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CEOs, CFOs at Risk For 'No-Fault' Clawback of Compensation in the Event of Restatement

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On July 22, 2009, the U.S. Securities and Exchange Commission filed a Section 304 action against Maynard Jenkins, former CEO of CSK Auto Corporation. This action seeks reimbursement from Jenkins to CSK for more than $4 million Jenkins received in bonuses and profits from stock sales while CSK was committing accounting fraud. The press release announcing the filing specifically states that the SEC is not alleging that Jenkins himself engaged in the fraudulent conduct that ultimately required the restatements. This is the first time the SEC has attempted to use Section 304 for reimbursement from a CEO or CFO who was not actively engaged in any fraudulent conduct, and demonstrates the willingness of the SEC to begin using Section 304 under these types of circumstances.

Section 304 of the Sarbanes-Oxley Act, the so-called executive "clawback" provision, provides that if an issuer is required to restate its financials "as a result of misconduct," then the CEO and the CFO must reimburse the issuer for any bonus or other incentive-based or equity-based compensation received, and any profits from the sale of securities of the issuer realized, during the 12-month period following the date of filing of the financials that subsequently are restated. Only the SEC can enforce Section 304 since there is no private right of action available under the statute.

Although Sarbanes-Oxley was adopted in 2002, the SEC did not bring its first enforcement action under Section 304 until 2007. In addition, until this recent filing all actions under Section 304 were brought against executives who were personally accused of wrongdoing, mostly in options backdating cases. Since its adoption, Section 304 has been criticized for its ambiguities, most importantly that the "misconduct" required under Section 304 is not defined, making it difficult to determine what actions would rise to the level of a cause of action under Section 304. This also means that Section 304 is silent as to whether the CEO or CFO who will be subject to the clawback must be actively involved, or even have knowledge of, the alleged misconduct. The filing against Jenkins makes it clear that the SEC is interpreting Section 304

to require reimbursements even if the CEO or CFO had no actual knowledge of the misconduct that caused the accounting restatement to be required in the first place.

D&O insurance policies typically contain an exclusion for claims for return of "profit or advantage" to which an executive was "not legally entitled." A D&O insurer would likely take the position that this excludes coverage for any obligation to repay under Section 304. Although the policy might require the insurer to advance defense costs, under a typical policy the insurer could demand repayment of those costs if the officer is determined "in fact" to be liable under Section 304. If the SEC's current interpretation of Section 304 is adopted, CEOs and CFOs may not be able to utilize D&O insurance policies to protect themselves, even if they were not actively engaged in any wrongdoing.

While it appears that Jenkins intends to oppose the SEC's lawsuit and to put the SEC's interpretation of the statute to the test of the judicial system, it is apparent that the SEC is now taking the position that the "misconduct" required under Section 304 does not need to be that of the CEO or CFO to trigger the clawback provision. As stated in the SEC's press release, liability attaches to the CEO merely because he is "captain of the ship." CFOs, however, should take no comfort in the fact that this press release focuses only on the captain and not the first mate—CSK's CFO had already been criminally indicted, and was already the subject of a Section 304 disgorgement claim in the SEC's civil case against him.

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