Legal Backgrounder

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WHISTLEBLOWERS UNDER SOX:

MORE DEFINITION, LESS SATISFACTION FOR PLAINTIFFS IN APPEALS COURT RULING

by

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The U.S. Court of Appeals for the Fourth Circuit recently issued a decision that adds definition to "protected activity" under the Sarbanes-Oxley Act's (SOX) whistleblower provision. The court's ruling makes SOX unavailable to employees who blow the whistle on questionable business practices or even formal compliance issues, if the employee cannot demonstrate that they involve alleged fraud against shareholders or violations of federal securities laws.

The Fourth Circuit's decision in *Livingston v. Wyeth* is significant as one of the first appellate decisions under Section 806 of SOX. Although it is well-reasoned, the decision was not unanimous and it promises to generate additional criticisms from the plaintiffs' bar that the whistleblower protections of SOX are an empty promise.

Livingston v. Wyeth Background. As a pharmaceutical company, Wyeth is subject to regulation by the U.S. Food and Drug Administration (FDA). Under the FDA's regulatory scheme, Wyeth and other companies must follow "good manufacturing practices" — or GMPs — in the production of drugs. GMPs require, among other things, that each person engaged in the manufacture of drugs possess sufficient education, training and experience to perform the functions assigned to them. Any product produced in a facility that is found to not adhere to GMPs is legally considered adulterated and subject to seizure by the FDA. For this very reason — an alleged failure to follow GMPs — the FDA seized alleged adulterated products from Wyeth's Pearl River, New York and Marietta, Pennsylvania facilities. The seizure led to a Consent Decree in October 2000. Whether Wyeth complied with this Consent Decree became the focus of the eventual SOX whistleblower complaint in this case.

The Consent Decree required Wyeth to retain an expert consultant to conduct a "division-wide" assessment of its quality control programs at all sites and to respond to the expert's report. Wyeth was also required to provide the FDA with a timetable for the actions it would take in response to the expert's report. Accordingly, Wyeth advised the FDA that it would implement training changes and verify compliance with the new program by September 30, 2002.

Not long before it entered into the Consent Decree, Wyeth hired Mark Livingston to be its first

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manager of Training and Continuous Improvement. In time he became the Associate Director of Training and Continuous Improvement in Wyeth's Sanford, North Carolina facility. Wyeth designated Livingston to direct and oversee preparations for training system audits at the Sanford site between January 2001 and September 2002.

As of late May 2002, Livingston advised that the Sanford facility remained "on track" for the implementation date. However, Livingston became concerned that Wyeth would not meet the training commitments by the September 30, 2002 implementation date. In July, Livingston was convinced that Wyeth could not meet its "internal" verification deadline and formally expressed his concerns in a July 10, 2002 memorandum to his superior, Kaylos, and various corporate directors and managers.

According to Livingston, Kaylos' response was not what it should have been. Kaylos reportedly threatened to fire him if he persisted in criticizing the status of Wyeth's compliance efforts. Kaylos also allegedly implied that Livingston should hide noncompliance issues from Wyeth's internal auditors. Nonetheless, Livingston acknowledged that when Kaylos met with him about his concerns, he did not allege that Wyeth was attempting to mislead either the FDA or those conducting the internal verification. In any event, Livingston in late July filed a formal complaint with Wyeth's Office of Compliance alleging that his superiors ignored his concerns. The Compliance Office investigated but found no violations and closed its file on October 9, 2002.

The Sanford facility met the September 30, 2002 compliance target provided to the FDA, and the training system for GMPs received full verification by the Office of Compliance. In fact, Livingston signed the verification certifying the compliance deadline had been met. To this day, the FDA has not suggested that Wyeth violated the October 2000 Consent Decree.

There is more to the story, of course. Livingston had performance problems — an always difficult situation for employers when the problem employee has a management or leadership role in assuring federal compliance. Shortly after the compliance date, Wyeth placed Livingston on a performance improvement plan because he was viewed as a poor leader, had an argumentative nature and short temper, and used abusive language. During 2001 and 2002, the Human Resources office had received numerous complaints from other employees about Livingston's abusive language and inappropriate behavior. Wyeth formally warned him about his unprofessional behavior in 2002; even Livingston admitted that a number of employees asked for transfers because of his conduct. Among other things, the performance plan required Livingston "to stop making non-constructive comments to internal and external staff or contacts regarding Wyeth's alleged defrauding of the FDA or other departments' non-compliance with training GMPs."

The matter came to a head in late 2002 at an offsite holiday party of Livingston's department. Wyeth's Human Resources director arrived at the party uninvited but with the purpose of wishing the group happy holidays. In front of company employees, Livingston told the HR director he was not invited, demanded he leave, and threatened to call the police to escort him from the party. Wyeth suspended Livingston the next day and soon fired him.

In turn, Livingston filed a complaint with the Department of Labor contending that his termination was due to SOX-protected disclosures. After the case ended up in federal court, Wyeth moved for summary judgment. The trial court granted Wyeth's motion for summary judgment, which Livingston appealed. The Fourth Circuit Court of Appeals in a 2-1 decision has now affirmed the district court's decision in Wyeth's favor.

The Fourth Circuit's Reasoning. Congress enacted SOX to protect shareholders by improving the accuracy and reliability of corporate disclosures made pursuant to securities laws. SOX Section 806 prohibits employers from retaliating against a covered employee who provides information that the employee reasonably believes constitutes a violation of specified laws related to fraud, including securities fraud, as well as any other provision of federal law relating to a company's fraud against shareholders.

Livingston expressed concerns about whether Wyeth would meet its training commitments made to the FDA pursuant to the 2000 Consent Decree. He alleged in his lawsuit that Wyeth retaliated against him because of his concerns about Wyeth's training program at the Sanford facility, which he communicated through two memos and verbal discussions. Specifically, he complained to management that he thought there were deficiencies in the training program for GMPs and that he did not believe the facility was ready for its planned internal audit. He argued that the company needed additional time — and to indicate otherwise would amount to providing false and misleading information to outside auditors and the FDA. But was this a "protected" disclosure under Section 806?

At the outset of its opinion, the Fourth Circuit found that, to "reasonably believe" that company conduct constitutes a violation of law, an employee must show not only that he believed that the conduct constituted a violation, but also that a reasonable person in his position would have believed that, too. In other words, SOX requires both a subjective and objective belief that the company's conduct constitutes a violation of the relevant law. The court further required that the reasonable belief must be about an *existing* violation and not upon some future contingency.

Applying this standard, the court found that Livingston's claim failed for four separate reasons. The court's findings on these four points can serve as a checklist in future SOX cases.

- *Concern Cannot Be "Potential" Or Based Upon Chain of Speculative Occurrences*— First, the court held that Livingston offered only speculation to support his claim that Wyeth concealed information or made false representations to the FDA, or had plans to do so. Livingston's argument was that Wyeth would fail to meet its internal date, would fail to develop an acceptable plan to address that failure, and would then misrepresent the state of affairs to the FDA on September 30, 2002. Livingston offered only a "chain of speculation . . . simply too long to support a claim that Wyeth in fact covered up anything and made misrepresentations to the FDA or was in the process of doing so, as is required to support a violation of securities laws."

- *Concern Is Viewed at the Time of the Alleged Conduct* — Second, the Fourth Circuit found there was no objectively reasonable basis from which to conclude that the 2000 Consent Decree had been or was being violated at the time Livingston raised his concerns. Wyeth committed to comply by September 30, 2002; Livingston's July 2002 complaints speculated about what might occur on September 30, 2002.

- *Concern Must Satisfy Legal Elements of Fraud* — Third, the court found no evidence that Wyeth misled or intended to mislead shareholders. Livingston failed to demonstrate the requisite elements of securities fraud — *i.e.*, that a material misrepresentation was made, with scienter, in connection with the purchase or sale of a security and on which the seller or purchaser reasonably relied causing economic loss. "The chain of speculation, in light of a record totally devoid of any Wyeth wrongdoing at the Sanford site, is simply too weak on which to hang even a postulated violation of the securities laws." Thus, the court held that Livingston could not reasonably have believed that Wyeth had violated or was violating securities laws.

- *Concern Must Be Material to Shareholders/Investors* — Fourth, the court held that even assuming Wyeth made false statements, none would be material in light of the requirement that "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available" to the investor. The court continued: "Thus, for deficiencies in the training program schedule to have had a *material* impact on Wyeth's finances, there must have been some realistic possibility that the FDA would take regulatory action against Wyeth having material financial consequences to a reasonable investor." The court found no realistic possibility: Livingston could not have reasonably

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believed the training issues presented a material impact, given that (1) training was but one element of 27 different quality elements defined by the Sanford facility GMPs; (2) Wyeth had $14 billion in revenue, and (3) Wyeth had more than two dozen facilities manufacturing pharmaceuticals worldwide.

The Fourth Circuit concluded: "[N]ot one link in Livingston's imaginary chain of horribles was real or was in the process of becoming real." Under these circumstances, Livingston failed to produce evidence that he complained to Wyeth about conduct which a reasonable employee in his position could have believed at the time constituted a violation of securities laws.

One of the court's three judges on the case dissented. The dissenting judge primarily took issue with the court's failure to construe the facts of the case in the light most favorable to Livingston, which the court was required to do upon review of the award of summary judgment. The dissent took issue with the court's conclusion that Livingston needed to show an "existing" violation of law. According to the dissent, Livingston stated a claim so long as he was retaliated against for reporting his reasonable belief that a violation "was taking shape, that 'a plan was in motion' to violate the law, or that a violation was 'likely to occur.' In other words, an employee's belief is unreasonable (and unprotected) if it is based entirely on unsupported conjecture about hypothetical future events, his belief must relate to activity that a reasonable person could conclude is or is about to become a violation."

What Does the Decision Mean for Employers? Livingston is an important decision for several reasons. The decision provides guidance on the scope of protected activity particularly with regard to what is required to satisfy the reasonable belief requirement under SOX. As one of the first federal appellate decisions interpreting Section 806, the court's decision establishes precedent that other courts and the Department of Labor are likely to follow. The court's relatively narrow interpretation of protected activity is a victory for employers and confirms that the whistleblower protections of SOX were never intended to encompass run-of-the-mill workplace disputes or speculative concerns that are neither reasonable nor material.

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