Ninth Circuit Finds No Private Right of Action Under Section 304 of the Sarbanes-Oxley Act

On December 11, 2008, the United States Court of Appeals for the Ninth Circuit issued its decision in *In re Digimarc Corporation Derivative Litigation*.[1] The decision addresses the question of whether Section 304 of the Sarbanes-Oxley Act,[2] provides a private right of action under which shareholders may bring suit. The Court of Appeals found that Section 304 does not provide a private right of action.[3]

I. Background and Procedural History

Digimarc Corporation ("Digimarc")[4] was a publicly traded company that described itself as a "leading supplier of secure personal identification systems," including watermarked personal identification documents and driver licenses.[5] On September 13, 2004, Digimarc announced that the company was reviewing certain of its accounting practices for possible errors in the reporting of its financial results for the years 2002 to 2004. The announcement stated that certain software development costs might have been improperly capitalized and that a restatement of its previously issued financial statements might be required.

Several class action lawsuits were filed within a month of Digimarc's announcement, despite the fact that the full extent of the accounting errors was not yet known.[6] In addition, two shareholder derivative complaints, later consolidated, were filed against nominal defendant Digimarc and a number of individual defendants in California Superior Court, stating claims for breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets, unjust enrichment, and violation of the California Corporations Code.

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1 *See* No. 06-35838, -- F.3d --, 2008 WL 5171347 (9th Cir. Dec. 11, 2008).

2 Section 304 (15 U.S.C. § 7243) provides, in pertinent part:

> (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
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> (1) Any bonus or other incentive-based or equity-based compensation received by that person from the issuer during that 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
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> (2) any profits realized from the sale of securities of the issuer during the 12-month period.

3 The Court of Appeals declined to dismiss the case because of subject matter jurisdiction premised upon diversity. *See infra*.

4 Digimarc is a Delaware Corporation with its headquarters in Oregon. The individual defendants were all current or former officers or directors and were citizens of Oregon. Plaintiffs were citizens of New York, and were shareholders in the corporation at all relevant times. *In re Digimarc Corp. Derivative Litig.*, 2006 WL 2345497, at *1 (D. Or. Aug. 11, 2006).

5 In August 2008, Digimarc separated its security identification and digital watermark businesses, spinning off the latter to its shareholders. References to Digimarc in this memorandum are to the company as it existed at the time of the litigation and prior to such transaction.

6 On April 5, 2005, Digimarc issued a formal restatement that indicated earnings had been overstated by approximately $2.7 million.

In November 2004, another shareholder, Christopher Beasley, made a demand on Digimarc to remedy the alleged breaches of fiduciary duty on which the California derivative actions relied.[7] Digimarc responded on January 5, 2005 by appointing a Special Litigation Committee ("SLC") to independently investigate these claims.[8] Beasley ultimately filed another shareholder derivative action in April 2005 in the Circuit Court of Oregon for Washington County against Digimarc and a number of individual defendants.[9]

Digimarc moved in California Superior Court to dismiss the present action on *forum non conveniens* grounds. The court granted that motion in July 2005, conditioning its order on Digimarc's representation that it would submit to jurisdiction in an Oregon court and that the statute of limitations would be tolled as of the date of filing in California. Instead of filing in Oregon state court, however, plaintiffs separately brought new derivative actions in the District Court for the District of Oregon in August 2005, each adding a claim under Section 304 of the Sarbanes-Oxley Act for disgorgement.[10]

On October 17, 2005, the individual defendants filed a motion to dismiss for lack of jurisdiction, on the grounds that Section 304 does not provide a private right of action and that the parties were not diverse because Digimarc should be aligned as a plaintiff in the action.[11] The district court found that there was no private right of action under Section 304, and that plaintiffs therefore lacked standing to assert the only federal law claim in the complaint.[12] Turning to the diversity jurisdiction argument, the district court found that the facts failed to meet the "actively antagonistic" exception to the general rule that a corporation in a derivative suit is to be aligned as a plaintiff for diversity purposes.[13] Thus, the court granted defendants' motion to dismiss. Plaintiffs appealed that decision, and the United States Court of Appeals for the Ninth Circuit affirmed in part and reversed in part, remanding the case to the district court for further proceedings.

II. The Court of Appeals' Decision

The Court of Appeals noted as an initial matter 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.'" For a statute to establish a private right of action, Congress must have intended for that right of action to exist, and

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7 The demand letter specified that the board ought to "'commence a civil action against each of the Directors and Officers to recover for the benefit of the Company' damages for misconduct and disgorgement of bonuses, stock options, and other incentive compensation." *In re Digimarc Corp.*, 2008 WL 5171347, at *2.

8 The SLC had power "'to undertake and supervise any action necessary and appropriate to implement any [factual findings it made],' and to 'determine whether or not the Company shall undertake or defend against any litigation against one or more of the present or former directors or officers of the company.'" *Id.*, at *2. The two original members of the SLC, who were directors of Digimarc and named directors in the suit, were eventually replaced by board members who were not named defendants; additionally, the SLC retained a law firm to participate in its investigation and sent a letter to Beasley in February 2005 inviting him to assist as well. *Id.*, at *2; *In re Digimarc Corp.*, 2006 WL 2345497, at *1. The plaintiffs were not invited to participate until September 2005, after their action had already been filed. *In re Digimarc Corp.*, 2008 WL 5171347, at *2-3.

9 *In re Digimarc Corp.*, 2006 WL 2345497, at *1.

10 *In re Digimarc Corp.*, 2008 WL 5171347, at *2; *In re Digimarc Corp.*, 2006 WL 2345497, at *2. These actions were later consolidated, in September 2005. *In re Digimarc Corp.*, 2008 WL 5171347, at *2.

11 *In re Digimarc Corp.*, 2008 WL 5171347, at *3.

12 *Id.*; *In re Digimarc Corp.*, 2006 WL 2345497, at *2-3.

13 *In re Digimarc Corp.*, 2008 WL 5171347, at *3; *In re Digimarc Corp.*, 2006 WL 2345497, at *3-5.

the statute must either explicitly create that right of action or implicitly contain it.[14] Comparing Section 304 with other sections of the Sarbanes-Oxley Act, the Court of Appeals quickly determined that Section 304 did not explicitly create a private right of action. The Court reasoned that unlike Section 306 (among others), Section 304 "does not mention the availability of any action to enforce its mandates, nor does it explicitly describe a forum in which suit may be brought or a plaintiff for whom such a forum is available."[15]

The Court of Appeals then went on to consider whether Section 304 implicitly contained a private right of action based on its language, structure, context, and legislative history. It examined Section 304 under the framework laid out in *Cort v. Ash*, 422 U.S. 66 (1975), used by courts to determine "the existence of an implied private right of action in a statute not expressly providing one."[16] The factors outlined in *Cort* to be considered are:

(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.'"[17]

Determining that the "key inquiry" in its analysis was the second factor, the question of congressional intent, the Court of Appeals determined that this factor weighed "decisively" against finding an implied private

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[14] *In re Digimarc Corp.*, 2008 WL 5171347, at *4 (quoting *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 568 (1979), and *First Pac. Bancorp, Inc.* v. *Helfer*, 224 F.3d 1117, 1121 (9th Cir. 2000)). The question is whether "[the statute that Congress has passed] displays an intent to create not just a private right but also a private remedy"; "[i]n the absence of clear evidence of congressional intent, we may not usurp the legislative power by unilaterally creating a cause of action." *In re Digimarc Corp.*, 2008 WL 5171347, at *5. The Court of Appeals noted both that the existence of a private right of action under Section 304 was a question of first impression in the Ninth Circuit, and that no circuit had yet answered the question of whether Section 304 creates an implied right of action, except in dicta. *In re Digimarc Corp.*, 2008 WL 5171347, at *4-5. A number of district courts, however, had considered the issue, deciding that the statute did not create a private right of action. *In re Digimarc Corp.*, 2008 WL 5171347, at *5; *see*, *e.g.*, *Pedroli ex rel. Microtune, Inc.* v. *Bartek*, 564 F. Supp. 2d 683 (E.D. Tex. 2008); *In re Diebold Derivative Litig.*, 2008 WL 564824 (N.D. Ohio Feb. 29, 2008); *In re iBasis, Inc. Derivative Litig.*, 532 F. Supp. 2d 213 (D. Mass. 1007); *In re Infosonics Corp. Derivative Litig.*, 2007 WL 2572276 (S.D. Cal. Sept. 4, 2007); *In re Goodyear Tire & Rubber Co. Derivative Litig.*, 2007 WL 43557 (N.D. Ohio Jan. 5, 2007); *Kogan* v. *Robinson*, 432 F. Supp. 2d 1075 (S.D. Cal. 2006); *In re Whitehall Jewellers, Inc. Shareholder Derivative Litig.*, 2006 WL 468012 (N.D. Ill. Feb. 27. 2006); *In re BISYS Group Inc. Derivative Action*, 396 F. Supp. 2d 463 (S.D.N.Y. 2005); *Neer* v. *Pelino*, 389 F. Supp. 2d 648 (E.D. Pa. 2005); *Mehlenbacher* v. *Jitaru*, 2005 WL 4585859 (M.D. Fla. June 6. 2005).

[15] *In re Digimarc Corp.*, 2008 WL 5171347, at *5. Section 306(a)(2)(B) provides in part that "[a]n action to recover profits in accordance with this subsection may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer...."

[16] *Id.*, at *5 (quoting *Cort*, 422 U.S. at 78) (internal quotation marks omitted).

[17] *In re Digimarc Corp.*, 2008 WL 5171347, at *6.

right of action in Section 304.[18] In so holding, the Court asserted that it "must consider 'the entire statutory scheme provided by Congress in determining if a private cause of action exists, noting that analogous provisions expressly providing for private causes of action can imply congressional intent not to create an implied cause of action."[19] The Court first considered the language of Section 304 itself. Calling it "at best ambiguous" as to its intention to provide a private right of action, the Court compared Section 304's language with that of Section 901(a) of Title IX of the Education Amendments of 1972, 20 U.S.C. § 1681, in which the Supreme Court found an implied private right of action.[20] Section 901(a) provides that "no person . . . shall be subjected to discrimination under any program or activity receiving Federal financial assistance," language that the Supreme Court found to be "rights-creating."[21] In contrast, the "no person" language on which the Court relied in implying a private right of action under Section 901(a) is "conspicuously absent from [S]ection 304."[22] Instead, according to the Court of Appeals, "Section 304 focuses on 'the person regulated' rather than the 'individual[ ] who will ultimately benefit from [the statute's] protection,' and thus does not provide a private right of action."[23]

Having examined the language of Section 304, the Court then moved on to consider its place in the statute as a whole.[24] In doing so, it looked to "analogous provisions" of the statute; as noted above, where other analogous provisions expressly provide for a private right of action, "we must infer that Congress did not intend to create a private right of action in the statutory section at issue, . . . because 'when Congress wished to provide a private damages remedy, it knew how to do so and did so expressly.'"[25] Plaintiffs, in identifying analogous provisions, relied on Sections 303 and 804 of the Act, both of which expressly *restrict* private enforcement, suggesting that congressional silence was commensurate with permitting the exercise of private rights of action.[26] Defendants identified Section 306, discussed above, which expressly created "an action to recover profits" that "may be instituted at law or in equity," arguing that congressional silence indicated that Congress did not intend for the provision to be privately enforced.[27] The Court of Appeals found that plaintiffs' reasoning, insofar as it suggested that Congress's failure to explicitly state that it did *not* intend to create a private right of action indicated congressional intent to affirmatively *create* such a right of action, "turned *Cort* on its head."[28] The Court also found that the similarity in the content of Sections 304 and 306 suggested that they appropriately functioned as analogous provisions.[29] While acknowledging that both of these sections involved equitable remedies, for which courts have been more likely to imply private rights of action, the juxtaposition of Sections

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18 *Id.*

19 *Id.*

20 *Id.*

21 *Id.*

22 *Id.*, at *6-7 (citing *Alexander* v. *Sandoval*, 532 U.S. 275, 286 (2001); *Cannon* v. *Univ. of Chicago*, 441 U.S. 677 (1979)).

23 *In re Digimarc Corp.*, 2008 WL 5171347, at *7 (quoting *Alexander*, 532 U.S. at 289).

24 *Id.*, at *7.

25 *Id.*, at *7 (quoting *Touche Ross*, 442 U.S. at 572).

26 *In re Digimarc Corp.*, 2008 WL 5171347, at *7. Section 303 gives the SEC exclusive authority to enforce the provision, while Section 804 (amending 28 U.S.C. § 1658 as to the statute of limitations period for certain actions) states that nothing in the section "shall create a new, private right of action." *Id.*

27 *Id.*, at *7.

28 *Id.* The Court also noted that Section 804 dealt merely with statute of limitations issues and did not create a new remedial scheme. *Id.*

29 *Id.*, at *8.

304 and 306 prevented the Court from finding an implicit private right of action here; the express provision in Section 306 simply did not leave room to find intent in Congress's silence in Section 304.[30]

Finally, the Court of Appeals concluded that because the text and structure of Section 304 was so clear, there was no need to delve into the other three factors of the *Cort* test.[31] In choosing not to analyze the section under the first factor of the *Cort* test, the court stated that even a finding in plaintiffs' favor on the first factor would be insufficient to "offset the clear text and structure of [S]ection 304."[32] The court further noted that none of the arguments that plaintiffs made as to the third and fourth factors called its conclusion into question.[33] It therefore affirmed the district court, finding that plaintiffs had no standing to bring suit under Section 304 and thus concluded that the court had no federal question jurisdiction.

Finally, after finding that the court lacked federal question jurisdiction, the Court of Appeals reversed the district court's decision as to diversity jurisdiction, determining that there was antagonism between the derivative plaintiffs and Digimarc's officers and directors at the time of filing and therefore that the corporation ought to be aligned with the defendants.[34] In doing so, it found both that the district court had improperly considered events that took place after the filing of the lawsuit, and that the individual defendants could fairly be said to continue to control the corporation and had a continuing pecuniary interest in preventing an adverse decision in the derivative action.[35] Thus, the Court of Appeals remanded the case to the district court for further proceedings.

III. Significance of the Decision

The question of private rights of action under Sarbanes-Oxley has been a matter of concern and debate since the Act was passed in 2002.[36] The Act is ambiguous, both in language and structure, particularly as to means of enforcement. The implications of private enforcement and all that comes with it -- including the dominance of plaintiffs' law firms in carrying out this role -- makes the means of enforcement an issue of concern.

The decision in *In re Digimarc Corp.* suggests that responsibility for enforcement of Section 304 will fall largely to the SEC, particularly if other circuits follow suit.

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30 *Id*. The Court found this to be dispositive despite a potentially meritorious argument based on procedural differences between the two provisions that could otherwise explain the discrepancy. *Id*, at *8 and n.2.

31 The court noted that it had previously recognized that the first two factors are dispositive of the court's inquiry if they indicate that the statute does not provide a private right of action. *Id.*, at *8 (citing *Opera Plaza Residential Parcel Homeowner's Ass'n v. Hoang*, 376 F.3d 831, 837 (9th Cir. 2004).

32 *In re Digimarc Corp.*, 2008 WL 5171347, at *8.

33 *Id.*

34 *Id.*, at *9.

35 *Id.*, at *9-12. While the Court of Appeals noted that the creation of the SLC weighed against a finding of antagonism, it was insufficient to outweigh all of the other factors. *Id.*, at *13.

36 Salehi, Nader H. and Marino, Elizabeth A., *Section 304 of SOX: New Tool for Disgorgement?*, N.Y.L.J., May 22, 2008; *see also* Stone, Peter M., Gandhi, Jay C., and Wilson, Joanna S., *Section 304 of Sarbanes-Oxley: The Continuing Demise of the Private Implied Right*, Corporate Governance Advisor, March 2006.

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Ilana Friedman Ehrlich at 212.701.3451 or iehrlich@cahill.com.