LJN LAW JOURNAL NEWSLETTERS

The Corporate Counselor®

An incisivemedia publication

Volume 24, Number 3 • July 2009

Federal Courts Adopt Narrow Constructions Of Sarbanes-Oxley Legislation

Recent Decisions May be a Harbinger of Federal Courts' Approach In Future Legislation

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Complex and systemic, the current financial crisis is nearly certain to yield extensive legislation regulating everything from the financial markets to mortgage brokers to ratings agencies. Any such legislation may raise interpretive issues similar to those that have arisen in recent Federal Court decisions interpreting section 304 and section 1514A(a)(1) of the sweeping Sarbanes-Oxley Act of 2002 ("SOX"). Although these sections cover very different subjects, the manner in which the courts strictly construed, and thereby limited the reach of, these sections may provide insight into how Federal Courts will apply any broad powers granted by the looming round of legislation.

SOX Section 304

Section 304 of SOX provides for "the forfeiture of certain bonuses and profits by corporate officers who fail to comply with securities law reporting requirements." In both *In re Digimarc Corporation Derivative Litigation* (2008 WL 5171347 (9th Cir. 2008)), and *U.S. v. Shanahan* (2008 WL 5211909 (E.D. Mo.)), Federal Courts narrowly interpreted SOX section 304. In *Digimarc*, the Ninth Circuit found that section 304 does not create a private right of action on the part of shareholders of affected corporations. In *Shanahan*, the U.S. District Court for the Eastern District of Missouri determined that section 304 requires the "actual filing of restated accounting reports" before its provisions will apply.

Under section 304:

> 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 —
>
> (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.

The Securities and Exchange Commission ("SEC") has not adopted rules specifically implementing section 304. Instead interpretation of the statute has been left to the courts.

Digimarc

Background

As a result of overestimated earnings over a period of six quarters, Digimarc Corporation was forced to restate its financial results for the affected fiscal periods. A shareholder derivative action was filed in the U.S. District Court for the District of Oregon which, among other claims, sought disgorgement under SOX section 304 of bonuses and profits earned by Digimarc's CEO and CFO during the relevant period. The District Court dismissed the action, concluding that there was no private right of action under section 304. The shareholder appealed this decision to the Ninth Circuit.

The Court's Analysis

To give rise to a private cause of action in favor of an injured person, "the statute must either explicitly create [that right] or implicitly contain one." The Ninth Circuit noted that "Section 304 does not explicitly create a private right of action." However, because section 304 also does not explicitly deny a private right of action, the court found the section to be "at best ambiguous," and turned its focus to whether the section implicitly creates such a right. This in turn required an inquiry into Congressional intent.

To conduct this inquiry, the court turned to the second of the four-factor test articulated by the U.S. Supreme Court in *Cort v. Ash* (422 U.S. 66 (1975)): whether "'there [is] any indication of legislative intent, explicit or implicit, either to create such a [private] remedy or to deny one.'" Parsing the language of the statute, the *Digimarc* court remarked that "[s]ection 304 focuses on 'the person regulated' rather than the 'individual … who will ultimately benefit from [the statute's] protection.'" This indicated to the Court that "congressional intent weighs decisively against finding a private right of action."

The court also rejected plaintiff's argument that because some sections of SOX expressly disclaim the availability of a private right of action, while section 304 does not, Congress must (through its silence) have intended to provide a private right of action under section 304. Rather, the court looked to an analogous section of SOX, section 306, which also requires

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non-compliant directors and officers to reimburse the issuer through disgorgement of profits in the event of a breach of the statute. Section 306, although otherwise analogous to section 304, explicitly provides a private right of action for affected company shareholders. Thus, the court concluded that it "cannot find in Congress' silence in section 304 an intent to create a private right of action where it was not silent in creating such a right to similar equitable remedies in other sections of the same Act."

Shanahan

Background

Michael Shanahan, Sr. served as CEO and Chairman of the Board of Directors of Engineered Support Systems, Inc. According to an SEC complaint, Engineered Support, with Shanahan's "participation, knowledge and consent," issued backdated stock options in violation of the company's shareholder-approved stock option plans. According to the SEC, this backdating caused Engineered Support to file financial statements containing materially false and misleading statements and omissions of material facts with the Commission. In addition to other relief, the SEC sought disgorgement by Shanahan of bonuses and profits under SOX section 304. In response, Shanahan filed a motion for partial summary judgment, asserting that the SEC "cannot prove a necessary element of" section 304.

The Court's Analysis

Shanahan argued that because Engineered Support never actually filed restated financial statements, section 304 did not apply. The SEC countered that, because an accounting restatement was required under general accounting principles to correct the material errors in the company's financial statements, the fact that such a restatement was not actually filed did not bar the SEC from seeking disgorgement under section 304. The court disagreed with the SEC, ruling that "the ordinary, contemporary, common meaning of section 304 is that, before penalties may be imposed, an issuer must be compelled or ordered to prepare a financial restatement, and must actually file the restatement." Accordingly, because Engineered Support had not actually filed restated financial statements, the court, based on its narrow reading of the statute, granted Shanahan's motion and dismissed the SEC's section 304 claim.

SOX Section 1514A

Section 1514A(a)(1) of SOX was designed to protect so-called "whistleblowers" at publicly traded companies "by prohibiting employers from retaliating against employees [who] provided information about specified potentially unlawful conduct."

In *Day v. Staples, Inc.* (No. 08-1689 (1st Cir. 2009)), and *Harp v. Charter Communications, Inc.* (No. 07-1445 (7th Cir. 2009)), the U.S. Courts of Appeals for the First and Seventh Circuits, respectively, joined the Fourth and Fifth Circuits in narrowly defining the "reasonable belief" requirement of the SOX whistleblower protection provision to encompass both "subjective reasonableness" and "objective reasonableness."

Under section 1514A:

> No [publicly traded company] … may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee … to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee *reasonably believes* constitutes a violation of … [Federal statutes relating to mail fraud, wire fraud, bank fraud or securities fraud], any rule or regulation of the [SEC], or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to … a person with supervisory authority over the employee … . [emphasis added]

As in the case of section 304, there are no SEC rules to help the courts interpret this statute.

Day and Harp

Background

Kevin M. Day filed a complaint with OSHA against his employer, Staples, Inc., "alleging retaliatory termination in violation of the SOX whistleblower protection provisions." Employed by Staples for less than three months before his termination, Day repeatedly complained to his supervisors regarding certain billing and collection practices at Staples. In Day's view, these practices raised the (obviously contradictory) risks of a reduction in Staples's profits and an inflation of supervisors' bonuses. Before Day was terminated due to his "inflexibility," failure to perform "his job well" and threats "not to follow his managers' instructions," he was permitted to air his grievances in a battery of meetings with senior managers. Staples' internal investigation uncovered no wrongdoing on the company's part. After an administrative court dismissed Day's complaint, he filed suit in Federal District Court, which granted summary judgment in favor of Staples. Day appealed to the First Circuit, which affirmed the lower court's decision.

In contrast to Day, Mary L. Harp was an experienced supervisor of the Technical Audit Department of Charter Communications' St. Louis marketing region. As part of her duties, she voiced concerns to her then immediate supervisor, Barry Wilson, that a contractor ("MSTA") was improperly charging for services outside of the scope of its contract. Wilson was receptive to Harp's complaints and scheduled a meeting with Harp, MSTA and others to discuss the allegations. Prior to the meeting, but for reasons that were not made clear in the decision, Wilson arranged for Harp to report to an intermediate supervisor, Tom Baker, who would in turn report to Wilson. Once the meeting devolved into mutual accusations between Harp and MSTA, Wilson "abruptly" called it to a halt without a resolution having been reached.

Harp eventually concluded that her concerns were not being properly addressed. Fearing that Wilson was going to pay the full invoiced amounts to MSTA despite her misgivings, Harp made an oral report of company ethics violations, on the part of Wilson, through the proper internal channels. As it turns out, Charter apparently never made payment of the full amounts claimed by MSTA.

Six weeks after the meeting with MSTA, Charter terminated Harp's employment, along with that of her entire 25-person department, as part of a 50-person reduction in force ("RIF") in response (according to Charter) to an unexpected budget-

ary shortfall in the company's St. Louis marketing area. Harp brought suit in the Southern District of Illinois, alleging that her termination was really in retaliation for her "whistleblowing activities" in violation of SOX section 1514A. The District Court granted summary judgment in favor of Charter. Harp appealed to the Seventh Circuit, which affirmed the lower court's decision.

The Courts' Analysis

Each court began its analysis by focusing on whether "the employee reported specific conduct that constituted a violation of federal law," regardless of whether the employee "correctly identified that law." The *Day* court had little trouble determining that Day's assertions did not "meet the basic components of fraud or of securities fraud," because "a complaint about corporate efficiency is … not within the intended protection of SOX." Conversely, the *Harp* court found that, because the conduct that Harp reported, if substantiated, would in fact constitute fraud in violation of federal law, the fact that her whistleblower report complained of company ethics violations, rather than identifying "the appropriate federal law by name," was not fatal to her claim.

Next, in analyzing each plaintiff's specific claims, the courts (consistent with previous Federal Circuit court decisions) addressed the "reasonable belief" language in SOX section 1514A. According to the courts, "reasonableness must be scrutinized under both a subjective and objective standard. [O]bjective reasonableness 'is evaluated based on the knowledge available to a reasonable person in the same factual circumstances with the same training and experience as the aggrieved employee.'" The First Circuit frankly declared Day's "generalized allegation of inaccuracy in accounting … insufficient to establish a reasonable belief in a violation of GAAP, much less a reasonable belief in shareholder fraud." Reviewing the substance of Harp's allegations, the Seventh Circuit concluded that her subjective belief with respect to her supervisor's allegedly fraudulent conduct provided "simply no objective basis for Harp to have believed that fraudulent payments were authorized on January 12th, or at a later date for that matter."

In dicta, the Seventh Circuit went on to consider whether, even if Harp could have convinced the court that she had an objectively reasonable belief that her employer was engaged in fraudulent conduct, she also could have satisfied her "burden of establishing by a preponderance of the evidence" that her termination constituted a whistleblower violation. Again, the court was not willing to accept Harp's view of the underlying facts regarding whether the RIF was a legitimate basis for her termination of employment, noting that the circumstances of her termination would make her task in carrying her burden of proof "insurmountable." The court noted that "the sheer scope of the RIF is relevant to what inference may reasonably be drawn."

Notably, a dissenting opinion in *Harp* marshaled the facts differently from the majority, leading the dissenting judge to conclude that "there are several factual matters that are sufficiently contested to warrant, in my opinion, determination by a jury." Based on his reading of the facts presented by Harp, the dissenting judge wrote that "it appears to me that she reasonably believed, both subjectively and objectively, that she had been called off the hunt, that her documented findings of fraud were being swept under the rug, and that Barry Wilson had ordered MSTA to be paid in full." Moreover, he was sympathetic to the plight of the concerned employee who believes that a fraudulent act is about to occur, writing that "[t]he employee should not have to wait until the fraud has been accomplished to register a concern." Similarly, the dissenting judge was not prepared to conclude, at least not at the summary judgment stage, that the RIF was the full explanation for the circumstances leading to the termination of Harp's employment.

Conclusion

SOX was enacted in reaction to what appeared to be systemic misfeasance amongst public companies, including the infamous cases of Enron, Worldcom and others. Each section of SOX addresses a separate shortcoming in the then-current regulation of public companies that was exposed by one or more of the accounting scandals. In large part because it was reactionary legislation, many of the provisions of SOX were broadly drafted and, arguably, over-inclusive.

The current financial crisis is exponentially more complex and far-reaching than the accounting and other scandals that spawned SOX, and legislation adopted in the wake of the current crisis may prove proportionately more vast. Thus, the narrow interpretation of SOX sections 304 and 1514A adopted by the Federal Courts in the cases described above may provide valuable insight into how Federal Courts will approach any future legislative regime.