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August 2010

# Securities Litigation Trends

## SEC Uses Section 304 to Claw Back Incentive-Based Compensation from "Innocent" Executives

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

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

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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—
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> (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

[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.

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."

[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.

# Supreme Court Limits Scope of "Honest Services" Statute

On June 24, 2010, the U.S. Supreme Court pared down what has been commonly referred to as the "honest services" law, a federal criminal statute often used by federal prosecutors in corruption and fraud cases. *Skilling v. United States* involved an appeal brought by former Enron CEO Jeffrey K. Skilling regarding his 19-count fraud conviction for engaging in a scheme to mislead investors about Enron's true financial performance.

In *Skilling*, the Supreme Court held that 18 U.S.C. § 1346, which prohibits "a scheme or artifice to deprive another of the intangible right of honest services," encompasses only bribery and kickback schemes.[1] Based on its narrow interpretation of the "honest

[1] *Skilling v. U.S.*, 561 U.S. —, No. 08-1394 (June 24, 2010); 18 U.S.C. § 1346.

services" statute, the Supreme Court determined that Skilling had not violated Section 1346 by conspiring to defraud Enron's shareholders. However, because the government had indicted Skilling for three objects of conspiracy—"honest services" wire fraud, money-or-property wire fraud and securities fraud—the Supreme Court remanded the case back to the Fifth Circuit to determine whether Skilling's conspiracy conviction should be upheld. Additionally, whether a potential reversal on the conspiracy count would affect Skilling's other convictions—securities fraud, making false statements to accountants and insider trading—was left an open question by the Supreme Court.

Writing for the majority, on a 6–3 decision, Justice Ruth Bader Ginsburg noted that Section 1346 pertains only to criminal defendants who have participated in bribery or kickback schemes. In reaching this decision, the majority rejected the Justice Department's argument that Section 1346 should encompass self-dealing. Three other Justices—Antonin Scalia, Clarence Thomas and Anthony M. Kennedy—agreed with the majority, but would have gone further in limiting the scope of Section 1346. These Justices would have struck down the "honest services" statute in its entirety for being unconstitutionally vague.

In a separate 6–3 vote in *Skilling*, the Supreme Court also rejected Skilling's second challenge on appeal—that he had not received a fair trial in Houston in 2006 due to pretrial publicity and community prejudice against him. Again writing for the majority, Justice Ginsburg noted that Skilling failed to establish that he had suffered actual prejudice at his trial or that actual bias had infected the jury. In her dissent to this portion of the majority's opinion, Justice Sonia Sotomayor, joined by Justices Paul Stevens and Stephen G. Breyer, wrote that Skilling's right to a fair trial had been violated on account of the animosity and prejudice that had infiltrated the community at large.

Since the "honest services" statute has been frequently invoked by federal prosecutors in corruption cases, the Supreme Court's narrowing of the law holds tremendous implications for both pending cases and future cases involving Section 1346.

## *SEC v. Tambone:* First Circuit Rejects the SEC's Broad Interpretation of Rule 10b-5

The First Circuit's *en banc* ruling in *SEC v. Tambone* rejected the SEC's expansive interpretation of Rule 10b-5(b), vacating part of a prior ruling by a three-judge panel. No. 07-1384, 2010 WL 796996 (1st Cir. Mar. 10, 2010). The court held that the SEC's interpretation is inconsistent with the text and structure of the rule and U.S. Supreme Court precedent.

As background, in early 2005 the SEC announced that it had reached a $140 million settlement with Columbia Management Advisors, Columbia Funds Distributors and three former employees relating to alleged undisclosed market timing arrangements in the Columbia funds. As the principal underwriter and distributor of the Columbia mutual funds, Columbia Funds Distributors sold shares in the funds and disseminated fund prospectuses to investors. Columbia Management Advisors drafted the prospectuses, which included representations that the Columbia funds prohibited market timing. On May 19, 2006, the SEC filed a civil complaint in the District of Massachusetts against defendants James Tambone and Robert Hussey, who were officers of Columbia Funds Distributors, Inc. The defendants were not alleged to have spoken or authored direct misstatements, but the SEC brought suit based on an "implied representation" theory. The SEC alleged that despite the defendants' awareness of the market timing prohibitions contained in the prospectuses, the defendants distributed the prospectuses while allowing certain preferred customers to engage in market timing in the Columbia funds.

In its complaint, the SEC alleged that the defendants had violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. In addition, the SEC alleged that the defendants had aided and abetted primary violations of Section 10(b) and Rule 10b-5 by Columbia Management Advisors and Columbia Funds Distributors, primary violations of Section 15(c) of the Exchange Act by Columbia Funds Distributors and primary violations of Section 206 of the Investment Advisers Act of 1940 by Columbia Management Advisors. The defendants moved to dismiss the complaint. In 2006, the district court dismissed all of the SEC's claims *en banc*, holding that the SEC did not allege that the defendants made untrue statements or material omissions to investors and therefore did not plead fraud with particularity under Rule 9(b) of the Federal Rules of Civil Procedure.

The SEC appealed the dismissal of its Rule 10b-5(b), Section 17(a)(2) and aiding and abetting claims. In late 2008, a divided panel of the First Circuit reversed and reinstated all of the SEC's primary and aiding and abetting claims. After the First Circuit's initial opinion, upon petition by the defendants, the court ordered the case to be reheard *en banc* to determine whether primary liability under Rule 10b-5(b) could extend to defendants under the theories advanced by the SEC. On *en banc* rehearing, a four-judge majority rejected the panel's reasoning and affirmed the district court's decision to dismiss the SEC's primary violator claims under Section 10(b) and Rule 10b-5(b).[1]

In rejecting the SEC's interpretation of Rule 10b-5(b), the court examined what it means to "make a statement" under Rule 10b-5(b). Based on the ordinary meaning of the word "make" and the absence of evidence that the drafters intended to attach any "exotic meaning" to the word, the court concluded that the SEC's proposed reading was inconsistent with the text of both the statute and the rule. The court further supported its conclusion with a contextual analysis of other statutory provisions of the federal securities laws, highlighting that the drafters specifically and deliberately used the narrower verb "make" in Rule 10b-5 in comparison to other provisions of the federal securities laws (e.g., Section 17(a)(2) and Rule 10b-5(a)).

Finally, in reaching its decision, the court analyzed Supreme Court precedent in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).[2] "Under modern Supreme Court precedent dealing with Rule 10b-5, much turns on the distinction between primary and secondary violators. . . . If *Central Bank*'s carefully drawn circumscription of the private right of action is not to be hollowed—and we do not think that it should be—courts must be vigilant to ensure that secondary violations are not shoehorned into the category reserved for primary violations." *Tambone* at 20–21.

[1] It is important to note that in the *en banc* rehearing the judges unanimously agreed that the district court erred in dismissing the SEC's Section 17(a) and aiding and abetting claims and remanded those claims to the district court for further proceedings.

[2] In *Central Bank*, the Supreme Court rejected Section 10(b) liability for those who assist the fraudulent conduct of others.

## Supreme Court Sheds Light on Limitations Period for Section 10(b) Violations

The U.S. Supreme Court recently clarified when the two-year statute of limitations period begins to run for private securities fraud actions brought under Section 10(b) of the Securities Exchange Act of 1934. In *Merck & Co. v. Reynolds*, the Court held that the two-year limitations period starts to run when a plaintiff discovers, or a reasonably diligent plaintiff should have discovered, the "facts constituting the violation," which includes facts regarding a defendant's scienter or fraudulent intent.[1]

A group of investors filed a securities fraud action under Section 10(b) and SEC Rule 10b-5 in November 2003, claiming that Merck had knowingly misrepresented the heart-attack risks associated with Vioxx®, a drug that it manufactured. Under the applicable statute, a securities fraud complaint will be considered timely if it is filed not later than "2 years after the discovery of the facts constituting the violation" or 5 years after the violation.[2] Merck moved to dismiss the investors' complaint, arguing that their lawsuit was time-barred because the investors had discovered, or should have discovered, facts constituting the securities violation more than two years before they filed suit. Specifically, Merck contended that the following circumstances had, or should have, alerted plaintiff investors to Merck's alleged misrepresentations: (i) a study that compared Vioxx® with the painkiller naproxen in March 2000; (ii) a warning letter from the Food and Drug Administration (FDA) made publicly available on September 21, 2001 claiming that Merck's marketing of Vioxx® was misleading; and (iii) complaints filed in various products liability actions in September and October 2001 claiming that Merck had concealed information about Vioxx®.

[1] *Merck & Co., Inc. v. Reynolds*, No. 08-905, 559 U.S. —, 2010 WL 1655827 (U.S. Apr. 27, 2010).

[2] 28 U.S.C. § 1658(b)(1) & (2).

The District Court for the District of New Jersey had granted Merck's motion to dismiss, finding that the investors' lawsuit was time-barred. The Court of Appeals for the Third Circuit subsequently reversed the opinion of the lower court, finding that, because pre-November 2001 events did not show that Merck had acted with *scienter*, the two-year limitations period had not been triggered at that point.

A unanimous Supreme Court held that the investors' Section 10(b) claim was timely filed and that *scienter* is among the "facts constituting the violation" that a plaintiff must discover in order for the two-year limitations period to begin. Since the plaintiff investors had not discovered facts relating to Merck's *scienter* or fraudulent intent more than two years before filing suit, the complaint was timely filed. Notably, in reaching this determination, the Supreme Court rejected Merck's theory that the lawsuit was time-barred because plaintiffs had been put on "inquiry notice" that Merck had made alleged misrepresentations.

The Supreme Court also clarified what constitutes "discovery" of a Section 10(b) violation. Writing for six justices, Justice Breyer stated that "discovery," such as triggers the two-year limitations period, includes not only a plaintiff's actual discovery of facts constituting the violation, but also facts that a reasonably diligent plaintiff would have discovered. Justices Scalia and Thomas disagreed with the majority's interpretation of "discovery," believing that the statutory language did not provide for such constructive "discovery" by a reasonably diligent plaintiff.

In light of the Supreme Court's holding in *Reynolds*, plaintiffs pursuing securities fraud actions under Section 10(b) may be more likely to succeed against motions to dismiss brought on statute of limitations grounds. For defendants and potential defendants facing Section 10(b) actions, it remains to be seen what facts will be considered sufficient for demonstrating *scienter* so as to trigger the limitations period.

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