.**” (emphasis added).

The plain text of Section 954 makes clear that incentive-based compensation is compensation necessarily linked to the achievement of one or more specified measures reported on an issuer’s financial statements. However, the SEC rules deviate from the statutory definition of incentive compensation.

The SEC rules³ define “incentive-based compensation” as “any compensation that is granted, earned, or vested based wholly or in part upon the attainment of a ‘financial reporting measure.’” The SEC, in part, defines financial reporting measures as “measures that are determined and presented in accordance with the accounting principles used in preparing the issuer’s financial statements, and any measures that are derived wholly or in part from such measures.” So far, the SEC definition of incentive-based compensation conforms with Section 954. However, the SEC determined financial reporting measures are not limited to actual financial reporting measures but include an issuer’s “stock price and total shareholder return.”

Section 954 is silent as to whether the contextual and universally understood definition of financial reporting measures should include non-financial reporting measures of stock price and total shareholder return. Under Chevron deference, federal courts may have deferred to the SEC’s interpretation of Section 954 (even if the courts would reach a different interpretation). Now, however, SEC rulemaking will no longer be afforded such deference. Rather, federal courts, not the SEC, are charged with independently making the legal determination as to the meaning of incentive-based compensation (and whether it includes compensation derived from achievement of specified stock price or total shareholder return) by statutory construction techniques. As noted earlier, statutory construction is intended to divine Congressional intent as to the meaning of enacted legislation.

Ultimately, a federal court could construe Section 954 to support or strike down the SEC’s expansive definition of incentive-based compensation. Alternatively, a court could find that it is unable to determine Congressional intent and stay the SEC’s expansive definition until such time as Congress adopts clarifying amendments to Section 954.

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The *Client Update* is prepared by Meridian Compensation Partners’ Governance and Regulatory Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-347-2524.

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³ As is its wont, the SEC issued voluminous rules and explanations under this single paragraph that totaled over 200 pages.