

SEC Seeks Sarbanes-Oxley Section 304 Clawback of Bonuses and Stock Profits from CEO Not Charged With Wrongdoing

On July 22, 2009, the Securities and Exchange Commission (the “SEC”) brought an action,¹ under Section 304 of the Sarbanes-Oxley Act (“Section 304” and “SOX”), seeking to compel a former CEO to reimburse his company and its shareholders for the bonuses that he received and stock sale profits that he had realized while his company committed accounting fraud.² Although the SEC has brought several actions in the past under Section 304 to require CEOs and CFOs of publicly held companies to disgorge bonuses and stock sale profits following a restatement of their companies’ earnings due to corporate misconduct, the current action marks the first time that the SEC has pursued such an action against an executive officer not otherwise alleged to have violated the securities laws. In its press release, the SEC made clear its view that “personal compensation received by CEOs while the companies they serve engage in wrongdoing can be clawed back.”

I. Section 304

The enactment of SOX on July 30, 2002 represented the legislative response to a number of major corporate and accounting scandals which shook financial markets in 2000 and 2001. The desire for greater corporate accountability that followed such scandals resulted in the inclusion of numerous provisions that sought to enhance executive responsibility for corporate misconduct. Notably, Section 302 of SOX requires the CEOs and CFOs of public companies to certify the lack of material misstatements and omissions in their companies’ annual reports and the existence of effective internal control over financial reporting. Section 304, in turn, imposes personal financial consequences on these executives if their companies’ financial statements turn out to have been materially inaccurate.

Section 304 requires a CEO and CFO of a public company to disgorge bonuses received and stock sale profits realized during the 12-month period following the company’s financial statements as a result of misconduct. It provides:

- a) **Additional Compensation Prior to Noncompliance With Commission Financial Reporting Requirements.**—If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for—
 - (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and
 - (2) any profits realized from the sale of securities of the issuer during that 12-month period.
- b) **Commission Exemption Authority.**—The Commission may exempt any person from the application of subsection (a), as it deems necessary and appropriate.

¹ Press Release, SEC Seeks Return of \$4 Million in Bonuses and Stock Sale Profits From Former CEO of CSK Auto Corp (July 22, 2009), *available at*: <http://www.sec.gov/news/press/2009/2009-167.htm>

² Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C.A. § 7243 (2002).

Section 304's Ambiguities and Uncertainties

The SEC has instituted few Section 304 disgorgement actions in the seven years since SOX's enactment and the results of such actions are mixed, arguably due to ambiguities in Section 304 that are not clarified by the provision's legislative history.³

- **What is considered to be “misconduct”?** Section 304 states that, to give rise to liability, the restatement requirement must have stemmed from “misconduct.” However, neither SOX nor any of the other federal securities laws define that term. Left unresolved, therefore, is whether mere negligence would satisfy the “misconduct” requirement or whether conduct involving a higher degree of culpability, such as recklessness or intent, is required.
- **Whose misconduct triggers the disgorgement obligation of the CEO and CFO?** Section 304 appears to hold a company's CEO and CFO liable for their company's financial misstatements, even if those misstatements were caused by another employee's misconduct without the CEO or CFO's knowledge. Some commentators have noted that the statute's departure from a pre-enactment version of SOX, which expressly linked misconduct to the officer subject to the liability, suggests that Congress intended for Section 304 to reach even innocent CEOs and CFOs.⁴ On the other hand, Section 304's inclusion of a provision allowing for the exemption of certain executives from liability may suggest that Congress sought to give the SEC authority to prevent its application to innocent executives.
- **What is the extent of CEO and CFO liability?** While Section 304 requires executives to disgorge any bonus, incentive- or equity-based compensation, or profits realized during the 12-month period following the first filing of financial statements which subsequently require restatement, it is unclear if the disgorgement includes any and all compensation items that the executive received during that period, or only compensation items directly related to the misconduct that necessitated the financial restatement.⁵
- **What stock sale profits must be disgorged?** Section 304 does not indicate whether the entire transaction giving rise to the profit—namely a stock award or purchase and a stock sale—must have both occurred in the 12 month period. What if there are multiple purchases and sales in this period—is the intention to “match” these sales to produce the highest disgorgement amount as in the case of “short-swing profits” under Section 16(b) of the Securities Exchange Act of 1934? Must the “profit” have stemmed from a transaction involving the same identifiable securities?

³ Those courts that have addressed the question of whether Section 304 provides a private right of action have followed *Neer v. Pelino*, Case No. 04-4791 (E.D.Pa. Sept. 27, 2005), in holding that it does not provide such a right of action. See for example CGR Memorandum dated December 16, 2008 “Ninth Circuit Finds no Private Right of Action under Section 304 of the Sarbanes-Oxley Act,” available at <http://cgrnyvs1/Firm%20Memos/Ninth%20Circuit%20Finds%20No%20Private%20Right%20of%20Action%20Under%20Section%20304%20of%20the%20Sarbanes-Oxley%20Act.pdf>. See also *Sommers v. Lewis*, Case No. 07-1142 (D.Or. April 8, 2009).

⁴ See S. Fraidin, A. M. Genser and D. S. Hoverman, *Payback: Disgorging bonuses, equity and incentive-based compensation under Sarbanes-Oxley Section 304*, 2 International Journal of Disclosure and Governance 52 at 58 (February 2005).

⁵ See *id.* at 60-61 (noting that compensation amounts that seem arbitrary and unrelated to the government's interest may be subject to challenge).

- **Is Section 304 Remedial or Punitive?** Section 304’s ambiguities are animated by a more fundamental uncertainty—whether disgorgement pursuant to Section 304 is meant to penalize wrongdoing or provide a remedy for the consequences of such wrongdoing. Some courts have understood Section 304’s potentially draconian measures to imply that Section 304 is more of a penalty than a remedy. Most, however, have avoided addressing the issue.

II. SEC v. Jenkins

The SEC’s announcement of a Section 304 disgorgement action against Maynard L. Jenkins, the retired CEO of CSK Auto Corporation, once one of the nation’s largest auto parts retailers, is the third enforcement action in the SEC’s investigation of CSK’s alleged accounting misconduct. In March 2009, the SEC charged four former CSK executives, including the company’s former CFO and COO but not Jenkins, with orchestrating a multimillion-dollar accounting scheme to inflate the company’s financial results and overstate its net income in 2002 through 2004.⁶

According to the SEC’s Complaint, CSK had a program by which it collected allowances from its vendors that decreased CSK’s cost of goods sold and, thus, increased CSK’s pre-tax income. The SEC alleges that, between 2002 and 2004, CSK could not collect tens of millions of dollars in vendor allowance receivables that it had previously recognized, and that instead of writing off these allowances in accordance with GAAP, the defendants hid these uncollected allowances using a variety of improper accounting methods. As a result, CSK filed false financial statements that overstated CSK’s pretax income for the 2002, 2003 and 2004 fiscal years. Furthermore, throughout this time, in order to hide their conduct, the defendants allegedly lied repeatedly to the company’s independent auditors and provided false documentation.

As a result of these improper activities, CSK was forced to restate its earnings for the 2002, 2003, and 2004 fiscal years twice. CSK made its first restatement as part of CSK’s Form 10-K annual report for the 2004 fiscal year and made its second restatement, after additional irregularities were discovered, in CSK’s Form 10-K for the 2005 fiscal year. In May 2009, the SEC brought and settled an enforcement action against CSK for its false financial statements.

The SEC’s Complaint does not allege that Jenkins engaged in fraudulent conduct. The SEC grounds its Section 304 disgorgement action against Jenkins—who has not been charged with any wrongdoing—by alleging that “Jenkins was captain of the ship” and signed CSK’s false and restated financial statements, coupled with the allegation that he “profited during the time that CSK was misleading investors about the company’s financial health.”

By its action, the SEC seeks an order, pursuant to Section 304, requiring Jenkins to disgorge all of Jenkins’ bonuses and other incentive- and equity-based compensation, and all profits that Jenkins realized from his sale of CSK stock, during the 12-month period following the issuance of CSK’s financial statements contained in its annual reports for the 2002, 2003, and 2004 fiscal years. Such compensation allegedly amounted to approximately \$4 million.

The SEC’s action against Jenkins bears watching as it may serve to clarify some of the ambiguities associated with Section 304.

⁶ Litigation Release, SEC Charges Former CSK Auto Corporation Management With Accounting Fraud (March 6, 2009), available at: <http://www.sec.gov/litigation/litreleases/2009/lr20933.htm>

CAHILL

* * *

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.

This memorandum is for general information purposes only and is not intended to advertise our services, solicit clients or represent our legal advice.

80 Pine Street | NY, NY | 10005-1702 | Phone: 212.701.3000 | Fax: 212.269.5420 | Cahill.com

CAHILL GORDON & REINDEL LLP