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Corporate Governance Group

Client Alert

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NINTH CIRCUIT FINDS NO PRIVATE RIGHT OF ACTION UNDER SECTION 304 OF SARBANES-OXLEY

Individual Shareholders not Permitted to Bring Action to Recoup Bonuses or Profits From Corporate Executives

In *In re Digimarc Corporation Derivative Litigation*,¹ the U.S. Court of Appeals for the Ninth Circuit ruled on December 11, 2008 that section 304 of the Sarbanes-Oxley Act of 2002 (“SOX”),² which “provides for the forfeiture of certain bonuses and profits when corporate officers fail to comply with securities law reporting requirements,” does not create a private right of action on the part of shareholders of affected corporations. According to the Court, the Ninth Circuit is the first Federal circuit to rule on this issue, although “a number of district courts have squarely addressed the issue and have concluded that there is no such right.” As a result of the *Digimarc* ruling, going forward, it will be up to the Federal government to enforce this aspect of the SOX legislation.

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 –

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¹ *In re Digimarc Corporation Derivative Litigation*, 2008 WL 5171347 (9th Cir. 2008).

² 15 U.S.C. § 7243.

(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.”

Clearly, section 304 was included in SOX to put the onus on CEO’s and CFO’s (in addition to the CEO and CFO certification requirements) to take additional steps to try to make sure that their companies’ financial statements comply with SEC rules. However, unlike so many other sections of SOX, the SEC has not adopted rules specifically implementing section 304.

On September 13, 2004, Digimarc Corporation, a self-proclaimed “leading supplier of secure personal identification systems,” publicly announced that it had likely overestimated earnings for the previous six quarters due to a failure to properly record the costs of internal software development as expenses. As a result, Digimarc was forced to restate its financial results for the affected fiscal periods. Several shareholder suits were subsequently filed, including a derivative action brought by George Diaz 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 executives during the relevant period. The District Court dismissed the action, concluding that there was no private right of action under section 304. Diaz appealed this decision to the Ninth Circuit.

The Court’s Analysis

The Ninth Circuit began its analysis by stating that “[T]he fact that a federal statute has been violated and some person harmed does not automatically give rise to a private cause of action in favor of that person. . . . Instead, the statute must either explicitly create a right of action or implicitly contain one.” Next, the Court noted that “Section 304 does not explicitly create a private right of action because nothing in the text of the section makes any mention of a cause 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, requiring an inquiry into Congressional intent.

To conduct this inquiry, the Court turned to the four-factor test created by the U.S. Supreme Court in *Cort v. Ash*.³ Under *Cort*, in order to determine whether there is “clear evidence of congressional intent” to create an implied private right of action under any particular piece of Federal legislation, a court must consider “(1) whether the plaintiff is ‘one of the class for whose especial benefit the statute was enacted - that is, [whether] the statute create[s] a federal right in favor of the plaintiff’; (2) whether ‘there [is] any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one’; (3) whether the cause of action is ‘consistent with the underlying purposes of the legislative scheme’; and (4) whether ‘the cause of action [is] one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law’.”

³ *Cort v. Ash*, 422 U.S. 66, 78 (1975).

Focusing on the second *Cort* factor, the *Digimarc* Court remarked that “Section 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.” Nevertheless, the Court noted that “to satisfy our inquiry into legislative intent,” it was required to “examine the entire statutory scheme provided by Congress”⁴ by comparing section 304 to analogous sections of SOX. In this regard, the Court rejected plaintiff’s argument that because some sections of SOX expressly disclaim the availability of a private right of action,⁵ while section 304 does not, Congress must (through its silence) have intended to provide a private right of action under section 304. According to the Court, such reasoning would “turn *Cort* on its head”.

Rather, the Court looked to what it considered to be the most analogous section of SOX, section 306,⁶ which provides that “it shall be unlawful for any director or executive officer ... to purchase, sell or otherwise acquire or transfer any equity security of the issuer ... during any [pension fund] blackout period with respect to such equity security if such director or officer acquires such equity security in connection with his or her service or employment as a director or executive officer. As in the case of section 304, section 306 requires non-compliant directors and officers to reimburse the issuer through disgorgement of profits in the event of a breach of the statute. Despite this similarity to section 304, because section 306 also explicitly provides (in contrast to section 304) for a private right of action on the part of affected company shareholders to recover profits, 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.”

Finally, the Court noted that it was not required to analyze the remaining three *Cort* factors. According to the Court, a finding that “the first two *Cort* factors weigh against finding a private right of action is dispositive of our inquiry.” Moreover, it was the Court’s view that even if it were to conclude that plaintiff “would prevail under the first *Cort* factor, that is not enough to offset the [Court’s finding under the second *Cort* factor that the] clear text and structure of section 304” argue against a Congressional intent to provide an implied private right of action. Thus, the Ninth Circuit agreed with the lower court that it lacked federal question jurisdiction over Diaz’s claims against the *Digimarc* executives and upheld dismissal of Diaz’s lawsuit.

Conclusion

Assuming that the other Federal circuits follow the lead of the Ninth Circuit in *Digimarc*, it seems clear that individual shareholders who suffer a decline in the market prices of their shares due to accounting irregularities or other violations of SEC rules will not have access to the Federal courts through actions to seek disgorgement of executive bonuses and profits under SOX section 304, but instead will be compelled to pursue their claims against corporate executives under state law. Furthermore, it would appear that shareholders will generally have a difficult time convincing Federal courts to allow them to pursue claims under other sections of SOX that, similar to section 304, do not expressly contemplate enforcement through private rights of action.

⁴ Citing *Opera Plaza Residential Parcel Homeowners Ass’n v. Hoang*, 376 F.3d 831, 836 (9th Cir. 2004).

⁵ In this regard, plaintiff cited section 303 of SOX, which makes it unlawful for any officer or director of an issuer to improperly influence the issuer’s outside accountants in connection with the performance of their audit “for the purpose of rendering such financial statements materially misleading,” and section 804 of SOX, which extended the statute of limitations for certain actions.

⁶ 15 U.S.C. § 7244.

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