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Digimarc: The Final Nail In The SOX 304 Coffin

Law360, New York (January 05, 2009) -- Shortly after the passage of the Sarbanes-Oxley Act of 2002, private plaintiffs began adding claims for violations of Section 304 of the Sarbanes-Oxley Act ("SOX 304") to shareholder derivative complaints.

SOX 304 provides that "[i]f an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for

1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever occurs first) of the financial document embodying such financial requirement; and

2) any profits for the sale of securities of the issuer during that 12-month period."

SOX 304 also provides the SEC with the authority to exempt "any person" from the application of the disgorgement provisions described above.

District Courts have repeatedly rejected private plaintiffs' SOX 304 claims on the ground that there exists neither an express nor implied private right of action under SOX 304, as has the United States Court of Appeals for the District of Columbia Circuit in language that that Ninth Circuit describes as "dicta".

Last month, the Ninth Circuit considered the issue directly in *In re Digimarc Corporation Derivative Litigation*, and held squarely that no private right of action exists under SOX 304.

If the Ninth Circuit's reasoning is adopted across circuits, CEOs and CFOs can breathe a sigh of relief, as private plaintiffs will almost certainly begin to gradually abandon attempts to assert SOX 304 claims in shareholder derivative actions.

Digimarc supplies secure personal identification systems, including personal identification documents and drivers' licenses based on digital watermarking technology.

In September 2004, Digimarc announced that it had failed to record the costs of internal software development as expenses on its balance sheet. As a result of this failure, it had overstated its earnings over the previous six quarters, and would have to issue a restatement.

Digimarc issued its restatement of earnings on April 5, 2005, covering the four quarterly and yearly results for 2003 and quarterly results for the first two quarters of 2004, revealing that it had overstated earnings by approximately \$2.7 million.

In August 2005, derivative plaintiff George Diaz filed an action alleging that certain current and former officers and directors of Digimarc breached their fiduciary duties to the corporation and its shareholders by issuing misleading financial statements and misrepresenting the business prospects of Digimarc.

In addition to the state law claims for breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets, unjust enrichment, and violations of the California Corporations Code, Diaz also included a claim against Digimarc's CEO and CFO for disgorgement of certain payments received during the period covered by Digimarc's restatement under SOX 304.

The Ninth Circuit concluded that Section 304 does not explicitly create a private right of action "because nothing in the text of the section makes any mention of a cause of action."

In fact, the Court cited to Section 306 of the Sarbanes-Oxley Act to "demonstrate how Congress expressly creates private rights of action." With that issue clearly settled, the Court turned to the question of whether SOX 304 created an implied right of action.

After citing to the decision of the United States Court of Appeals for the District of Columbia Circuit in *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Raines*, see 2008 WL 3166142 (D.C. Cir. 2008), and district court decisions from California, Florida, Illinois, Massachusetts, New York, Ohio, Pennsylvania and Texas, each of which concluded that SOX 304 did not create a private right of action, the Ninth Circuit reached the same conclusion.

Focusing on the second factor of the four-part test in *Cort v. Ash*, the Ninth Circuit concluded that "congressional intent weighs decisively against finding a private right of action," and that "section 304 does not create a right to disgorgement in shareholders.

Instead, it speaks in terms of the remedy, detailing when and under what circumstances a CEO and CFO must reimburse an issuer."

The Court expressly rejected plaintiff's argument that SOX 304 created a private right of action because other sections of SOX "expressly disclaim private enforcement," reasoning that "[i]t 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 801, Congress affirmatively intended to create rights of action in sections where it omitted such an express denial."

The Court declined to address the other three Cort factors "[b]ecause the text and structure of the Sarbanes-Oxley Act do not demonstrate an intent to create a private right of action under section 304."

The Ninth Circuit's decision is consistent with those of every other court that has considered the issue. With this definitive statement, echoing holdings in the D.C. Circuit and district courts in eight states, the Ninth Circuit has indeed hammered the final nail in the SOX 304 coffin.

The case is *In re Digimarc Corp. Derivative Litig.*, case number 06-35838, in the United States Court of Appeals for the Ninth Circuit.

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