Legal Backgrounder

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EMPLOYEE-PROTECTED ACTIVITY UNDER SARBANES-OXLEY § 806:

IS FRAUD AGAINST SHAREHOLDERS ESSENTIAL?

by

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As part of the congressional plan to address financial ethical breaches of the type that brought down such corporate powerhouses as Enron, WorldCom and Arthur Andersen, Congress enacted the "Corporate and Criminal Fraud Accountability Act," commonly known as Sarbanes-Oxley or simply "SOX." Among other provisions, SOX includes a "whistleblower" provision, Section 806, which essentially deputizes corporate employees as overseers of corporate financial wrongdoing that would be misleading to investors in publicly traded companies. These whistleblowers are afforded protection in the form of the right to sue their employer should they suffer retaliation for reporting fraud against shareholders.

However, in the five years since the enactment of SOX, the admirable goal of preventing corporate fraud and promoting corporate accountability and compliance for the benefit of shareholders while protecting reporting employees remains subject to tension in the definition of protected conduct. Department of Labor (DOL) and some court decisions have reigned in the scope of protected conduct, and various commentators recently have lamented that SOX fails to protect employees to the extent originally hoped. However, some recent decisions continue to suggest that Section 806 will serve as a pseudo-catchall for any workplace complaint. Accordingly, questions remain about the degree to which reported fraud must be of the kind that would actually impact shareholders.

The whistleblower provisions of SOX seek to protect employees of publicly traded companies. Their employers may not

> discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee - -
> (1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341 [mail fraud], 1343, [fraud by wire, radio or television] 1344 [bank fraud], or 1348 [securities

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> fraud], any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders . . . .
> or
>
> (2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of section 1341 [fraud and swindles], 1343, [fraud by wire, radio or television] 1344 [bank fraud], or 1348 [securities fraud], any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders. 18 U.S.C. § 1514A.

To establish a whistleblower retaliation case under Section 806, an employee must establish that: (1) the employee engaged in protected activity; (2) the employer knew or could be presumed to know of the employee's protected activities; (3) the employee suffered unfavorable personnel action; and (4) the circumstances suggest that the protected activity was a contributing factor to the unfavorable personnel action.

Judicial decisions analyzing the threshold employee conduct necessary for a SOX claim fall into three general camps: (1) cases finding that fraud is an integral element of a SOX claim which necessarily includes, at least as implicit, an element of deceit that would impact shareholders or investors; (2) cases permitting a remedy to an employee so long as the employee reasonably believes that his employer's conduct constitutes a fraud; and more recently, (3) cases finding that SOX protects an employee against retaliation based upon any *potential* mail or wire fraud regardless of whether the fraud impacts a shareholder of the company.

Camp 1: Protected Activity Requires Fraud Against Shareholders. One line of cases espouses a narrow view of fraud in the context of protected activity under SOX. To pass muster, the employee must not only report and reasonably believe that the conduct about which he complains constitutes fraud under one of the enumerated frauds in the statute, but also he must tie the fraud to the effect on shareholders.

In *Minkina v. Affiliated Physician's Group*, 2005 SOX 19 (ALJ Feb. 22, 2005), the Administrative Law Judge (ALJ) rejected a SOX whistleblower claim where the allegations did not tie into fraud against shareholders. The complainant alleged she was discriminated against after filing reports with OSHA regarding a ventilation problem in the workplace. The ALJ found it "undeniable that the Complainant's reports concerned air quality and had nothing to do with fraud of the protection of investors." Further, the ALJ added that "[q]uite simply, while the Complainant may have had a valid claim of poor air quality, Sarbanes-Oxley . . . was enacted to address the specific problem of fraud in the realm of publicly traded companies and not the resolution of air quality issues, even if there is a possibility that poor air quality might ultimately result in financial loss."

Another decision that reflects a narrow interpretation of fraud and the requisite consequent impact to shareholders under SOX is *Wengender v. Robert Half International, Inc*., 2005 SOX 59 (ALJ Mar. 30, 2006). The complainant alleged that his manager reassigned sales credits from the house account to herself and others. Complainant maintained that the reassignment of credits was an accounting violation and generally alleged that this was fraud under SOX. However, the ALJ found that SOX does not apply to generic allegations of accounting violations or general allegations of fraud. The fraud must be supported by evidence of intent to deceive shareholders.

The Department of Labor Administrative Review Board (ARB) in *Platone v. FLYI, Inc.*, ARB Case No. 05-154 (Final Dec. & Order Sept. 29, 2006), reversed an ALJ's decision in favor of an airline employee who alleged she was terminated for reporting billing discrepancies which she believed amounted to abuse of the airlines' flight pay loss system and the union's failure to properly reimburse the airline. Finding that the complainant's reports were not protected, the ARB advised that SOX whistleblower protections did not provide "whistleblower protection for all employee complaints about how a public company spends it money or pays its bills." The ARB found that the complainant's communications did not amount to an expression of concern of possible fraud against shareholders. Similarly in *Allen v. Stewart Enterprises, Inc*., 2004 SOX 60 (ALJ Feb. 15, 2005), the ALJ found that despite allegations of instances of faulty interest calculations, inconsistent and untimely refunds, and improper accounting involving cost recognition, the complainant did not engage in protected activity because he could not demonstrate that the errors in financial accounting and reporting were related to a scheme of intentional corporate fraud.

In even more resolute fashion than the above cases, the ALJ in *Marshall v. Northrop Grumman Synoptics*, 2005 SOX 8 (ALJ June 22, 2005), found that "[f]raud is an integral element of a SOX claim, which necessarily includes an implicit element of deceit that would impact shareholders or investors." The Act "was not intended to capture every complaint an employee might have as a potential violation of the Act. . . . [Instead], the "goal of the legislation was to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities law." Under *Marshall*, the mere fact that the concerns involve accounting and finances does not automatically mean or imply that fraud or illegal conduct took place.

Under this line of cases, to be considered protected activity, a complainant must report fraudulent conduct that he reasonably believes constitutes a violation of the laws and regulations *related to fraud against shareholders*. Other cases have made this standard clear: "To be protected under Sarbanes-Oxley, an employee's disclosures must be related to illegal activity that, at its core, involves shareholder fraud." *Livingston v. Wyeth, Inc*., 2006 WL 2129794 (M.D.N.C. July 28, 2006); *Bishop v. PCS Admin (USA), Inc.*, 2006 WL 1460032 (N.D. Ill. May 23, 2006), (finding that the phrase "relating to fraud against shareholder" must be read as applying to all violations enumerated under Section 806).

Camp 2: Employee's Reasonable Belief of Fraud is Sufficient. The middle-ground in the area of protected activity, while recognizing that a fraud must be alleged, allows for a more generalized fraud with a more tenuous connection of the reported activity to fraud against shareholders.

In *Harvey v. Safeway, Inc*., 2004 SOX 21 (ALJ Feb. 11, 2005), the complainant alleged that he was not being paid for his time in violation of the Fair Labor Standards Act. He raised internal complaints to Safeway's corporate counsel about these allegations. Ultimately, the employee filed a SOX complaint charging that he was terminated in violation of SOX for having reported possible fraud against shareholders. His argument was that Safeway's under-compensation of its employees could impermissibly affect the accuracy of its financial disclosures required by SOX. Safeway moved to dismiss on the basis that the alleged conduct was not protected under SOX.

While the ALJ granted dismissal to Safeway, he held that had the facts involved a more significant, and thus material, violation, the employee's allegations may have satisfied SOX. The ALJ noted that because the allegations involved only the complainant's personal wage claim for which the underpayment was only one dollar an hour over a four week period, the complainant could not have reasonably believed that such a microscopic amount would have an effect on Safeway's financial reporting prepared for its shareholders. Ostensibly, if the number of employees and dollars in controversy had been more significant, the ALJ likely would have allowed the claim to go forward without regard to whether the underpayment specifically arose from a fraud against shareholders.

Although granting summary decision in favor of the employer on causal grounds, an ALJ in *Hendrix v. American Airlines, Inc.*, 2004 SOX 23 (ALJ Dec. 9, 2004), found that the employee engaged in protected activity when he reported his good faith belief that the improper use of company materials and time to create sculptures used as gifts for retirees was defrauding the company and likewise the shareholders. The respondent argued that the complainant did not report any of the types of fraud contained under SOX. Nevertheless, without addressing respondent's argument and apparently only considering the complainant's subjective viewpoint, the ALJ found the complainant engaged in protected activity because he reasonably believed that a fraud was being committed against the company and its shareholders. Additionally, without further explanation, the ALJ held that "undoubtedly" the use of mail or wires was utilized as part of the sculpture business making this the kind of fraudulent activity proscribed by SOX.

Camp 3: Shareholders Having Nothing to Do with It. Some decisions in the last year broaden the scope of protected activity by not only ignoring the fact that the complainant has not alleged one of the enumerated SOX frauds but also by ignoring whether the activity is a fraud impacting shareholders.

In *Walton v. NOVA Information Systems*, 2005 SOX 107 and 2006 SOX 18 (ALJ Mar. 29, 2006), the complainant, an employee for a credit card processor, alleged that his reports of security lapses in the company's database could foreseeably result in large scale criminal fraud against credit card holders as well as the shareholders of the company. The ALJ expressly rejected the employer's argument that providing information of

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such a violation is only protected when it is related to fraud against shareholders. In other words, the ALJ held that a SOX claim does not require the allegation of fraud against shareholders, but merely a violation of any of the enumerated frauds or Securities Exchange Commission laws.

In a recent case, a Georgia federal court created the widest berth yet for protected activity. In *Reyna v. ConAgra Foods, Inc.*, 2007 WL 1704577 (M.D.Ga. 2007), the Plaintiffs were employees in the human resources department of ConAgra Foods. Reyna worked as the employment coordinator responsible for all non-exempt hiring and Ortega was the FMLA Coordinator and Assistant to the Benefits Coordinator. Plaintiffs alleged that they were terminated for reporting two incidents of fraud: (1) they informed management about a scheme by a supervisory employee, which was perpetrated with knowledge of their supervisor, whereby the supervisor falsely requested that individuals identified as his wife and child, who were in fact his sister and nephew, be added to his health insurance plan; and (2) they informed management that a supervisor created a fake social security card to satisfy I-9 requirements for a maintenance employee. Reyna and Ortega pursued these complaints to the General Manager who requested that the plaintiffs provide him with proof of these allegations. The day the information was provided to the General Manager, plaintiffs were placed on suspension by their immediate supervisor and her boss. Plaintiffs were ultimately terminated.

Plaintiffs filed a complaint with OSHA alleging that ConAgra terminated them in violation of SOX and later re-filed their claims in federal court. They argued that the conduct they complained about necessarily involved the use of mail or the Internet and, therefore, that the reporting of this mail or wire fraud qualified as protected activity under SOX.

ConAgra argued that even assuming the plaintiffs' reports involved use of the mail or Internet, SOX only protects the activity insofar as it relates to fraud against shareholders. The plaintiffs argued that protected activity is the reporting of mail or wire fraud regardless of whether that fraud relates to fraud against shareholders. The court recognized that a conflict exists among the various courts as to whether protected activity is limited to fraudulent activity against shareholders. But the court went on to hold that Section 806 "clearly protects an employee against retaliation based upon that employee's reporting of mail fraud or wire fraud *regardless* of whether that fraud involves a shareholder of the company" (emphasis added). Thus, according to this decision, protected conduct encompasses complaints of *any* potential mail or wire fraud. The court held that the plaintiffs' reports of fraud "constitute protected activity under SOX." Under this rationale, essentially any fraudulent concerns, so long as the mail or wires *may* be used, is sufficient to come within the purview of protected activity.

To date, employers have been the victors in the SOX arena. At the OSHA level, employers have won Section 806 cases more than 96% of the time compared to employees winning only 3.6% of the time. At the ALJ level, employers have won 93.5% of the time compared to employees winning 6.5% of the time. Richard E. Moberly, *Unfulfilled Expectations: An Empirical Analysis of Why Sarbanes-Oxley Whistleblowers Rarely Win*, 49 WILLIAM AND MARY L. REV. 1 (2007). The data is particularly interesting given that the evidentiary framework of SOX imposes a higher hurdle for employers than under the general body of employment discrimination law. Of course, many cases are settled prior to a decision on the merits of the claim, which influences these statistics.

Failing to satisfy the element of protected activity is one of the top three rationales utilized in cases where the employer wins at either the OSHA or ALJ level. *Id.* at 27. Indeed, in nearly a quarter of the cases resolved in favor of the employer, the court held that the employee did not engage in protected activity because the employee's concerns did not relate to one of the six statutorily-defined acts of wrongdoing. *Id*. Moreover, the empirical data reveals that employees allege "fraud" or fraud generally related to "accounting" far more frequently than they allege specific types of fraud enumerated in the Act. *Id*. at 37.

As the DOL and courts continue to rule in SOX cases, employers should remain alert to the definitions adopted by the courts regarding protected activity. In particular, employers should distinguish between allegations of fraud in general, fraud of the kind specifically enumerated in the statute, and fraud of a kind that would actually impact shareholders.