THE SEC CLAWS BACK: THE CASE FOR STRICT ENFORCEMENT OF SARBANES OXLEY SECTION 304 REQUIRING CEO PAYBACK AFTER RESTATEMENTS CAUSED BY "MISCONDUCT."

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Somewhat under the radar and quickly eclipsed by other headlines like the $33 million settlement with Bank of America, the Securities and Exchange Commission (SEC) recently brought a case under a powerful but hitherto virtually ignored provision of the Sarbanes-Oxley Act (SOX), Section 304. This section basically "claws back" CEO and CFO bonuses and stock sale profits when a company must restate its financials for "misconduct." The case marks the first time the SEC has used the provision without alleging that the targeted CEO himself was guilty of any fraud. Humble a beginning as it may be, if the SEC is successful in this case and receives judicial approval of its broad (but as I argue herein correct) interpretation of the statute, Section 304, if vigorously enforced, could become a major force for accuracy in financial reporting, strict compliance with the securities laws, and effective corporate governance.

THE CASE AGAINST MR. JENKINS

The SEC sued Maynard Jenkins, the former CEO of CSK Auto Corp., at the time in question a large auto parts manufacturer, under Section 304, seeking to force him to repay to his former employer more than $4 million in bonuses and stock sale profits he made during times when, the SEC alleges, his company was engaged in a significant accounting fraud involving overstated vendor allowances which substantially inflated

income over three years and, when corrected, resulted in two separate restatements. In announcing the lawsuit, the SEC was careful to state that Jenkins himself was not alleged to have been a participant in the fraud.

If you have never heard of Section 304, you have a good excuse. Over the seven years since its enactment, and the thousands of accounting restatements filed by public companies, the statute has *never before* been used by the SEC against a CEO who was not himself accused of securities law violations. In fact, it took the SEC five years to use the statute at all, and then mainly in a handful of cases involving CEO's and CFO's who had reaped personal profits from options backdating, e.g. William McGuire of UnitedHealth Group ($448 million reimbursed in bonuses, stock sales and unexercised options).

DEBATE SURROUNDING PROPER USE OF THE SEC. 304 CLAWBACK

The SEC's prior disinterest in Section 304 is curious, given the magnitude and number of restatements in recent years and the obvious breadth of the statute. Section 304 of SOX provides that if a public company "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 CEO and CFO of the issuer "shall reimburse the issuer" for any bonus or other incentive or equity-based compensation received and any profits realized from the sale of the issuer's stock, during the year following the issuance of the original financial report (15 U.S.C. § 7243).

Commentators have speculated that the SEC chose to shy away from Section 304 cases in which the CEO or CFO was not clearly himself involved in the underlying fraud or other "misconduct" that caused the restatement, to avoid having to face the issue of

whose "misconduct" triggers the disgorgement obligations. Some feel it is inappropriate to target "innocent" executives for the wrongful actions of others within management. There could be constitutional implications, they argue, in depriving employees without fault of property and rights guaranteed by contract. Indemnification provisions could be impacted if the executives were not shown personally to have acted contrary to the interests of the company. Strict enforcement might also discourage reliance on performance based compensation. There will be difficulties in trying to calculate the amount of disgorgement due in the case of exercised options which are now valued below the price paid. The issue of what constitutes "material noncompliance" could also be troublesome. In a recent client advisory, the Wachtell, Lipton firm called the SEC's filing of this case "an unfortunate contribution to the overheated atmosphere surrounding executive compensation generally" and a "regrettable policy choice." On the other side, former SEC Chairman Harvey Pitt's reported reaction to the case filing was blunt: "that was the intent of this provision of [SOX], and the SEC needs to enforce it…" In short, there are strong views on both sides as to how, when and against whom this statute should be enforced.

A GOOD CASE TO TEST THE "CAPTAIN OF THE SHIP" THEORY

Like a long-dormant volcano, the new enforcement team at the SEC appears eager to test the statute's breadth and utility in the Jenkins case. In its press release, the agency went out of its way to acknowledge that its "complaint does not allege that Jenkins engaged in the fraudulent conduct." The head of the SEC's Los Angeles office, which brought the case in a federal court in Arizona, put the SEC position succinctly: "Jenkins was captain of the ship and profited during the time CSK was misleading investors about

the company's financial health. The law requires Jenkins to return those proceeds to CSK." Enforcement Director Rob Khuzami added: "The costs of such misconduct need not be borne by shareholders alone."

The SEC has clearly signaled its intention to disinter the claw back statute as a powerful enforcement weapon (albeit by a 3-2 vote, with the Republican appointees reportedly voting no and new Chairman Schapiro breaking the tie). The agency, still working to erase the lingering "Madoff stigma", will surely see its robust view of the breadth of Section 304 tested by the defendant's forthcoming motions to dismiss.

In choosing hapless CEO Jenkins as its claw back guinea pig, the SEC has deftly chosen a strong case for hammering the CEO, even if it evidently cannot prove he was a participant in the fraud. As the SEC complaint puts it (Par. 2): "During a substantial portion of Jenkins' decade-long tenure as Chairman and [CEO] of CSK, CSK was engaged in a pervasive accounting fraud, which involved many of its senior officers, that resulted in CSK filing fraudulent financial statements in its annual reports for fiscal years 2002, 2003, and 2004, all of which Jenkins signed." The fraud involved manipulation of vendor allowances to increase reported income, improper allocation of such allowances between years, false journal entries, and various "accounting tricks." The company's income was overstated by 47% in one year, and 65% in another. Total overstatement of income was $66 million over three years. The company has settled with the SEC although the four individual managers sued over the fraud have not settled. Two of the top managers, including the controller and a supervisor, have pled guilty to criminal obstruction of justice charges in the case.

What may have particularly tweaked the SEC about Mr. Jenkins was the fact that there were two restatements on his watch. The first one allegedly made numerous false statements itself, and the SEC alleged that "CSK knew, or was reckless in not knowing, about the false disclosures and misstatements contained in its First Restatement." (Complaint, Par. 39). In the second restatement, the company itself recognized "numerous instances of improperly supported journal entries…override of Company policies and procedures… [and an] ineffective control environment." (Complaint Par. 41). Thus, Mr. Jenkins, after allegedly certifying to the original false financial statements, reviewed and certified to a false restatement, which effectively extended the fraud. The SEC, and investors, have every reason to expect that when a public company restates, especially after a fraud is uncovered, that it will get it right the first time. In short, even if CEO Jenkins did not know about the fraud, he presided over a corporate governance disaster and his personal certifications in the financial reports (including the first restatement) were obviously wrong.

WHOSE WRONGDOING SHOULD IT BE, ANYWAY?

So, under these circumstances should Jenkins keep his bonuses and stock profits? Does the "wrongdoing" required for the claw back have to be that of the CEO or CFO from whom the payback is sought, or just that of the company itself, acting through other managers. Does the "wrongdoing" have to amount to fraud, or can it just be reckless or negligent accounting or corporate governance practices which cause a financial statement impact material enough to require a restatement? In its haste to pass SOX, Congress did not address these issues directly.

By the end of the first year of law school we have learned (if awake) that when the legislature speaks clearly in a statute (even if cryptically), generally the courts should not reinterpret or reject the language, unless the law is otherwise unconstitutional. Section 304 is not a model of clarity, but neither is it "ambiguous" as the critics are now saying. It says simply that if the company restates based on "wrongdoing," the CEO and CFO must disgorge. While someone in management presumably must be a "wrongdoer," the statute could have, but does not, say the CEO or CFO must be among the bad guys. This is certainly the SEC's stated position—it is company wrongdoing, not that of any individual, that counts. Stanford University Professor Joseph Grundfest has said correctly that "for a statute [SOX] that contains a lot of inartfully drafted provisions, this is among the most inartful." Still, it says what it says.

A SPARSE LEGISLATIVE HISTORY SUPPORTS THE SEC'S POSITION

There are some clues to the intentions of the drafters of Section 304 of SOX regarding the nature of the "wrongdoing" necessary, and by implication the responsibilities of top management in such circumstances. Importantly, the concerns of the drafters centered on the certifications to be given by the top managers to the financial statements. They all point to holding the CEO and CFO "strictly liable" for material errors requiring restatements.

The father of Section 304 was an unheralded corporate governance crusader—former President George W. Bush. In his now largely forgotten "10 Point Plan" of March 2002 to toughen the federal securities laws (which was the basis for, but was quickly eclipsed by, Sarbanes-Oxley), the President's fourth point stated that "CEO's or other officers should not be allowed to profit from erroneous financial statements." Later

that month, Mr. Bush gave an address in Washington in which he explained his plan. In that context he discussed point four:

> Currently, a CEO signs a nominal certification of annual financial statements, and does so merely in its capacity on behalf of the company. In the future, the CEO's signature should also be his personal certification, vouching for the veracity and fairness of the financial disclosures. *When he signs a statement, he's giving his word, and should stand behind it.*
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> Oftentimes businesses base executive bonuses on financial statements. If, however, a ***financial statement turns out to be grossly inaccurate, or the result of serious misconduct,*** those bonuses should be returned to the company's treasury on behalf of its shareholders. (emphasis added).

Thus, the Bush proposal ties the claw back to either or both "gross inaccuracy" or "serious misconduct" impacting the financial statements. Bush singled out the CEO who is "giving his word" through his "personal certification" and thus should be prepared to "stand behind it." He did not confine this obligation only to those CEO's who personally commit "serious misconduct." Subsequently, when Congress took over the effort and produced SOX, the House bill reported out of the Financial Services Committee in April 2002 in Subsection 12, authorized the SEC to promulgate disgorgement rules against "any officer or director" of an issuer filing a restated financial statement and allowed the SEC to "identify the scienter requirement that should be used in order to determine to impose the requirement to disgorge." Draft Sec. 12(b)(3), H.R. Rep. No. 107-414, at 12 (2002).

The report accompanying the Senate version of July 2002 (which became the eventual SOX), also discussed the disgorgement provision:

> Recent events have raised concern about management benefiting from unsound financial statements, many of which ultimately result in corporate restatements. The President has recommended that `CEOs or other officers should not be allowed to profit from erroneous financial statements,' and that `CEO bonuses and

> other incentive-based forms of compensation [sh]ould be disgorged in cases of accounting restatement and misconduct.
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> Title III includes provisions designed to prevent CEOs or CFOs from making large profits by selling company stock, or receiving company bonuses, *while management is misleading the public and regulators about the poor health of the company.* The bill requires that in the case of accounting restatements that result from *material non-compliance with SEC financial reporting requirements*, CEOs and CFOs must disgorge bonuses and other incentive-based compensation and profits on stock sales, *if the non-compliance results from misconduct*. The required disgorgement applies to amounts received for the 12 months after the first public issuance or filing of a financial document embodying such financial reporting requirement. Under this section, the SEC may exempt any person from this requirement as it deems necessary and appropriate. (emphasis added).

Sen. Rpt. 107-205 (2002), at 26.

Thus, both the President and Senate spoke of misconduct in the context of the *management* putting out misleading financial statements. The House version was even prepared to let the SEC decide the level of scienter required for disgorgement. Neither the executive nor either branch of the legislature ever indicated that the CEO or CFO had to be personally responsible for the "wrongdoing." Rather, the reasonable inference from the admittedly sparse record is that the CEO and CFO could be held responsible because they held final responsibility for the actions of management and for the accuracy of the financial statements.[1]

THE SIGNIFICANCE OF CEO AND CFO CERTIFICATIONS

Following up on point four of the Bush proposal, SOX eventually included certification provisions for CEO's and CFO's which, upon implementation by SEC rules, require these executives to certify that the financial report has no untrue material facts,

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[1] One prominent law firm, while raising many issues with the drafting of Section 304, did feel constrained to acknowledge at the time that "[w]hile Sec. 304's disgorgement provisions apply only to CEO's and CFO's, there is no specific requirement that such officers be the actual source of the misconduct in question. The concept of resting ultimate responsibility for the integrity of financial reporting with the CEO and CFO's is a general theme of the Act." Alston & Bird LLP, *Securities Law Advisory*, Sept. 9, 2002.

that the information fairly presents the company's financial condition, that he/she is responsible for establishing and maintaining disclosure controls and internal control over financial reporting, that the controls have been designed to provide reasonable assurance of the reliability of the financial reports, has evaluated the effectiveness of such controls, and has disclosed to the auditors and audit committee all "significant deficiencies and material weaknesses in internal controls" which are "reasonably likely" to adversely affect the company's ability to report its financial information. After the passage of SOX, thousands of such certifications have subsequently appeared in financial statements with CEO's and CFO's making those specific and reassuring assertions.

While the process of filing such certifications has become somewhat rote, and in most companies a set of similar certifications from middle managers up the line is required to give the CEO and CFO comfort (and perhaps someone to point the finger at if their own certifications are later proven deficient), the fact remains that a CEO or CFO bears great responsibility to shareholders to mean what they say when "certifying." It is in a sense the CEO's and CFO's personal guarantee or warranty as to the accuracy of the financials and the effectiveness of internal controls.

There should be a price to pay if that guarantee proves worthless. If a subsequent restatement shows that the earlier certification could not be relied upon, a Section 304 claw back action may be the only effective remedy to enforce the certification process against the CEO and CFO by hitting them squarely in the wallet (or purse, as the case may be). A strong, predictable financial penalty creates a true incentive for top management to insure their certifications are accurate, and thus to insist on ethical

behavior, proper reporting, and internal controls and risk evaluation programs that really work, not just look good on paper.

Several federal courts have held there is no private right of action under Section 304, so the burden is on the SEC alone to enforce the statute as written, even against executives not personally guilty of the wrongdoing. Otherwise, Section 304 becomes little more than another count with which to charge a CEO or CFO who can otherwise be sued under Rule 10b-5 or other anti-fraud or negligence statutes, or indicted under the criminal law. The Section 304 claw back remedy is not unlike that given to corporations under the short-swing profits rule, Section 16 of the Securities Exchange Act, which allows employers to sue on their own behalf to require disgorgement of profits by certain corporate insiders on purchases and sales of company stock within 6 months, regardless of intent or proof of actual insider trading. This rule presumes the potential of insider trading in such quick trading, but does not require proof of such. One court has called the short swing rule "arbitrary and sweeping coverage" for "optimum prophylactic effect." Even Forbes Magazine suggested in 2002 that Rule 16 be expanded to cover profits on sales of stock and bonuses "that occur within one year of any restatement of earnings or assets."

Section 304 is similar in that it presumes some degree of responsibility on the top executives for breakdowns in internal controls or other deficiencies leading to the need for a restatement, particularly when the certification given by those executives is later proven to be false, regardless of their state of knowledge when making the certification. Likewise, the overlooked subsection (b) of Section 304 contains a highly unusual if not unique provision giving the SEC the authority to "exempt any person from the

application of subsection (a), as it deems necessary and appropriate." This provision for amnesty, as it were, suggests that Congress, having adopted a broad and inclusive disgorgement requirement which may ensnare the so-called "innocent" CEO or CFO, also gave the SEC complete discretion to give them a pass in appropriate circumstances , provided their company has committed "wrongdoing" as demonstrated by the inaccuracy of the financial restatements. Restatements premised on innocent mistakes, such as justifiable misinterpretation of a complex accounting rule or an innocent miscalculation in an obscure account, may not be considered "wrongdoing" per se, but the bar to establish whether the cause for a restatement originates in some corporate activity that is "wrong" should be set very low. Options backdating, for example, although widely practiced until called out by an academic study and thought by many lawyers and auditors to be acceptable, was nevertheless "wrong" in the sense that it resulted in many substantial misstatements in financial statements, and permitted millions of dollars in improper profits to top managers.

THE NEED FOR STRICT SECTION 304 ENFORCEMENT GOING FORWARD

If the SEC wins the motions in the Jenkins case, it should seriously consider a thorough review of the several thousand public company restatements issued since the enactment of Section 304. It should articulate its own definition of "wrongdoing" and apply it to the review of each prior restatement. For example, in those cases where the company admitted to material weaknesses in internal controls, and the prior certifications in the financial statements by the CEO and CFO regarding those controls can reasonably be viewed as incorrect, and where the financial impact on the financials meets some articulated threshold of materiality in relation to revenue or income, or assets and

liabilities, the SEC should ask the company promptly to calculate the bonuses and stock sales that would be eligible for disgorgement under Section 304. After the company provides this information, the SEC should then contact the CEO's and CFO's to request appropriate disgorgement, or face litigation. Particularly in cases where the "wrongdoing" involves fraud or gross misconduct by anyone in upper management leading to a restatement (and certainly in any company whose restatement reflects improper actions tied in some way to the current financial crisis), the SEC should file suit against any CEO or CFO who declines to enter into serious disgorgement discussions.

Restatements have consequences. They typically cost public companies millions in legal and accounting fees. While they are now more common and typically have less impact on market value than previously, they can sometimes have a devastating impact on a public company. This may be happening now to Huron Consulting Group, a forensic accounting and litigation support organization which typically aids companies in their restatements, but recently announced a restatement of its own that caused an immediate two-thirds drop in stock value ($660 million) and in the view of many observers may have dealt a fatal blow to the company's reputation and business model. Restatements with that kind of impact should cause careful SEC review for potential claw back actions under Section 304.

Going forward, the SEC should also consider requiring (or at a minimum strongly encouraging) companies to adopt aggressive claw back provisions (as of June 2008 some 329 companies had done so, according to The Corporate Library, compared to only 14 four years earlier). They should cover all executive officers whose job functions may affect the company's financial reporting and be performance-based, i.e. "no fault"

provisions not dependant on individual misconduct but rather covering any executive who received an incentive payment based on incorrect financials. A growing number of companies, such a Qwest, Monsanto and International Paper, have instituted such provisions already.

Likewise, the SEC should make it clear that future restatements which fit into certain specified criteria (which should be made explicit) will be subject to Section 304 disgorgement actions. Such a stance is better than just selectively picking off a CEO here and a CFO there like a cop with a radar gun, without establishing clear criteria for when "innocent" executives will suffer Section 304 treatment. The SEC should make Section 304 into the enforcement tool that Congress intended it to be, and that shareholders who rely on CEO and CFO certifications have the right to expect.

If the SEC takes this stand, it can safely be predicted that, understanding that restatements have personal consequences, and that their financial statement certifications are now effectively their personal guarantee, secured by their bonuses and stock profits, CEO's and CFO's will exhibit a decidedly new emphasis on effective corporate governance and financial statement integrity.