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Lessons From The First SOX Whistleblower Cases

By Carrie Wofford & Lisa Stephanian — November 16, 2004

The whistleblower protections contained in the Sarbanes-Oxley Act of 2002 are already creating a groundswell of employee complaints, with more than 300 whistleblowers claiming their employers retaliated against them for their allegations of corporate misconduct. While only a handful of claims to date have been decided on their merits, they offer important cautionary tales for corporations.

The Sarbanes-Oxley Act defines whistleblowing broadly. Complaints must be made either to someone "with supervisory authority over the employee"—rather than, for example, a coworker—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, who may then have independent obligations under the Act to report the wrongdoing "up the ladder."

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.

Lessons for Employers from the Case Law:

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

   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" constitutes a violation of any covered law—whether or not he is correct. Several of the cases under the Act make clear that employees are protected even if they are incorrect about their allegations of corporate wrongdoing. The employee may

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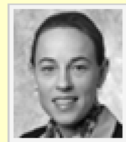

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misunderstand the company's accounting or may simply be misinformed; she is nevertheless protected from retaliation for her whistleblowing so long as she makes her allegation in good faith and on a reasonable basis. Most employees are able to meet 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.

In addition, employees who only participate in a proceeding, rather than making a direct complaint, need not even meet the threshold of "reasonably believ[ing]" wrongdoing occurred; they are protected for merely participating in the inquiry.

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

Under the Act, whistleblowers are protected for complaints about violations of securities, bank, mail, or wire fraud laws or of any federal law, rule or regulation related to fraud against shareholders. What kinds of allegations rise to the level of "fraud against shareholders"? 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. In one decision, allegations of improprieties in internal accounting issues were 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. For instance, one administrative law judge concluded that a whistleblower could not reasonably believe that shareholders would be affected by an 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*, 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, and discovery may be permitted of the records of an internal investigation, depending on the circumstances. 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, and cases to date have embraced this.
- The investigation into corporate wrongdoing arising from the whistleblower's report should be bifurcated from any employment review or actions based on the whistleblower'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 CFO'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 must 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 the 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 who actively participated in the discussions and decision-making, 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. **Corporate subsidiaries may be liable.**

The Act's coverage is limited to publicly traded companies and their officers, employees, contractors, subcontractors and agents. However, several administrative law judges have expanded upon this definition to include non-publicly traded subsidiaries in certain circumstances. Specifically, non-publicly traded subsidiaries may fall under the Act if the employee correctly names the publicly traded parent company in his complaint and if there is a 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 its subsidiary. 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.

6. **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.

7. **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.

8. **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, again in the equal employment context, 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.

9. **Settlement agreements must be crafted carefully.**

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.

As whistleblowers gain publicity and as avenues for reporting concerns are highlighted—like the national hotline and online filing system for employee tips and complaints recently established by the Public Company Accounting Oversight Board—the number of these complaints will only increase. Corporations need to carefully consider how to handle such complaints.