

Legal Updates & News

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SEC Raises Stakes On Restatements

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Consistent with Chairman Mary Shapiro's promise to reclaim the image of the U.S. Securities and Exchange Commission ("SEC") as "an unrelenting law enforcement agency," last week the SEC raised the stakes for CEOs and CFOs of public companies when it asked a federal court to require a CEO to return his bonus and profits from sales of company stock because his company had restated its financial statements. On July 22, 2009, the SEC requested that an Arizona district court order Maynard L. Jenkins, former CEO of CSK Auto Corporation ("CSK"), to reimburse the company \$4 million that he received in bonuses and stock sale profits during the time the company filed financial statements containing misstatements.

Although the SEC charged several other CSK officers with securities fraud, it did not allege that Mr. Jenkins knew CSK's public statements were false or misleading when he signed them. Instead, the SEC pleaded three allegations – that Mr. Jenkins signed and certified public filings that ultimately turned out to contain material misstatements, that he received more than \$4 million in bonuses and profits from sales of CSK stock during the 12 months following publication of the misstated financials, and that he failed to reimburse the company for this \$4 million.

Rosalind R. Tyson, Director of the SEC's Los Angeles Regional Office, commented that "the law requires Jenkins to return those proceeds to CSK" because he was "captain of the ship" and he "profited during the time that CSK was misleading investors about the company's financial health." Robert Khuzami, Director of the SEC's Division of Enforcement, added that "the cost of such misconduct need not be borne by shareholders alone."

The SEC brought its suit against Mr. Jenkins under Section 304 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. § 7243). Section 304 states that if a company restates its financials "as a result of misconduct," the CEO and CFO "shall reimburse" the company for any bonuses, incentive-based and equity-based compensation, and profits from sales of the company's stock during the 12 months following the issuance of the public filing that is later restated. While the SEC has previously relied on Section 304 to seek reimbursement from officers it alleged to have engaged in securities fraud, this is the first time that it has cited Section 304 to seek reimbursement from an officer not charged with any other violation of the

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securities laws.

The SEC's suit raises several issues:

First, what does "misconduct" mean? Do all restatements involve misconduct or only those restatements in which someone acts fraudulently?

Second, is "misconduct" by the CEO or CFO required? The SEC's position, as confirmed by its public statements, is that the CEO and CFO are on the hook for reimbursement regardless of their conduct.

In addition, in connection with a restatement, a company and its officers and directors now need to consider the potential for an enforcement action against the CEO and CFO, regardless of their involvement in or knowledge of the underlying financial events. CEOs and CFOs may therefore face increased personal exposure, as will companies to the extent indemnification agreements cover such litigation.