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Using SOX 'Clawback' Against Uncharged Execs?

Law360, New York (August 13, 2009) -- In a case that raises important questions about the nature and scope of the remedy provided in Section 304 of Sarbanes-Oxley Act of 2002, the U.S. Securities and Exchange Commission on July 22, 2009, filed a civil suit seeking to “claw back” compensation from a former chief executive officer who has not been accused of any securities law violation.

The case is SEC v. Jenkins, Case 2:09-cv-01510-JWS (D. Ariz. July 23, 2009) (available at sec.gov/litigation/complaints/2009/comp21149.pdf).

Background

Maynard Jenkins was formerly the chief executive officer of CSK Auto Corp., an automotive parts retailer. Earlier this year, the SEC instituted a settled enforcement action against the company which alleged that CSK improperly accounted for vendor allowances and consequently overstated income in 2002, 2003 and 2004.[1]

The SEC also filed civil charges against several former CSK executives, including the COO, CFO, controller and a supervisor, for their involvement in the alleged accounting misstatements.[2]

The CFO and COO are also charged in a parallel criminal action. The controller and supervisor have each pleaded guilty to criminal charges of obstruction of justice.

Section 304 of Sarbanes-Oxley

Section 304 provides that if an issuer “is required to prepare an accounting restatement due to material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws,” the CEO and CFO shall reimburse the issuer for any bonus or other incentive-based or equity-based compensation received, and any profits realized from the sale of the securities of the issuer, during the year following issuance of the original financial report. 15 U.S.C. § 7243.

Until now, the SEC only sought to apply Section 304 against CEOs and CFOs who were alleged to have been personally involved in wrongdoing leading to the restatement.

For example, several early cases involved CEOs or CFOs who participated in option backdating and received backdated options.[3] Another case involved an officer who allegedly participated in a fraud and misappropriated company funds.[4]

The SEC's Complaint

In its latest complaint, the SEC does not allege that the CEO committed any violation of the securities laws.

The SEC seeks a court order pursuant to Section 304 requiring the CEO to reimburse CSK and its shareholders more than \$4 million that he allegedly received in bonuses and stock sale profits in the period following the filing of annual financial statements that were ultimately restated.

The SEC's complaint recites in general the factual allegations of accounting improprieties contained in the SEC's earlier charging documents.

The complaint further alleges that CSK was required to restate its annual financial reports for 2002-2004, due to CSK's material noncompliance with financial reporting requirements, "as a result of its misconduct."

The complaint seeks reimbursement of approximately \$2 million in bonuses and \$2 million in profits realized from the sale of CSK stock in the relevant period.

Implications and Significance of the SEC's Action

The case against Mr. Jenkins, who is not accused of personally violating the securities laws or other "misconduct," extends the Commission's interpretation of Section 304, stands in stark contrast to prior cases and reflects the SEC's current willingness to adopt more expansive and aggressive legal interpretations.

It also raises important legal and policy questions about the nature and applicability of Section 304, including whether such a case may be brought in the first instance, and if so, what the appropriate scope of the required "reimbursement" would be.

The threshold question is whether a Section 304 claim may be brought against an executive who did not participate in the alleged misconduct.

Experts disagree on this point. Some argue that predicating liability on the misconduct of individuals other than the CEO and CFO would be consistent with a purpose of Section 304 to prevent senior officers from profiting from false or inaccurate financial statements and to encourage executive accountability.

Other commentators counter that some level of culpability on the part of the CEO or CFO should be necessary before they are required to forfeit compensation, and argue that Congress aimed section 304 at senior officers who committed serious fraud.

Having filed this complaint, the SEC may argue that, if Section 304 does not allow it to claw back compensation from officers who were not directly involved in the misconduct, then the provision does not add to its pre-existing disgorgement remedies.

The appropriate scope of the Section 304 remedy also will be at issue. In the Jenkins case, it appears that the SEC is trying to claw-back all of the CEO's bonuses and stock sale proceeds from the applicable timeframe.

This raises the question of whether all qualifying compensation may be clawed-back regardless of the magnitude of the underlying misconduct, the size of the resulting restatement and whether the incentive compensation was causally related to particular financial metrics that were subsequently restated.

The apparent effort to apply Section 304 to "no fault" executives raises a host of significant questions of statutory interpretation. What is "material noncompliance?" What is "misconduct?" Simply a failure to apply GAAP? Is fraud required? Is mere negligence sufficient? And misconduct by whom?

The SEC's complaint bases its claim on CSK's alleged misconduct. But CSK can only act through individuals and, at present, no individual has admitted to any violations of the securities laws.

More broadly, this case raises significant legal questions. For example, is Section 304 constitutional, if it deprives an employee of property and contractual rights without any allegation of fault?

Further, how does Section 304 relate to the officer's indemnification rights, which typically provide that a corporation may, and sometimes must, indemnify an executive against all losses, unless the executive is shown to have acted in bad faith and contrary to the best interests of the corporation?

Finally, the use of a "no fault" clawback also raises significant public policy questions. Corporate governance experts have long sought to align the compensation of an executive with corporate performance.

But if an executive's compensation can be forfeited because of the "misconduct" of others for which the executive is not at fault, then corporations and executives would have a powerful incentive to seek compensation that is not performance-based, delinking corporate success and executive compensation.

--By Mark K. Schonfeld (pictured) and Matthew R. Estabrook, Gibson Dunn & Crutcher LLP

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The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] In the Matter of CSK Auto Corporation, Securities Act Release No. 9032 (May 26, 2009) (available at www.sec.gov/litigation/admin/2009/33-9032.pdf).

[2] SEC v. Fraser, et al., Case No. 2:09-cv-00442-LOA (D. Ariz.); Litigation Release No., 20933 (March 6, 2009) (available at www.sec.gov/litigation/litreleases/2009/lr20933.htm).

[3] See, e.g., SEC v. McGuire, Civil Action No. 07-CV-4779-JMR/FLN (D.Minn. 2007); see also SEC Litigation Release No. 20387 (Dec. 6, 2007).

[4] SEC v. Brooks, Civil Action No. 07-61526-CIV-Altonaga/Turnoff (S.D.Fl. 2007).