ANDREWS LITIGATION REPORTER

THOMSON WEST

Securities Litigation & Regulation

COMMENTARY

REPRINTED FROM VOLUME 11, ISSUE 22 / MARCH 8, 2006

Courts Deny Plaintiffs' Lawyers a Role In Enforcing Sarbanes-Oxley Section 304

By Peter L. Welsh, Esq.*

Two recent decisions by federal courts in Pennsylvania and New York have rejected the latest attempt at rent-seeking by entrepreneurial class action plaintiffs' attorneys. Through decisions declining to recognize a private right of action under Section 304 of the Sarbanes-Oxley Act, the United States District Courts for the Eastern District of Pennsylvania and for the Southern District of New York have rightly left to the Securities and Exchange Commission (SEC) the task of seeking disgorgement of executive pay following a material restatement by a corporate issuer.

As each of these courts has found, this was Congress's intent in enacting Section 304. It is also efficient. Because the SEC is inevitably on the scene when an issuer restates its financials, the Commission's Division of Enforcement is entirely capable of ferreting out fraud or other misconduct associated with any restatement. Any productive role for plaintiffs' attorneys in this process, if any, is extremely limited. Allowing a private right of action under Section 304 would only promote economic inefficiency with little to no social benefits.[1]

Section 304

Section 304 of Sarbanes-Oxley was intended to provide a nearly automatic mechanism for compelling chief executive officers and chief financial officers to disgorge bonuses, equity gains, and other incentive-based compensation and benefits earned during the period preceding a material restatement by their corporation and where the circumstances leading to the restatement involve misconduct.[2] Section 304 was intended to prevent CEOs and CFOs from benefiting from any material misrepresentations of their corporation's financial statements. It provides for mandatory disgorgement where it is shown that the restatement was the result of "material noncompliance" with any financial reporting requirement and that such non-compliance is the "result of misconduct."

In recent months, at least five courts have been presented with the question of whether a private right of action exists under Section 304 of Sarbanes-Oxley.[3] None has recognized such a private right of action, and two have specifically held that there is no such private right of action. In *Neer v. Pelino* and *In re Bisys Securities Litigation*, the courts held that the plain language of Sarbanes-Oxley, as well as the congressional intent as revealed by the Act's legislative history, preclude recognizing a private right of action under Section 304.

Neer v. Pelino

Neer involved four restatements by the Stonepath Group. Inc., a "non-asset-based third-party logistics services company." The first of these restatements involved reductions of between 27% and 97% in quarterly net income over a two year period. The second restatement reduced net income by 15%. Two additional restatements followed. Prior to these restatements, Stonepath had an aggregate net loss for the period 2001 through 2003 of approximately $54.7 million. As a result of the restatement, Stonepath's aggregate net loss during 2001 through the first six months of 2004 widened by approximately $16.3 million.

Following announcement of the last of these restatements, Stonepath shareholders brought suit in federal court. The suit alleged violations of Section 304 of Sarbanes-Oxley, breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets, and unjust enrichment. The defendants moved to dismiss the Section 304 claim for lack of standing and sought dismissal of the rest of the action for lack of federal jurisdiction. The court allowed the motion and dismissed the entire action.

In dismissing the action, the court held that Section 304 of Sarbanes-Oxley did not create either an express or an implied private right of action. In so holding, the court noted that the United States Court of Appeals for the Third Circuit has directed that "'a court may find [an implied right of action] only where it can *confidently conclude* Congress so intended.'"[4] Applying the four part test set forth by the Supreme Court in *Cort v. Ash*,[5] the court found that Congress did not clearly intend to create a private right of action under Section 304. The court observed that the Act explicitly provides for a private right of action to enforce the pension fund trading blackout restrictions under Section 306. Section 304, by contrast, lacks such an explicit provision. *Expressio unius est exclusio alterius*, noted the court.

Finding no definitive guidance in the text of the statute, the court also reviewed the legislative history of Sarbanes-Oxley and found that the history clearly establishes that Congress did not intend to create a private right of action under Section 304. In particular, the court found that the House of Representatives was divided between those, on the one hand, who believed that the Act should provide that only the SEC has the power to enforce Section 304 and those, on the other hand, who believed that the SEC should be directed to formulate a rule addressing *inter alia* enforcement of the Section. "Yet one point is clear: neither supporters nor opponents of the House draft wanted to give private parties the right to seek disgorgement under this provision."[6] Nothing in the Senate Report indicates any intent that departs from that of the House of Representatives. The court found that the Act, as passed, implemented the House's intent that the SEC enforce Section 304.

In re Bisys Group, Inc. Derivative Action

In *Bisys*, like *Neer*, the plaintiffs brought suit in federal court under Section 304 and a variety of state law theories. The court concluded that there is no private right of action under Section 304 and consequently dismissed the entire action. The court held simply "there is no private right of action under Section 304 of Sarbanes-Oxley, substantially for the reasons stated in *Neer*."[7]

The holdings of *Neer* and *Bisys* are, moreover, buttressed by dicta in *Cree*[8] and *Freidman's*.[9]

While the courts in *Neer* and *Bisys* focused principally on whether Congress intended that private litigants enforce Section 304, another of the *Cort* v. *Ash* factors weighs against finding a private right of action implied under Section 304. *Cort* v. *Ash* directs courts, in addition to considering legislative intent, to look at whether recognizing a private right of action would be consistent with the underlying purpose of the statute.[10] The purposes of Sarbanes-Oxley would not be furthered by creating a private right of action under Section 304.

Recognizing a private right of action under Section 304 would attract entrepreneurial plaintiffs' attorneys.[11] Indeed, in each of the Section 304 actions discussed herein, the plaintiffs were represented by plaintiffs' class action firms. Such firms are compensated on a contingency fee basis, typically earning a percentage of the funds recovered in the litigation. In a Section 304 case, moreover, a plaintiffs' firm earns its fees out of the compensation recovered from the defendants. The fees therefore reduce dollar-for-dollar the company's recovery of any amounts under Section 304. It is a zero sum game.

While the costs of permitting plaintiffs' attorneys to claim a percentage of the recovery in a Section 304 case are clear, the benefits of permitting them to bring Section 304 actions are far from clear. A principal purpose of the fee structure in a typical shareholder class or derivative action is to reward plaintiffs' firms for ferreting out and bringing actions that would otherwise not be identified and brought. The promise of a fee upon successfully identifying and asserting a private right of action encourages plaintiffs' firms to monitor corporate governance and disclosure in order to identify instances of actionable misconduct.

In the context of Section 304, however, there is little role for such entrepreneurial plaintiffs' firms. A prerequisite to any Section 304 claim is a material restatement of the corporation's earnings that results from misconduct. Such restatements are highly public affairs, and the staff of the SEC routinely vets the circumstances leading to such restatements. A material restatement resulting from misconduct does not go unnoticed by the SEC and, in most cases, the SEC becomes intimately familiar with the circumstances surrounding such a restatement. The SEC also possesses the enforcement tools necessary to bring an action under Section 304. By the time an issuer restates its earnings, therefore, an entrepreneurial plaintiffs' firm has little to add to the process and certainly nothing to add that would justify the level of fees typically earned by such firms. Any such fees would be little more

than a form of economic rent to be earned by plaintiffs' firms while providing little to no benefit to shareholders or to the public at large.[12]

Conclusion

The *Neer* and *Bisys* courts' refusals to recognize a private right of action thus promote not only Congress' intent but also economic efficiency and social welfare.

Notes

[1] For a recent example of the inefficient, rent-seeking behavior of shareholder plaintiffs' firms, *see*, *e.g.*, *In re Cox Communications, Inc. S'holder Litig.*, No. CIV. A 613-N, 2005 WL 1355478 (Del. Ch. June 6, 2005).

[2] Section 304 provides as follows:

> (a) 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 the 12-month period.
>
> 15 U.S.C. § 7243.

[3] *In re Bisys Group Inc. Deriv. Action*, No. 04 Civ. 4600 (LAK), 2005 WL 2847424 (S.D.N.Y. Oct. 31, 2005); *Neer* v. *Pelino*, 389 F. Supp. 2d. 648 (E.D.Pa. Sept. 27, 2005); *In re QWEST Comm. Int'l Sec. Litig.*, 01 CV 01541, 2005 WL 2351319 (S.D.N.Y. Sept. 23, 2005); *In re Friedman's Inc. Deriv. Litig.* 386 F. Supp. 2d 1355 (N.D. Ga. 2005); *In re Cree, Inc. Sec. Litig.*, No. 03 CV 00549, Fed. Sec. L. Rep. 93,327, 2005 WL 1847004 (M.D.N.C. Aug. 2, 2005).

[4] *Neer*, 389 F. Supp. 2d. at 653 (quoting *Dep't of Envtl. Protection & Energy v. Long Island Power Auth.*, 30 F.3d 403, 421 (3d Cir. 1994)) (emphasis added by court).

[5] 422 U.S. 66, 78 (applying four part test, which reviews 1) whether plaintiff is one of the class for whose special benefit the statute was created, 2) whether there is any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one, 3) whether it is consistent with the underlying purpose of the legislative scheme to imply such a remedy by the plaintiff, and 4) whether the cause of action is one traditionally relegated to state law.).

[6] *Neer*, 389 F. Supp. 2d at 657.

[7] *In re Bisys Group, Inc. Deriv. Action*, 2005 WL 2847424 at *1.

[8] *Cree*, 2005 WL 1847004, *15.

[9] *Friedman's*, 386 F. Supp. 2d 1368, n. 20.

[10] *Cort*, 422 U.S. at 78.

[11] *See, e.g.*, Jonathan R. Macey and Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. Chi. L. Rev. 1, 3 (discussing the class and derivative action plaintiffs' attorney as "entrepreneurs who bear a substantial amount of the litigation risk and exercise nearly plenary control over all important decisions in the lawsuit.")

[12] See, e.g., Gordon Tullock, The Welfare Costs of Tariffs, Monopoly and Theft, 5 Western Econ. J. 224 (June 1967).

** Peter L. Welsh is an associate in the Boston office of the law firm of Ropes & Gray LLP. Mr. Welsh practices in the areas of securities litigation, director and officer litigation and representation, and corporate governance. He is the chair of the ABA's Committee on Director and Officer Liability Litigation and serves on the ABA Business Law Section's Task Force on Director and Officer Liability. The statements contained in this article do not necessarily represent the views of Ropes & Gray LLP or its clients and are not intended to constitute and do not constitute legal advice.* *Reprinted with permission of Washington Legal Foundation. © 2006.*