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REPORT

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JURISDICTION AND PROCEDURE

Private Rights of Action and the Sarbanes-Oxley Act of 2002

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The Sarbanes-Oxley Act (“SOX”)¹ was enacted on July 30, 2002, in response to highly publicized corporate scandals involving companies such as Enron and WorldCom. SOX has drastically altered corporate governance and disclosure obligations. Its impact on the landscape of private litigation, however, remains to be seen. This article provides an overview of how SOX does—or may in the future—relate to claims and defenses in private securities litigation.

A. Express Causes of Action SOX only creates two express causes of action, under Sections 306 and 806(a).

1. Section 306

Section 306 of SOX, codified at 15 U.S.C. § 7244, prohibits directors or officers of issuers from trading equity securities acquired in connection with their services as directors or officers during any blackout period.² A “blackout period” is any period longer than three business days during which 50 percent or more of the participants in the issuer’s retirement plans are prevented

from trading.³ Issuers are required to notify directors, officers and the SEC in advance about any blackout periods.⁴

Private actions to redress violations of Section 306 may be brought by the issuer itself or derivatively by shareholders to recoup any profit realized by an offender.⁵ However, as one commentator already has noted, the relatively few number of blackout periods combined with the notice issuers are required to provide in advance of any blackout period make it “unlikely that there will be a significant number of violations.”⁶

2. Section 806(a)

Section 806(a), codified at 18 U.S.C. § 1514A, forbids companies from discharging, demoting, suspending, threatening, harassing, or otherwise discriminating against whistleblowing employees.⁷ Protected activities include providing information on or otherwise assisting investigations of conduct an employee reasonably believes constitutes a violation of 18 U.S.C. §§ 1341, 1343, 1344 or 1348 (i.e., various forms of fraud), any Commission rules or regulations, or any federal law relating to fraud against shareholders.⁸ However, the employee’s conduct is only protected by Section 806(a) if the information is provided to or the investigation is being con-

¹ Pub. L. No. 107-204, 116 Stat. 745 (2002).

² 15 U.S.C. § 7244(a)(1).

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³ *Id.* at (a)(4)(A).

⁴ *Id.* at (a)(6). *See also* 17 C.F.R. § 245.104.

⁵ 15 U.S.C. § 7244(a)(2).

⁶ HAROLD S. BLOOMENTHAL, *SARBANES-OXLEY ACT IN PERSPECTIVE* § 10:3 (2004).

⁷ 18 U.S.C. § 1514A(a).

⁸ *Id.* at (a)(1).

ducted by a federal agency, Congress, or a person with supervisory authority over the employee.⁹ An employee's activities in connection with proceedings relating to alleged violations of 18 U.S.C. §§ 1341, 1343, 1344 or 1348, any Commission rules or regulations, or any federal law relating to fraud against shareholders, such as filing an action, testifying, or otherwise assisting, are also protected.¹⁰

An affected employee may commence a private action to remedy conduct proscribed by Section 806(a) by filing a complaint with the Occupational Safety and Health Administration ("OSHA").¹¹ The complaint must be filed with OSHA within 90 days of the alleged violation.¹² Relying on the Supreme Court's decision in *National Railroad Passenger Corp. v. Morgan*,¹³ courts have held that there is a distinct 90-day filing period with respect to each alleged adverse employment decision.¹⁴ Failure to amend a complaint based on additional adverse employment actions occurring after a complaint is filed with OSHA precludes a plaintiff from later basing a federal suit on those adverse actions.¹⁵

If OSHA fails to act within 180 days of an employee's filing (and that delay is not a result of the employee's bad faith), then an action for *de novo* review may be brought in a federal district court.¹⁶ To prevail, the plaintiff must prove by a preponderance of the evidence that she engaged in protected conduct, her employer knew of the conduct, she suffered an adverse employment decision, and circumstances suggest that her conduct was a contributing factor to the employment decision.¹⁷ Thus far, the case law is sparse as to what constitutes protected conduct for purposes of Section 806(a). At least one court, however, has held that the conduct need not rise to the level of specificity of the conduct that led Congress to pass Section 806(a) in the first place (i.e., the whistleblowing at Enron). Rather, more general allegations of misconduct by the employee may be sufficient to bring her within the statute's protection.¹⁸ As for circumstances suggesting the adverse employment decision was retaliatory, temporal proximity alone may be sufficient.¹⁹ Once the employee has set out her *prima facie* case, the burden then shifts

to the employer to prove by clear and convincing evidence that it would have subjected the plaintiff to the same employment decisions in the absence of the protected behavior.²⁰

At least one court has held that Section 806(a) plaintiffs are not entitled to a jury trial.²¹ Available remedies include compensatory damages, reinstatement, back pay, and "special damages" including litigation costs, expert fees, and attorney's fees.²² It is unclear whether special damages includes reputational injury.²³ Courts so far have held that punitive damages are unavailable for Section 806(a) violations.²⁴

B. Possible Implied Causes of Action. It is possible that courts also will imply causes of action from SOX. Judicial enthusiasm for implied rights of action, however, has waned recently.²⁵ Moreover, both provisions in SOX itself and SEC implementing rules countenance against implying causes of action.²⁶ Nevertheless, there are at least two sections of SOX from which courts conceivably may imply causes of action: Sections 304 and 807.

1. Section 304

Section 304, codified at 15 U.S.C. § 7243, provides that when a company is required to restate its accounts

²⁰ *Id.* at 1376 (citing 49 U.S.C. § 42121).

²¹ *Murray v. TXU Corp.*, No. 03-0888, 2005 WL 1356444, *1-4 (N.D. Tex. June 7, 2005) (concluding, based on plain language, Seventh Amendment analysis and legislative history, that there is no right to a jury trial for Section 806(a) claims).

²² 18 U.S.C. § 1514A(c).

²³ *Compare Murray*, 2005 WL 1356444, at *3 (reputation damages unavailable), with *Hanna v. WCI Cmty., Inc.*, 348 F. Supp. 2d 1332, 1333-34 (S.D. Fla. 2004) (reputation damages available).

²⁴ *See Murray*, 2005 WL 1356444, at *3-4; *Hanna*, 348 F. Supp. 2d at 1333.

²⁵ *See, e.g., N. Henry Simpson et al., After the Fall: The Sarbanes-Oxley Act of 2002 Part 2*, 66 Tex. B.J. 316, 321 (2003) ("The Supreme Court has steadily reduced the number of implied rights of action available under [federal securities laws]. In light of this reduction, it may be likely that new implied rights of action will not be readily recognized by courts.").

²⁶ For example, Section 804(c) of SOX explicitly states that "[n]othing in this section shall create a new, private right of action." Pub. L. No. 107-204, § 804(c), 116 Stat. 745, 801 (2002). Section 307 of SOX, codified at 15 U.S.C. § 7245, commands the SEC to issue rules regarding attorney conduct. The implementing SEC rule explicitly states that "[n]othing in this part is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions" and that "[a]uthority to enforce compliance with this part is vested exclusively in the Commission." 17 C.F.R. § 205.7.

⁹ *Id.*

¹⁰ *Id.* at (a)(2).

¹¹ *Id.* at (b)(1)(A).

¹² 18 U.S.C. § 1514A(b)(2). The 90-day period commences when the employer makes and reasonably communicates the adverse employment decision to the employee, even if the effect of the decision is not felt until later. *McClendon v. Hewlett-Packard Co.*, No. 05-087, 2005 WL 1421395, *3 (D. Id. June 9, 2005) (citing *Del. State College v. Ricks*, 499 U.S. 250, 258 (1980)).

¹³ 536 U.S. 101 (2002).

¹⁴ *See McClendon*, 2005 WL 1421395, at *3 (noting that "[e]ach separate and discrete discriminatory employment act starts a new clock for the filing of an administrative claim"); *Willis v. VIE Fin. Group, Inc.*, No. 04-435, 2004 WL 1774575, *4-6 (E.D. Pa. Aug. 6, 2004) (holding threatened termination not actionable if threat was made more than 90 days before plaintiff filed complaint with OSHA, even though plaintiff could still proceed with timely claim based on loss of job responsibilities).

¹⁵ *Willis*, 2004 WL 1774575, at *4-6.

¹⁶ 18 U.S.C. § 1514A(b)(1)(B); 29 C.F.R. § 1980.114.

¹⁷ *See Collins v. Beazer Homes USA, Inc.*, 334 F. Supp. 2d 1365, 1375 (N.D. Ga. 2004) (citing 49 U.S.C. § 42121).

¹⁸ *Id.* at 1376-77.

¹⁹ *Id.* at 1379.

Note to Readers

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“due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws,” the CEO and CFO of the company must disgorge certain monies.²⁷ When such a violation has occurred, the CEO and CFO must return to the issuer all bonuses and incentive- and equity-based compensation received in the 12 months following the first public issuance or filing with the SEC of the financial document violating the reporting requirement in question (whichever comes first), as well as all profits realized from the sale of the issuer’s securities during that 12-month period.²⁸

Section 304 is silent as to how it is to be enforced and thus potentially ripe for implying a private cause of action. Indeed, at least one commentator, applying the four criteria laid out by the Supreme Court in *Cort v. Ash*,²⁹ has concluded that courts might be persuaded to imply a private right into the statute.³⁰ To date, there have been only a handful of reported decisions relating to claims brought under Section 304. In *In re Interpublic Securities Litigation*, the court did not rule on plaintiffs’ Section 304 claim, but noted in passing that it agreed with the defendants that plaintiffs’ Section 304 claim was “perilously weak.”³¹ The court in *In re AFC Enterprises Inc. Derivative Litigation* arguably appears to have accepted tacitly that Section 304 can be privately enforced.³² There, the defendants moved to dismiss plaintiffs’ Section 304 claim on the grounds that the conduct in question occurred prior to the effective date of SOX.³³ The court’s analysis addressed only the merits of the retroactivity dispute, and did not touch upon whether the plaintiffs could actually bring a Section 304 claim in the first place.³⁴ The court in *Neer v. Pelino*, undertaking an extensive *Cort* inquiry, unequivocally rejected a claimed right of action under Section 304.³⁵ *In re BISYS Inc. Derivative Action* also rejected an implied right under Section 304, for the same reasons set forth in *Neer*.³⁶

2. Section 807

Section 807, codified at 18 U.S.C. § 1348, criminalizes securities fraud.³⁷ At least two commentators have argued for a private right of action for violations of Section 807.³⁸ The provision does not contain an explicit bar on private actions, and is analogous to the civil provision Rule 10b-5, which courts have long recognized as a source of a private right of action. It could be argued that if Congress desired to restrict private claims under Section 807, it could have explicitly so provided. To date, there are no reported judicial decisions relating to Section 807.

²⁷ 15 U.S.C. § 7243(a).

²⁸ *Id.*

²⁹ 422 U.S. 66, 78 (1975).

³⁰ See HAROLD S. BLOOMENTAL, *SARBANES-OXLEY ACT IN PERSPECTIVE* § 10:4 (2004).

³¹ No. 02-6527, 2004 WL 2397190, *9 (S.D.N.Y. Oct. 26, 2004).

³² 224 F.R.D. 515 (N.D. Ga. 2004).

³³ *Id.* at 521.

³⁴ *Id.*

³⁵ No. 04-04791, slip op. at 8-22 (E.D. Pa. Sept. 27, 2005).

³⁶ 396 F. Supp. 2d 463, 464 (S.D.N.Y. 2005).

³⁷ 18 U.S.C. § 1348.

³⁸ George Lee Flint, Jr., *Annual Survey of Texas Law: Article: Securities Laws*, 56 SMU L. Rev. 1995, 2024 (2003); Carol B. Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scinter*, 52 Kan. L. Rev. 147, 167 (Nov. 2003).

C. New SEC Regulations Promulgated Pursuant to Sarbanes-Oxley That Potentially Expand Liability Under Section 10(b) and Rule 10b-5. Certain of the regulations promulgated by the SEC pursuant to SOX may create new theories on which to base claims under Section 10(b) and Rule 10b-5.³⁹ At least three such regulations potentially could expand these already-existing private rights of action.

Securities Act Release No. 8124, promulgated pursuant to Section 302(a), sets forth rules regarding certification of quarterly and annual reports by a company’s principal executive and financial officers.⁴⁰ Although Section 302(a) itself does not address private enforcement, the Release is explicit about the interplay between the rules of certification and other securities laws. Under the heading “Liability for False Certification,” the SEC pointedly observes that executives or financial officers who falsely certify any of the reports listed in the Release could face private actions under Section 10(b) and Rule 10b-5.⁴¹

Similar observations are found in the SEC Release adopting Regulation G, promulgated pursuant to Section 401(b).⁴² Regulation G implements rules regarding untruthful or misleading *pro forma* financial information.⁴³ Addressing liability for violations of Regulation G, the SEC explicitly notes that “materially deficient” disclosures could give rise to liability under Section 10(b) or Rule 10b-5.⁴⁴ So far, at least one plaintiff has alleged violations of Regulation G in a 10b-5 action.⁴⁵

Regulation AC, promulgated pursuant to Section 501(a), requires that brokers, dealers, and associated persons include in their research reports certain certifications by the research analyst working on the report.⁴⁶ In its implementing Release, the SEC briefly addresses liability for analysts who run afoul of Regulation AC.⁴⁷ Despite invitation from commenters, the SEC declined to definitively state that Regulation AC does not create new liability for analysts or their firms.⁴⁸ Rather, the SEC equivocates, in one breath saying that Regulation AC “does not alter any other existing obligations under the federal securities laws” but also suggesting that violation of Regulation AC might constitute securities fraud.⁴⁹ This ambiguity could turn Regulation AC into a basis for Section 10(b) or Rule 10b-5 actions.

³⁹ See generally Alan R. Bromberg & Lewis D. Lowenfels, *Implied Private Actions Under Sarbanes-Oxley*, 34 Seton Hall L. Rev. 775 (2004).

⁴⁰ Certification of Disclosure in Companies’ Quarterly and Annual Reports, 2002 WL 31720215 (S.E.C. Release No. 8124 Aug. 28, 2002).

⁴¹ *Id.* at *8-9.

⁴² Conditions for Use of Non-GAAP Financial Measures, 2003 WL 161117 (S.E.C. Release No. 8176 Jan. 22, 2003). See Regulation G, 17 C.F.R. §§ 244.100-244.102.

⁴³ 2003 WL 161117, at *3-7.

⁴⁴ *Id.* at *7.

⁴⁵ See *In re Netflix, Inc. Sec. Litig.*, Nos. 04-2978, 04-3021, 04-3204, 04-3233, 04-3329, 04-3770 & 04-3801, 2005 WL 3096209, *10-*11 (N.D. Cal. Nov. 18, 2005).

⁴⁶ 17 C.F.R. §§ 242.500-242.505.

⁴⁷ Regulation Analysis Certification, 2003 WL 397879, *11 (S.E.C. Release No. 8193, Feb. 20, 2003).

⁴⁸ *Id.*

⁴⁹ *Id.* (noting that “even without Regulation AC, analysts may be found to have violated the anti-fraud provisions of the federal securities laws if they make baseless recommendations that they disbelieve”).

D. Limitations on Defenses in Securities Actions. Two SOX provisions relax limits on certain pre-existing securities causes of action. These sections are considered below.

1. Section 804

Section 804 amends 28 U.S.C. § 1658 to extend the statute of limitations for certain securities claims to the earlier of two years after the discovery of the facts constituting the violation or five years after the violation.⁵⁰ The claims subject to this enlarged limitations period are those involving “fraud, deceit, manipulation or contrivance in contravention of a regulatory requirement concerning the securities laws,” as defined in 15 U.S.C. § 78c(a)(47)—that is, securities fraud claims.⁵¹ Previously, the statute of limitations for such claims was the earlier of one year from discovery of the violation or three years from the violation.⁵²

Section 804’s effect on private actions is obvious—it gives plaintiffs more time to sue for securities fraud violations. Since its enactment, however, a considerable amount of litigation has surrounded one thorny issue raised by the enlargement of the limitations period: Does Section 804 revive securities fraud claims that were barred under the old statute of limitations as of July 30, 2002, but that would still be viable under the new limitations period? In other words, does Section 804 retroactively resurrect previously-stale claims? Most courts have concluded that Section 804 is not retroactive, starting with the Second Circuit in *In re Enterprise Mortgage Acceptance Co., LLC, Securities Litigation*.⁵³ It remains to be seen, however, how the Eleventh Circuit will construe Section 804. In *Roberts v. Dean Witter Reynolds, Inc.*, a district court in Florida held

that Section 804 does apply retroactively to revive previously-stale claims.⁵⁴ The Eleventh Circuit vacated *Roberts* in *Tello v. Dean Witter Reynolds, Inc.* and remanded for further proceedings.⁵⁵ In so doing, however, the Eleventh Circuit specifically chose not to resolve the issue of retroactivity, instead reserving decision until the lower court made certain factual findings.⁵⁶

2. Section 803

Section 803, codified at 11 U.S.C. § 523(a)(19), amends the Bankruptcy Code to exempt from discharge debts arising out of liability for securities law violations. The purpose of Section 803 is to ensure that victims of securities violations are eventually made whole, and therefore the coverage of Section 803 is very broad.⁵⁷ It applies to debts arising out of violations of federal or state securities laws or regulations (or orders issued pursuant to them), as well as to debts related to common law fraud, deceit or manipulation in connection with the purchase or sale of securities, where such debts have resulted from any state or federal judgment, order, consent order or decree, or from a settlement agreement.⁵⁸ Debts are exempted whether they arose before, on or after the date on which the debtor’s petition was filed.⁵⁹

There has been scant litigation over Section 803 since its enactment. Two courts have considered whether the provision applies to petitions filed before July 31, 2002. Both have concluded that it does.⁶⁰ One court has affirmed the constitutionality of Section 803 under the uniformity requirement of Article I, Section 8, Clause 4 of the United States Constitution.⁶¹

⁵⁰ 28 U.S.C. § 1658(b).

⁵¹ *Id.*

⁵² See *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 359-60 (1991).

⁵³ 391 F.3d 401, 405-11 (2d Cir. 2004). See *Lieberman v. Cambridge Partners, LLC*, 432 F.3d 482, 492 (3d Cir. 2005); *In re ADC Telecomms., Inc. Sec. Litig.*, 409 F.3d 974, 976-78 (8th Cir. 2005); *Glaser v. Enzo Biochem, Inc.*, 126 Fed.Appx. 593, 598 (4th Cir. 2005); *Foss v. Bear, Stearns & Co.*, 394 F.3d 540, 542 (7th Cir. 2005); *Wuliger v. Owens*, 365 F. Supp. 2d 838, 846-50 (N.D. Ohio 2005); *Quaak v. Dexia, S.A.*, 357 F. Supp. 2d 330, 336-37 (D. Mass. 2005); *In re Royal Ahold N.V. Sec. & ERISA Litig.*, 351 F. Supp. 2d 334, 364-68 (D. Md. 2004); *Milano v. Perot Sys. Corp.*, Nos. 02-1269, 02-1300, 02-1533, 03-0031, 03-0032, 03-0022, 03-0356 & 03-0357, 2004 WL 2360031, *5-8 (N.D. Tex. Oct. 19, 2004).

⁵⁴ No. 02-2115, 2003 WL 1936116, *2-4 (M.D. Fla. Mar. 31, 2003).

⁵⁵ 410 F.3d 1275 (11th Cir. 2005).

⁵⁶ *Id.* at 1294 n.19.

⁵⁷ See *Idaho v. McClung (In re McClung)*, 304 B.R. 419, 424 (Bankr. D. Id. 2004) (recounting legislative history of Section 803).

⁵⁸ 11 U.S.C. § 523(a)(19).

⁵⁹ *Id.* at (a)(19)(B).

⁶⁰ *Smith v. Gibbons (In re Gibbons)*, 289 B.R. 588, 591-97 (Bankr. S.D.N.Y. 2003), *aff’d*, 311 B.R. 402, 403-04 (S.D.N.Y. 2004), *aff’d*, Slip Copy, 2005 WL 3134156, *1 (2d Cir. Nov. 21, 2005); *Harvey ex rel. Widmann v. Lewandowski (In re Lewandowski)*, 325 B.R. 700, 704-08 (Bankr. M.D. Pa. 2005).

⁶¹ *Fishbach v. Simon (In re Simon)*, 311 B.R. 641, 644-46 (Bankr. S.D. Fla. 2004).