SEC Uses Section 304 to Claw Back Incentive-Based Compensation from "Innocent" Executives - SEC v. O'Dell & SEC v. Jenkins

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The **U.S. Securities and Exchange Commission** (SEC) is ramping up its use of Section 304 of the **Sarbanes-Oxley Act** as an independent cause of action in order to obtain reimbursement of bonuses and other incentive-based and equity-based compensation from CEOs and CFOs, regardless of the executives' involvement in their companies' alleged accounting improprieties.

Two recent cases are particularly important. The first settled case, which was filed by the SEC on June 2, 2010, is *SEC v. Walden W. O'Dell*, No. 1:10-CV-00909 (D.D.C. June 2, 2010), SEC Litigation Release No. 21543 (June 2, 2010). The second case, *SEC v. Maynard L. Jenkins*, No. 09-1510 (D. Ariz. July 22, 2009), SEC Litigation Release No. 21149A (July 23, 2009), has received significant attention, and defendant Maynard L. Jenkins's motion to dismiss the SEC's Section 304 complaint was recently denied. Although the complaints in *SEC v. O'Dell* and *SEC v. Jenkins* contain similar allegations, defendant Walden W. O'Dell chose to settle with the SEC instead of litigating the merits of the SEC's interpretation of Section 304 as defendant Jenkins has done.

SEC v. O'Dell

On June 2, 2010, the SEC filed—and settled—an enforcement action against O'Dell, former CEO of Diebold, Inc. In its complaint, the SEC alleged that Diebold, a manufacturer and seller of automated teller machines, engaged in fraudulent accounting practices and materially misstated several annual, quarterly and other reports filed with the SEC.[1] To correct those material misstatements, Diebold restated its financial statements for 2003 through 2006, and the first quarter of 2007.[2]

The SEC alleged that, pursuant to Section 304, O'Dell is required to "reimburse Diebold for bonuses and other incentive-based and equity-based compensation, received during the 12-month period following the issuance of Diebold's financial statements contained in its annual report for fiscal year

2003."[3] As part of the settlement with the SEC, O'Dell agreed to repay Diebold $470,016 in cash bonuses, 30,000 shares of Diebold stock, and stock options for an additional 85,000 shares of stock. Notably, the SEC did not allege that O'Dell engaged in any financial fraud, and the SEC's complaint against O'Dell does not explicitly connect the cash bonuses or stock received by O'Dell to the misconduct or resulting restatement by Diebold.

SEC v. Jenkins

Motion to Dismiss Denied

The SEC complaint filed against defendant Maynard L. Jenkins is strikingly similar to the *O'Dell* complaint; both complaints seek to claw back bonuses and other compensation paid to former CEOs whose respective companies engaged in financial fraud, and neither complaint alleges that the CEO defendants engaged in any personal misconduct. As noted above, unlike in *O'Dell*, where O'Dell agreed to settle and repay his bonuses and stock shares and options, defendant Jenkins filed a motion to dismiss, challenging the merits of the SEC's allegations. Jenkins's motion to dismiss was subsequently denied on June 9, 2010 by District Court Judge G. Murray.

A Background

The SEC filed its complaint against Jenkins—former chief executive officer of CSK Auto Corporation—on July 22, 2009 in the U.S. District Court for the District of Arizona. In its complaint, the SEC alleges that many of CSK's senior officers were involved in "pervasive accounting fraud" and other securities violations, which led CSK to restate its financials not once, but twice within three years.[4] The SEC's complaint notably fails to allege any wrongdoing, misconduct or fraud committed by Jenkins himself. Instead, the SEC seeks, as it did subsequently *O'Dell*, to use Section 304 to claw back more than $4 million in bonuses and other incentive-based and equity-based compensation from Jenkins, without alleging any personal misconduct by Jenkins.

The basis for the SEC complaint is Section 304's requirement that CEOs and/or CFOs must "reimburse" their employer for any bonus, incentive-based or equity-based compensation they received if it is necessary for their employer to restate their financials under that CEO's or CFO's tenure. Section 304(a) states, in relevant part:

(a) **Additional compensation prior to noncompliance with Commission financial reporting requirements.** If 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—

(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period.[5]

In previous Section 304 actions brought in recent years, the SEC has alleged that the defendant CEOs and CFOs are personally engaged in misconduct that led to the filing of a restatement and therefore should reimburse their issuers for their direct role in the restatement.[6] However, the complaint in *SEC v. Jenkins* marked the first time the SEC, without accusing the CEO of any misconduct leading to the restatements, attempted to force a CEO to repay his bonuses and other discretionary compensation. Indeed, in its complaint against Jenkins, the SEC essentially argued vicarious strict liability; because the accounting fraud happened on Jenkins's watch—or while Jenkins, as CEO, was the "driver of that bus"—Section 304 requires Jenkins to repay his former employer.[7]

Jenkins's motion to dismiss, filed on September 25, 2009 and argued on April 30, 2010, focused on the following main arguments: (1) whether the language of Section 304 is ambiguous; and (2) whether Section 304, as interpreted by the SEC in this case, is unconstitutional.

Section 304 Is Not Ambiguous

Jenkins argued in his motion to dismiss, and during oral argument, that the words "as a result of misconduct" in Section 304 are ambiguous because the statute fails to delineate *whose* misconduct triggers the reimbursement obligations of the CEO and CFO. In its written opinion issued June 9, 2010, the court disagreed, holding that "the ordinary, contemporary and common meaning of [Section 304's] language is that the misconduct of the issuer is the misconduct that triggers the reimbursement obligation of the CEO and the CFO."[8] The court also rejected Jenkins's argument that a CEO or CFO must engage in personal misconduct in order to be liable under Section 304. Instead, the court noted that a corporate executive need not be personally aware of financial misconduct in order to benefit from that misconduct. Accordingly, the court held that the SEC may claw back any equity-based compensation or bonuses earned by an executive during the period of the issuer's misconduct.[9]

Constitutionality Issues

The court refused to determine, on a motion to dismiss, whether Section 304 is a purely remedial statute or whether it is punitive in nature.[10] Further, because the court was able to determine the plain meaning of Section 304 by analyzing both the text of Section 304 and the supporting, concurring legislative history, the court refused to consider Jenkins's arguments regarding the constitutionality of Section 304.

Finally, the court rejected Jenkins's argument that the SEC's complaint was deficient because the SEC failed to allege a specific amount to be reimbursed and failed to allege a causal connection between a specific amount and the alleged misconduct.[11] To this argument, the court stated, "Arguments based on the appropriate measure of reimbursement sought by the SEC are not dispositive with respect to whether the SEC has stated a claim for reimbursement against Mr. Jenkins."

Considerations Going Forward

Both *O'Dell* and *Jenkins* suggest that the SEC will continue to use Section 304 to claw back compensation paid to CEOs and CFOs where their companies have filed a restatement caused by fraudulent conduct, regardless of whether there can be a showing of personal misconduct or fraudulent acts by the executive. Indeed, Scott W. Friestad, Associate Director of the SEC's Division of Enforcement, recently stated, "Section 304 of Sarbanes-Oxley is an important investor protection provision, because it encourages senior management to proactively take steps to prevent fraudulent schemes from happening on their watch. We will continue to seek reimbursement of bonuses and other incentive compensation from CEOs and CFOs in appropriate cases."[12] Further, the recent denial of Jenkins's motion to dismiss in *Jenkins* may encourage and bolster the use of Section 304 to claw back compensation from executives regardless of the executive's knowledge of or participation in financial misconduct.

In sum, *O'Dell* and *Jenkins* raise several pertinent issues to be examined by public companies and executives alike. For example, corporations and executives should reexamine the benefits and drawbacks of performance-based compensation in light of the potential of Section 304 to expose CEOs and CFOs to strict liability. Further, corporations may want to consider adopting aggressive internal clawback provisions for their own use, even if the SEC chooses not to continue to apply Section 304 to "innocent" executives. Indemnification provisions for directors and officers should also be reexamined for the potential impact of "innocent" executives being held liable to reimburse their bonuses and other compensation after a restatement. More than ever, corporate executives need to assess potential liability after the filing of a restatement, and executives should further evaluate their financial reporting obligations, stress the importance of internal controls, foster a culture of compliance and be particularly mindful of the "tone at the top."

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[1] *SEC v. O'Dell* Complaint ¶ 8 (June 2, 2010).

[2] *Id.*

[3] *Id.* ¶ 1.

[4] *SEC v. Jenkins* Complaint ¶¶ 2, 38–41 (July 22, 2009).

[5] 15 U.S.C. § 7243 (italics added).

[6] *See*, *e.g.*, *SEC v. McGuire*, Civil Action No. 07-CV-4779 (D. Minn. 2007).

[7] *SEC v. Jenkins* Oral Argument 30:15–24, April 30, 2010.

[8] *SEC v. Jenkins* Order at 5, June 9, 2010.

[9] *Id.* at 6, June 9, 2010.

[10] *Id.* at 9, June 9, 2010.

[11] *Id.* at 6–7, June 9, 2010; *see SEC v. Jenkins* Oral Argument 33:11–24, April 30, 2010. The complaint in *SEC v. O'Dell* also fails to allege a causal connection between the amount the SEC sought to claw back and the alleged misconduct of the company.

[12] SEC Press Release 2010–93, June 2, 2010.

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