

August 11, 2008

## Fourth Circuit Rejects SOX Whistleblower Appeal Based on Employee's Failure to Show Protected Activity

The United States Court of Appeals for the Fourth Circuit in *David E. Welch, CPA v. Elaine L. Chao*, No. 07-1684 (slip op., Aug. 5, 2008) (Motz, J.) (click [here](#) for the opinion) rejected the whistleblower claim of former Cardinal Bankshares Corporation ("Cardinal" or the "Company") Chief Financial Officer ("CFO") David Welch based upon his failure to show that he reasonably believed that the actions of his employer violated any of the laws related to fraud against shareholders listed in 18 U.S.C. § 1514A (the whistleblower provision of the Sarbanes-Oxley Act of 2002 ("SOX")). SOX prohibits publicly traded companies from taking adverse employment action against an employee who complains of, or provides information regarding, any conduct that the employee reasonably believes violates federal law relating to fraud against shareholders. See 18 U.S.C. § 1514A(a).

### The Welch Case

Welch served as Cardinal's CFO from 2000 until his termination in late 2002 and was responsible for oversight of the Company's accounting practices and procedures, including preparation of quarterly and annual reports to the Securities and Exchange Commission ("SEC"). During his employment, Welch made several oral and written complaints regarding the Company's accounting practices, which, he contended, constituted fraudulent acts. Specifically, Welch complained that personnel who routinely made entries on Cardinal's general ledger lacked accounting expertise, a practice that violated generally accepted accounting principles, and that the Company's Chief Executive Officer ("CEO") Ronald Moore excluded him from communications with Cardinal's independent auditor. As a result, Welch claimed that the Company had misclassified loan recoupments and overstated its income on its 2001 third-quarter report to the SEC.

As Welch grew more vocal in his criticism of Cardinal's accounting practices, his relationship with Moore became increasingly strained. In August 2002, Welch refused to certify Cardinal's second-quarter report to the SEC, which Moore certified himself. In September 2002, Welch held a meeting for senior Cardinal personnel, dubbed a "Sarbanes-Oxley briefing," during which he alleged that three employees were "parties to fraudulent acts" and requested a severance package. *Welch*, No. 07-1684, slip op. at \*6. Following this meeting, Welch refused to meet with the Company's attorney and a representative of its independent auditor without his personal attorney present. Cardinal's Board of Directors suspended Welch without pay and ordered him to meet with Cardinal's attorney and auditor. When Welch refused, his employment was terminated.

Welch filed a complaint with the Department of Labor ("DOL") alleging that he was terminated in violation of SOX. Welch initially prevailed after a hearing before an administrative law judge ("ALJ"), and Cardinal was ordered to reinstate Welch to his former position with back pay. Cardinal appealed to the DOL's Administrative Review Board ("ARB"). The ARB reversed the ALJ, finding that Welch had not engaged in a protected activity. Welch appealed to the United States Court of Appeals for the Fourth Circuit.

### The Court of Appeals Decision

The Court of Appeals affirmed the ARB's dismissal, holding that Welch had failed to articulate how he reasonably could have believed that Cardinal violated one of the securities laws related to fraud against shareholders listed in section 1514A. The court found that in his arguments to the ALJ and the ARB, Welch relied on laws and regulations that fell outside the scope of section 1514A, and cited general

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accounting standards and the purpose of the federal securities laws. *Id.* at \*\*14-15. Without more, the court held, Welch’s arguments before the DOL were insufficient to establish that he had engaged in a protected activity when complaining about Cardinal’s accounting practices. *Id.* The court was careful, however, to limit its decision to the facts of the case and clarify that a whistleblower need not identify a specific statutory provision or regulation when complaining of conduct to an employer. *Id.* at \*15.

Importantly, the Court of Appeals held that to establish the protected activity prong of a SOX claim, the employee must show that his or her communications to the employer were “definitively and specifically related to one of the laws listed in § 1514A.” *Id.* at \*\*8-9 (quoting *Platone v. FLYi, Inc.*, ARB Case No. 04-154, slip op. at \*17 (ARB Sept. 29, 2006)) (internal quotation marks omitted). That is, the employee’s communications to the employer must, without necessarily referring to a particular statute or regulation, be specific as to the conduct believed to be illegal. In so holding, the court rejected two of Cardinal’s arguments regarding the effect of the “definitively and specifically” requirement. First, the court rejected Cardinal’s position that this requirement results in protection only for those communications related to material violations of a listed law. Cardinal’s argument in this regard was predicated upon the fact that several of the laws listed in section 1514A, such as SEC Rule 10b-5, contain a threshold materiality requirement. The court, however, found nothing in the text of section 1514A that imposes an independent materiality requirement on whistleblowers. Second, the court rejected the notion that the definite and specific requirement imposes a heightened pleading standard in SOX cases similar to that required for pleading securities fraud. The inquiry, the court held, should be focused on what the employee actually communicated to the employer, not the bare allegations of the complaint.

### The Practical Effect of the Welch Decision

The *Welch* decision, although limited in many respects to its facts, makes clear that to establish the protected activity prong of a SOX whistleblower claim, the employee must show that (i) his or her complaints relate to specific conduct by the employer that the employee believes to be illegal and (ii) this belief was subjectively and objectively reasonable when viewed in relation to one or more of the laws and regulations listed in section 1514A. SOX plaintiffs who fail to meet these requirements will not be successful in their claims. As the Court of Appeals noted in its decision, Welch might have been able to establish that his complaints regarding Cardinal’s accounting practices were directed at specific conduct that he believed violated applicable federal securities laws, but he failed to tie his complaints to relevant authority at the agency level. In general, the *Welch* decision indicates that the bar for establishing a protected activity under SOX is rising. Nonetheless, employers should continue to respond carefully to allegations of fraud by employees and consult with legal counsel before taking adverse action against an employee who makes such a complaint.



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