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Broadening Enforcement Of Exec Compensation Clawbacks

Law360, New York (December 05, 2011, 12:38 PM ET) -- Last month, Maynard Jenkins, former CEO and chairman of CSK Auto Corporation (CSK), agreed to return nearly $2.8 million he was paid in bonuses and other compensation to settle an enforcement action the U.S. Securities and Exchange Commission brought against him.

The SEC had brought the case under Section 304 of the Sarbanes-Oxley Act of 2002, the so-called executive compensation "clawback" provision. The SEC has had authority to pursue such clawbacks since SOX was enacted, but did not bring any enforcement actions at all under Section 304 until 2007.

The Jenkins case was closely watched because, prior to that case, the SEC had limited enforcement actions to instances in which a CEO or chief financial officer knowingly or intentionally directed, participated in, or approved of fraudulent acts or misrepresentations concerning a company's financials. Jenkins represented a significant broadening of SEC enforcement in this arena, marking the first time since the passage of SOX that the agency sought reimbursement of compensation paid to a CEO who did not participate in any misconduct.

Since the SEC brought the Jenkins case, the agency has entered into several other settlements without any allegation that the settling individual himself engaged in any misconduct. This shift in enforcement merits some attention, since there are both statutory and policy arguments against enforcing SOX Section 304 in the absence of any wrongdoing by the individual charged.

In the coming weeks, the SEC is expected to propose rules under the executive compensation clawback provisions found in Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. In the current volatile economic and political environment, characterized by hostility toward high-paid executives, there is cause for concern that the anticipated Dodd-Frank rules will prove even more far-reaching than Section 304 and lead to additional SEC enforcement efforts, even where enforcement may not be warranted in a particular case.

Increased Enforcement of SOX Section 304

According to documents filed in the Jenkins case, the SEC action against Jenkins stemmed from accounting fraud committed by the company between 2001 and 2006. During that time, other high-ranking executives — though, notably, not Jenkins himself — engaged in a scheme to artificially inflate CSK's income by failing to write off millions in uncollectible vendor allowance receivables.

CSK accounted for the vendor allowances by reducing the cost of goods sold on its balance sheets; in the case of uncollectible allowances, the CSK executives involved used fraudulent accounting maneuvers to hide them rather than write them off in accordance with Generally Accepted Accounting Principles. Over three years during this time, CSK overstated its pretax income by more than $65 million, reporting income where a loss should have shown during at least one of those years.

Jenkins, for his part, was not privy to the accounting fraud perpetrated by others at CSK. Nevertheless, the SEC brought a Section 304 action against him, seeking reimbursement of bonus and incentive-based compensation paid during that time period. Section 304 permits clawbacks of bonus, incentive-based or equity-based compensation paid to CEOs and CFOs when a company must prepare an accounting restatement "due to material noncompliance ... as a result of misconduct, with any financial reporting requirement under the securities laws."

Notably, Section 304 does not specify whether the "misconduct" must be misconduct of the executive charged. In addition, Section 304 specifically permits the SEC to exempt an individual from liability under this section. Thus, a reasonable interpretation of Section 304 would be to charge only those individuals who actually participated in the wrongdoing. Indeed, prior to Jenkins, the SEC had used this enforcement mechanism to seek reimbursement only from CEOs and CFOs personally involved in the misconduct.

Here, however, the SEC did not contend that Jenkins was engaged in actions that constituted misconduct; the agency argued merely that he certified the company's quarterly and annual reports during the period in which the fraud occurred and that this was enough to justify reimbursement under Section 304.

The District Court of Arizona agreed that this theory stated a claim, denying a motion to dismiss the case and holding that the misconduct at the root of a Section 304 action need not have been committed by the defendant officer. The subsequent settlement between Jenkins and the SEC — in which Jenkins agreed to pay nearly 75 percent of the amount originally sought by the SEC — may well signal a new level of SEC enforcement, in which even conscientious executives are not protected from suits.

Two additional cases, both brought after Jenkins¸ support this notion. Earlier this year, the SEC settled with the former CEO and CFO of Beazer Homes USA Inc. (Beazer), clawing back $6.5 million and $1.4 million, respectively, when neither of these individuals was charged with any personal wrongdoing. Similarly, in 2010, the SEC settled with the former CEO of Diebold Inc. (Diebold) without alleging any wrongdoing by the CEO.

A common theme in Jenkins and Beazer is that both cases involved parallel criminal investigations. In the case of Jenkins' company, CSK, both CSK and those executives involved in the scheme were targeted in a U.S. Department of Justice criminal investigation; in September, CSK entered a nonprosecution agreement with the DOJ that obligates it to pay a $20.9 million penalty to resolve the criminal securities violations.

Three former CSK executives — its former CFO, controller, and director of credits and receivables — all pled guilty to criminal charges. In Beazer, the company also entered into a nonprosecution agreement. In both Jenkins and Beazer, the SEC also brought fraud charges against individuals the SEC alleged participated in the fraud. While no criminal charges were filed in Diebold, the case did allege a multiyear, multifaceted fraud involving numerous members of Diebold management; Diebold paid $25 million to settle the civil charges levied by the SEC.

There are valid policy reasons in favor of restrained enforcement of Section 304. In the case of members of company management who have worked hard to improve systems and improve transparency so that problems are uncovered and financials restated where necessary, unfettered enforcement of Section 304 could create a disincentive among executives to exhibit the type of behavior that the agency seeks to promote.

If the SEC is signaling, through Jenkins and similar cases, an interest in stepped-up enforcement of SOX Section 304, hopefully it will do so only in cases where the underlying behavior and harm to shareholders is particularly egregious.

Coming Soon: Rules Enforcing New Dodd-Frank Clawback Provisions

On top of more vigorous Section 304 enforcement, the SEC will soon have a new tool at its disposal to secure executive compensation clawbacks — rules under Section 954 of Dodd-Frank. Under Section 954, the SEC must write rules directing the national securities exchanges and associations to prohibit the listing of securities issuers that do not develop certain policies. One such policy relates to executive compensation clawbacks and requires issuers to adopt a policy providing that:

> in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) ... based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.

The SEC rules, due out in proposed form before the end of the year, will have a significantly broader reach than SOX Section 304. Section 954 requires only "material noncompliance" to trigger a mandatory clawback, as opposed to the "misconduct" required under Section 304. This standard suggests that clawbacks may be required automatically in the event of a restatement, irrespective of any wrongdoing by anyone at the company.

Furthermore, Section 954 also reaches a far greater number of individuals within any given company than does Section 304. Section 304 enforcement is limited to CEOs and CFOs; actions that could be taken in conjunction with Section 954 rules, on the other hand, can reach any executive officer of a company employed during the three years prior to filing an accounting restatement.

Unlike Section 304, Section 954 requires issuers, rather than the SEC, to seek clawbacks. However, Section 954 also provides the SEC with authority to direct the national securities exchanges and national securities associations to delist companies that fail to comply with the clawback mandates of Section 954.

Although rules under Section 954 have not yet been promulgated, there is cause for concern. The SEC has taken a hard line in its recent rulemaking under Dodd-Frank, including in connection with its rules on swaps and a new whistleblower program. At least one proposed rule, dealing with registrant and transaction requirements related to shelf registration of asset-backed securities, having met with opposition, had to be retracted and reproposed after substantial redrafting.

And in July, a three-judge panel of the U.S. Court of Appeals for the District of Columbia Circuit vacated an SEC rule that would have permitted any shareholder meeting certain requirements to include his own director nominees' names in a public company's proxy materials. In a searing opinion, the court held that the SEC had not performed sufficient economic analysis to support its rulemaking.

While the SEC may perform more careful economic analyses going forward, there is no reason to think that the agency will shy away from opportunities to promulgate far-reaching rules that will further its enforcement priorities and there is little reason to expect that rules under Section 954 will be narrow in scope.

Potential Implications of Heightened Clawback Enforcement

Together, the potential new direction of Section 304 enforcement implied by Jenkins and the other cases discussed above and the upcoming availability of Section 954 rules as an alternate means to seek clawbacks of executive compensation suggest that it is going to become more difficult for companies to attract and retain the best executive-level talent.

Previously, executives could feel comfortable that, if they personally committed no material misconduct, they were safe from SEC enforcement actions aimed at them as an individual. Not so anymore. Even the straightest arrows will be subject to tarring by punishment due to “misconduct” (under Section 304) and “material noncompliance” (under Section 954) anywhere in their organization.

Going forward, companies will need to think critically about strategies and internal policies by which they can prevent, detect, and deter both fraudulent and inadvertently noncompliant accounting. Furthermore, they will have to implement protections for executives from unfair clawbacks, including frank reexaminations of compensation policies. Finally, it will be imperative that companies participate in the SEC comment process for rules proposed under Section 954, ensuring that the SEC understands the full panoply of effects of a lowered enforcement threshold.

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