CORPORATE LITIGATION:

SOX Certification Requirement and Clawback Provision

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The Sarbanes-Oxley Act of 2002 (SOX), enacted in the wake of several high-profile accounting frauds at public companies, implemented a variety of measures designed to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws. Among the reforms adopted by SOX were: (1) a requirement that the chief executive officer (CEO) and chief financial officer (CFO) of each company filing periodic reports under the Securities Exchange Act of 1934 (the Exchange Act) certify the accuracy of the issuer's financial reports; and (2) a mandate that in the event of "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 CEO and CFO must reimburse the issuer for any incentive- or equity-based compensation they received. In *SEC v. Jensen*, the U.S. Court of Appeals for the Ninth Circuit recently provided needed guidance on the scope of these distinct requirements, adopting an expansive view of liability for CEOs and CFOs under SOX.[1]

The Certification Requirement

Promulgated pursuant to SOX Section 302, Exchange Act Rule 13a-14 provides that each report filed on Forms 10-Q, 10-K, 20-F or 40-F must include a certification signed by the issuer's CEO and CFO, "or persons performing similar functions, at the time of the filing of the report."

The certification must indicate, among other things, that "(1) the signing officer has reviewed the report; (2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made not misleading; (3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer; and (4) the signing officers . . . are responsible for establishing and maintaining internal controls," have designed those internal controls "to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers," have evaluated the effectiveness of the issuer's internal controls within 90 days prior to the date of the report, and "have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation."

In *Jensen*, the Securities and Exchange Commission (SEC) sued Peter Jensen and Thomas Tekulve, the former CEO and CFO of a now-defunct public company, under Rule 13a-14 for alleged participation in a

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scheme to defraud investors by overstating the company's financial results. The suit was premised, in relevant part, on an allegation that the defendant officers signed and filed false certifications. The defendants argued that while Rule 13a-14 creates a cause of action against CEOs and CFOs who fail to sign or file certifications, it "does not create a cause of action based on *false* certifications independent of the existing provisions in the Exchange Act that prohibit fraudulent statements." (Emphasis in opinion.) The district court agreed and granted summary judgment to the defendants dismissing this cause of action; the court explained that "[t]he evidence does not support this claim because the financial statements at issue . . . contained the required certification."[2]

On appeal, the Ninth Circuit reversed. As an initial matter, the court cited Ninth Circuit case law indicating that "signers of documents should be held responsible for the statements in the document" and that a signature signifies that "the signer has read the document and attests to its accuracy." To buttress its conclusion that "a mere signature is not enough for compliance," the court highlighted the wording of Rule 13a-14, noting that the dictionary definition of "certify" is "to testify by formal declaration" or to guarantee or vouch for something.

Though recognizing that it has "not previously had the opportunity to define the scope of Rule 13a-14," the Ninth Circuit noted that it has "in the past concluded that other, similar rules include an implicit truthfulness requirement." The Ninth Circuit had previously held that Rule 13a-13—similarly promulgated under the authority of Exchange Act Section 13(a)—"'requires the filing of quarterly reports that are not misleading,' . . . even though the rule itself states only that issuers are required to file such reports without specifying whether they must be truthful." Similarly, the Ninth Circuit had previously "upheld the SEC's determination that the defendant had violated Rule 13a-1, which requires issuers to file annual reports, by filing reports that contained misleading information."

The *Jensen* court bolstered its ruling with decisions of other circuit courts that reflect a recognition that rules promulgated pursuant to Exchange Act Section 13 "create liability for false statements even when the rules did not explicitly require truthfulness." Accordingly, the *Jensen* court concluded that Rule 13a-14 likewise "includes an implicit truthfulness requirement."

The Clawback Provision

Under SOX 304, commonly referred to as SOX's clawback provision, "[i]f 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 CEO and CFO must reimburse the issuer for "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 [SEC] (whichever first occurs) of the financial document embodying such financial reporting requirement." Additionally, the CEO and CFO must disgorge "any profits realized from the sale of securities of the issuer during that 12-month period."

In its complaint in *Jensen*, the SEC alleged that Jensen and Tekulve violated SOX Section 304 by failing to reimburse the company following the company's restatement. The district court disagreed, concluding that the defendants did not violate Section 304 because the issuer's "restatement was not issued due to any misconduct on the part of Defendants."[3] The district court explained that "Defendants did not act with scienter or negligence in preparing the financial documents that were restated."

The district court further stated that the issuer's outside auditor "found that the restatement was not necessitated by any fraud," and the issuer's board of directors "never made a determination that the restatement was required due to misconduct by Jensen or Tekulve."

On appeal, the SEC argued that "this conclusion was legally erroneous because SOX 304 is concerned not with individual misconduct on the part of the CEO and the CFO, but rather with the misconduct *of the issuer*."[4] The Ninth Circuit agreed. Looking first to the text of SOX 304, the appellate court indicated that the statute requires reimbursement to the issuer in the event of 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.'"[5] According to the Ninth Circuit, "the clause 'as a result of misconduct' modifies the phrase 'the material noncompliance of the issuer,' suggesting that it is the issuer's misconduct that matters, and not the personal misconduct of the CEO or CFO."

In support of its conclusion, the *Jensen* court cited SOX's legislative history, which reflects that the clawback provision was designed to address concerns "about management benefitting from unsound financial statements." Additionally, given the fact that an earlier version of the bill provided for disgorgement if the officer or director "engaged in misconduct resulting in, or made or caused to be made in, the filing of a financial statement," the court concluded that Congress specifically chose not to limit the disgorgement remedy to cases of officer or director misconduct.

The *Jensen* court thus held that "SOX 304 allows the SEC to seek disgorgement from CEOs and CFOs even if the triggering restatement did not result from misconduct on the part of those officers." According to the court, SOX's disgorgement remedy is intended to prevent corporate officers from profiting from misconduct—whether their own or that of the companies they manage.

Significance of 'Jensen'

Jensen provides guidance on important questions regarding the liability of CEOs and CFOs for filing false certifications, as well as the scope of SOX's clawback provision. While it is unclear whether other circuits would take the same approach, *Jensen* makes clear that it is not sufficient for CEOs and CFOs to sign the requisite SOX 302 certification indicating that the relevant SEC filing contains no material misstatements or omissions, without a sufficient basis to believe that the certification is accurate. *Jensen* thus underscores the critical importance of CEOs and CFOs ensuring that they have a reasonable basis to rely on the accuracy of the certifications they sign. *Jensen* also reinforces that the clawback obligation of CEOs and CFOs is not conditioned on these executives' personal involvement in the misconduct that led to the issuer's financial misstatement.

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[1] *SEC v. Jensen*, 2016 WL 4537377 (9th Cir. Aug. 31, 2016).
[2] *SEC v. Jensen*, 2013 WL 6499699, at *31 (C.D. Cal. Dec. 10, 2013).
[3] Id.
[4] *SEC v. Jensen*, 2016 WL 4537377, at *10 (emphasis in original).
[5] Id. (citing SOX 304) (emphasis added by the court).

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