

# Client Alert

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## SOX SECTION 304 REVISITED

*Dale E. Short*

One of the most problematic remedial provisions of the Sarbanes-Oxley Act enacted in 2002 is Section 304. Section 304 purports to require chief executive and chief financial officers to reimburse their companies for stock-based incentive compensation and stock-trading profits received by the officers during the 12 months following the issuance of erroneous financial statements of the company that the company subsequently is required to restate due to "misconduct."

As we and other commentators noted at the time, Section 304 raised a number of significant interpretive questions, including the nature of the "misconduct" necessary to trigger a repayment obligation and how "profits realized" are to be calculated. Read literally, however, Section 304 seemed to provide for strict liability (similar to the short-swing trading prohibition under §16(b) of the Exchange Act (15 USC §78p(b)) of the chief executive officer and chief financial officer, even if they were not guilty of the "misconduct" triggering the financial restatement, or even actually aware of the financial accounting problems. Also, it was not clear whether Section 304 created a private right of action on behalf of companies or their shareholders.

This last issue was addressed in 2005 in one of the first of only a few cases involving Section 304. In *Neer v. Pelino*, the U.S. District Court for the Eastern District of Pennsylvania ruled that Congress intended for Section 304 to be enforced only by the Securities and Exchange Commission, or SEC, and does not provide for a private right of action by shareholders or, presumably, companies, themselves.

Now, in an enforcement action announced on July 22, the SEC has asked a court to order the former chief executive officer of CSK Auto Corporation to reimburse the company and its shareholders more than \$4 million that he received in bonuses and profits from stock sales while CSK was reporting erroneous financial results. The SEC had brought two previous enforcement actions against CSK based on its financial accounting irregularities, one of which charges four executives of CSK, but not its chief executive officer, of wrongdoing.

This is the first SEC action seeking reimbursement under Section 304 from an executive who is not alleged to have violated any securities laws other than Section 304. In its press release announcing the action, the Directors of the SEC's Los Angeles Regional Office commented that "[the CEO] was the captain of the ship and profited during the time that CSK was misleading investors about the company's financial strength." According to the SEC, "The law requires [the CEO] to return these proceeds to CSK."

It may be premature to predict the outcome of this SEC enforcement action, but as in its recent insider trading case against Dallas Mavericks' owner, Mark Cuban, which was dismissed by the trial court in the preliminary stages of the action, it seems the SEC may be overreaching in its attempt to address concerns over perceived excesses in executive compensation and regain credibility after its embarrassing failures to uncover frauds allegedly perpetrated by Bernard Madoff, Stanford Financial, Private Equity Management Group and others. In the meantime, chief executive and chief financial officers, be forewarned.