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It's an SEC Option

Sarbanes-Oxley's disgorgement section creates no private claim.

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Section 304 of the Sarbanes-Oxley Act—which requires chief executive and financial officers to reimburse their company for incentive-based compensation and stock trading profits received during the 12 months before an announcement of an accounting restatement resulting from "misconduct"—constitutes one of the statute's more puzzling provisions. One major issue has been whether Section 304 creates an implied private right of action.

On Sept. 27, in *Neer v. Pelino*, U.S. District Judge Stewart Dalzell of the Eastern District of Pennsylvania ruled, in a matter of first impression, that Section 304 does not provide a right of action for shareholders derivatively against the corporate officers. By extension, the logic of Dalzell's decision should also preclude suits by the corporation itself.

Dalzell concluded that the statutory language and context of Section 304, as well as its legislative history, indicate that Congress intended for the section to be enforced only by the Securities and Exchange Commission.

In reaching this conclusion, Dalzell had to grapple with some thorny issues of statutory interpretation arising from Sarbanes-Oxley. He had to reconcile statutory provisions that may or may not have been envisioned as an integrated piece of legislation. Plus he delved into murky legislative history that provided only limited guidance about Congress' intent.

While some finer points of Dalzell's analysis may be open to debate, his conclusion is sound: Nothing in Sarbanes-Oxley affirmatively evinces a congressional intent to create a private right of action.

No Express Language

The unusual circumstances under which the Sarbanes-Oxley Act was passed are well known.

In July 2002, in the wake of the WorldCom scandal, there was strong public pressure for quick action to address perceived corporate abuses. Despite significant differences between the House and Senate versions of the corporate-reform legislation, a House-Senate conference committee agreed on a final bill in little less than a week. The legislation was enacted shortly thereafter. The House-Senate conference report that accompanied the final version of the bill contained no substantive comment on the law.

In these circumstances it is difficult to imagine that members of Congress had much time or inclination to consider carefully how the provisions of the statute should interact with one another.

Section 304 is one of numerous new remedial provisions created by Sarbanes-Oxley. Titled "Forfeiture of Certain Bonuses and Profits," it provides:

"(a) *Additional compensation prior to noncompliance with Commission financial reporting requirements*. 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.

"(b) *Commission Exemption Authority*. The Commission may exempt any person from the application of subsection (a), as it deems necessary and appropriate."

At issue in *Pelino* was whether a shareholder of Stonepath Group Inc. should be allowed to bring a derivative action under Section 304 against the former and current officers and directors of the company after a series of accounting restatements between 2003 and 2005. The defendants moved to dismiss for lack of federal subject-matter jurisdiction. The court was called upon to address whether Congress intended to create, either expressly or by implication, a private right of action for shareholders under Section 304.

To answer this question, the court first noted that the lan-

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guage of Section 304 does not confer on private parties any express right of action.

The plaintiff put forward two arguments for finding such a right in the statute despite the absence of express language.

First, the plaintiff argued that Section 304(a) creates a reimbursement right for issuers that should be enforceable by shareholders through a derivative action. This provision, which creates the substantive rule regarding forfeiture of bonuses and profits, states that the CEO and CFO "shall reimburse the issuer." It could be read to establish a legal obligation that benefits the issuer.

The court, however, characterized Section 304(a)'s remedy as disgorgement and held that disgorgement is an "equitable remedy" intended to punish wrongdoers, rather than to reimburse an injured class.

Second, the plaintiff contended that the authority granted to the SEC under Section 304(b) to "exempt any person from the application" of Section 304(a) would be unnecessary if the SEC had sole enforcement power under the statute.

But the court interpreted this language as providing the SEC with discretion to consider other factors (type of misconduct, persons involved, etc.) when deciding whether to bring an enforcement action.

In Context

Having rejected the plaintiff's "plain text" arguments, the court then looked to other provisions of Sarbanes-Oxley to determine if they shed any light on the enforcement issue.

Of particular importance to the court was Section 306, which prohibits directors and executive officers from buying or selling their company's equity securities during so-called pension fund blackout periods. Section 306(a)(2) provides for a right of action by the issuer, or by a shareholder if the issuer fails to bring suit within 60 days of a shareholder demand notice, to recover blackout-period trading profits. For the court in *Pelino,* this was evidence that "when Congress wished to provide a private right of action, it knew how to do so and did so expressly."

Citing the interpretative canon *expressio unius est exclusio alterius* ("express mention of one thing implies the exclusion of another"), the court reasoned that, because Congress expressly created such a right in Section 306 and did not do so in Section 304, the "natural inference" is that Section 304 was not intended to provide a private right of action.

The court acknowledged that other provisions of Sarbanes-Oxley might point in the opposite direction. For example, Section 303 (addressing improper influence on auditors) expressly provides that the SEC will have exclusive enforcement authority. Similarly, Section 804 (extending the statute of limitations for securities fraud cases) states that it creates no new private rights of action. These provisions might suggest that Congress also knew how to grant exclusive authority to the SEC or to exclude private rights of action, if that was its intent.

But the court reasoned that Section 306 is the more apt comparison. In the court's view, Sections 304 and 306 share an important characteristic in that "each provides for issuers to be reimbursed with wrongdoing officers' profits."

Congressional Intent

Perhaps mindful of these textual difficulties, the court looked to the legislative history of the statute for further guidance as to Congress' intentions.

As the court noted, Section 304 had its origins in President George W. Bush's "Ten-Point Plan to Improve Corporate Responsibility and Protect America's Shareholders," issued in March 2002. The fourth point in the president's plan stated that "CEOs or other officers should not be allowed to profit from erroneous financial statements." Both the House and Senate finance committees attempted to implement this concept in their versions of Sarbanes-Oxley.

The House bill required the SEC to (1) describe the conditions under which an officer would be required to disgorge profits, including what constituted an accounting restatement; (2) establish appropriate exceptions and exemptions to the provision; (3) identify the applicable *scienter* requirement; and (4) specify that enforcement was to lie solely with the SEC and that any profits disgorged should go to the issuer.

But the House bill did not actually mandate disgorgement. Instead it directed the SEC to study the issue to determine whether disgorgement was "necessary or appropriate in the public interest and for the protection [of] investors." As a result, the provision was heavily criticized by the House minority, which called on Congress to "act quickly to provide the SEC with power to require disgorgement of compensation in an administrative proceeding."

The court in *Pelino* offers these remarks as evidence that both the majority and the minority in the House intended for Section 304 to be enforced by the SEC, not by private litigants. According to the court, "Neither supporters nor opponents of the House draft wanted to give private parties the right to seek disgorgement under this provision."

The Senate adopted a much different version of a disgorgement provision, which was incorporated into the final bill without amendment as Section 304. Unlike the House bill, the Senate version did not state how the law should be enforced, nor did it refer to *scienter* or the other requirements addressed in the House bill. In particular, it did not purport to vest enforcement authority in the SEC. The only specific remedial provision was the one empowering the SEC to make exemptions.

Still, the Senate language could be seen as consistent with the House position that no one in Congress favored giving private parties the power to compel disgorgement. That was the view adopted by the *Pelino* court.

Notwithstanding the uncertainties surrounding the provision's language and history, the *Pelino* court's decision that no private right of action should be inferred under Section 304 is an entirely reasonable outcome given the lack of affirmative evidence that Congress intended to create such a right.

As *Pelino* demonstrates, courts will continue to confront many uncertainties in discerning the intent of Congress in the Sarbanes-Oxley Act. But in this case, at least, the court has taken a sound approach.

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