Court Says Sarbanes-Oxley Allows "Clawbacks" of Executive's Bonuses

No Misconduct Required by the Executive for Disgorgement Due to Restatements

The District Court of Arizona has just ruled (*SEC v. Jenkins*) that Section 304 of the Sarbanes-Oxley Act of 2002 gives the SEC the power to "clawback" certain executive compensation on behalf of the issuer even when the affected executive is not personally guilty of misconduct.

Section 304 of the Sarbanes-Oxley Act requires that "[i]f 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 [certain incentive-based and equity-based compensation as well as certain profits from the sale of the issuer's securities]." While the SEC has filed a number of suits against executives under Section 304 of the Sarbanes-Oxley Act based upon the executive's own misconduct, the current suit against Maynard Jenkins, former CEO of CSK Auto Corporation, is the first instance in which a court has recognized a Section 304 claim to compel reimbursement when a CEO or CFO has not been accused of any misconduct.

The SEC filed this action in the District Court of the District of Arizona on July 22, 2009, alleging that Jenkins violated Section 304 when he refused to reimburse CSK for incentive-based compensation he received during 2002, 2003 and 2004, years that were the subject of a financial statement restatement by CSK. In connection with the restatement, the SEC filed civil and criminal charges against other CSK officers (alleging misconduct by them), but the SEC did not allege that Jenkins himself was aware of the violations or participated in any misconduct. Jenkins filed a motion to dismiss the suit against him on the grounds, among others, that Section 304 requires misconduct on the part of the executive from whom reimbursement is sought.

The court held that the plain language of the statute requires reimbursement by a CEO or CFO of incentive-based compensation when a restatement is due to material noncompliance of the issuer as a result of misconduct—even if someone other than the executive is responsible for the misconduct. The court also held that Section 304 contains no scienter requirement, noting that a scienter provision had been removed from earlier drafts of the legislation. The court declined to comment on the appropriate measure of reimbursement.

Jenkins may be only the beginning of increased activity in this area. For example, on November 16, 2009, Beazer Homes USA disclosed that its CEO, Ian J. McCarthy, had received a "Wells" notice from the SEC that could also lead to a Section 304 reimbursement claim without allegations of misconduct by McCarthy.

Jenkins is a critical development in the evolution of the law governing clawbacks and provides the first judicial determination of which we are aware that misconduct on the part of the executive is not a precondition to requiring disgorgement of the executive's incentive compensation and profits from sales of the issuer's shares. This decision will likely resonate within both the issuer and executive communities, particularly in light of the ongoing efforts by institutional shareholders to cause issuers to adopt clawback policies requiring disgorgement of incentive compensation in the event of a restatement, and the pending regulatory reform legislation, which would likewise require disgorgement on a more comprehensive basis than is required by Section 304 of the Sarbanes-Oxley Act.

If you would like to discuss these or any other executive compensation, governance or securities law matters, please contact any member of Ropes & Gray's Tax & Benefits department or Securities & Public Companies practice, or your usual Ropes & Gray advisor.