

ABA Section of Litigation Class Actions & Derivative Suits Committee

Ninth Circuit Determines No Private Right of Action Under SOX Section 304

In re Digimarc Corp. Derivative Litig.

165 Cal. App. 4th 209 (2008)

In this case of first impression, the Ninth Circuit determined that there is no private right of action under Section 304 of the Sarbanes-Oxley Act, 15 U.S.C. § 7243 (which provides for the forfeiture of certain bonuses and profits when corporate officers fail to comply with the reporting requirements of the securities laws).

The Sarbanes-Oxley Act was enacted in 2002 in response to high-profile accounting scandals involving corporations such as Enron, Tyco, and WorldCom, and was designed to further protect investors and enhance corporate transparency and corporate governance. The act explicitly creates only two private causes of action, under Sections 306 and 806. Section 306 prohibits directors or officers from buying or selling securities during a pension fund blackout period. Under Section 806, companies are proscribed from discharging, harassing, or otherwise discriminating against employee whistleblowers.

Appellant George Diaz filed a derivative action in Oregon federal court against current and former officers of Digimarc Corporation (Digimarc) for breaching their fiduciary duties to the corporation and its shareholders by issuing misleading financial statements in violation of state law and Section 304 of the Sarbanes-Oxley Act. The district court dismissed the Sarbanes-Oxley Act claim on the grounds that there was no private right of action for violation of Section 304, and realigned Digimarc as a plaintiff, thereby destroying diversity jurisdiction over Diaz's state law claims. The Ninth Circuit affirmed the district court's judgment with regard to dismissal of the Sarbanes-Oxley Act claim but reversed with regard to its decision to realign Digimarc as a plaintiff for the purpose of determining diversity jurisdiction.

Noting that the text of Section 304 did not explicitly create a private right of action, the court of appeals applied the four-factor test articulated by the Supreme Court in *Cort v. Ash*, 422 U.S. 66 (1975) to determine whether an implied private right of action existed under Section 304. Focusing on the second *Cort* factor, whether Congress intended to provide the plaintiff with a private right of action, as "the key inquiry in [its] calculus," the court analyzed the language of Section 304 as well as the statutory scheme of the Sarbanes-Oxley Act to determine legislative intent. Finding the language of Section 304 to be ambiguous at best, the court examined analogous provisions of the Sarbanes-Oxley Act to ascertain whether Congress intended to create a private right of action. Diaz directed the court's attention to sections of the act that contain specific restrictions on private enforcement, and argued that if Congress intended to disclaim private enforcement of Section 304, it would have done so expressly. Digimarc highlighted Section 306 of the act as being the provision most analogous to Section 304. Section 306, which prohibits insider trading during "pension fund blackout periods," explicitly creates an "action to recover profits" for issuers and shareholders against corporate officers who engage in such trading. Digimarc argued that where Congress intended to create a private right of action under the act, it did so explicitly.

The Ninth Circuit rejected Diaz's argument, stating "It would turn *Cort* on its head to hold that by making clear it did **not** intend to create a private right of action in Sections 303 and 804, Congress affirmatively **intended** to create rights of action in sections where it omitted such an express denial." (Emphasis original.) The court then considered Sections 304 and 306 of the act, and noted that while both require disgorgement of profits from noncompliant directors and officers, Section 306 also expressly creates a private right of action to enforce the remedy. Accordingly, the court of appeals "[did not] 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." The court found that since neither the text of Section 304 nor the structure of the Sarbanes-Oxley Act demonstrated legislative intent to create a private right of action, it need not delve into the other three *Cort* factors.

With regard to the realignment of Digimarc as a plaintiff, the Ninth Circuit held that the district court erred in considering facts that arose after the complaint was filed in federal court when it made its determination that Digimarc was not antagonistic to the maintenance of a derivative suit. The court of appeals assessed the evidence “at the time of filing” and found that antagonism was present between Diaz and the controlling members of Digimarc. In reaching its decision, the court “weigh[ed] heavily that a majority of the members of the corporation’s board were named as defendants in the derivative action.” The court deemed that it was in the pecuniary interest of the controlling board members to oppose the derivative action, and all would have been significantly harmed by an adverse judgment.

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