## Litigation - USA

# Sarbanes-Oxley Whistleblower Provision Lacks Extraterritorial Reach

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### Background

In the wake of the Enron and WorldCom scandals, the US Congress rushed to enact legislation that would dramatically increase the penalties for corporate malfeasance and, it was hoped, restore some measure of investor confidence. The result was the Sarbanes-Oxley Act of 2002, which is widely considered the most significant legislation affecting the US securities markets since the 1930s. The act became law a mere seven months after Enron filed for bankruptcy and one month after WorldCom announced a $3.8 billion restatement of earnings. The act was introduced into Congress - where it received not only bipartisan, but almost unanimous, support - in July 2002. President Bush signed the act into law later that month.

In the United States, many hailed Sarbanes-Oxley as a long-overdue effort to compel corporate responsibility. Among other measures, the act required US executives to attest to the accuracy and validity of their company's financial statements, took aim at certain accounting practices that some believed compromised auditor independence and put an end to the era of accounting self-regulation. The act also created protections for corporate whistleblowers whose actions, it was thought, had the potential to avert cataclysmic financial disasters such as Enron, WorldCom and Adelphia. Many in the United States confidently declared that such measures would deter the corporate corruption that seemingly had become epidemic. At the signing of the bill, Bush thus proclaimed: "The era of low standards and false profits is over... No boardroom in America is above or beyond the law".

The reaction from overseas, however, was immediate and overwhelmingly critical. Foreign commentators and officials attacked Sarbanes-Oxley as a rash and imperious overreaction to isolated failures of US corporate governance. At the more than 1,300 foreign firms that traded on US exchanges, uncertainty reigned about which provisions of the act applied to them. Some in the foreign community were indignant that the United States would presume to pass a law that purported to regulate foreign accounting services and corporate governance. The sense that the United States had overreached was captured in the sardonic observation of Howard Davies, chairman of the UK Financial Services Authority, that "[w]ith their usual generosity of spirit the Americans have ensured that a number of [Sarbanes-Oxley's] provisions apply to overseas companies as well as to their own".

As is often the case with hastily drafted legislation, unresolved questions about Sarbanes-Oxley abound and are only beginning to find their way into the courts. The US Court of Appeals for the First Circuit recently confronted one such issue when called upon, in a case of first impression, to decide whether Sarbanes-Oxley's whistleblower provisions should be given extraterritorial effect. The case, *Carnero v Boston Scientific Corp*,(1) provides some important insights into how US courts are likely to interpret provisions of Sarbanes-Oxley that, at least based on the plain text of the statute, arguably apply to claimed misconduct that occurs outside the United States.

**Whistleblower Claim**

Plaintiff Ruben Carnero was an Argentine citizen who worked in Brazil for two subsidiaries of Boston Scientific Corporation, a US manufacturer of medical equipment that has worldwide operations. Carnero alleged that the Boston Scientific subsidiaries for which he worked fired him in retaliation for reporting to his superiors in the United States that the subsidiaries had inflated their sales figures and committed accounting fraud. The allegedly improper conduct occurred entirely in Latin America. Carnero claimed, however, that Boston Scientific managers exercised extensive control over his work and duties in Latin America, and that he frequently spoke and met with his supervisors at Boston Scientific, all of whom worked in the United States.

On July 2 2003, pursuant to Title VIII of Sarbanes-Oxley, Carnero filed a whistleblower complaint against Boston Scientific with the US Department of Labour. On January 7 2004, when the Department of Labour failed to issue a final decision within the prescribed period of time, Carnero filed a complaint in the US District Court for the District of Massachusetts for violation of Sarbanes-Oxley's whistleblower provision. Among other relief, Carnero asked the court to reinstate him to his former positions with the Boston Scientific subsidiaries.

Boston Scientific moved to dismiss Carnero's complaint. On August 27 2004 the district court granted the motion after reviewing the language and legislative history of Sarbanes-Oxley. The court concluded that nothing in Sarbanes-Oxley suggests that Congress intended the act's whistleblower provision to apply outside the United States. Carnero appealed that decision to the US Court of Appeals for the First Circuit, which last month affirmed the district court decision.

**First Circuit Decision**

In a case of first impression for a US court of appeals, the First Circuit decided that Congress did not intend for Sarbanes-Oxley's whistleblower provision to have extra-territorial application. The whistleblower provision is designed to protect "employees of publicly traded companies" who lawfully "provide information...or otherwise assist in an investigation regarding any conduct which the employee believes constitutes a violation" of US mail, wire, bank or securities fraud statutes, any rule or regulation of the US Securities and Exchange Commission or any other provision of US federal law relating to fraud against shareholders. Companies subject to the act are those "with a class of securities registered under Section 12 of the Securities Exchange Act of 1934 (15 USC Section 781)" or those "required to file reports under Section 15(d) of the Securities Exchange Act of 1934 (15 USC Section 781(d))". Such registration and reporting provisions apply both to US companies and to foreign companies listed on US securities exchanges. As a US company, Boston Scientific therefore clearly was subject to Sarbanes-Oxley's whistleblower provision.

However, Carnero worked for Boston Scientific subsidiaries, not for Boston Scientific itself, and neither subsidiary was listed on a US securities exchange. An individual invoking the protection of Sarbanes-Oxley's whistleblower provision also ordinarily must be an employee of a publicly traded company subject to the act. The First Circuit assumed, without deciding, however, that Carnero - who claimed to have been supervised by Boston Scientific executives and was an employee of two Boston Scientific subsidiaries - might qualify as an 'employee' of Boston Scientific under the expansive definition the Department of Labour gave that term in its regulations pertaining to the whistleblower section of the statute.

The court further noted that Sarbanes-Oxley clearly protected not only against misconduct by the publicly traded company itself, but also against that of "any officer, employee, contractor, subcontractor or agent of such company" who retaliates or otherwise discriminates against a protected employee. As a result, the First Circuit concluded that - putting aside for the moment questions about whether the whistleblower provision of the act applied to foreign companies and citizens - Sarbanes-Oxley might well create a cause of action for Carnero's allegedly retaliatory discharge by two Boston Scientific subsidiaries for reasons proscribed by the act.

The question that remained, therefore, was whether the whistleblower provision has extraterritorial effect such that a foreign employee who complains of misconduct abroad by the foreign subsidiary of a US company may bring suit under Sarbanes-Oxley against a publicly traded US parent company. The First Circuit decided that Sarbanes-Oxley's whistleblower provision was not intended to have extraterritorial application, notwithstanding Carnero's arguments that his claim was authorized under the literal language of the statute and that restricting Sarbanes-Oxley's

whistleblower provision to purely domestic conduct would frustrate the purpose of the statute, which was to protect investors in the United States and thereby promote the integrity of the US securities markets. As Carnero maintained, frauds against foreign subsidiaries uncovered by foreign whistleblowers may threaten investors in a US parent company in much the same way as domestic frauds.

The First Circuit noted that Carnero's argument, although not without force, could not overcome the well-established presumption against extraterritorial application of congressional statutes. As the US Supreme Court has recognized, "[i]t is a longstanding principle of American law 'that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States'." This presumption can be overcome only if there is an "affirmative intention of the Congress clearly expressed", for it is assumed that Congress legislates with an awareness of the time-honoured presumption against extraterritorial application. The presumption serves two principal purposes. First, it protects against unintended clashes between US laws and those of other nations, and thus reduces the potential for international discord. Second, it reflects the notion that when Congress legislates, it is primarily concerned with domestic conditions.

The First Circuit observed that not only was the text of Sarbanes-Oxley's whistleblower provision entirely silent as to any intent to apply it abroad, but the legislative history likewise contained no suggestion that Congress gave consideration to overseas application or any problems that doing so might cause. By contrast, the court pointed out that Congress had provided expressly for extraterritorial enforcement elsewhere in the Sarbanes-Oxley Act with respect to a different, criminal whistleblower statute. The First Circuit also noted that Congress had made no provision in Sarbanes-Oxley for how the US Department of Labour, the agency charged with enforcement of the whistleblower statute, was to conduct foreign investigations or regulate employment relationships in foreign countries, both of which would have been expected if Congress intended the provision to have foreign application. The court further observed that the statute's venue provisions were expressly applicable only to whistleblower violations within the United States and to complainants residing in the United States on the date of violation, but made no provision for venue as to foreign complainants claiming violations in foreign countries. In the view of the First Circuit, these factors not only failed to support any clear congressional intent for extraterritorial application of Sarbanes-Oxley's whistleblower provision, but confirmed that Congress never anticipated such foreign application.

**Implications**

The First Circuit's decision in *Carnero* concerns but a small part of the sweeping statutory reforms instituted by Sarbanes-Oxley and binds only one of the 12 US courts of appeals. At the same time, it provides some important insights into how US courts are likely to analyze questions of extraterritorial application of Sarbanes-Oxley and other US statutes.

The presumption in such cases will be that Congress did not intend its laws to apply overseas. This presumption exists as a matter of international comity and because Congress generally focuses its attention on matters of domestic concern. To overcome this presumption, express statutory language will often be required. At a minimum, courts will look for some indication in the legislative history or the provisions of the statute that Congress considered the implications of extraterritorial application and reached a considered conclusion that achieving the goals of the legislation warranted the potential intrusion on foreign sovereignty.

It should be of some comfort to foreign companies that, even though Sarbanes-Oxley was conceived as a vehicle for restoring investors' faith in the integrity of US securities markets after a period of great unrest, the First Circuit was not prepared to assume that the importance of this goal justified giving the whistleblower provision an expansive territorial scope. This suggests that judicial decisions concerning the scope of other parts of the statute may be equally restrictive, at least where Congress provided no hint that extraterritorial application was considered essential to the statutory scheme.

That is not to say, however, that the reasoning of *Carnero* preordains the results in other Sarbanes-Oxley cases, even those involving the whistleblower provision. The First Circuit cautioned near the end of its decision that it necessarily had decided the case on its own facts and that other fact patterns may or may not be covered by its reasoning. For example, the First Circuit noted that its decision did not address whether Congress intended to cover an employee based in the United States who had been retaliated against for whistleblowing while on a temporary assignment

overseas. Nor would *Carnero* necessarily be dispositive of a case in which the complainant was a US citizen working for a foreign subsidiary or, for that matter, a foreign citizen working for a US subsidiary. Resolution of these questions will have to await future decisions, but *Carnero* suggests that the worst fears of Sarbanes-Oxley's foreign critics - that the statute would effectively and indiscriminately subject foreigners to US laws - may have been overblown.

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**Endnotes**

(1) 433 F 3d 1 (1st Cir, January 5 2006).