SEC INVOKES SARBANES-OXLEY CLAWBACK PROVISION WITHOUT ALLEGING WRONGDOING BY DEFENDANT

On July 22nd, the SEC filed a complaint alleging that Maynard Jenkins, former CEO of Phoenix-based CSK Auto Corporation ("CSK"), is liable under the Sarbanes-Oxley "clawback" provision for the return of over $4 million in compensation earned during his tenure at CSK. To date, no prosecuting authority has accused Jenkins of wrongdoing relating to his duties at CSK. The case marks the first time that the SEC has invoked the Sarbanes-Oxley clawback provision in the absence of an allegation of wrongdoing against the defendant, and may be a harbinger of future enforcement efforts in this area.

Earlier this year, the SEC charged CSK and four of its top executives -- the CFO, the COO, a supervisor, and the controller -- with violations of the securities laws relating to alleged accounting improprieties that occurred during 2002--2004.[1] According to complaints, the CSK executives caused the company to misstate its accounts receivable entries, thereby forcing the company to restate its annual financial reports in 2004 and again in 2007. The CFO and the COO face a pending parallel criminal action brought by the Department of Justice; the controller and supervisor have pled guilty to obstruction of justice.[2] In May, the SEC brought a settled enforcement action against CSK in which the company neither confirmed nor denied the commission's findings and agreed to cease and desist from further violations of the securities laws.

The sole charge brought against Jenkins is the violation of the clawback provision. Jenkins is not mentioned in any of the complaints filed against his former coworkers. The SEC complaint alleges that Jenkins must return over $2 million in bonuses and over $2 million in proceeds from the sale of CSK stock pursuant to the clawback provision, 18 U.S.C. 7243. That provision states that "if the 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," then the CEO and CFO "shall" reimburse the issuer for all incentive-based compensation earned during the 12-month period following the restatement.[3]

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[1] *See* Press Release, "SEC Charges Former CSK Auto Corporation Management With Accounting Fraud," March 6, 2009, *available at* http://www.sec.gov/litigation/litreleases/2009/lr20933a.htm.

[2] *See* Press Release, "SEC Seeks Return of $4 Million in Bonuses and Stock Sale Profits From Former CEO of CSK Auto Corp.," July 23, 2009, *available at* http://www.sec.gov/litigation/litreleases/2009/lr21149a.htm.

[3] For the full text of the provision, *see* www.law.uc.edu/CCL/SOact/sec304.html.

I. Background

Although Congress passed the Sarbanes-Oxley clawback provision in 2002, the SEC declined to use the provision until 2006.[4] Since then, the SEC has used the provision sparingly and always in conjunction with an allegation of wrongdoing by the defendant. For example, in 2007 the SEC charged Dr. William McGuire, former CEO of UnitedHealth Group, with violations of the clawback provision and a host of other securities law violations relating to his participation in a stock options backdating scheme.[5] The SEC has more frequently sought repayment of bonuses by the more conventional means of seeking disgorgement of ill-gotten gains.[6] The clawback provision does not provide a private right of action.

Companies often implement private clawback provisions that require the return of compensation under certain circumstances. Sixty-four percent of Fortune 100 companies have clawback provisions of some type.[7] Companies institute clawback provisions in order to create an atmosphere of compliance, avoid the possible time and expense associated with defending against an SEC action, and become eligible for certain government programs that require participating companies to have clawback provisions.[8]

II. Issues raised by the SEC's prosecution

The SEC's prosecution of Jenkins raises several issues regarding the reach of the clawback provision and the constitutionality of the SEC's interpretation, which would require disgorgement in the absence of wrongdoing.

a) Reach of the clawback provision

As a threshold issue, no clear definition exists of a "restatement due to the material noncompliance of the issuer," which is a prerequisite to prosecution under the clawback provision. In 2005, 8.5% of all U.S. public companies filed a restatement of some kind.[9] Because a restatement is typically required only in the event of a material misstatement, nearly all restatements could meet this threshold requirement. Indeed, the SEC argued in 2008 that the clawback provision can apply even where the issuer has never actually restated its financials, but should have done so under accounting rules.[10] The district court rejected this argument, holding

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4 *See* "SOX 304 Forfeiture Clause Goes Unused," *Compliance Weekly*, June 6, 2006.

5 *SEC v. William McGuire, M.D.,* Civil Action No. 07-CV-4779-JMR/FLN (D. Minn. 2007).

6 *See, e.g., SEC v. Frank Gruttadauria*, Civil Action No. 1:02CV324 (N.D. Ohio 2002), *available at* http://www.sec.gov/litigation/complaints/complr17369.htm.

7 *See* "SEC Orders Ex-CEO to Return Pay," *The Wall St. Journal*, July 23, 2009.

8 In February, Congress required clawback provisions for companies that receive federal bailout aid.

9 *See* "A Closer Look at Financial Statement Restatements," *The CPA Journal*, December 2006.

10 *SEC v. Shanahan*, Fed. 2008 U.S. Dist. LEXIS 100640 (D. MO 2008).

that the company must actually restate its financials in order to trigger the clawback provision. Nonetheless, the SEC may continue to take this aggressive position regarding the meaning of a "restatement due to … material noncompliance."

A second interpretative question, which will likely arise in the *Jenkins* case, regards the requirement of "misconduct." The statute states simply that the issuer's restatement must be "a result of misconduct." But does the CEO have to be involved in or have knowledge of the misconduct? Must the misconduct have occurred during the CEO's tenure, or can the CEO be liable for misconduct that occurred before his or her tenure? Can the misconduct occur at any level of the company? Is "misconduct" equivalent to illegality, or can it consist of something less than a violation of securities laws? What standard of proof must the SEC meet when showing that misconduct occurred? The SEC's complaint refers to "CSK's fraudulent conduct," implying that the commission believes that it can satisfy the misconduct requirement by proving the corporation's misconduct. But since a corporation can act only through its agents, and none of CSK's agents have been convicted of (or admitted to) misconduct that led to a restatement, the SEC will presumably have to show that one of Jenkins's coworkers engaged in misconduct.

The provision's scant procedural history provides no clear answers regarding the misconduct requirement. The rapid debate and passage of Sarbanes-Oxley produced little discussion of the clawback provision, and the conference committee adopted the Senate's version of the provision without modification. The conference report that accompanied the final version of Sarbanes-Oxley contained no substantive comment on the law.

b) Constitutionality of the provision

The SEC's interpretation of the clawback provision raises issues of due process. Under the SEC's interpretation, the commission can prevail with a showing that one of Jenkins's coworkers engaged in misconduct which led to a restatement. This would put Jenkins in the awkward position of having to defend a third party in order to defend himself. Moreover, Jenkins will likely have to proceed without the benefit of the third party's testimony, which would likely be withheld on Fifth Amendment grounds. This arrangement, along with the overarching fact that Jenkins would be forced to forfeit compensation without a showing of wrongdoing, may form the basis for a due process challenge to the SEC's interpretation of the provision.

III. Steps that may reduce SEC scrutiny

Even with these questions regarding the scope of the clawback provision, the statutory language provides a basis for the SEC to seek repayment of compensation at a time when the agency and companies are under scrutiny for extraordinary payments to executives. The SEC is likely to use the clawback provision in other matters involving financial reporting violations, and companies should position themselves to limit SEC scrutiny of compensation arrangements with their senior officers. Companies should consider adopting their own clawback provisions in order to reduce the chances of an SEC clawback suit. In addition, companies should clarify their indemnification provisions so that the provisions clearly state whether indemnification applies to SEC clawback suits that lack allegations of wrongdoing against the executive being charged.

Finally, companies should monitor the *Jenkins* case and design compensation arrangements that account for the possibility of clawback and unambiguously state the executive's rights in the event of an SEC clawback suit.

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