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Second Circuit Holds That No Private Right Of Action Exists Under Section 304 Of The Sarbanes-Oxley Act

In *Cohen v. Viray*, 2010 WL 3785243 (2d Cir. Sept. 30, 2010), the United States Court of Appeals for the Second Circuit held that no private right of action exists under Section 304 of the Sarbanes Oxley Act, 15 U.S.C. § 7243 ("Section 304"), to recover from chief executive officers ("CEOs") and chief financial officers ("CFOs") any bonus or similar compensation, or any profits realized from stock sales, they may have received during the twelve-month period prior to a restatement of company financial statements due to misconduct. The Second Circuit concluded further that because only the Securities & Exchange Commission ("SEC") may enforce Section 304, a settlement agreement between a shareholder derivative plaintiff and a CEO and CFO may not purport to indemnify or release those senior corporate executives from liability under Section 304. This decision follows that of the Ninth Circuit on the question of whether a private right of action exists under Section 304.

The facts in *Cohen* were straightforward. DHB Industries, Inc. ("DHB") is a manufacturer of body armor used by the military. In 2005, the price of DHB's stock "plummeted" when it was revealed that the metal used in DHB's body armor "contained an inferior material prone to rapid deterioration." Thereafter, several shareholder derivative lawsuits were filed, each naming as defendants David H. Brooks ("Brooks"), DHB's former Chairman and CEO, and Dawn M. Schlegel ("Schlegel"), DHB's former CFO. The derivative suits were consolidated in the United States District Court for the Eastern District of New York. Plaintiff shareholders subsequently settled the lawsuit.

As part of the settlement agreement, plaintiff shareholders agreed to release Brooks and Schlegel "from any liability" under Section 304 and to "indemnify them against any liability" they might incur under Section 304. Another DHB shareholder, David Cohen, intervened and objected to the settlement, arguing that the "indemnification and relief provisions violate [the Sarbanes-Oxley Act] and public policy because Congress vested authority to exempt CEOs and CFOs from application of § 304(a) solely in the SEC, and did not grant such discretion to the public companies themselves, . . . and because the indemnification and release provisions would nullify the right and remedy that Congress expressly provided in the statute." Subsequently, the United States objected as well, asserting that the derivative action settlement "(i) limited the remedies available to the government in pending criminal cases against" Brooks and Schlegel and "(ii) undermined efforts by the SEC to hold the individual defendants liable for disgorgement under § 304."

In response, Brooks and Schlegel agreed to modify the settlement agreement. The amended settlement agreement provided that "[n]othing contained in this Settlement is intended to limit the United States' ability to pursue forfeiture, restitution or fines in any criminal, civil or administrative proceeding." However, Brooks' acceptance of this agreement was premised on a portion of the settlement agreement that provided that Brooks and Schlegel "were indemnified against liability under § 304." The district court held a hearing on this amended settlement agreement and, over the objection of Cohen and the United States, granted final approval of the settlement.

The United States later filed a criminal indictment against Brooks and Schlegel (among others), alleging that they inflated corporate earnings and profit margins, and then profited on those inflated earnings through the sale of DHB stock. The SEC also filed a civil complaint against Brooks and Schlegel based upon the same facts.

Cohen and the United States then appealed the district court's approval of the derivative action settlement. The Second Circuit reversed and remanded. The first issue before the Second Circuit was whether Section 304 provides a private right of action. If Section 304 provided a private right of action available to companies and their shareholders, the Court reasoned, "the SEC would have no claim that the Settlement usurps its sole authority to exempt person from § 304 liability."

To determine if a private right of action exists under Section 304, the Second Circuit looked first to the plain language of the statute. The Court noted that the plain language did "not answer the question of whether a private right of action exists § 304." Consequently, the Second Circuit turned to "analyzing congressional intent."

The Second Circuit started this analysis by pointing to the obvious: Section 304 "makes no explicit provision of a private cause of action for violations of § 304." More than this, however, it held that Section 304 imposes "a mandatory duty on those subject to it" — CEOs and CFOs "*shall* reimburse" — and, further, Section 304 "vests the SEC with the authority to exempt any person from the obligations to reimburse the issue under § 304(a), *as it deems necessary and appropriate*" (emphasis in original). As a result, the Court reasoned, "Congress thus provided *only the SEC* authority to exempt person from § 304(a), indicating that only the SEC has the authority and that other parties do not" (emphasis in original). The Second Circuit's conclusion is consistent with the holding by the United States Court of Appeal for the Ninth Circuit in *In re Digimarc Corp. Derivative Litigation*, 549 F.3d 1223, 1233 (9th Cir. 2008) [blog article here], where the Court similarly concluded that there is no private right of action under Section 304.

After determining that no private right of action exists under Section 304, the Court then turned to whether "the Settlement's provision releasing and indemnifying DHB's former CEO and CFO against liability under § 304 violate that statute." The Court concluded that the settlement agreement was not consistent with

Section 304, holding "[t]he Settlement's release and indemnification provisions attempt an end run around § 304 that vitiates the SEC's role and is inconsistent with the law."

The Court's reasoning turned, in large part, on policy — if former CEOs and CFOs were allowed to be indemnified from liability under Section 304, it "would effectively bar the relief the SEC is authorized to seek." Though the SEC could seek disgorgement, the settlement agreement "would allow Brooks and Schlegel to pass that claim on to DHB so that they, individually, would suffer no penalty at all." This, the Court held, would vitiate an important public policy animating Section 304, namely, that Section 304 "is an enforcement mechanism that ensures the integrity of the financial markets." Allowing those executives to be indemnified for Section 304 liability would diminish, if not eliminate, the deterrent effect of this enforcement mechanism.

The Second Circuit went on to note that its decision was in keeping with its findings "addressing similar situations under comparable statutes." In particular, the Court noted that it had refused to give effect to contract language purporting to waive or release individuals from liability under SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, and Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k.

In light of *Cohen*, neither corporations nor their shareholders have the right to enforce the disgorgement provisions in Section 304. But if *Cohen* so "giveth" to CEOs and CFOs, it also "taketh away," as settlement agreements may not release or indemnify CEOs and CFOs against liability under Section 304.

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