SOX Whistle-Blowers Find Little Relief in Federal Court, Say Practitioners

by Linda Friedman

The Sarbanes-Oxley Act of 2002 includes a provision protecting whistle-blowers who report suspected accounting fraud, but only a few employees who've litigated the issue in court have achieved the remedies they sought.

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The Sarbanes-Oxley Act of 2002 includes a provision protecting whistle-blowers who report suspected accounting fraud. To the extent that those cases have been litigated, however, few employees have achieved the remedies they sought.

In *Livingston v. Wyeth Inc.*this summer, a federal district court dealt a blow to the cause of employees who, punished for calling attention to perceived violations at their companies, sought redress under SOX whistle-blower provisions (*Livingston v. Wyeth Inc.*, no. 1:03-cv-00919 (M.D. N.C., summary judgment granted July 28, 2006)).

The court granted Wyeth's motion for summary judgment, finding that Livingston could not prove that he was entitled to whistle-blower protection under SOX. Judge P. Trevor Sharp reasoned that because the activity at Wyeth that Livingston had complained about didn't implicate shareholder fraud, Livingston's complaints were not "protected activity" under SOX.

The act provides protection for whistle-blowers in section 806. The legal question of what sort of corporate malfeasance prompts protection under that section is in flux, with whistle-blowers' advocates and employers' counsel trying to convince federal courts that their interpretation is the correct one.

The *Livingston* decision "represents the minority view and is contrary to the plain meaning and intent of section 806," according to Jason M. Zuckerman, principal of the law office of Jason M. Zuckerman PLLC and of counsel at the Employment Law Group. Zuckerman's practice, primarily represents whistle-blowers.

But Michael Delikat, a partner at Orrick, Herrington & Sutcliffe LLP and chair of the firm's employment law practice group, said, "The *Livingston* decision is not only consistent with the specific language of section 806, which requires a complaint to involve a fraud on the shareholders, but also follows the handful of federal courts that to date have interpreted SOX."

Courts' Interpretation of SOX Section 806

Section 806 protects employees who either provide information or assist in an investigation of certain misconduct. To be protected, the employee must have acted with a reasonable belief that the employer's conduct constitutes a violation of:

- the various antifraud sections of the act (including bank fraud, securities fraud, postal fraud, and wire fraud);
- any rule or regulation of the SEC; or
- any provision of any federal law regarding fraud against shareholders.

The investigation must be one carried out by a federal regulatory body or law enforcement agency, a member of Congress or a congressional committee, or a person with supervisory or firing authority over the employee. Filing, testifying in, or participating in a proceeding regarding an alleged violation is also protected conduct.

Mark Livingston had raised concerns that his employer, Wyeth Inc., had devoted insufficient resources to train employees working with a new vaccine in the Wyeth facility in Sandford, N.C., where he worked. He claimed that there were serious gaps in the facility's training program and that he believed Wyeth would not meet its commitment to the Food and Drug Administration to have training programs in place by a particular date. In his complaint, he said he believed that if the Sanford facility underwent a compliance verification process as scheduled, it would be providing false and misleading information to compliance auditors, including the Food and Drug Administration.

Dismissing Livingston's case, Judge Sharp wrote that to be protected under SOX, an employee's disclosures must "be related to illegal activity that, at its core, involves shareholder fraud." There is nothing in the record of Livingston's allegations to indicate that Wyeth made false or misleading statements, or omitted relevant information, in any shareholder documents, Judge Sharp wrote.

Judge Sharp's view is a "contorted" interpretation of section 806, according to Zuckerman. "If Congress wished to limit protected conduct only to concerns that directly implicate shareholder fraud, it would have done so."

Lynn Bernabei of Bernabei Law Firm, Washington, and Zuckerman argue that such narrow interpretations of section 806 undermine the purpose for which SOX was enacted.

"The courts are rewriting SOX -- are coming out with decisions that go against the law and are not sufficiently protecting the rights of whistle-blowers," Bernabei

said. “Some of the interpretations by [administrative law judges] would not have protected Sherron Watkins. It was clearly not the intent of Congress, and [is] not what should be happening.”

Zuckerman and Bernabei say that the reasoning in a recent decision by the Department of Labor’s Administrative Review Board, *Klopfenstein v. PCC Flow Technologies Holdings, Inc.*should prevail (*Klopfenstein v. PCC Flow Technologies Holdings, Inc.,* ARB No. 04-149, ALJ No. 2004-SOX-11 (ARB May 31, 2006)).

Klopfenstein was fired after he reported discrepancies in inventory balances. The administrative review board remanded the case for a determination of whether the parties Klopfenstein had named were proper defendants, and it did not make a determination whether Klopfenstein had engaged in activity protected under SOX.

But the board rejected a narrower reading of section 806, saying, “SOX protection applies to the provision of information regarding not just fraud, but also ‘violation of any rule or regulation of the Securities and Exchange Commission.’”

According to the review board, the problems with the inventory “suggested, at a minimum, incompetence in [the employer’s] internal controls that could affect the accuracy of its financial statements.”

Zuckerman said he thought it was likely that other federal courts hearing this issue would defer to the administrative review board’s finding in *Klopfenstein*.

One Whistle-Blower Prevails; Many Others Have Not

In early June, the first employee to seek whistle-blower protection under SOX was reinstated to his job at a Virginia bank. David E. Welch, the former CFO at Cardinal Bankshares Corp., was fired after he complained that the bank’s reported income was inflated because of improper accounting (*Welch v. Cardinal Bankshares Corp.*, ARB case no. 06-062 (DOL Admin. Review Board, June 9, 2006)). (For prior coverage, see *Doc 2006-11585* or *2006 FRW 115-3*.)

An administrative judge ordered the bank to reinstate Welch, but an attorney for the bank said it would not put Welch back in his job unless a federal district judge orders it. Welch was fired from the bank in October 2002 and has been pursuing his case since then.

However, Welch's outcome was better than that of most employees who try to vindicate their rights through SOX's whistle-blower protection provisions.

Delikat has been gathering statistics on SOX whistle-blower cases. He said between July 30, 2002, and April 30, 2006, there were 737 SOX whistle-blower complaints filed with the Department of Labor's Occupational Safety and Health Administration (OSHA). The complaint to OSHA is the first step in a whistle-blower action; it is followed by a preliminary investigation by the Department of Labor (DOL).

Of the 679 complaints that had been resolved in DOL hearings, 483, or 71 percent, had been dismissed as lacking merit, Delikat said. Only 15 complaints had been decided in favor of the employee plaintiff, he said.

At the next level, at which cases were heard by administrative law judges, 34 cases were found to be meritless, and only 5 were determined in favor of the employee plaintiff.

"Most SOX whistle-blower cases have been dismissed at the first level – the DOL investigation – or at the hearing level, before the ALJ," Delikat said. *Welch* was significant, he said, because it was the first case that a SOX whistle-blower won in front of an ALJ.

Welch's attorney said that there are three whistle-blower cases under SOX remaining, and all three are currently before the administrative review board.

Those statistics are not the entire picture, however, because many whistle-blower disputes are settled before they are filed. "Many, many cases are resolved before filing," Bernabei said. "These tend to be the cases with more validity. The terrifically meritorious cases are often settled before filing."

Advice for Potential Whistle-Blowers

Bernabei offered some advice for employees who believe they've discovered financial misconduct at their workplace. First, the employee should report the problem to management.

"We always encourage people to go through their chain of command," Bernabei said. "If they're in the reporting chain, then they should make the disclosure in writing, so they don't get caught up in not-reporting information."

Bernabei urges employees who think their companies are engaging in illegal activity to go to the SEC. She acknowledges that "it ends up being a balancing test as to what you think will happen to your career and how the investigation could turn out for you."

"If it looks like there's going to be an SEC investigation, then you want to be one of the first ones to talk to [the SEC]," Bernabei said. It will be harder for the

employer to fire you without creating the appearance that it's being done out of retaliation, she said.

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