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SARBANES-OXLEY ACT OF 2002

Decisions refine SOX whistleblower protection

It's been four and a half years since Congress enacted the Sarbanes-Oxley Act (SOX) affording broad protection for employees who report activities they reasonably believe to be fraudulent and misleading to investors in publicly traded companies. Last year the *Washington Post* reported that approximately 750 people had filed complaints with the Department of Labor (DOL) since SOX was enacted.

To date, SOX complainants have not been terribly successful. Numerous decisions by the ALJs have attempted to discern what is protected and what is not. Decisions of the Administrative Review Board (ARB) of the Department of Labor, which reviews ALJ decisions, are fewer in number, but they are beginning to further refine the parameters of the whistleblower provisions. Court decisions are even fewer and have not shed a whole lot of light on how SOX whistleblowers and employers will fare in the judicial arena when they are able and choose to go that route.

Employee advocates and management representatives see the developing law quite differently. Management attorney Peter Petesch likens it to the enforcement history of the Americans with Disabilities Act and the Racketeer Influenced and Corrupt Practices Act. "The flurry of SOX claims after its enactment mirrors the explosion of claims brought under those laws following their enactment. Since then the scope of what they cover has narrowed," he noted.

Petesch thinks we are just starting to see some court decisions, as well as decisions by the ARB, that place some limitations on SOX whistleblower claims. "That is not to say, however, that the statute is not alive and well."

Need for change. Those who represent whistleblowers are alarmed by decisions that narrow what is considered protected activity and add requirements that are not in the law, said Lynne Bernabei. From her perspective, things have gone downhill. "These decisions create hurdles that do not exist in the law. Our overall sense is that a legislative fix is needed."

Livingston v Wyeth, Inc.

A pending case in the Fourth Circuit may indicate where the courts—or at least the Fourth Circuit—are headed. In *Livingston v Wyeth, Inc,* 88 EPD ¶42,638, a district court in North Carolina ruled that Mark Livingston, a Manager of Training and Continuous Improvement at a Wyeth plant in Sanford, North Carolina where components of a vaccine for infants and toddlers was manufactured, was terminated for insubordination and not for reporting his belief that Wyeth was about to engage in wrongdoing that would impact shareholders. The district court cited several decisions of the Department of Labor's Office of Administrative Law Judges in concluding that Livingston's actions were not protected under SOX.

Reasonable belief. As the deadline for an internal audit to determine compliance with a consent decree between Wyeth and the Food and Drug Administration (FDA) approached, Livingston wrote memos to his superiors reporting his concern that training deficiences would delay verification of compliance and could possibly lead to the release of adulterated vaccines. The court found no evidence of omissions of relevant information nor any false or misleading statements made by Wyeth in documents provided to shareholders."To be protected under [SOX], an employee's disclosures must be related to illegal activity that, at its core, involves shareholder fraud," said the court. The employee does not have to know "precisely what securities law is about to be violated, but there must be some basis for an objectively reasonable belief, considering the employee's experience and knowledge, that the corporation is about to commit wrongdoing."

Inside

Decisions under the whistleblower provisions of the Sarbanes-Oxley Act of 2002 are the subject of comments by:

- **Lynne Bernabei**, founding partner of The Bernabei Law Firm, PLLC, Washington, DC. She is a civil rights lawyer, representing employment discrimination plaintiffs and whistleblowers; and
- **Peter J. Petesch**, Partner in the Washington, DC, office of Ford & Harrison. He represents management in SOX and other whistleblower cases.

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There was no objective basis for Livingston to equate training deficiencies with imminent wrongdoing. The court found it "entirely speculative" to conclude that because Wyeth management disagreed with his belief that the facility could not meet the deadline, Wyeth planned to conceal critical information. Livingston knew that any training deficiences would be deemed adequately addressed if a legacy plan was adopted whereby even if the required training curricula was not fully developed and implemented by the FDA commitment date, the Sanford site would nevertheless be deemed compliant, and Livingston signed off on the verification plan because there was a legacy plan in place, the court reasoned.

Materiality. Even if it was reasonable to believe that the FDA might take some future action based on training compliance issues, it was not clear that Wyeth would be required to report any alleged violations to shareholders before the FDA acted, the court added."Information must be sufficiently material to a company's financial picture before it will form the basis for securities fraud," said the court.

Non-discriminatory reasons for termination. Even if Livingston's communications were protected, clear and convincing evidence established that Wyeth terminated him for insubordination six days after Livingston requested that the Director of Human Resources leave a holiday party and then threatened to have police remove him. The court noted that Livingston had been counseled and reprimanded for professional misconduct in the past and he did not deny using harsh and/or profane language toward subordinates during his tenure.

Platone v Flyi, Inc.

Last September, the ARB reversed an ALJ's decision in favor of an airline employee, a former employee of the pilot's union, who alleged she was terminated for reporting billing discrepancies that she believed amounted to pilot abuse of the airline's flight pay loss system and the union's failure to properly reimburse the airline. The ALJ found that she was terminated for reporting her concerns and for failing to disclose her romantic relationship with the pilot and high-ranking union union member who had referred her. The ALJ further found that the airline failed to establish that it would have terminated her solely on the basis that she failed to disclose her romantic relationship.

No protected activity. Finding that her reports were not protected, the ARB cautioned that SOX whistleblower protection provisions do not provide "whistleblower protection for all employee complaints about how a public company spends it money and pays its bills." None of her communications amounted to an expression of concern of possible fraud against shareholders, said the ARB. Moreover she testified at the hearing to less than $1,500 of potential losses to the company, an amount a reasonable shareholder was unlikely to find material, the ARB noted. *Platone v Flyi, Inc,* DOL ARB Dkt No 04-154, (September 29, 2006), CCH EPG ¶5222

The Fourth Circuit's decision in Livingston *could very well be the landmark case so far on protected activity under SOX.*

Peter Petesch

Klopfenstein v PCC Flow Technologies Holdings, Inc.

In a case decided last May, the ARB recognized that SOX protection applies to the provision of information regarding not just fraud, but also violation of any rule or regulation of the SEC. Reversing an ALJ's decision dismissing an employee's SOX complaint, the ARB stated, "[W]e do not believe that activity is protected only when the complainant is the first to raise the issue, or when the communications relate to published information, or when the complainant believes he is reporting 'fraud.'" The case involved a company vice president's reports of inventory balance discrepancies that he believed could affect the accuracy of financial statements. He was terminated after a separate investigation found that he was responsible for changing shipping procedures allowing revenue to be prematurely recognized.

The ARB left it to the ALJ to determine whether Klopfenstein had engaged in protected activity but suggested that it was possible that he had because his reported problems "suggested, at a minimum, incompetance in Flow's internal controls that could affect the accuracy of its financial statements." On the other hand, his reports might not have been protected if his belief that his concerns related to a violation of an SEC rule, which the ARB suggested the ALJ examine, was not reasonable.

Causation. The ARB also faulted the ALJ for requiring the employee to prove more than what SOX requires to prove causation. The correct standard is whether the protected activity was a contributing factor—any factor, which alone or in combination with other factors tends to affect in any way the outcome of the decision—in the termination. "[A] complainant is not *required* to prove pretext," said the ARB, because he may prevail by showing that the employer's reason, while true, is only one of the reasons for its conduct,and another motivating factor is the complainant's protected activity. *Klopfenstein v PCC Flow Technologies Holdings, Inc,* DOL ARB, Dkt No 04-149 (May 31, 2006)

On remand, the ALJ affirmed his finding that the *sole* reason for the employee's termination was for violating the company's revenue policy. He based his conclusion among other things on the employee's admission that he did not believe that his concerns about inventory discrepancies amounted to fraud. In addition, the ALJ noted, those responsible for the investigation that led to his termination had no knowledge of his concerns

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over discrepancies at the time of his termination. *Klopfenstein v PCC Flow Technologies Holdings, Inc,* DOL ALJ, Dkt No 2004-SOX-11 (October 13, 2006), CCH EPG ¶5216.

Walton v NOVA Information Systems

Last March, an ALJ denied an employer's motion to dismiss in a case involving reports by a credit card processor's database administrator of lapses in the databases "which could foreseeably result in large scale criminal fraud against credit cardholders, merchants and their banks, and customers and shareholders of the [employer] and the shareholders of [the parent company]." The ALJ expressly rejected the employer's argument that providing information of a violation of a rule or regulation of the SEC is only protected when the rule or regulation referenced is related to fraud against shareholders. Such a requirement would "subsume the violation of a SEC rule or regulation into the phrase 'any provision of Federal law,'" the ALJ observed.

The ALJ also rejected the employer's argument that the employee was only complaining of dissatisfaction with the internal structure of the employer's IT department. On the contrary, failure to disclose to outside auditors security lapses making the databases vulnerable to internal and external intrusion and unauthorized access would violate SOX requirements, the ALJ said.

Job duties. The employer also argued that because the administrator was hired to review databases to verify their compliance with industry practices and to render an opinion on whether or not they met those practices, her report was not protected. The ALJ rejected that argument as well, finding no evidence that her job duties required her "to risk the disfavor of her superiors by asserting that disclosures of security problems had not been fairly made to the external auditors." According to the employee's counsel, the case is now pending on a motion for summary decision. *Walton v NOVA Information Systems and Bancorp,* DOL ALJ, Dkt No 2005-SOX-107 and 2006-SOX-18 (March 29, 2006).

Protected activity

Given the somewhat vague statutory language regarding protected activity, initially a handful of ALJs pretty much accepted the argument that almost any workplace-related complaint was encompassed by SOX, Petesch said. "Some opinions refused to attach any kind of materiality requirement. Many failed to closely analyze whether the activity involved a fraud on shareholders. Many claims went forward that should not have."

Shareholder fraud. Although he predicts that people will continue to try to bootstrap workplace complaints to allegations of fraud against shareholders, Petesch thinks some core principles are beginning to emerge, citing the ARB's decision in *Platone.*The ALJ did not engage in a very deep analysis of what was protected, he observed. "To be protected, the employee's report must definitively and specifically relate to one or more of the criminal laws or securities regulations relating to shareholder fraud." That is consistent with the district court's decision in *Livingston,* he added.

"In other decisions the ARB has stated that the test is whether a reasonable shareholder would consider the matter important to a decision to invest," Petesch said. He expects to see more cases echoing that requirement.

"In some of the whistleblower cases that I've handled recently where the complainant is well advised by counsel, the complainants use words of art such as 'fraud against shareholders.' That won't necessarily make conduct protected that is not legally protected. It is well-accepted that the complainant's concern that practices could rise to the level of shareholder fraud must be subjectively and objectively reasonable," he explained.

The district court's decision in *Livingston* looked to decisions by the ALJs and the ARB, which Petesch sees as a good thing. "It is impossible to predict how the Fourth Circuit will rule, but the lower court's legal analysis is sound and consistent with decisions so far by the ARB. I would expect the court to affirm the legal principles cited in the case. It could very well be the landmark case so far on protected activity under SOX," he suggested.

SEC rule violations. "The law protects employees who suffer an adverse employment action for reporting a violation of a securities law *or* SEC regulation," Bernabei explained. "However, the ALJs and the ARB are also requiring that the subject of the report be limited to something that would defraud investors. That is not what the law says. It is not that narrow."

Bernabei represents an employee who was fired after reporting violations of the Foreign Corrupt Practices Act. "That is obviously covered by the SOX whistleblower provisions, but the other side is arguing that his report is not protected because the conduct was not intended to defraud investors."

"Under the laws of statutory construction, if the statute is clear, you follow the statute. It is clear what is protected under SOX whistleblower provisions. Reporting violations of SEC rules is clearly protected. There is no justification for requiring that a violation also be a fraud on investors because the purpose of the statute is to protect investors," she asserted.

Bernabei doesn't hold much hope for Livingston given the Fourth Circuit's conservative reputation. "It's a pretty clear case. The district court judge is absolutely wrong. There is no such requirement."

When does reporting one's concerns regarding "internal accounting measures" rise to the level of protected activity? It's possible to characterize everything as "internal accounting" matters, Bernabei responded. "The question under established whistleblower law is whether the person has a reasonable belief that there has been a violation of the statute or regulation.

Then you must determine whether the belief is objectively reasonable. Many of these people are subject matter experts who believe it is a violation."

Remedial statute. "The fact that SOX is a remedial statute designed to encourage people to report corporate illegalities in order to prevent what happened at Enron, MCI and other corporations means that the statute should be read broadly. But recent decisions make it almost impossible for someone who is not a securities lawyer to prove that he or she made a protected disclosure," said Bernabei.

Suggesting that the whistleblower must prove that what he alleged was actually illegal is tantamount to requiring that the whistleblower be a securities lawyer, she added. "Lawyers who represent whistleblowers can usually determine whether there is a claim or not, but there may be safe harbors in the securities laws that even we do not know about. Erecting these kinds of hurdles which are not in the law disserves the remedial purpose of the law."

***Garcetti* requirements.** Bernabei also noted recent attempts to incorporate the *Garcetti* requirements into SOX cases. In *Garcetti v Ceballos,* 87 EPD ¶42,353, the Supreme Court held that First Amendment protections do not extend to public employees making statements "pursuant to their official duties," even if the employee was acting to expose alleged government wrongdoing. *Garcetti* made it absolutely clear that the decision applied to government employees in the Section 1983 context, but even so, defendants are attempting to apply the *Garcetti* holding to private SOX claimants, she said.

"On a couple of occasions I have seen the argument that an auditor's reporting of mistakes is not protected because finding accounting errors is the auditor's responsibility." According to Bernabei, the courts do not like *Garcetti,* so she doubts this argument will be very successful. "The courts are letting this issue go to the jury and juries are finding that these individuals reported their concerns as private individuals and not in their official capacities," she reported.

Burden of proof

One developing issue Petesch noted is whether an employer who articulates a non-discriminatory reason for its action essentially throws out the prima facie case for the complainant unless the complainant can show that the employer's articulated reason for its action is false or a pretext for retaliation. If that happens, the employer then bears the burden, under the statutory and regulatory burden-shifting scheme, to prove by clear and convincing evidence that it would have taken the same action in the absence of any protected activity.

As more claimants successfully establish that their actions are protected, Petesch is starting to see SOX cases look to Title VII production-and burden-shifting analysis with respect to pretext. "The clear and convincing evidence burden on an employer essentially requires the employer to prove a negative—that the protected activity had nothing to do with the decision, for example, to terminate. If the employer articulates a non-retaliatory reason for the adverse action before the real burden of proof, as distinguished from the burden of production, shifts to the employer, should the employee then be required to show that the articulated reason is false or otherwise some sort of pretext for retaliation?"

Redefining clear and convincing evidence. Bernabei's concern is that the growing tendency of the ARB to accept less than credible explanations for the adverse action is re-defining the clear and convincing evidence standard the employer must meet to rebut the whistleblower's claim that protected conduct was a contributing factor in the adverse action.

Judicial or administrative arena?

We are starting to see more dismissals of administrative cases because of claimants' desire to take their cases to court, which Petesch thinks may mean a preference on the part of claimants to proceed in court. Going to court is more expensive and raises the stakes for companies, he noted. The administrative process is much more fast-tracked."There are few court decisions so far but if cases follow the *Livingston* pattern, I think we'll see a pretty consistent treatment by both ALJs and the courts."

Bernabei does not encourage people to use the administrative process and recommends going to court if possible. She acknowledges that there were certain benefits to the administrative process, but thinks they are being overshadowed by the decisions of the ARB.

"One of the early advantages of the administrative process was a quick settlement when reinstatement was ordered following an OSHA investigation and pending resolution of the case at the ALJ level. That was a pretty significant remedial measure but even that has been lessened with these decisions, so it is best to get out of the administrative arena if possible." In many cases, however, there is no choice, she said.

Legislative changes?

Plaintiffs' counsel are looking to the new Democratic Congress to correct some of what they see as errors. It does not necessarily require an amendment to the statute, Bernabei suggested. "A statement that 'we meant what we said' is enough so that the ARB understands that its decisions are wrong," she said. "But no one is eager to open the statute up to amendment because of so much pressure from the business community to eviscerate SOX."

She likened it to what happened in 1991 when Congress overhauled the Civil Rights Act in response to decisions by conservative courts that narrowed its coverage. "Congress legislatively eliminated a number of poorly reasoned decisions. Plaintiffs' counsel hope that will happen here as well."

So far, proposals to amend SOX have not included revisions to its whistleblower provisions. Whether there will be any legislative action remains to be seen. Stay tuned. ■