SEC v. Jenkins: SOX 304 Clawback Requires Innocent CEOs and CFOs to Return Incentive-Based Compensation if the Company Restates Its Financials Due to "Misconduct"

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In a case of first impression, the United States District Court for the District of Arizona recently ruled that Section 304 of the Sarbanes-Oxley Act of 2002 ("SOX"), the so-called "Clawback Provision," does not require personal misconduct by a company's CEO or CFO to trigger reimbursement obligations after an accounting restatement. Rather, a restatement caused by the misconduct of any officer, agent or employee acting within the scope of his or her employment is sufficient to require the CEO or CFO to disgorge funds under Section 304.

Section 304 of the Sarbanes-Oxley Act of 2002

SOX 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," then the CEO or CFO must reimburse the issuer for certain incentive-based compensation. This reimbursement includes any bonus or other incentive-based or equity-based compensation received during the twelve-month period following the first public filing of the financial document that is subsequently restated, as well as any profits the CEO or CFO realized from the sale of the issuer's securities during that twelve-month period. 15 U.S.C. § 7243.

Background

In *SEC v. Jenkins*, the Securities and Exchange Commission ("SEC") filed a complaint against Maynard Jenkins, the former CEO of CSK Auto Corp. ("CSK"), and invoked Section 304 to "claw back" more than $4 million in bonuses, incentive compensation and stock profits that he earned while CSK was allegedly committing accounting fraud.[1] According to the complaint, CSK was required to prepare two accounting restatements due to its allegedly fraudulent conduct while Jenkins served as CEO. Although the complaint did not assert that Jenkins was aware of the purported misconduct, he certified the company's inaccurate financial statements during the period of the alleged fraud. *SEC v. Jenkins* is the SEC's first attempt to obtain Section 304 reimbursement from an individual who is not otherwise accused of violating any securities laws.[2]

The SEC did not allege that Jenkins was negligent in failing to uncover the fraud. Indeed, the SEC filed civil complaints against other CSK officers, alleging that those officers concealed the fraudulent scheme at issue from Jenkins.[3] Jenkins moved to dismiss the SEC's complaint, arguing that he should not be liable under Section 304 because he neither participated in the alleged wrongdoing that led to the restatements nor had any knowledge that misconduct was occurring. Jenkins argued that the SEC was "attempting to force a novel 'vicarious strict liability' interpretation" of Section 304 that would result in the imposition of a "Draconian penalty on an admittedly innocent person."[4]

Section 304 Does Not Require Personal Misconduct

In denying Jenkin's motion to dismiss, the court found that the text and structure of "Section 304 require only the misconduct of the issuer, but do not necessarily require the specific misconduct of the issuer's CEO or CFO."[5] The Court reasoned that "[w]hen a CEO either sells stock or receives a bonus in the period of financial noncompliance, the CEO may unfairly benefit from a misperception of the financial position of the issuer that results from those misstated financials, even if the CEO was unaware of the misconduct leading to the misstated financials."[6]

1 *See* Complaint (Dkt. # 1), *SEC v. Maynard L. Jenkins*, Case No. CV-09-1510-PHX-GMS (D. Ariz. filed July 22, 2009).

2 SEC Seeks Return of $4 Million in Bonuses and Stock Sale Profits from Former CEO of CSK Auto Corp., *SEC v. Maynard L. Jenkins*, Litigation Release No. 21149A, Accounting and Auditing Release No. 3025 (July 23, 2009), *available at* http://www.sec.gov/litigation/litreleases/2009/lr21149a.htm.

3 *See* Second Amended Complaint ¶¶ 164-193 (Dkt. # 60), *SEC v. Fraser*, *et al*., CV-09-0443-PHX-GMS (D. Ariz. Sept. 11, 2009).

4 *See* Def. Jenkins' Mot. to Dismiss at 1 (Dkt. #17), *SEC v. Maynard L. Jenkins*, Case No. CV-09-1510-PHX-GMS (D. Ariz. Sept. 15, 2009).

5 *See* Order at 4 (Dkt. # 49), *SEC v. Maynard L. Jenkins*, Case No. CV-09-1510-PHX-GMS (D. Ariz. June 9, 2010).

6 *Id*. at 6.

The Court also found support for its interpretation of Section 304 by reference to the larger statutory scheme of which Section 304 is a part. For example, in reference to SOX Section 302 (which requires an issuer's CEO and CFO to certify each annual or quarterly report of the issuer), the Court noted that "Section 304 provides an incentive for CEOs and CFOs to be rigorous in their creation and certification of internal controls by requiring that they reimburse additional compensation received during periods of corporate non-compliance regardless of whether or not they were aware of the misconduct giving rise to the misstated financials."[7]

In addition, the Court concluded that the legislative history of the statute confirmed its interpretation of Section 304. The House and Senate passed different versions of SOX. While the House Bill would have required intent to engage in misconduct in the context of disgorgement, the language of the Senate Bill, which ultimately was the version signed into law, did not mention or require misconduct on behalf of the CEO or CFO in order to trigger the reimbursement obligation.[8]

Implications of the Ruling

The Court's ruling in *SEC v. Jenkins* leaves many open questions, including:

- Does this ruling indicate that, in the post-Madoff world, the SEC will be taking a much tougher stance against innocent officers whose companies issue restatements?
- What is the likelihood of reversal if this ruling is ultimately appealed?
- What about the fundamental unfairness of requiring an innocent person to reimburse a corporation for the wrongdoing of others? Will other courts follow the *SEC v. Jenkins* court and apply what amounts to "vicarious strict liability"?
- To the extent that the SEC has discretion to "exempt any person from the application of [Section 304] . . . as it deems necessary and appropriate[,]" 15 U.S.C. § 7243(b), what factors will the SEC consider in deciding whether or not to invoke the clawback?
  - *Magnitude of Restatement* – Does the restatement need to be of a certain magnitude or duration before the SEC will seek reimbursement under Section 304?

    As alleged in the *SEC v. Jenkins* complaint, CSK issued two restatements, covering approximately three years during which the company "materially overstated its pre-tax income as follows: (a) by at least 47%, or $11 million, for fiscal year 2002; (b) by at least $34 million, thereby . . . reporting pre-tax income instead of an actual loss, for fiscal year 2003; and (c) by at least 65%, or $21 million, for fiscal year 2004."[9]
  - *Egregiousness of Alleged Conduct* – How egregious must the "misconduct" by the alleged wrongdoers be before the SEC seeks to invoke Section 304 against the CEO or CFO?

    Although Jenkins did not participate in the alleged misconduct at CSK, the SEC charged several other CSK officers with securities fraud in a separate proceeding.[10] Additionally, several of these officers were indicted by the Department of Justice for, among other things, allegedly conspiring to conceal information relating to the accounting errors from Jenkins and CSK's Board of Directors.[11] Furthermore, it appears that two CSK employees pleaded guilty to obstruction of justice for making false statements about

7 *Id*. at 8-9.

8 *Id*. at 10 (comparing Section 12 of H.R. 3763 with Senate Bill 2673, 107th Cong. § 304 (2002) and 15 U.S.C. § 7243).

9 *See* Complaint ¶ 5 (Dkt. # 1), *SEC v. Maynard L. Jenkins*, Case No. CV-09-1510-PHX-GMS (D. Ariz. filed July 22, 2009).

10 *See* Second Amended Complaint (Dkt. # 60), *SEC v. Fraser*, *et al.*, CV-09-0443-PHX-GMS (D. Ariz. Sept. 11, 2009).

11 *See* Indictment (Dkt. #1), *United States v. Fraser*, *et al*., CR 09-372-PHX-SRB-LOA (D. Ariz. filed April 7, 2009).

the alleged fraud during the course of CSK's internal investigation.[12]

- *Due Diligence of CEO and CFO* – What if the CEO and CFO did everything in their power to ensure that proper accounting principles were followed – are they still fair game under Section 304?

  In *SEC v. Jenkins*, the SEC did not allege that Jenkins had participated in or had any knowledge of the alleged fraud. Additionally, there were not even allegations that Jenkins acted negligently in failing to discover the fraud.[13]

- *Amount of the Clawback* – When deciding whether to pursue a specific CEO or CFO under Section 304, will the SEC consider the amount of the officer's incentive-based compensation? What if the officer's clawback amount is relatively small?

  In *SEC v. Jenkins*, the CEO received more than $4 million in incentive-based compensation during the relevant period.

12 *See* Order (Dkt. #40), *United States v. Gary Michael Opper*, CR 09-365-2-PHX-SRB (D. Ariz. May 13, 2009); *see also* Order (Dkt. # 39), *United States v. Edward William O'Brien*, *III*, CR 09-365-1-PHX-SRB (D. Ariz. May 13, 2009).

13 *See* Def. Jenkins' Mot. to Dismiss at 8 (Dkt. #17), *SEC v. Maynard L. Jenkins*, Case No. CV-09-1510-PHX-GMS (D. Ariz. Sept. 15, 2009).

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