

## A Key Decision For SOX Practitioners

*Tuesday, Jan 29, 2008* --- On Jan. 22, 2008, the Fifth Circuit rendered an important decision addressing whistleblower claims under the Sarbanes-Oxley Act (“SOX”), 18 U.S.C. § 1514A. See *Allen v. Administrative Review Board*, \_\_\_ F.3d \_\_\_, 2008 WL 171588 at \*5 (5th Cir. Jan. 22, 2008).

Allen discusses and relies upon several decisions of the Department of Labor (“DOL”) Administrative Review Board (“ARB”) and, to that extent, the legal principles announced in Allen are not revolutionary. Allen is nevertheless a significant decision for SOX practitioners because it confirms, in four important respects, the federal courts’ agreement with the legal standards announced by the ARB.

First, Allen confirms the two-prong standard for proving a whistleblower claim under SOX. Under this standard, a plaintiff first “must prove by a preponderance of the evidence that (1) she engaged in protected activity; (2) the employer knew that she engaged in the protected activity; (3) she suffered an unfavorable personnel action; and (4) the protected activity was a contributing factor in the unfavorable action.” Allen, 2008 WL 171588 at \*5 (citing 49 U.S.C. § 42121(b)(2)(B)(iii); *Stojicevic v. Arizona-American Water*, ARB Case No. 05-081, 2007 WL 3286331, at \*7 (ARB Oct. 30, 2007); *Welch v. Cardinal Bankshares Corp.*, ARB Case no. 05-064, 2007 WL 1578493, at \*5 (ARB May 31, 2007)).

Second, “[i]f the employee establishes these four elements [of a prima facie SOX whistleblower claim], the employer may avoid liability if it can prove ‘by clear and convincing evidence’ that it ‘would have taken the same unfavorable personnel action in the absence of that [protected] behavior.’” Allen, 2008 WL 171588 at \*6 (quoting 49 U.S.C. § 42121(b)(2)(B)(iv)).

Notably, this standard “is distinct from the McDonnell Douglas burden-shifting framework applicable to Title VII claims.” *Id.*; see also *Collins v. Beazer Homes USA, Inc.*, 334 F. Supp. 2d 1365, 1375 n.11 (N.D. Ga. 2004) (“The evidentiary framework to be applied in Sarbanes-Oxley is an analysis different from that of the general body of employment discrimination law.”).

Unlike the ease with which plaintiffs can establish a prima facie case under McDonnell Douglas, the plaintiff’s burden to establish a prima facie case under SOX “by a preponderance of the evidence” is demanding.

Indeed, in most SOX cases before the ARB that have been decided on the merits, the ARB has determined that the plaintiff failed to meet that burden. The Fifth Circuit reached the same conclusion in Allen, confirming that this same rigorous standard of proof will be adhered to in the federal courts as

well as before the DOL.

Second, Allen confirms that a plaintiff seeking to prove the first element of her prima facie case, that she engaged in a protected activity, must establish that she “definitively and specifically” complained of unlawful conduct prohibited by the statute.

In particular, “an employee’s complaint must ‘definitively and specifically relate’ to one of the six enumerated categories found in § 1514A: (1) 18 U.S.C. § 1341 (mail fraud); (2) 18 U.S.C. § 1343 (wire fraud); (3) 18 U.S.C. § 1344 (bank fraud); (4) 18 U.S.C. § 1348 (securities fraud); (5) any rule or regulation of the SEC; or (6) any provision of federal law relating to fraud against shareholders.” Allen, 2008 WL 171588 at \*6.

Here again, a SOX whistleblower claim differs significantly from a retaliation claim under Title VII. Under a liberal application of the McDonnell Douglas framework, a plaintiff may be able to state a claim based upon complaints that impliedly relate to racial or gender discrimination. Under SOX, however, that is not enough.

Allen confirms the uniform holding of lower courts and the ARB that a complaint under SOX must “definitively and specifically” relate to shareholder fraud. See, e.g., *Bozeman v. Per-Se Technologies, Inc.*, 456 F. Supp. 2d 1282, 1359 (N.D. Ga. 2006) (“Protected activity must implicate the substantive law protected in Sarbanes-Oxley ‘definitively and specifically.’”) (citation omitted).

The Fifth Circuit held that one of the plaintiffs therein, Laura Waldon, had no claim under SOX because she did not “definitively and specifically” complain of shareholder fraud.

Waldon had alleged that the defendant failed to comply with an SEC Staff Accounting Bulletin (“SAB”), SAB-101. “Waldon discussed her concerns about SAB-101 compliance with Mike Hymel, Stewart’s Chief Accounting Officer, who assured her that Stewart was working on making adjustments to its system.” Allen, 2008 WL 171588 at \*3.

The Court held that Waldon’s inquiries about compliance with SEC regulations were not enough to “definitively and specifically” allege shareholder fraud, even if Waldon secretly believed that that company was engaging in such fraud when she inquired about SAB compliance.

“Although Waldon apparently had subjective suspicions that Stewart’s SEC statements might not be SAB-101 compliant based on her review of Stewart’s 2003 internal financial statement, substantial evidence supports the ALJ’s and ARB’s factual finding that she did not sufficiently complain or raise particular concerns about whether Stewart’s SEC statements were SAB-101 compliant.” *Id.* at \*8.

Third, Allen confirms that while an employee’s complaint that “definitively and

specifically” alleges shareholder fraud can be protected even in the absence of actual shareholder fraud, the plaintiff must have “reasonably” believed that shareholder fraud had occurred. “[A]n employee’s reasonable belief must be scrutinized under both a subjective and objective standard.” Allen, 2008 WL 17158 at \*6 (citing Welch, 2007 WL 1578493, at \*7).

In this respect, employment practitioners are on more familiar grounds. The Fifth Circuit notes that, “[t]he ‘objective reasonableness’ standard applicable to SOX whistleblower claims is similar to the ‘objective reasonableness’ standard applicable to Title VII retaliation claims.” Id. at \*7. Notably, “the objective reasonableness of an employee’s belief can be decided as a matter of law in some cases.” Id.

The Fifth Circuit explained, however, that “[t]he objective reasonableness of a belief is evaluated based on the knowledge available to a reasonable person in the same factual circumstances with the same training and experience as the aggrieved employee.” Id. at \*6.

In other words, employees with more knowledge and experience with legal or financial matters will be held to a higher standard.

Applying this standard, the court in Allen held that, “[b]ecause she is a licensed CPA, the objective reasonableness of Waldon’s belief must be evaluated from the perspective of an accounting expert.” Id. at \*8.

The Fifth Circuit noted that Waldon could have reviewed the defendant’s SEC statements to ascertain whether they complied with SAB-101, but she failed to do so. Accordingly, Waldon lacked a reasonable belief that the defendant engaged in shareholder fraud, and she failed to establish a whistleblower claim.

Fourth, Allen confirms that a plaintiff alleging a SOX whistleblower claim based on alleged shareholder fraud must reasonably believe not only that shareholders have been misled, but that the defendant had the specific intent to deceive them. As the Fifth Circuit explains, “the plain language of the statute indicates that some form of scienter related to fraud against shareholders is required.” Allen, 2008 WL 171588 at \*9.

“Mere negligence on the part of the employer does not constitute a violation of federal law relating to fraud against shareholders.” Id. Thus, “the employee must reasonably believe that his or her employer acted with a mental state embracing intent to deceive, manipulate, or defraud its shareholders.” Id.

(By contrast, the Fifth Circuit did not decide the question, not before it, whether scienter was a necessary element of a claim based on one of the other enumerated categories, such as mail fraud or wire fraud.)

The court rejected the claims of the remaining two plaintiffs, Patricia Allen and Dana Breux, on the grounds that they lacked reasonable beliefs that the defendant had engaged in shareholder fraud.

Allen and Breux had complained to their employer about a malfunction in its computer system for calculating interest when customers prepaid their installment contracts for services or merchandise to be provided in the future. *Id.* at \*1.

They claimed that the company's financial condition would be negatively impacted and that it failed to disclose this fact to its shareholders. *Id.* at \*9. The Fifth Circuit affirmed the dismissal of their claims, concluding that they did not engage in a protected activity because they "did not reasonably believe that [defendant] acted with a 'mental state embracing intent to deceive, manipulate, or defraud.'" *Id.* at \*10.

In sum, Allen provides confirmation of the legal standards applicable to SOX whistleblower claims articulated by the ARB and district courts.

Its holding is in accordance with the numerous administrative and district court decisions that require plaintiffs to "definitively and specifically" allege shareholder fraud, and it provides a firm foundation for practitioners seeking to evaluate the merits of SOX whistleblower cases.

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