

ALERT



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SECTION 304: ALL BARK AND NO BITE?

DISTRICT COURT FINDS NO PRIVATE CAUSE OF ACTION IMPLIED BY SECTION 304 OF SARBANES-OXLEY

On September 27, 2005, in *Neer v. Pelino*, Case No. 04-4791, (E.D.Pa. Sept. 27, 2005), the United States District Court for the Eastern District of Pennsylvania dismissed a private shareholder suit seeking, among other things, to recover bonus compensation paid to company officers under Section 304 of the Sarbanes-Oxley Act of 2002 ("SarbOx" or the "Act"). The court dismissed the complaint after finding that Congress did not intend to create an implied cause of action in Section 304 of the Act and, as a result, the court lacked subject matter jurisdiction as the remaining claims alleged violations of state law. To the extent other jurisdictions adopt its reasoning, the *Neer* decision represents a substantial limitation on the otherwise potentially draconian scope of Section 304, and is a clear set-back to the plaintiffs' bar. We expect that other pending cases will continue to test the limits of Section 304. The *Neer* decision, however, suggests that Section 304 may have more bark than bite, and may not appreciably enhance the remedies previously available to private parties and the Securities and Exchange Commission.

Section 304 requires an issuer's CEO and CFO to reimburse the issuer for "any bonus or other incentive-based or equity-based compensation" and "any profits realized from the sale of securities of the issuer" during the 12-month period following the issuance of a financial statement that was subsequently required to be restated because of "misconduct."¹ The provision is notable because it appears to require disgorgement even in the absence of any misconduct or fault on the part of the CEO or CFO.

The Act represents the Congressional response to a series of corporate scandals, notably Enron, Tyco and WorldCom, that shocked regulators, legislators, and

¹ Sarbanes-Oxley Act, §304, Pub.L.No. 107-204, 116 Stat. 745 (2002).

investors with their brazenness and sheer magnitude; Section 304 represents the legislative reaction to the officers of these companies who distorted financial statements to mislead the public while simultaneously accepting exceptionally generous incentive compensation based on those misstatements. Read literally, Section 304 imposes strict liability on CEOs and CFOs to return all bonus, incentive or equity-based compensation received and profits realized from the sale of company stock within the prescribed 12-month period, regardless of whether they were personally culpable for the misconduct. The scope of liability imposed under Section 304 is potentially draconian, and the silence of the Section on whether it may be enforced through a private action has inspired a number of private plaintiffs to seek disgorgement under Section 304.²

In *Neer v. Pelino*, plaintiff Ronald Jeffrey Neer, a shareholder in the Stonepath Group, Inc. sought disgorgement under Section 304 from Stonepath's CEO and CFO following four restatements, in August and November of 2003, January 2004 and January 2005, of the Stonepath financial statements filed with the Commission. Prior to the decision by the District Court, no court had ruled on whether Section 304 contained an implied private right of action.

Finding no textual evidence of a private right of action in Section 304, the District Court analyzed the structure of the Act as a whole. The District Court noted that Congress created an explicit private right of action in only one section of the Act -- Section 306. "The contrast between Sections 304 and 306," stated the

District Court, "is apparent... Because Congress explicitly created a private right of action in Section 306 and did not do so in Section 304, the natural inference is that Congress did not intend to create a private right of action in Section 304. *Expressio unius est exclusio alterius*." The District Court found itself "left with the core reality that Congress expressly granted a private right of action in Section 306, a provision sharing important features with Section 304, yet elected not to do so in Section 304. We will not disturb that election."

The holding in *Neer v. Pelino*, to the extent it is followed in other jurisdictions,³ appears to keep the deterrent value of Section 304 within the pale of existing securities regulation. Despite the proliferation of private suits seeking redress pursuant to Section 304, the Commission has yet to use Section 304 in any enforcement action. Instead, the Commission has sought equitable remedies under Section 21(e) of the Securities Exchange Act of 1934, which empowers the Commission to obtain injunctive relief for violations of the securities laws.⁴

As the Commission already is authorized to seek, and has sought, such remedies in equity, Section 304 would only serve to augment the power of the Commission to seek restitution of CEO and CFO compensation in cases where the CEO and CFO are not personally responsible for the misconduct leading to the restatement. If the Commission were to institute an enforcement action in such a case, it is possible that a court may determine that such a remedy would be "clearly arbitrary and irrational" to the extent the *amount* of

² For example, Red Hat, Inc., Computer Associates International, Inc., Goodyear Tire & Rubber Co., Microtune Inc., I2 Technologies Inc., Interpublic Group of Companies, Inc. and Sportsline.com, Inc., among others, have all been named as defendants in civil lawsuits by private plaintiffs seeking disgorgement under Section 304.

³ As noted, the *Neer* case neglected to "trudge through all four of the factors" presented in *Cort*. Thus, it remains to be seen whether an analysis of the four enumerated factors will support a conclusion finding no private right of action, particularly if the issuer, rather than a shareholder, were plaintiff. The authors note that several shareholder plaintiffs have either demanded an issuer seek restitution of incentive compensation under Section 304 (e.g., Sportsline.com, Inc.) or alleged breaches of fiduciary duties based on an issuer's failure to seek restitution of incentive compensation under Section 304 (e.g., Quality Dining, Inc. and I2 Technologies, Inc.).

⁴ See 15 U.S.C. §78u(e).

compensation to be disgorged is unrelated to the underlying misconduct.⁵ Such an arbitrary application of the Section arguably would not be "rationally related to the government's interest in preventing fraud,"⁶ and therefore might be held unconstitutional.⁷ If Section 304 is thus circumscribed, then it adds little to the

Commission's repertoire. Without a private right of action, it similarly provides nothing for the plaintiffs' bar. It thus appears possible that, in the aftermath of Enron, WorldCom, Tyco and others, it was the spirit of the response, and not necessarily the substance, that carried the day.

⁵ *Traficanti v. United States* 227 F.3d 170, 176 (4th Cir. 2000) (citing *Hodel v. Indiana*, 452 U.S. 314, 331 (1981)).

⁶ *Traficanti* at 175.

⁷ See generally, Stephen Fraidin, Andrew M. Genser and Daniel S. Hoverman, "Payback: Disgorging bonuses, equity and incentive-based compensation under Sarbanes-Oxley's Section 304," *International Journal of Disclosure and Governance*, Volume 2, Number 1, (February 2005).

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