Legal Times
WEEK OF JUNE 2, 2008 • VOL. XXXI, NO. 22
ALM

The Umpires Strike Back

Misguided circuit courts hammer intended protection for Sarbanes-Oxley whistle-blowers.

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When Congress passed the Sarbanes-Oxley Act, was it warning top management to pay more or less attention to signs of potential corporate fraud? Silly question, right? But sometimes courts seem to miss the point.

SOX, among its other provisions, seeks to "encourage and protect those who report fraudulent activity that can damage innocent investors." To accomplish this goal, Congress included robust whistle-blower protection for employees of publicly traded companies.

Unfortunately, this legislative goal is undermined by two federal appellate decisions earlier this year concerning the scope of protected activity under SOX's whistle-blower protection provision, Section 806. The first came in January from the U.S. Court of Appeals for the 5th Circuit—which includes Texas, home state of the Enron Corp., which so dramatically showed why SOX protections are necessary. The second came in March from the 4th Circuit.

Although Section 806 still remains a relatively potent remedy for whistle-blowers who have suffered retaliation, these recent decisions substantially undermine SOX's whistle-blower shield by limiting the scope of protected disclosures.

LESS PROTECTION

Section 806 protects an employee who provides information to a person with supervisory authority over the employee, to a federal agency, or to Congress about a reasonably perceived violation of the federal mail, wire, radio, TV, bank, or securities fraud statutes, "any rule or regulation of the Securities and Exchange Commission," or any provision of federal law relating to fraud against shareholders.

Although the plain meaning of Section 806 protects an employee's disclosure about a violation of "any rule or regulation of the Securities and Exchange Commission," the 4th Circuit's decision, *Livingston v. Wyeth Inc.,* concluded that a disclosure about a violation of an SEC rule is protected only if it pertains to shareholder fraud. The court's rationale, in part, was to avoid protecting "complaints about administrative missteps or inadvertent omissions from filing statements."

This narrow construction of the scope of protected disclosures substantially undermines the purpose of Section 806 by denying protection to employees who report violations of SEC rules that could lead to shareholder fraud.

In responding to the accounting schemes that led to the collapse of Enron and other companies, Congress did not merely increase the penalties for shareholder fraud. Instead, it enacted comprehensive reform designed to detect and prevent fraud. For example, SOX requires publicly traded companies to strengthen internal accounting controls "to identify potential weaknesses and deficiencies in advance of a system breakdown" to help detect fraudulent reporting earlier. By limiting protected conduct to disclosures about actual shareholder fraud, the 4th Circuit excludes a wide range of disclosures, such as those about deficient internal controls, that could prevent such fraud.

Fortunately, the 4th Circuit's position is an outlier. Nearly all federal court decisions construing Section 806 have held that a disclosure about a reasonably perceived violation of any SEC rule is protected. In addition, the Labor Department's Administrative Review Board held in 2006 that providing information to management about deficient internal controls can constitute protected conduct.

METAPHYSICAL CERTAINTY

The 4th Circuit's *Livingston* decision also undermines Section 806 by placing a much heavier burden on the whistleblower than Congress ever intended.

To establish protected conduct under Section 806, an employee need not demonstrate that she disclosed unequivocal shareholder fraud. Instead, Section 806 specifically protects disclosures based on a "reasonable belief" about the existence of fraud. The legislative history of Section 806 states that the reasonableness test "is intended to include all good faith and reasonable reporting of fraud, and there should be no presumption that reporting is otherwise, absent specific evidence."

But the 4th Circuit in *Livingston* appears to require SOX plaintiffs to demonstrate that they disclosed actual fraud.

Mark Livingston blew the whistle on Wyeth's violation of a Food and Drug Administration consent decree and Wyeth's failure to disclose such noncompliance to shareholders. In particular, Livingston alleged that Wyeth was concealing from shareholders the same type of manufacturing violations that resulted in FDA enforcement action, which Wyeth settled by paying a $30 million fine and entering into a consent decree.

When Livingston raised his concerns to his superiors, he was told that he would be terminated unless he retracted his disclosures and refrained from making any further complaints about noncompliance with the consent decree.

The 4th Circuit held that Livingston's disclosures are not protected because his "speculative beliefs" do not constitute an existing violation of SEC rules prohibiting shareholder fraud. It concluded that a violation of the consent decree is not material to shareholders.

As Judge M. Blane Michael points out in a vigorous dissent, Livingston reasonably believed that Wyeth was violating the consent decree. Moreover, "a reasonable shareholder would want to know whether a company is engaged in activity that could trigger [a $30 million settlement] and fines."

By disregarding Congress' clearly expressed intent in including a "reasonable belief" standard in Section 806, *Livingston* discourages employees from blowing the whistle until they become aware of unequivocal shareholder fraud, thereby deriving companies of an opportunity to take corrective action before shareholders are defrauded.

A TOUGH STANDARD

The 5th Circuit has also adopted an anomalous interpretation of the "reasonable belief" standard.

Under Section 806 and similar retaliation statutes, "reasonable belief" has both an objective and subjective component. The objective component assesses whether a person with the plaintiff's knowledge and experience would have believed the reported conduct violated the relevant statute.

In *Allen v. Administrative Review Board*, the 5th Circuit imposed an unduly high standard of objective reasonableness that will likely defeat many meritorious claims.

In *Allen*, Laura Waldon, a certified public accountant, alleged that she was terminated because she raised concerns about a violation of Staff Accounting Bulletin 101, which prohibits publicly traded companies from recognizing sales revenue before they deliver merchandise to the customer.

The 5th Circuit held that the plaintiff's disclosure was not protected because it pertained to internal consolidated financial statements, and SAB-101 applies only to revenue recognition in financial statements submitted to the SEC. According to the 5th Circuit, the reasonableness of a CPA's belief must be evaluated "from the perspective of an accounting expert," and the plaintiff, as a CPA, should have known that SAB-101 does not apply to internal financial statements.

This unduly high standard of objective reasonableness undermines the prophylactic purpose of Section 806. As an administrative law judge pointed out in *Morefield v. Exelon Services Inc.* (2004), Section 806 "is largely a prophylactic, not a punitive measure" designed to encourage employees to "head off the type of 'manipulations' that have a tendency or capacity to deceive or defraud the public. By blowing the whistle, they may anticipate the deception buried in a draft report or internal document, which if not corrected, could eventually taint the public disclosure."

Blowing the whistle on deceptive or inaccurate draft financial statements should be protected because, if left uncorrected, the inaccurate financial statements will be distributed to shareholders. Moreover, if an employee suffers retaliation for disclosing fraud in draft financial statements, then the employee and her coworkers will be chilled from disclosing fraud in publicly filed financial statements.

STILL ROBUST

Fortunately, these two appellate decisions, though mistaken, do not destroy the statute's whistle-blower protection.

Although *Livingston* imposes onerous and unwarranted hurdles on SOX plaintiffs in the 4th Circuit, Section 806 will continue to provide relatively robust protection to corporate whistle-blowers.

Moreover, because the *Livingston* decision is so patently contrary to the plain meaning and purpose of Section 806, it is unlikely that other courts will adopt a similar construction of SOX. Indeed, most federal courts interpreting whistle-blower protection statutes do not search for the narrowest possible construction and instead construe such statutes broadly to effectuate their remedial purpose.

More generally, the burden-shifting framework for Section 806 claims is very favorable to employees. After the employee demonstrates that her protected conduct was a contributing factor in the employer's adverse action, the employer must prove by clear and convincing evidence that it would have taken the same action in the absence of the protected conduct. Under that framework, SOX plaintiffs who survive summary judgment are likely to prevail at trial.

To be effective, however, this legislative promise of protection has to be upheld by the courts. At a time when investors are suffering massive losses and workers are being laid off because of fraud in the financial services sector, the judiciary should not muzzle corporate whistle-blowers. Instead, it should provide robust protection to corporate whistle-blowers, as Congress intended.

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