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Ambiguity Deters Claims Pursuit

Practicalities May Make Section 304 More Trouble Than It's Worth

By Nina "Nicki" Locker and Peri Nielsen

Section 304 is the provision in the Sarbanes-Oxley Act that requires CEOs and CFOs to disgorge incentive-based compensation and trading profits in the event of a restatement. So far, only one issuer has filed suit under Section 304.

The reason for issuers' apparent lack of interest in pursuing claims under Section 304 probably lies in a combination of textual ambiguity and practical obstacles that, together, may make Section 304 more trouble than it is worth.

To begin with, the language of Section 304 reads much like a strict liability statute by providing that a CEO and CFO "shall" reimburse an issuer for incentive-based compensation and trading profits whenever there is a restatement "as a result of misconduct." This language raises the first question: whose misconduct is relevant?

Section 304 does not expressly state that only the CEO's or CFO's misconduct is relevant in considering whether to impose disgorgement. The legislative history of Section 304 is silent on this point and, thus, provides no guidance. On the other hand, as at least one commentator has pointed out, had Congress intended that misconduct by someone other than the CEO or CFO was sufficient to trigger disgorgement, it could easily have stated that more clearly.

For example, it could have drafted Section 304 to require disgorgement based on "any" misconduct "without regard to the personal involvement of the CEO or CFO."

A number of policy-related reasons justify a narrow interpretation that limits Section 304's application to instances in which the CEO or CFO personally was involved in the misconduct. Perhaps most importantly, a broader reading arguably would create a new category of liability under the securities laws: vicarious liability not subject to any defense.

A CEO or CFO could still be liable even if he or she avoided unlawful conduct or presented a state-of-mind defense. also arguably would be inconsistent with Congressional intent to require some level of culpability on the part of a CEO or CFO before liability could be imposed for false certifications under Sections 302, 404 and 906 of the Sarbanes-Oxley Act. Liability for false certifications under those sections is limited to instances in which an officer acts either recklessly or with actual knowledge.

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NINA "NICKI" LOCKER — "Until the federal courts or Congress provides guidance regarding the many open issues, few issuers likely will be filing Section 304 actions in the near future."

The second question raised by the misconduct requirement is: what level of misconduct is sufficient to trigger the disgorgement penalty?

Section 304 is silent as to whether the misconduct must be negligent, grossly negligent, knowing or willful. The legislative history provides no guidance on this issue; while the House bill required the SEC to determine the state of mind required to impose disgorgement, the Senate bill, which was ultimately enacted, was silent on this point.

Consequently, even if an issuer were to interpret the statute as requiring misconduct on the part of the CEO or CFO, it still would have to determine what level of personal culpability is sufficient. For example, does personal involvement mean playing an active role — or would a CEO or CFO's awareness of misconduct, and failure to prevent it, be sufficient?

Another factor complicating the analysis is that issuers typically indemnify their officers, to the fullest extent of the law, for claims made against them relating to their employment with the company. In so doing, they often agree to advance defense costs until final disposition of an action.

As a result, issuers could face an ironic situation — one in which they are contractually obligated to fund the CEO or CFO's defense in any action brought against them seeking disgorgement under Section 304.

Issuers also often adopt wholesale the protections afforded by Section 145 of Delaware General Corporation Law, and agree to fully indemnify any officer who "acted in good faith and in a manner [that the officer] reasonably believed to be in or not opposed to the best interests of the corporation."

A broad interpretation of Section 304, which would require disgorgement based on lesser levels of misconduct (or indeed, no misconduct by the CEO or CFO at all), could lead to an even more ironic situation in which issuers would be contractually obligated to indemnify CEOs and CFOs for settlements or judgments paid in connection with Section 304 claims asserted against them.

By remaining silent, Congress left it to courts to decide whether Section 304 disgorgement preempts issuers' contractual indemnification obligations under state law.

Both of the questions addressed above assume that the issuer is the entity entitled to bring a Section 304 suit. The statute itself, however, is silent on this topic. While it allows the SEC to exempt persons from the application of Section 304(a)'s disgorgement provisions, Section 304 does not expressly give the SEC the right to enforce Section 304.

To date SEC has not filed any enforcement actions or administrative proceedings seeking disgorgement under Section 304. Consequently, it would appear that the SEC will look to issuers to enforce Section 304.

That being said, the question of whether issuers may bring a private right of action under Section 304, as opposed to just asserting typical common law claims for breach of fiduciary duty, is far from clear. Courts will look to the intent of Congress in determining whether a private right of action exists.

Since Section 304 provides that any reimbursement by the CEO or CFO will be made to the issuer, it would seem logical that Congress intended issuers to enforce Section 304. There is no clear evidence, however, that Congress intended this. Unlike other provisions of Sarbanes-Oxley, Section 304 does not contain express language creating a private right of action. See, e.g., Section 306 (expressly permitting private actions brought by issuers or by individual shareholders on behalf of issuers, to recover profits from improper insider trading during "blackout periods").

Moreover, Congress's omission of this express language may well be construed as its intent to avoid creating a private right of action. See *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979) ("Obviously ... when Congress wished to provide a private damage remedy, it knew how to do so and did so expressly"). To date, no court has addressed this issue.

Another unanswered question is whether Section 304 has retroactive application. Since restatements occurring now often involve financial statements issued for the first time prior to July 30, 2002 — Section 304's effective date — this question has significance for issuers today.

If, in fact, issuers could not recoup the profits earned by officers during the "boom years," in many instances there is little money to be recovered; thus, filing a Section 304 lawsuit would not be cost-effective. To date, the only reported case to address this issue tentatively concluded that the statute did not apply to misconduct that predated Section 304's effective date. *AFC Enterprises Inc. Derivative Litigation,* 224 F.R.D. 515 (N.D. Ga. 2004) ("there is no 'clear indication' from Congress that [Section 304] was intended to have a retroactive application to misconduct which occurred before its effective date.").

The parties in that case apparently referred to the alleged "misconduct" as the benchmark for measuring retroactivity. Given the wording of Section 304, however, the date by which the restatement was "required" also could provide the benchmark for measuring retroactivity. Without knowing whether the statute will be applied retroactively and what the benchmark for applying retroactivity would be, however, issuers have no way of calculating whether bringing a Section 304 would make financial sense.

Given the textual ambiguities and uncertainties plaguing Section 304, the low number of issuer-instituted Section 304 lawsuits is not surprising. Practical realities also play a role; any litigation, by definition, involves significant legal expense, as well as management distraction. Taking into account an issuer's potential obligation to advance defense costs incurred by the CEO or CFO (and to provide indemnification for any settlements or judgments if not precluded by federal public policy), the costs can quickly outweigh the benefits to the issuer and its shareholders.

The stakes are even greater if an issuer already is involved in securities class action litigation, as most issuers facing restatements tend to be. Suing the CEO or CFO would put the issuer in the position of having to prove misconduct, which could, in turn, be imputed back to the issuer in the class action litigation.

In addition no significant upside appears to exist in filing a Section 304 lawsuit vis-a-vis the government regulators. To date, neither the SEC nor the Department of Justice has issued any pronouncement indicating that an issuer's decision to sue its CEO or CFO under Section 304 will earn it "cooperation" points in pending regulatory investigations.

The lack of such a pronouncement is not surprising, since the SEC would not have the power to stay such a lawsuit while its investigation is ongoing. The DOJ would not be able to stay the lawsuit unless a criminal proceeding actually is pending.

Consequently, neither agency would be able to stop the discovery process from occurring in a Section 304 lawsuit. Since this process would almost certainly require the issuer to turn over documents produced to the SEC and DOJ, it could interfere significantly with their investigative processes.

In fact, the cost-benefit analysis may weigh in favor only of an issuer's filing to seek reimbursement under Section 304 in one scenario — that in which the issuer has already settled with private litigants and regulators and the misconduct by the CEO or CFO is sufficiently egregious that Section 304 would apply even if the court determined that the statute should be construed narrowly, requiring willful misconduct by the CEO or CFO.

This is precisely the scenario faced by the only issuer that has filed a lawsuit under Section 304 to date. Symbol Technologies, Inc. restated its financial statements issued between 1998 and 2001. The restatement followed a two year internal and governmental investigation, which culminated in a series of criminal indictments against both the CEO and CFO.

In late 2004, Symbol sued both of them under Section 304, seeking to recoup more than $40 million in bonuses and trading profits. At the time, Symbol had already settled with the SEC, the DOJ and class action plaintiffs at an aggregate cost of more than $300 million.

Bottom line: until the federal courts or Congress provides guidance regarding the many open issues, few issuers likely will be filing Section 304 actions in the near future.

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