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Corporate Governance Group

Client Alert

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FIRST CIRCUIT REQUIRES “OBJECTIVE REASONABLE BELIEF” OF FRAUDULENT CONDUCT IN ORDER FOR TERMINATED EMPLOYEE TO OBTAIN SARBANES- OXLEY WHISTLEBLOWER PROTECTION

SOX “does not provide whistleblower protection for all employee complaints about how a public company spends its money and pays its bills”

In *Day v. Staples, Inc.*,¹ the U.S. Court of Appeals for the First Circuit recently ruled that the “reasonable belief” requirement of the whistleblower protection provision of the Sarbanes-Oxley Act of 2002 (“SOX”) contemplates both “objective reasonableness” and “subjective reasonableness.” In this case of first impression before the First Circuit, the Court joined the Fourth Circuit² in denying whistleblower protection to aggrieved employees whose allegations of improper conduct – even when made in good faith – failed to allege violations of the “basic elements” of one of the laws specifically cited in the whistleblower statute. As noted in earlier Client Alerts, this is yet another example of a strict constructionist approach to interpreting, and thereby limiting the reach of, broadly-phrased SOX provisions.³

¹ *Day v. Staples, Inc.*, No. 08-1689 (1st Cir. 2009).

² See *Welch v. Chao*, 536 F.2d 269 (4th Cir. 2008).

³ See our previous Client Alerts discussing section 304 of SOX, entitled “*Ninth Circuit Finds No Private Right of Action Under Section 304 of Sarbanes-Oxley*,” dated January 5, 2009; and “*Federal District Court Finds That Material Errors In Financial Statements – In the Absence of An Actual Restatement – Not Sufficient to Support a Claim Under Section 304 of Sarbanes-Oxley*,” dated January 9, 2009.

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Background of Whistleblower Statute

Under section 1514A(a) (1) of SOX:

“No [publicly traded company] . . . may 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 . . . 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 . . . [Federal statutes relating to mail fraud, wire fraud, bank fraud or securities fraud], any rule or regulation of the [SEC], or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to . . . a person with supervisory authority over the employee”⁴

This provision, adopted as part of the sweeping SOX legislation signed into law in 2002 in the wake of the accounting scandals at Enron, WorldCom and other companies, was designed to protect so-called “whistleblowers” at publicly-traded companies “by prohibiting employers from retaliating against employees because they provided information about specified potentially unlawful conduct.” In adopting this protection, Congress sought to combat a perceived “corporate code of silence” that damages investors in publicly-traded companies by both “hamper[ing] investigations” of corporate wrongdoing and “creat[ing] a climate where wrongdoing can occur with virtual impunity.”

Key Facts

On September 26, 2005, Kevin M. Day filed a complaint with OSHA against his employer Staples, Inc., “alleging retaliatory termination in violation of the SOX whistleblower protection provisions.” Day had worked for Staples for less than three months prior to his termination. During this period, Day repeatedly complained to his supervisors regarding three types of billing and collection practices at Staples. In Day’s view, these practices raised the (obviously contradictory) risks of a reduction in Staples’s profits and an inflation of supervisors’ bonuses. Before Day was terminated due to his “inflexibility,” failure to perform “his job well” and threats “not to follow his managers’ instructions,” he was permitted to air his grievances in a battery of meetings with senior managers. Staples’ internal investigation uncovered no wrongdoing on the company’s part.

The OSHA investigator concluded that Day’s claim “lacked merit” and that Day’s concerns appeared to be “a ‘disagreement with management’ about internal procedures.” A subsequent administrative hearing resulted in the dismissal of Day’s complaint. Day then filed suit in Federal district court. The district court granted summary judgment in favor of Staples, concluding that while Day’s concerns “were stated with adequate particularity,” his “belief that he had uncovered fraud was not reasonable.” Day appealed this ruling to the First Circuit, which affirmed the lower court decision.

The Court’s Analysis

The First Circuit, after reviewing the statutory background of the whistleblower statute, focused on the “requirement that a SOX complainant be a person who ‘provide[s] information . . . regarding any conduct which the employee *reasonably believes* constitutes a violation’ of the pertinent laws listed in § 1514A.” [emphasis added] According to the Court, “the term ‘reasonable belief’ has both a subjective and objective component.”

⁴ Day, *supra* note 1, at 19 (brackets in original).

Finding that the *subjective* component was satisfied because Day had acted in good faith in bringing his complaint, the Court quickly moved to the *objective* component, observing that “§ 1514A requires . . . an objectively reasonable belief that conduct complained of constituted a violation of the relevant law set out in the statute.” Thus, while “[t]he employee is not required to provide the employer with the citation to the precise code provision in question,” or to prove “that there was an actual violation of the provision involved,” objective reasonableness “must be measured against the basic elements of the laws specified in the statute.”

Next, the Court noted that “the plain language” of § 1514A “restricts the employee’s protection to . . . three broad categories” of conduct: (1) a violation of specified Federal criminal fraud statutes, including securities fraud, (2) a violation of any rule or regulation of the SEC or (3) a violation of any provision of Federal law relating to fraud against shareholders. Based on the recognized common elements of fraud,⁵ and in particular of securities fraud,⁶ the Court determined that for an employee to be protected by the SOX whistleblower provision, he or she “must have an objectively reasonable belief that the company intentionally misrepresented or omitted certain facts to investors, which were material and which risked loss.”

Based on this measure, the Court had little trouble determining that “Day’s assertions do not meet the basic components of fraud or of securities fraud.” The Court then proceeded to a specific analysis of Day’s various allegations against Staples. Noting that “[s]everal of Day’s complaints amount to allegations that the company’s practices did not maximize shareholder profits,” the Court responded that “[a] complaint about corporate efficiency is . . . not within the intended protection of SOX.” Furthermore, the Court stated that “[a] claim of ‘needless loss of revenue’ is not a claim of fraud” and “[a] billing discrepancy, without more, does not equal fraud.”

The Court also rejected the notion that Staples’s alleged accounting violations amounted to shareholder fraud, stating that “[a] generalized allegation of inaccuracy in accounting is insufficient to establish a reasonable belief in a violation of GAAP, much less a reasonable belief in shareholder fraud.” Moreover, inasmuch as Day’s complaint focused on “purely internal practices that are not financial in nature and are not reported to shareholders,” the Court continued, “Day’s belief was also objectively unreasonable because he has made no showing that any inaccuracy was material to shareholders.”

Lastly, the Court noted that the “company’s explanations given to the employee for the challenged practices also were relevant in the objective reasonableness of an employee’s belief in shareholder fraud.” In the Court’s view, “Day’s beliefs were not initially reasonable as beliefs in shareholder fraud and they became less reasonable as he was given explanation.”

Conclusion

The First Circuit’s ruling in *Day v. Staples, Inc.* has construed the “reasonable belief” requirement of the whistleblower protection statute so as to limit its reach to complaints that sufficiently allege a threshold case of fraud, as opposed to unhappiness with internal corporate operations that does not impact shareholder value in a material way. As such, this decision creates an additional hurdle for employees who seek to redress their grievances against their employers via the whistleblower protections of SOX. The Court’s approach in *Day* is consistent with other recent Federal court decisions that have limited the reach of other provisions of SOX.

⁵ “The hallmarks of fraud are misrepresentation or deceit.” *Day*, at 27.

⁶ “Those elements [of securities fraud] typically include a material misrepresentation or omission, scienter, loss, and a causal connection between the misrepresentation or omission and the loss. (citations omitted). Securities fraud under section 10(b) and Rule 10b-5 requires: (1) a material misrepresentation or omission; (2) scienter; (3) connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation.” *Day*, at 28 (citations omitted).

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