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Sarbanes-Oxley Whistleblower Protections: First Cases and Recent Developments

The groundbreaking whistleblower protections included in the Sarbanes-Oxley Act of 2002 are proving to be very popular with employees of public companies–thus far generating more than 300 claims of retaliation by employees against their employers. While only a handful of claims have been decided on the merits, they offer important cautionary tales for corporations. This newsletter provides an overview of the Sarbanes-Oxley Act's whistleblower provisions; describes the lessons learned from the decisions to date; and summarizes recent regulations implementing the Act.

What the Sarbanes-Oxley Act Protects

Enacted as a response to the corporate scandals of 2001 and 2002, the Sarbanes-Oxley Act is intended to protect shareholders by ensuring corporate responsibility, enhancing public disclosure, and improving financial reporting and auditing. The whistleblower provisions are intended to encourage company insiders to report corporate wrongdoing by offering them protection from retaliation.

Section 806 of the Sarbanes-Oxley Act prohibits retaliation against an employee of a publicly traded company who has reported conduct that the employee "reasonably believes" –whether or not he is correct–constitutes a violation of any federal law related to fraud against shareholders.[1] Retaliation can include discharge, demotion, suspension, threats, harassment, or any other discrimination against an employee because of his whistleblowing.

Only employees[2] of publicly traded companies[3] are covered, although any retaliation by the company's officers, employees, contractors, subcontractors, and even agents would risk liability for the company. Non-publicly traded subsidiaries may fall under the Sarbanes-Oxley Act if the employee correctly names the publicly traded parent company in his complaint and if there is sufficient connection between the parent company and subsidiary, such as participation by the parent company in the hiring and firing of the subsidiary's whistleblower, or where the parent company's value and performance is based, in part, on the value and performance of

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its subsidiary.[4] At this point in the nascent case law, the Act has not been interpreted to protect whistleblowers based outside the United States.

The Sarbanes-Oxley Act broadly defines whistleblowing. Whistleblowers are protected for complaints about violations of covered laws so long as the complaints are made either to someone "with supervisory authority over the employee"–rather than, for example, a co-worker–or to someone working for the employer who has the authority to investigate, discover, or terminate the misconduct. This could include complaints made to a company's auditor or outside counsel. Whistleblowers also are protected for complaints made to government authorities, including a federal regulatory agency, a federal law enforcement agency, or a member or any committee of Congress. In addition to direct complaints, employees are protected for testimony, as well as direct or indirect assistance or participation in a proceeding either filed or about to be filed. Such employees do not need to meet the requirement that they "reasonably believe" corporate wrongdoing has occurred; this provision covers employees who merely participate in a proceeding, presumably including those who do so involuntarily, regardless of their belief about the merits of the proceeding.

The Department of Labor's Occupational Safety & Health Administration (OSHA) is charged with investigating whistleblowers' claims of retaliation under the Act. Given that OSHA's historical regulatory focus did not include accounting standards or securities laws, it is operating in unfamiliar territory as it implements the requirements of the Sarbanes-Oxley Act.[5]

A separate criminal provision, contained in section 1107 of the Sarbanes-Oxley Act, prohibits knowingly harming a whistleblower who reports illegal conduct under *any* Federal law, not just regarding corporate fraud.[6] Corporate executives who terminate a whistleblower could face criminal exposure under this provision, if they knowingly interfere with the whistleblower's lawful employment or livelihood as intentional retaliation for the whistleblower's providing truthful information to a law enforcement officer regarding the commission or possible commission of a Federal offense. There has been no public report of prosecutorial activity under this provision to date.

Lessons for Employers from the Case Law

1. **Employees' allegations need not be correct**

Several of the cases under the Act to date make clear that employees are protected even if they are incorrect about their allegations of corporate wrongdoing. The employee may misunderstand the company's accounting or may simply be misinformed; she is nevertheless protected from retaliation for her whistleblowing so long as she makes her allegation in good faith and on a reasonable basis. Most employees are able to meet this low threshold, although one whistleblower admitted in a deposition that his employer's manipulation of an internal employee satisfaction survey did not present fraud against shareholders or a violation of securities law.

2. **Employees' allegations need not rise to the level of the accounting improprieties that led to the Sarbanes-Oxley Act**

What kinds of allegations rise to the level of "fraud against shareholders" that fall under the protections of the Sarbanes-Oxley Act? Very few cases have addressed this question. In September 2004, a federal court in Georgia allowed an employee to pursue her claim under the Act, despite the fact that the employee's allegations dealt with internal accounting controls (overpayment to an advertising agency because of a personal relationship and possible kickbacks and overpayments to sales agents) rather than acts that might constitute fraud against shareholders of the kind that inspired the Act. The court considered it a "close case" whether the employee's complaints to management should be protected, reasoning, "if Congress had intended to limit the protection of the Act to accountants, or to have required complainants to specifically identify the code section that they believe was being violated, it could have done so.

It did not. Congress instead protected 'employees' and adopted the 'reasonable belief' standard for those who 'blow the whistle on fraud and protect investors.'"

Administrative law judges at the Department of Labor generally have applied a lenient standard in determining whether an employee's complaints fall under the Act's protections.[7] In one decision, allegations of improprieties in internal accounting issues was found to be protected under the Act because such internal accounting problems could develop into larger problems that would affect shareholders. In another case, allegations of a scheme to induce concessions in labor negotiations by having the company absorb the costs of airline pilots' absence for union meetings–which the union should have borne directly–was deemed to affect the company's "bottom line" and, therefore, its shareholders. The exceptions to this general lenience are few. One administrative law judge concluded that a whistleblower could not reasonably believe that shareholders would be affected by alleged inflation of the cost of employee meals at a restaurant chain. And another administrative law judge dismissed as insufficient a claim that a company manipulated the line counts in its documents, thereby cheating transcriptionists of income.

3. Both the whistleblower and the whistleblower's allegations must be handled carefully

The first whistleblower case decided on the merits under the Sarbanes-Oxley Act, *Welch v. Cardinal Bankshares Corporation*,[8] illustrates errors that companies should avoid in handling the whistleblower and his allegations. In that case, a publicly traded bank terminated its CFO–allegedly for substandard performance issues–shortly after he complained to senior executives about ongoing improprieties in the bank's financial statements, which he refused to certify. The CFO prevailed in his whistleblower retaliation case in part because the bank failed to document his alleged poor performance and then botched its investigation into the alleged corporate wrongdoing. The administrative law judge concluded that the bank's investigation "was orchestrated" by the CEO, "acting in concert with" investigators, who "manipulated" both the investigation and the audit committee to "justify" terminating the CFO.

Based on this decision, companies are well-advised to follow certain procedures in handling whistleblower complaints:

- Do not select a senior manager–even the chief legal officer–to participate in an investigation into alleged corporate wrongdoing if that manager's own conduct is at issue in the allegations. In *Welch*, the bank's investigation team consisted of only two people, one of whom was a subject of the whistleblower's allegations. Bear in mind that any internal investigation may become the focus of administrative agency action or litigation.[9] The people assigned to conduct investigations may become witnesses and all their documents may come into issue. Take care, therefore, in selecting the individuals to manage the investigation and in deciding how the reporting is to be handled.

- Audit committees will invite liability if there are improprieties in an internal investigation. In *Welch*, the bank's audit committee was unaware that one of the two people it assigned to investigate the allegations was himself accused of the wrongdoing. The bank's audit committee also was unaware that the ultimate reason for which the CFO was terminated–his refusal to meet with the investigators–may have been a pretext because he was willing to meet with the investigators so long as he could bring an attorney and he was also willing to meet with the audit committee directly rather than the investigators. Audit committees must take steps to discover all the employee's allegations and must remain alert to both the substantive allegations and the investigation's progress.

- Carefully consider the optics of taking action against an employee shortly after her whistleblowing, even if there are other issues, such as substandard job performance. The Department of Labor regulations implementing the Sarbanes-Oxley Act (discussed further below) allow administrative law judges to draw an inference of improper motive if an employer takes action against a whistleblower "shortly after" the whistleblowing,[10] and cases to date have embraced this.

- The investigation into corporate wrongdoing arising from the whistleblower report should be bifurcated from any employment review or actions based on the employee's job performance. In *Welch*, the administrative law judge rejected the bank's purported reason for terminating the CFO in part because its investigation report was "replete" with criticisms of the whistleblower's performance, despite the fact that his performance was not at issue in the allegations of corporate wrongdoing. Corporate directors must take seriously any allegation of financial impropriety, given their fiduciary responsibilities and legal duty under the Sarbanes-Oxley Act. If a company wishes to terminate a whistleblower for substandard job performance, it must consider his performance issues separately from his legally protected right to make complaints, and handle his performance issues in the same way it handles the performance issues of non-whistleblowing employees. Careful and consistent documentation of any employee performance issues is required, prior to the whistleblowing, in order to support a company's explanation that it terminated the whistleblower for substandard performance.

In contrast to the *Welch* case discussed above, a major technology company recently successfully defended a whistleblower retaliation case by proving that it "had adequate reasons to fire complainant . . . unrelated to his protected disclosures to the SEC and to [the] CEO." The strength of the company's documentation of the whistleblower's violation of company policies, aggression toward co-workers, and substandard performance–which "appeared repeatedly in his evaluations" prior to his whistleblowing–adequately supported the company's decision, despite the judge's finding that the company also had "set complainant up for failure by assigning him unattainable tasks." Similarly, a leading financial management company defeated a whistleblower's claim when it proved that the whistleblower was a substandard trader who was treated no differently from other low-performing traders. This finding carried the day even though the employee was correct about the company's unauthorized sale of stock and even though the company discussed his productivity problems at the same time it chastised him for calling the ethics hotline. On the other hand, one administrative law judge rejected a company's documentation of an employee's poor performance and of a plan to terminate him, as insufficient for summary judgment, where the company terminated him the day after he blew the whistle on accounting improprieties and where there was contradictory evidence regarding the termination plan. This led the administrative law judge to conclude that the decision to terminate the whistleblower was merely under consideration and had not been finalized, such that a full hearing was needed to determine if a retaliatory motive contributed to the company's decision to terminate him.

4. Corporations may be responsible for retaliatory motives of mid-level managers

One employee won her claim of retaliation even though the senior manager who made the final determination to terminate her had no knowledge of her whistleblowing. The administrative law judge concluded that the senior manager could be

viewed as having had "constructive knowledge" of her whistleblowing because the mid-level manager who initiated the process that led to her termination, and actively participated in the discussions and decisionmaking, was aware of her allegations. The court reasoned that the mid-level manager had, "[i]n effect . . . , planted the seeds for the Complainant's dismissal, being careful not to taint any other person among the group that debated [Complainant's] fate with any knowledge of her protected activities."

5. Dual motive cases turn on credibility

Many cases under the Act involve a "dual motive," in which the company has alleged a legitimate business reason for its adverse personnel action against the whistleblower but where the court also finds sufficient circumstantial evidence of a retaliatory motive. In such "dual motive" cases, the burden is on the company to prove by clear and convincing evidence that it would have taken the same action even in the absence of the employee's whistleblowing. Such cases often turn on which party the court finds more credible. Any discrepancy in the company's stated reason for taking action against the whistleblower will undermine the company's case. An investment brokerage firm discovered this when it first acknowledged and later denied that a meeting had occurred at which a stock analyst allegedly was pressured to change her rating of a stock. The administrative law judge considered this change in story "a substantial inconsistency that harms Respondent's credibility in general and renders it non-credible" regarding what took place at the meeting.

6. Employees' complaints must allege each unfavorable personnel action

Wilmer Cutler Pickering Hale and Dorr LLP succeeded on behalf of a client, in one of the few federal court decisions to date under the Sarbanes-Oxley Act, in convincing the court to dismiss a whistleblower claim for an adverse employment action that occurred *after* the employee had filed his complaint with OSHA. Similarly, two administrative law judges have concluded that employees must allege each unfavorable personnel action and may not claim a "continuing violation theory" in the absence of a hostile work environment.

7. Employers' mandatory arbitration clauses may govern Sarbanes-Oxley Act claims

Many companies include in their standard employment contracts a mandatory arbitration clause for all employment disputes. Employers may be able to enforce such clauses for complaints of whistleblower retaliation under the Sarbanes-Oxley Act. Only one federal court has confronted this question to date; it granted a company's motion to stay a whistleblower's federal suit for retaliation in light of the company's mandatory arbitration clause. The court relied on case law holding that arbitration clauses are generally enforceable unless there is a clear Congressional intent to preempt them or an inherent conflict between arbitration and the statute's purpose. The court concluded that nothing in the Sarbanes-Oxley Act evinces an intent to preempt arbitration and that there is no conflict between arbitration and the Act's purpose. Hence, at least based on this one decision, whistleblowers must abide by their company's mandatory arbitration clause to resolve a whistleblower claim under the Act.

The issue is not yet settled, however, in light of case law concerning other statutes. First, in the context of equal employment opportunity law, the Supreme Court has cautioned that arbitration clauses are not enforceable if the employee did not enter the agreement voluntarily. Second, under another whistleblower statute, a federal court has ruled that any employment contract that waives the employee's right to file a whistleblower claim with the Department of Labor raises serious regulatory issues. Third, the Supreme Court has cautioned that a government agency can independently pursue a claim on behalf of an employee if that employee is unable to do so because of an arbitration clause, so long as the statute so enables the agency. Given that the Act allows the Department of Labor to pursue whistleblower retaliation

claims on behalf of employees even without their participation, employers may face whistleblower claims pursued by the Department of Labor where the employees are subject to mandatory arbitration clauses. Nevertheless, at least one major U.S. employer recently amended its employment contract to specify that Sarbanes-Oxley Act claims must be arbitrated.

8. Settlement agreements must be carefully crafted

Agreements to settle Sarbanes-Oxley Act complaints must be approved by the Department of Labor. More than one company has seen its settlement agreement rejected because the agreement restricted the employee's future rights to bring claims against the company and to participate in investigations into the whistleblowing allegations.

New OSHA Regulations

At the end of August 2004, OSHA issued its final regulations implementing the whistleblower protections of the Act. The major procedural and substantive components of the regulations are as follows:

- An employee has only 90 days from the date of an "unfavorable personnel action" to file his complaint with OSHA. In the case law to date, this 90-day statute of limitations has been strictly enforced.[11]

- All complaints must be filed with OSHA, rather than with the federal courts, at least until OSHA and the Department of Labor (which manages the review process) have failed to conclude the case within 180 days, at which time the employee has the right to pursue his claim in federal court.[12]

- The SEC will be informed of every complaint, and may choose to participate in the Department of Labor proceedings. In addition, the SEC may choose to pursue its own action against an employer for any violations of securities laws.

- OSHA will dismiss a complaint outright unless the employee makes a *prima facie* showing that his whistleblowing was a "contributing factor" in the unfavorable personnel action against him. Generally, this low hurdle is met when the employee alleges facts and circumstantial evidence–such as a short time span between the whistleblowing and the personnel action–giving rise to an inference that the whistleblowing was a factor in the personnel action.

- An employer can defeat a claim at the outset, and thereby head off a full-scale investigation, by providing "clear and convincing evidence" that it would have taken the same personnel action against the employee in the absence of the whistleblowing.

- Either party may request a *de novo* review of OSHA's initial findings and order by writing, within 30 days, to the Chief Administrative Law Judge at the Department of Labor. An administrative law judge then conducts an investigation and hearing much like a bench trial in court.[13] The same standards of proof apply before the administrative law judge as in the initial investigation–specifically, the employee must demonstrate that his whistleblowing was a contributing factor in the company's unfavorable personnel action against him, and the employer can defeat the claim by demonstrating by clear and convincing evidence that it would have taken the same personnel action in the absence of the employee's whistleblowing. The employee then must prove by a preponderance of the evidence that the company's rationale is pretext, and may rely on circumstantial evidence to do so. The administrative law judge has the power to make the employee whole by rewarding reinstatement, back

pay with interest, and compensation for any special damages such as attorney's fees.

- Either party may appeal the administrative law judge's finding, within 10 business days, to the Administrative Review Board at the Department of Labor, which then has 30 days to decide whether to accept the case for review. On review, rather than conducting a *de novo* hearing, the Board determines whether the administrative law judge had "substantial evidence" for his decision.

- Either party may appeal the final order of the Board, within 60 days, to the federal appeals court for the circuit in which the violation allegedly occurred or in which the complainant resided on the date of the violation.

These final regulations vary little from the interim regulations issued a year ago, apart from two substantive changes. First, the interim regulations allowed the Department of Labor to issue a preliminary order reinstating any employee who successfully presented a *prima facie* case and whose employer was unable to defeat the claim at the outset, such that the employee retained his job during the full investigation. The final regulations allow employers to challenge any such preliminary order of reinstatement. Second, the final regulations simplify the definition of retaliation by eliminating a lengthy listing of acts considered retaliatory–including coercion and blackmail–and replacing it with the broader phrase, "in any . . . manner discriminates" against the employee.

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The Sarbanes-Oxley Act's whistleblower provision is already creating a groundswell of employee complaints. We anticipate the number of these complaints will increase in the future as whistleblowers gain publicity, and as avenues for reporting employee concerns both inside and outside companies are highlighted, as required under other provisions of the Act. In particular, a new national hotline and on-line filing system for employee tips and complaints recently established by the Public Company Accounting Oversight Board is likely to encourage additional whistleblowing. Corporations need to carefully consider how to handle any allegations of corporate misconduct.

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[1] The statute also protects whistleblowers who report violations of securities, bank, mail, or wire fraud, as well as those who report violations of any SEC rule or regulation. *See* 18 U.S.C. § 1514A(a)(1).

[2] The Department of Labor's regulations implementing the Sarbanes-Oxley Act also protect former employees and even individuals applying to work at companies or those whose employment could be affected. *See* 29 C.F.R. § 1980.101. This definition has been criticized as improperly expanding the statute's scope, which lists only "employees." *See* 69 Fed. Reg. 52103, 52105 (Aug. 24, 2004). The Department of Labor's expanded definition of employees has not been fully tested, although one administrative law judge dismissed a complaint under the Sarbanes-Oxley Act by a former employee because the former employee's allegation of adverse treatment did not regard the "terms and conditions of [his] employment," as required under the Act, because he was no longer an employee. The administrative law judge suggested, however, that if an employer were to blacklist a former employee or actively interfere with the former employee's subsequent employment, such activity might be covered under the Act.

[3] Two classes of publicly traded companies fall under the Act: (1) companies required to register their securities under section 12 of the Securities Exchange Act of 1934; and (2) companies required to file reports under section 15(d) of that Act. *See* 18 U.S.C. § 1514A(a). For instance, one administrative law judge concluded that a company was not covered by the Sarbanes-Oxley Act because it was not required to register its securities under section 12, and, even though it had historically been subject to section 15(d), it was no longer subject to that provision at the time of the alleged retaliation because its securities were held by fewer than 300 persons.

[4] For example, one administrative law judge held a parent company responsible for retaliatory action by its subsidiary where the parent company used the two corporate logos and titles interchangeably, administered employee benefits and contracts for the subsidiary, had common senior management, board members, and officers, and where the parent was merely a holding company, with no employees, and had only one subsidiary, which was its operating arm.

[5] *See* Deborah Solomon, *For Financial Whistle-Blowers, New Shield is an Imperfect One: Claims of Employer Reprisal Go to OSHA Investigators Unschooled in Accounting*, Wall St. J., Oct. 4, 2004, at A1.

[6] *See* 18 U.S.C. § 1513.

[7] However, administrative law judges have rejected whistleblower claims regarding violations of environmental laws, unfair labor practices, and racial discrimination as having no recourse under Sarbanes-Oxley.

[8] *See* 2003-SOX-15 (ALJ Jan. 28, 2004), *available at* http://oalj.dol.gov/public/wblower/decsn/03sox15c.htm.

[9] Discovery may be permitted of the records of the internal investigation, depending on the circumstances.

[10] *See* 29 C.F.R. § 1980.104(b)(2).

[11] Indeed, the vast majority of employee claims have been dismissed outright, many for failing to meet the Act's strict 90-day statute of limitations.

[12] Employers should be aware that senior officials of the Department of Labor have publicly stated that they anticipate that most cases will take longer than 180 days. Therefore, employees usually will have the opportunity to pursue the case in federal court.

[13] At this time, administrative law judges presumably lack subpoena power, as the statute and regulations do not explicitly grant such power. In an analogous environmental case, however, one Department of Labor panel determined that such judges do have subpoena power, although there remains dispute within the Department of Labor over this question.