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Arizona Federal District Court Holds That Securities & Exchange Commission Need Not Allege Wrongdoing On The Part Of CEO When Pursuing Reimbursement Under Section 304 Of Sarbanes-Oxley Act

In *Securities & Exchange Commission v. Jenkins*, No. CV-09-1510-PHX-GMS, 2010 WL 2347020 (D. Ariz. Jun. 9, 2010), the United States District Court for the District of Arizona held that the responsibility of a CEO under Section 304 of the Sarbanes-Oxley Act of 2002 (the "Act") to reimburse an issuer for bonuses, incentive compensation and stock sale proceeds he or she received in the year prior to a restatement of the issuer's financial statements does not require a showing that CEO committed or even knew of misconduct that led to the restatement. This decision marks the first time a court has applied Section 304 of the Act in the absence of allegations that the targeted CEO personally committed any wrongdoing, enforcing strict liability of CEOs and CFOs in the event of a restatement due to corporate (as opposed to their own) misconduct.

The action centered around Maynard L. Jenkins, former CEO and chairman of the board of directors of CSK Auto Corporation ("CSK"), a publicly-traded retail company of automotive parts and accessories, operating under three brand names: Checker Auto Parts, Schucks Auto Supply, and Kragen Auto Parts. As CSK's CEO and chairman, Jenkins received a base salary, bonuses and stock option grants from January 1997 through August 2007. During the 2002, 2003 and 2004 fiscal years, CSK reported greater pretax income than the company actually earned. Although the SEC did not allege that Jenkins was *personally* aware of the fraudulent concealment by various CSK officers, Jenkins did certify the company's inaccurate financial statements for those years. Indeed, the Securities & Exchange Commission's ("SEC") complaint did not allege that Jenkins played *any role* in the scheme, and the SEC filed both civil complaints and criminal indictments against other CSK officers, alleging that those officers *concealed the scheme* from Jenkins.

From May 2003 through May 2005, Jenkins received over $2 million in compensation in the form of bonuses and other incentive-based and equity-based compensation and over $2 million from the sale of CSK securities. The SEC brought an action seeking an order compelling Jenkins to reimburse CSK for this income pursuant to Section 304 of the Act. Section 304 of the Act requires that, if an issuer, such as CSK, must prepare an accounting restatement because of its material noncompliance with financial reporting securities laws, and if that noncompliance was caused by "misconduct," then the CEO or CFO must provide certain reimbursement to the issuer. 15 U.S.C. § 7243(a). Under the Act, such reimbursement includes any bonuses and incentive-based and equity-based compensation received during the twelve-month period following the first improper public issuance or filing. Because the complaint in the matter did not allege that Jenkins was personally responsible for either of the incorrect SEC filings, except to the extent that Jenkins certified the

SEC filings, Jenkins's liability depended on whether Section 304 requires a CEO to reimburse an issuer even where the CEO committed no *personal* wrongdoing.

Jenkins moved to dismiss the complaint, arguing for various reasons that a fault requirement should be imputed into the language of Section 304. In analyzing the issue, the district court applied traditional rules of statutory interpretation. It held that the text and structure of Section 304 of the Act require only the misconduct of the *issuer*, not necessarily the specific misconduct of the issuer's CEO or CFO. First, the court held that the "ordinary, contemporary and common meaning" of the language is that the misconduct of the *issuer* is the misconduct that triggers the reimbursement obligation of the *CEO and the CFO*. Hence, since CSK (as the "issuer") is a corporation and, generally, a corporation acts through its officers, agents or employees and is liable for the actions of such persons acting within the scope of their agency, then the *plain language* of the statute indicates that the misconduct of corporate officers, agents or employees acting within the scope of their agency or employment is sufficient misconduct to meet the element of the statute.

Next, the court looked to the statutory title of the subsection of the Act for guidance. Congress entitled the subsection of the Act as "Additional Compensation Prior to Noncompliance with Commission Financial Reporting Requirements." 15 U.S.C. § 7243(a). The court held that based on the statutory title, Congress' purpose was to recapture the additional compensation paid to a CEO during any period in which the corporate issuer was not in compliance with financial reporting requirements. A CEO need not be personally aware of financial misconduct to have received additional compensation during the period of that misconduct, and to have unfairly benefitted therefrom. Thus, the court held that "it is not irrational" for Congress to require that such additional compensation amounts be repaid to the issuer.

The court then looked at the "larger statutory scheme" of which Section 304 is a part. Pursuant to the immediately preceding sections of the Act, particularly Section 302, an issuer's CEO and CFO are required to certify each annual or quarterly report of the issuer. 15 U.S.C. § 7241. In so doing, the CEO and the CFO also certify that they are responsible for the existence, design and operation of effective internal controls that provide assurances as to the accuracy of the issuer's financial statements. Thus, the court held that Section 304 provides an incentive for CEOs and CFOs to be rigorous in their creation and certification of internal controls by requiring that they reimburse additional compensation received during periods of corporate non-compliance *regardless* of whether or not they were aware of the misconduct giving rise to the misstated financials.

Finally, the court looked at the legislative history to "confirm" and "support" the Court's holding that Section 304 requires no personal misconduct by the CEO or CFO. The House and Senate passed different versions of the Act, but only the House's version, which *did not become law*, included language regarding the CEO or CFO's scienter in the context of disgorgement. Additionally, the Senate had the opportunity to

consider an amendment that would have limited Section 304 to the officers and directors "with knowledge, at the time of the misconduct, of the material noncompliance of the issuer." Hence, the amendment would have created a personal misconduct element, but it was tabled.

Jenkins also argued that the court's approval of the SEC's interpretation of Section 304 would create "absurd results" because Delaware law, which governs CSK as a Delaware corporation, would allow Jenkins to be indemnified by CSK if Jenkins acted "in good faith" and in a manner that Jenkins "reasonably believed to be in or not opposed to the best interests of the corporation." 8 Del. C. § 145(a). The court held that while the availability of indemnification by the issuer for amounts allegedly recoverable by the issuer may "disrupt Congress's apparent purpose in having a CEO reimburse the issuer," Jenkins cited no authority that a federal statute's interpretation must conform to state statutes. Rather, the court held that the Supremacy Clause suggests the analysis "cuts the opposite way." Hence, the court held that "the existence of a state statute does not alter the meaning of the federal statute."

Prior to this case, over the seven years since Section 304's enactment, and the hundreds of accounting restatements filed by public companies, the statute had never before been used by the SEC against a CEO or CFO who was not personally accused of securities law violations. The court's interpretation of Section 304 here connotes that no matter how astute and assiduous a CEO may be, he/she must repay any bonus or other incentive-based or equity-based compensation if there is misconduct by *any* officer or employee of the issuer that results in an accounting restatement. Hence, if Section 304 is vigorously enforced in this manner, CEOs and CFOs will become easy targets of SEC enforcement activity and activist corporate boards.

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