Milbank

Corporate Governance Group

Client Alert

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FEDERAL DISTRICT COURT FINDS THAT MATERIAL ERRORS IN FINANCIAL STATEMENTS — IN THE ABSENCE OF AN ACTUAL RESTATEMENT — NOT SUFFICIENT TO SUPPORT A CLAIM UNDER SECTION 304 OF SARBANES-OXLEY

Actual Filing of Restated Financial Statements Required Before SEC May Bring Action

In a recent Client Alert, we discussed the ruling of the U.S. Court of Appeals for the Ninth Circuit in *In re Digimarc Corporation Derivative Litigation*[1] that section 304 of the Sarbanes-Oxley Act of 2002 ("SOX")[2] does not create a private right of action on the part of shareholders of affected corporations. On December 12, 2008, in *U.S. v. Shanahan*,[3] decided just one day after *Digimarc*, the U.S. District Court for the Eastern District of Missouri similarly adopted a strict constructionist approach in interpreting section 304. In a case of first impression in the Eighth Circuit, the Court determined that section 304, which provides for disgorgement of certain executive officer bonuses and profits in the event "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," requires the "actual filing of restated accounting reports" before its provisions apply.

Background

Under section 304 of SOX:

"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] 2008 WL 5171347 (9th Cir. 2008). This case was described in our Client Alert entitled "Ninth Circuit Finds No Private Right Of Action Under Section 304 Of Sarbanes-Oxley", dated January 5, 2009.
[2] 15 U.S.C. § 7243.
[3] 2008 WL 5211909 (E.D. Mo.).

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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."

The SEC has not adopted rules specifically implementing section 304, instead leaving interpretation to the courts.

Michael Shanahan, Sr. served as CEO and Chairman of the Board of Directors of Engineered Support Systems, Inc., a "holding company for a number of wholly-owned subsidiaries that design and manufacture military support equipment and electronics," from its inception until April 2003 and as Chairman until May 2005. According to a complaint filed by the SEC, Engineered Support, with Shanahan's "participation, knowledge and consent," issued backdated stock options having an exercise price lower than the price of the Company's common stock on the actual award date, in violation of the company's shareholder-approved stock option plans. The SEC further contended that this backdating improperly increased the compensation of Engineered Support's officers, employees and directors, which in turn "caused Engineered Support to file official documents with the Commission that [the company's officers] knew, or were reckless in not knowing, contained materially false and misleading statements and omissions of material facts relating to the Company's stock option program." These "official documents" included the company's financial statements. 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 since Engineered Support never actually filed restated financial statements, section 304 did not apply. The SEC countered that since 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 prepared and filed did not detract from the Commission's ability to seek disgorgement under section 304. In addressing this dispute, the Court noted that "[i]n interpreting the statute, this Court must be guided by the rule that, '[c]ourts properly assume, absent sufficient indication to the contrary, that Congress intends the words in its enactments to carry their 'ordinary, contemporary, common meaning'."[4]

The Court disagreed with the SEC's interpretation of the statute, 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." The Court also determined that its reading of the statute was consistent with the legislative intent. Accordingly, because Engineered Support had not actually filed restated financial statements, the Court granted Shanahan's Motion for Partial Summary Judgment and dismissed the SEC's section 304 claim.

Conclusion

As with the Ninth Circuit Court of Appeals' decision in *Digimarc*, the *Shanahan* Court narrowly construed the reach of section 304. This decision creates yet another barrier to penalizing corporate officers for wrongdoing under this section. Perhaps partially in response to continued criticism that the SOX legislation, and the SEC's rule-making thereunder, reflect an over-reaction to the problems they were intended to address, these two recent decisions suggest that courts will continue to narrowly construe, and thereby limit the reach of, this and other provisions of SOX.

[4] *Pioneer Inv. Servs. Co. V. Brunswick Assoc. Ltd. Partnership*, 507. U.S. 380, 388 (1993) (quoting *Perrin v. United States*, 444 U.S. 37, 42 (1979).

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