July 24, 2009

# SEC Pursues Unprecedented Sarbanes-Oxley "Clawback"

In a recently filed case, the SEC is for the first time seeking to "claw back" incentive-based compensation from a former CEO who is not accused of any wrongdoing. The case is emblematic of the new aggressiveness of the SEC's enforcement program, and is an unfortunate contribution to the overheated atmosphere surrounding executive compensation generally.

The SEC is seeking a court order directing Maynard L. Jenkins, the former CEO of CSK Auto Corporation, to pay back to CSK over $4 million in bonuses and stock sale proceeds that Jenkins received during a period for which CSK's financial statements were later restated. *SEC v. Jenkins*, No. CV 09-1510-PHX-JWS (D. Ariz. July 22, 2009). Earlier this year, the SEC brought a settled fraud case against CSK and a separate case charging four former CSK executives with fraud and other violations, all relating to the accounting practices from 2002 to 2004 that led to CSK's restatement. The SEC has not charged Jenkins – either in the earlier enforcement actions against the company and other executives, or in the new clawback proceeding – with any involvement in or knowledge of accounting improprieties, or any other wrongdoing.

Section 304 of the Sarbanes-Oxley Act requires a CEO or CFO to return incentive-based compensation to an issuer in the event of a financial restatement that occurs "as a result of misconduct . . . ." The statute is at best ambiguous as to whether this obligation arises only where the "misconduct" has been committed by the CEO or CFO in question. As a result of that ambiguity, it has always been an open question whether the SEC would use this weapon against a CEO or CFO who did not personally engage in misconduct, and whether such an aggressive claim would be sustained in litigation.

The SEC's decision to depart from its prior reasonable restraint in using Section 304 is a regrettable policy choice. Clearly, the SEC believes fraud occurred at CSK, but apparently can find no basis to assert that the CEO was culpable in it. The SEC has not even pursued any of the lesser charges that would be available against a blameworthy executive in these circumstances, such as a negligence-based administrative case. In these circumstances, it is difficult to discern what conduct by similarly situated CEOs the SEC may think this case will deter or encourage. It also remains to be seen whether a federal agency may constitutionally deprive a person who is not alleged to have violated any law of compensation that was lawfully received, particularly where the statute's intended reach is ambiguous.

Finally, it is far from clear that the SEC's policy choice in this case is well tailored to the goals of Section 304. Under Section 304, recovered compensation is paid back to "the issuer." CSK, however, was sold in July 2008 and is now a wholly owned subsidiary of another company. The acquirer presumably paid what it thought CSK was worth one year ago, and the shareholders of CSK received that consideration at that time. The SEC now seeks to recover $4 million from a CEO that it cannot accuse of wrongdoing, in order to pay that money over to a company that was not harmed.

John F. Savarese
Wayne M. Carlin