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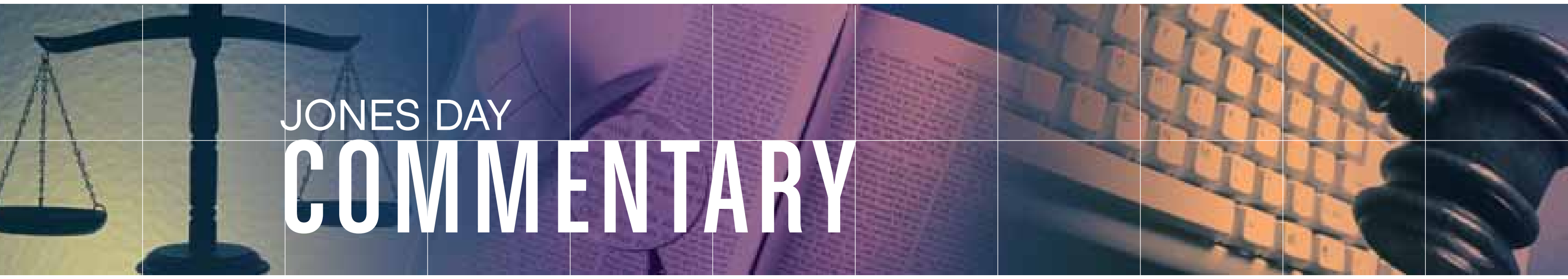

COURT UPHOLDS SEC'S ABILITY TO "CLAW BACK" MILLIONS FROM SENIOR EXECUTIVE NOT CHARGED WITH WRONGDOING

On June 9, 2010, a federal district court in Arizona denied former CEO of CSK Auto Corp. ("CSK") Maynard Jenkins' Motion to Dismiss an SEC complaint. See SEC v. Jenkins, No. CV-09-1510, 2010 U.S. Dist. LEXIS 57023 (D. Ariz. June 9, 2010). The court's decision is significant to officers and directors because Jenkins' motion challenged the SEC's ability to recover millions of dollars in stock profits and bonuses from Jenkins despite the fact that the SEC alleges no personal wrongdoing by Jenkins. This is the first time that the SEC has attempted to "claw back" a CEO's or CFO's compensation or stock profit in the absence of alleged personal wrongdoing by the CEO or CFO. The court ruled that under the plain, unambiguous language of the "clawback" statute at issue, the SEC had adequately stated a claim. Moreover, because the court ruled that the SEC's interpretation of the statute was capable of constitutional application to Jenkins, the court held that dismissing the allegations would be premature.

BACKGROUND

In May of this year, the SEC settled an administrative action against CSK, alleging that the company violated the securities laws by failing to properly account for vendor rebates. The SEC initiated an investigation of CSK after the company restated its financial statements for fiscal years 2002, 2003, and 2004. The company consented to the entry of a cease-and-desist order.

In addition to the charges against the company, the SEC filed a civil action, and the Department of Justice filed a criminal action, against CSK's former CFO, COO, Controller, and Director of Receivables. Both actions allege numerous intentional violations of the securities laws. The SEC, however, never alleged that Jenkins personally committed fraud, or knew or even should have known about the alleged fraud, nor did the SEC directly allege the fraud allowed Jenkins to obtain any incentive-based compensation or increased profit on his stock sales. Nevertheless, the SEC, in a departure from its historical approach to enforcing the "clawback" provision of Sarbanes-Oxley 304(a), sought to recover more than $2 million in incentive-based compensation and $2 million in stock profits Jenkins earned in the 12-month periods following each of the restated fiscal years.

THE MOTION TO DISMISS

In September 2009, Jenkins moved to dismiss the SEC's complaint. Jenkins' motion argued that the SEC's interpretation of SOX 304(a) is unfounded and that it would be unconstitutionally punitive to apply SOX 304 against an innocent executive. Jenkins argued that, without tying his compensation or stock profits to the alleged fraud, any recoupment would constitute punishment in the absence of wrongdoing—a mechanism that Jenkins argued is expressly prohibited by Supreme Court precedent.

Jenkins also argued that principles of statutory construction, as well as other courts' interpretations of SOX 304, required the court to reject the SEC's proposed expansion of the provision. Finally, Jenkins argued that SOX 304 is not a standalone basis for liability, but instead is merely a remedy for other violations of the securities laws.

At oral argument, Jenkins' counsel reiterated that the constitution prohibits the government from punishing an innocent person. Jenkins' counsel highlighted that in its complaint, the SEC makes no allegation whatsoever of any basis for the bonus or any causal relationship between the restatement and the payment of the bonus. Without a causal relationship between Jenkins' bonus and stock profit and the alleged fraud, the SEC's interpretation of SOX 304 represented unconstitutional punishment in the absence of misconduct.

Next, Jenkins' counsel argued that the court did not need to reach the constitutional issue because the more plausible interpretation of the statute—and the one the SEC had relied on for the first seven years of the statute's existence—was that SOX 304 was a remedial statute and required wrongdoing on the part of the executive from whom disgorgement is sought. Jenkins' counsel did concede, however, that even if SOX 304(a) does not require allegations of improper conduct, it could have potential constitutionally sound applications—namely, to prevent unjust enrichment and restore the status quo.

In response, the SEC argued that SOX 304(a) was not ambiguous. The plain language of the statute allows the SEC to seek recoupment in the absence of wrongdoing. Additionally, the SEC argued that even if the statute were ambiguous, statutory construction favors the SEC's interpretation. The SEC argued that if the statute were given Jenkins' interpretation, it would be redundant to remedies the SEC already had at its disposal.

Finally, in contrast to certain of its initial arguments, the SEC appeared to indicate that it was not seeking the entirety of Jenkins' stock profits and incentive-based compensation. Rather, the SEC seemed to indicate it would seek only those monies that Jenkins received as a result of the company's fraud. The SEC further argued that because discovery was necessary to determine exactly what those amounts were, dismissing its complaint was inappropriate.

THE COURT'S DECISION

In denying Jenkins' motion, the court began by noting that the text of SOX 304(a) is not ambiguous. Rather, the plain language of SOX 304(a) "require[s] only the misconduct of the issuer, but [does] not necessarily require the specific misconduct of the issuer's CEO or CFO." The court found that misconduct of an issuer that requires an accounting restatement triggers the reimbursement obligation of a CEO or CFO, even in the absence of misconduct. Moreover, the court stated that this interpretation is consistent with Congressional intent and legislative history. The court stated that when a CEO either sells stock or receives a bonus during a period of financial noncompliance, the CEO may benefit from a misperception of the financial position of the issuer, even if the CEO was unaware of the misconduct. Therefore, it is not irrational for Congress to require such additional compensation be repaid. In addition, early House versions of SOX 304(a) contained a misconduct requirement, but that requirement was eliminated prior to final passage.

With regard to the constitutionality of the SEC's interpretation, the court held that it was premature to determine whether the SEC was seeking an unconstitutionally punitive recovery. The court stated that "such matters, if relevant, can only be ascertained through development of the nature of the recovery sought by the SEC against Jenkins in light of the facts of the case." The court did note that "to the extent that the statute or the remedy sought under it results in a severe and unjustified deprivation to the Defendant, constitutional issues may arise." Nevertheless, the court stated, even if Jenkins' constitutional arguments have merit, the court did not have before it facts sufficient to decide such issues.

CONCLUSION

In short, the court found that because the statute was unambiguous, and because it was capable of a constitutional application, further development of the facts was required. Whether the SEC's new interpretation of SOX 304(a) can withstand constitutional scrutiny after discovery remains to be seen. The constitutional inquiry will be influenced by whether the SEC continues to seek all of Jenkins' incentive-based compensation and stock profit, or only that which it believes it can tie to CSK's misconduct.

Regardless of how discovery proceeds, one thing is certain: The SEC's new interpretation of SOX 304 presents an aggressive departure from its previous enforcement approach. This presents a serious concern for CEOs and CFOs who cannot possibly monitor every action of every employee. Officers and directors around the country should be watching closely as the SEC further develops its new SOX 304 jurisprudence.

LAWYER CONTACTS

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