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Defining "Protected Activity" Under SOX

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In what should be seen as a significant step forward for employers, the U.S. Department of Labor, OSHA Administrative Review Board ("ARB") has issued a decision that provides a clearer, more definitive, more limited and arguably more appropriate definition of what constitutes "protected activity," under the whistleblower provisions of the Sarbanes-Oxley Act ("SOX"). Welch v. Cardinal Bankshares Corp., ARB Case No. 05-064 (Dep't of Labor May 31, 2007).

Clarifying a legal issue which has caused a good deal of debate among courts and practitioners, the ARB held that in or order to be protected under SOX, a whistleblower must report or "blow the whistle" on conduct that he/she "reasonably believes" to be a violation of the securities fraud laws, mail fraud laws, banking fraud laws or SEC regulations – the laws which SOX was enacted to police.

In so doing, the ARB also held that a complaint about a violation of GAAP accounting standards, or about inadequate internal corporate controls, was not "protected activity" under SOX.

The ARB also offered a new definition of the concept of "reasonable belief," containing both a subjective and objective component, and articulating a higher standard of "reasonableness" for an educated plaintiff, who sits at the higher levels of a corporate hierarchy.

Welch is one of the strongest statements out of the Department of Labor ("DOL") defining SOX "protected activity." This case, along with other federal court and DOL decisions, has gradually clarified the law to the point where no longer should every employee who "blows the whistle" on what they perceive to be corporate wrongdoing, violations of internal polices or minor accounting errors be able to successfully claim SOX whistleblower status.

While the debate as to the scope of "protected activity" is far from over, Welch and its progeny could remove a huge group of potential plaintiffs from the umbrella of SOX's protection.

* Background *

The Sarbanes-Oxley Act was enacted in 2002 "for the purpose of eliminating perpetration of fraud against shareholders." Frederickson v. The Home Depot U.S.A., Inc., ALJ Case No. 2007-SOX-13, at 13-14 (Dep't of Labor July 10, 2007). In addition to creating new standards for corporate auditors and financial reporting, the statute contained a broadly-worded whistleblower provision that, as drafted, extended to anyone who reported what they “reasonably believed” to be unlawful activity.

Many feared that this new whistleblower protection would spawn a rush of plaintiffs’ lawsuits.

Indeed, in the early years after SOX’s enactment, we did see SOX whistleblower claims filed by employees who had made complaints over issues like missing airplane parts and pilots’ overuse of overtime.

See, e.g., Hendrix v. American Airlines, Inc., ALJ Case No. 2004-SOX-23 (Dep’t of Labor Dec. 9, 2004) (employee brings a SOX whistleblower complaint based on complaints as to misuses of discarded airplane parts); Collins v. Beazer Homes USA, Inc., 334 F. Supp. 2d 1365 (N.D. Ga. 2004) (employee brings a SOX whistleblower complaint, based on allegations that marketing costs were not being properly categorized and improper payments were being made to an advertising agency); Platone v. FLYi, Inc., ARB Case No. 04-154 (Dep’t of Labor Sept. 29, 2006) (employee brings a SOX whistleblower complaint based on allegations of pilots’ misuse of time off policies).

Notwithstanding their somewhat tenuous connection to the securities and fraud statutes, many of these complaints were deemed SOX “protected activity.”

This trend seems to have taken a turn and more recently, and certainly with Welch, the ARB has adopted a more limited view, recognizing that an employee must be blowing the whistle on a SOX issue in order to be engaged in SOX “protected activity.”

* The Welch Facts *

David Welch was a Certified Public Accountant and the CFO for Cardinal Bankshares Corporation (“Cardinal” or “the Bank”), a small, publicly-traded Virginia bank. Welch alleged that in September 2001 he discovered entries in Cardinal’s financial reports, in which he believed certain loan recoveries had been “misclassified” as “income,” in violation of “GAAP” accounting standards.

This income was then included in Cardinal’s quarterly filings with the Securities and Exchange Commission, which, according to Welch, artificially inflated the bank’s earnings.

Welch notified Cardinal’s CEO of these allegedly misclassified entries, and what he believed to be the overstatement of Cardinal’s income. At around the same time, Welch also raised other complaints with senior management regarding Cardinal’s internal financial controls and made an allegation that Cardinal’s CEO had engaged in insider trading.

Ultimately, Welch filed a formal complaint with the SEC in March 2002 of this alleged insider trading by the CEO. He also advised state banking examiners of “issues” he wished to report. After the completion of an investigation by outside counsel and Cardinal’s auditors into Welch’s allegations, Welch’s complaints were deemed without substance.

Welch alleged that after making these various complaints, he was excluded from meetings, denied access to Cardinal’s outside auditors, and otherwise allegedly prevented from doing his job.

It was undisputed that Welch refused to meet with counsel and the auditors who Cardinal had retained to investigate his complaints, and also refused to sign certain financial documents.

Cardinal ultimately suspended Welch for insubordination and refusing to cooperate with the investigation. On October 1, 2002, Cardinal’s legal counsel and auditor informed the Board of Directors that they had determined Welch’s claims to be without merit.

The Board thereafter voted to terminate Welch for insubordination, after he refused to certify one of Cardinal’s quarterly filings, and for refusing to cooperate with that investigation.

After his dismissal, Welch filed a SOX whistleblower complaint with the U.S. Department of Labor, alleging that he was unlawfully terminated in retaliation for reporting suspected fraud and unlawful activity by Cardinal.

With that began a five-year odyssey of litigation for Welch and Cardinal.

The DOL investigated Welch’s complaint and initially found no merit to his allegations. Welch then requested a hearing before an ALJ. After a hearing, in 2006, the ALJ at first found that Welch had been unlawfully terminated for his participation in SOX-protected activities, and recommended that Welch be reinstated, with back pay.

This decision was one of the first findings that a company had unlawfully retaliated against an employee in violation of SOX. Cardinal immediately requested a federal court stay of the reinstatement order and a review of the decision by the ARB. It was not until May 2007 that the ARB finally decided Cardinal’s appeal.

* The ARB Defines “Protected Activity” *

In its decision on May 31, 2007, the ARB reversed the ALJ’s determination and held that Welch’s termination was not a violation of SOX. Central to the ARB’s holding was its conclusion that Welch’s complaints about misclassified accounting entries and inadequate internal controls did not constitute “protected activity” under SOX, because the issues he raised did not concern actual or possible violations of federal fraud statutes, SEC regulations or federal laws regulating shareholder fraud.

The ARB began with the basic premise that “[t]he [whistleblower] provision of the SOX prohibits employers from retaliating against employees for providing information or assisting in investigations related to securities fraud.” Welch, at 14-15.

Thus, in order to establish that he engaged in protected activity under SOX, the ARB stated that Welch had to show that he "definitively and specifically" had made complaints to his employer regarding issues that he "reasonably believed constituted ... mail fraud,...wire, radio, TV fraud, ... bank fraud, securities fraud ... , a violation of an SEC rule, ... or any federal law relating to fraud against shareholders." Id. at 15-17.

This was not all – the ARB also articulated a new and arguably more stringent standard for this "reasonable belief." SOX has always required that the complaining employee establish that he/she had a "reasonable belief" that there was some unlawful activity.

The ARB in Welch went one step further, setting out a new objective standard for the "reasonable belief." It held that the complaining employee must prove two elements: first, a "personal belief," (i.e., that he "actually believed" that the particular action or activity being reported was a SOX violation).

Second, the employee must prove that his personal belief was "reasonable," considering his "expertise," "knowledge" and position within the company. Id. at 22-23.

Applying these standards to the particular facts, the ARB found that Welch could not have "actually" or "reasonably" believed that the various irregularities he reported had caused the Bank to overstate its income, or to have actually misled investors.

The ARB addressed three instances of alleged "protected activity" asserted by Welch. Welch's first and arguably most serious allegation of protected activity was his attempt to report internally and to Cardinal's auditors that Cardinal had "misclassified accounting entries," which, according to Welch, were a violation of GAAP Accounting Standards and could have led to an overstatement of Cardinals income in its SEC quarterly reports.

Notably, for purposes of the appeal, Cardinal did not dispute that these entries were wrong, and that it may have violated the GAAP Accounting Standards. Rather, Cardinal argued, "Welch did not have a reasonable basis for believing that Cardinal overstated its net income."

The ARB analyzed whether, under its new "objective" standard for "reasonable belief," Welch could prove that he "reasonably believed" these alleged misclassified entries would have "actually" misled potential investors. The ARB looked closely at Cardinal's finances and analyzed the actual effect that this alleged misclassification of income had on the Bank's public financial statements.

The ARB ultimately agreed with Cardinal's argument that, even if an accounting mistake had occurred, the Bank had received other income that essentially negated these errors. So, the errors Welch reported essentially had no material effect on the bottom line.

Further, the ARB found that as a certified public accountant with substantial business and financial experience, Welch could not have "actually believed" that this $195,000 "misclassified" entry would have caused the Bank to overstate its income. Hence, "a reasonable CPA and CFO could not have concluded that there was an overstatement of net income." Id. at 24.

Finally and ultimately, the ARB concluded that, because of his position, Welch should have known this - "an experienced CPA/CFO like Welch could not have reasonably believed that the third quarter SEC report presented potential investors with a misleading picture of Cardinal's financial condition." Id.

Welch also alleged that these misclassified loan entries were a violation of GAAP Accounting Standards, which he argued was effectively the same as a violation of the federal securities laws.

This argument was soundly rejected by the ARB, which held that violations of GAAP or FFIEC accounting rules are not, in and of themselves, covered by SOX. Indeed, the ARB found that to accept this contention would amount to a "wholesale re-writing of SOX," which was intended to protect whistleblowers who report about specifically enumerated employer conduct – violations of the federal fraud statutes, SEC rules or regulations, or federal laws relating to shareholder fraud." Id. at 26-27.

Congress did not intend, according to the ARB, to extend those protections to employees who report "violations of GAAS, GAAP or FFEIC standards." Id. at 27. Here again, the ARB construed to the language of SOX narrowly, finding that while SOX did direct that the Accounting Oversight Board adopt standards for these internal controls, a violation of these Accounting Standards was not a violation of federal law.

Welch's second allegation was that he was denied access to the company's internal auditors. Here again, the ARB found that this was not protected activity, stating "Welch did not prove...how his unhappiness about access to [the outside auditor] constituted a reasonable belief that Cardinal was violating or might violate the enumerated fraud statutes, any SEC rule or regulation, or any federal law relating to fraud against shareholders." Id. at 29.

As his final "toot" of the SOX whistle, Welch also alleged that he had complained to the CEO and other senior management about Cardinal's allegedly insufficient internal accounting controls, and that they had ignored his recommendations as to how to strengthen those controls.

Welch essentially claimed that, once he alerted the bank to the fact that he thought their conduct was unlawful, their failure to "make the correction" amounted to a fraud or potential fraud on shareholders. Id. at 32.

The ARB also rejected this contention, finding that there was no authority for the "proposition that rejecting the CFO's advice on accounting matters violates or could reasonably be regarded as violating the federal securities laws." Id.

Here again, the ARB adopts a narrow view of SOX’s protections, essentially holding that the failure to follow the suggestions of an executive as to what is “legal” does not amount to a per se violation of the securities laws or an intent to defraud.

* Other Decisions Defining Protected Activity *

Welch does not end the debate about the concept of protected activity. A number of courts have adopted the narrower definition of the ARB in Welch.

In Fraser v. Fiduciary Trust Co., 417 F. Supp. 2d 310 (S.D.N.Y. 2006), a New York federal judge held that a SOX complaint must have a certain “degree of specificity” and must “at the very least, reasonably identify a respondent’s conduct that the complainant believes to be illegal.” Fraser, 417 F. Supp. 2d at 322.

He concluded that some of the communications from plaintiff to company superiors were not protected activity because they were “barren of any allegations of conduct that would alert Defendants that [plaintiff] believed the company was violating any federal rule or law related to fraud on shareholders.”

However, those internal complaints by plaintiff which did allege a violation of federal securities laws were found to be protected under SOX.

In Bishop v. PCS Admin. Pacatish Corp., 2006 U.S. Dist. LEXIS 37230 (N.D. Ill. 2006) a district court in Illinois found that a general counsel who complained that a compliance program was insufficient to prevent future unlawful activity was not protected – because she was not reporting and did not have a “reasonable belief” that a violation had occurred.

Likewise, it has also been recognized that a report of suspected tax fraud alone is not automatically “protected activity” under SOX, unless it can be shown that the tax fraud was part of some larger scheme to commit securities fraud, mail fraud or wire fraud. JDS Uniphase v. Jennings, 473 F. Supp. 2d 697 (E.D. Va , 2007)

In Frederickson v. The Home Depot U.S.A., Inc., ALJ Case No. 2007-SOX-13 (Dep’t of Labor July 10, 2007), an OSHA ALJ held that plaintiff’s complaints to upper management regarding the store’s alleged “fraudulent” recording of returns on damaged goods was not protected activity under SOX.

For one, the ALJ found that plaintiff had no “reasonable basis” to believe that this alleged fraud extended beyond the one store where he worked. Second, even if his claims were true, it found that this “alleged fraudulent policy” was “not of a magnitude sufficient to support a reasonable belief that a reasonable investor would rely upon such information, or that it altered the ‘total mix’ of information available to an investor.

Thus, ... it is clear he had no reasonable belief that Respondent had engaged in any conduct or activity ... that constituted a fraud against its shareholders.”

Adding an element of “materiality” to the reasonable belief standard, in Deremer v. Gulfmark Offshore, Inc., ALJ Case No. 2006-SOX-2 (Dep’t of Labor June 29, 2007), another ALJ held that a SOX plaintiff had to prove that his employer “intentionally acted fraudulently, and that such conduct was sufficiently material so as to constitute fraud against the shareholders.”

Essentially, the ALJ there concluded that fraud was an essential element of the whistleblower claim, and that this had to include the intent to disseminate false information into the market, on which a reasonable investor may rely.

This would be a very high standard for a whistleblower to meet. See also Robinson v. Morgan Stanley, ALJ Case No. 2005-SOX-44 (Dep’t of Labor Mar. 26, 2007) (internal auditor’s memo to management reporting on misuse of company cell phones and calling cards did not rise to the level of “materiality” to constitute a fraud against shareholders).

The federal courts, however, do not all share the ARB’s narrow interpretation of SOX protected activity. In Smith v. Corning Inc., 2007 WL 2020063, Case No. 06-CV-6516, at *5 (W.D.N.Y. July 9, 2007), a federal court in New York held that an internal complaint that the company’s financial reporting system was not GAAP-compliant and “would have resulted in the issuance of incorrect quarterly reports” that could have misled investors was sufficient to assert a SOX whistleblower claim and survive a motion to dismiss.

In Reyna v. Conagra Foods, Inc., 2007 WL 1704577, Case No. 04-CV-00039 (M.D. Ga. June 11, 2007), another court held that a complaint about false insurance claims and violations of the immigration laws was SOX “protected activity,” even if plaintiff could not show that the conduct amounted to a “fraud against shareholders.”

Similarly, in Johnson v. Stein Mart, Inc., 2007 WL 1796265, Case No. 06-CV-000341 (M.D. Fla. June 20, 2007), plaintiff, a buyer in a clothing store, alleged that there were issues with recording of inventory markdowns and the collection of ‘markdown allowances’ from vendors. She had no accounting background, and no knowledge of the employer’s actual accounting practices. The court held that, because the employer had deemed her complaints “reasonable” enough to warrant an internal investigation, plaintiff had satisfied the standard for asserting a prima facie SOX whistleblower claim.

* Conclusion *

What does this all mean? The Welch decision represents a significant victory for Cardinal and for other employers, providing much-needed guidance as to the scope of the concept of “protected activity” under SOX.

Assuming Welch is followed, it should now be clear that complaints or grievances that fall outside the areas of banking and securities fraud laws should not be SOX complaints.

Furthermore, an employee must prove both an objective and subjective “reasonable belief” that a violation of federal securities laws has occurred in order to successfully prove they engaged in protected activity.

Under this new “Welch standard” for “reasonable belief,” employees with more knowledge and experience with legal or financial matters should be held to a higher standard, arguably making it more difficult for high-level employees, like Welch, to make their prima facie case of wrongful termination under SOX.

At the same time, this could make it easier for lower level employees to prove that they “reasonably believed” that illegal conduct has occurred, than high level corporate officers that have undergone training in SOX compliance and have advanced accounting experience.

Moreover, just because an employee’s complaint concerns an employer’s accounting procedures or financial controls under the Welch standard, that does not mean that the complaint will automatically be protected by SOX. Rather, to be protected, the complaint must “definitively and specifically” relate to violations of federal securities laws.

Complaints alleging violations of GAAP standards, like Welch’s complaint, will generally not constitute protected activity under SOX.

Welch should mean that complaints about discrimination, harassment, safety issues, workplace harassment and other non-securities fraud issues should no longer be entitled to claim SOX protection.

However, we see that the federal courts in every jurisdiction have not yet adopted this principle. In some jurisdictions, an employer may actually be better off litigating these legal maters at the DOL, and then hoping that a federal court will follow the DOL’s determinations.

However, we know that SOX procedures allow either side the option to pull the DOL complaint and go to federal court. Thus, Welch will not end the litigation over the scope of the concept of SOX protected activity.

The new standards enunciated in Welch certainly do not mean that public companies can become less vigilant when investigating or responding to potential SOX complaints.

Welch does not mean that a company should not take seriously any complaints of GAAP violations, or inadequate internal controls.

It does mean, however, that if a plaintiff chooses to bring a SOX whistleblower claim, an employer that has appropriate procedures in place, and has done a prompt and thorough investigation, now has a new arsenal of legal arguments available to it to mount a successful defense.

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