Understanding Developments in Whistleblower Law 2 Years After Sarbanes-Oxley

Presented by:

Michael Delikat
Orrick, Herrington & Sutcliffe LLP
666 Fifth Avenue
New York, New York 10103
(212) 506-5230
mdelikat@orrick.com

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Introduction

On July 30, 2002, President Bush signed Sarbanes-Oxley into law. Seeking to restore investor confidence in ailing financial markets reeling from a spate of highly-publicized alleged corporate financial wrongdoings, the Act reforms the oversight of corporate accounting practices and addresses a range of corporate accountability issues. The legislative history of Sarbanes-Oxley also makes it clear that Congress was intent upon closing loopholes in existing state and federal laws that provide protection for whistleblowers. See 148 Cong Rec S 6439-6440, 107th Congress, 2d Session (2002). It appears that Congress reacted strongly to Enron’s attempted retaliation against Sherron Watkins, the now-famous whistleblower, and sought to deter similar conduct in the future by making employers who perpetrate such acts subject to stiff civil liability and criminal penalties. *Id.*

In the two years since Sarbanes-Oxley’s enactment, the number of charges filed with the Department of Labor by employees under the Act’s whistleblower protection provisions has surpassed 300, according to agency statistics. So far, employers have fared quite well: 196 of the 230 cases that reached a determination at the DOL investigative level as of August 25, 2004 were either dismissed for lack of merit or were voluntarily withdrawn by complainants. Another 27 were settled before determination. Only a handful of cases have found their way to the federal courts.

Of the cases that have been appealed and have been tried before administrative law judges ("ALJs") as of August 25, 2004, three have gone against the employer on the merits, and six have been decided in employers’ favors on the merits. In addition, numerous cases have been dismissed on procedural grounds, for example, because they were untimely or because the alleged adverse employment action preceded the effective date of the statute.

Substantive decisions of the ALJs, although sometimes in conflict with one another, are providing important guidance as to the contours of the Act and how the whistleblower retaliation provisions will be construed. Of course, given the federal courts’ role in the ultimate interpretation and application of the whistleblower provisions, it will be some time before more a definitive interpretation of these provisions is available.

**Employers And Employees Covered By The Act.**

The scope of Sarbanes-Oxley is focused on public companies registered under Section 12 (or those required to file reports under Section 15d) of the Securities and Exchange Act of 1934; officers, employees, or agents of such public companies; and contractors and subcontractors of such public companies. See 18 U.S.C. § 1514A(a). This appears far broader in scope than many similar whistleblower and anti-retaliation statutes, which apply only to “employers.” In addition, although there are a number of somewhat contradictory administrative law judge decisions on this point, the emerging case law seems to suggest that non-publicly traded subsidiaries of publicly traded companies may face liability under Sarbanes-Oxley.

a. *Non-Publicly Traded Subsidiaries*

law judge ruled that a non-publicly traded subsidiary of another non-publicly traded subsidiary of a publicly traded company is a covered employer and its employees could state a claim for retaliation under Sarbanes-Oxley. The ALJ very broadly defined the term “employee of a publicly traded company” to include “all employees of every constituent part of the publicly traded company, including but not limited to, subsidiaries and subsidiaries of subsidiaries which are subject to internal controls, the oversight of its audit committee, or contribute information, directly or indirectly, to its financial reports.”

Similarly, a publicly-traded holding company of a non-publicly traded employer has been deemed an employer under certain limited circumstances. In Platone v. Atlantic Coast Airlines, 2003-SOX-27 (ALJ Apr. 30, 2004), the publicly traded holding company of a non-publicly traded subsidiary for which the Complainant worked was held to be an employer for the purposes of Sarbanes-Oxley. The ALJ in that case essentially pierced the corporate veil and concluded that the holding company held itself out as the entity ultimately responsible for the subsidiary’s actions.

Despite these two decisions, there is still support for the argument that a publicly traded company is not an employer of all of its subsidiaries’ employees. In Powers v. Pinnacle Airlines, Inc., 2003-AIR-12 (ALJ Mar. 5, 2003), an ALJ decided that the non-public subsidiary of a public company was not subject to Sarbanes-Oxley.

In that case, an employee of Pinnacle Airlines claimed she was retaliated against for raising issues about the accuracy of Pinnacle’s on-time flight record and the fraudulent impact that had on the stockholders of parent Northwest Airlines. The ALJ dismissed the complaint, noting that Northwest was not her employer, and in general, could not be held liable for the acts of its subsidiaries. Additionally, because Pinnacle was “not a publicly traded company, it d[id] not fall under the proscriptions of the Sarbanes Oxley Act and the Complainant [could not] maintain an action under that statute.”

b. Employees Outside Of The U.S.

Sarbanes-Oxley does not appear to apply to employees who work outside of the United States. In August 2004, the Department of Labor dismissed a whistleblower complaint by two former Asia-based managers of Swatch Group Limited of Switzerland. The agency stated that it did not have jurisdiction over the complaints because the complainants “were hired and employed outside of the U.S.”

Is There Individual Liability Under Sarbanes-Oxley?

Federal anti-discrimination laws generally permit claims to be brought against “employers,” not individual managers or other employees. The legislative history of Sarbanes-Oxley, however, is replete with references to the fact that this bill was also intended to address the actions of individual “employees.” Moreover, the DOL regulations refer to Sarbanes-Oxley’s “unique” statutory provisions that “identify individuals as well as the employer as potentially liable for discriminatory action.” As a result, Sarbanes-Oxley charges filed to date that name individual respondents in addition to the employer have been processed treating the individuals as proper parties.
Protected Activity Under Sarbanes-Oxley.

The Act provides for a wide range of protected activities. The subject matter of the whistleblower’s report must relate to any conduct the employee reasonably believes constitutes a violation of (1) federal criminal law provisions prohibiting mail, wire, or bank fraud; (2) any rule or regulation of the Securities and Exchange Commission; or (3) any provision of federal law relating to fraud against shareholders. See 18 U.S.C. § 1514A(a)(1). The statute specifies the broader “reasonably believes” standard, which eliminates any ambiguity and potential split among the federal circuits as to whether the whistleblower has to demonstrate that the employer actually violated a law or regulation, and the Act therefore appears to have broad application. The ALJ in Morefield, supra, also noted that reporting an alleged “manipulation” of internal financial data that only amounted to .0001% of the respondent’s annual revenues was still sufficient to protect the reporting employee. Id. It did not matter that it was a relatively small amount or that it was never made in a public disclosure. Id.

There are two main categories of protected activity. The first category relates to employees who provide information (or otherwise assist in an investigation, or cause information to be provided) to a Federal regulatory or law enforcement agency; any member or committee of Congress; or a person with supervisory authority over the employee (or other person working for the employer who has authority to investigate, discover, or terminate misconduct) regarding the aforementioned subject matter. See 18 U.S.C. § 1514A(a)(1). The “otherwise assist” and “or other person working for the employer who has authority to investigate, discover, or terminate misconduct” language will likely generate litigation as to what these rather vague terms mean.

The second category of protected activity relates to employees who have (through a lawful act) filed, caused to be filed, testified in, participated in, or otherwise assisted in a proceeding filed or about to be filed (with any knowledge of the employer) relating to the subject matter mentioned above. See 18 U.S.C. § 1514A(a)(2). This provision is very similar to the so-called “participation clause” of Title VII,¹ which has been hotly litigated and has led to a myriad of federal challenges. In the Title VII context, courts, with limited exception, have applied a broad standard when establishing whether or not an employee has participated in a protected activity. The language of Sarbanes-Oxley, however, appears much narrower than the language of Title VII. Specifically, Sarbanes-Oxley is limited to participation in “a proceeding filed or about to be filed,” while Title VII includes participation in any manner in “proceedings,” “investigations” and “hearings.” See 42 U.S.C. § 2000e-3(a).

Accordingly, the Sarbanes-Oxley participation clause will also probably generate litigation as to what constitutes a “filed proceeding.” In particular, the statute appears silent as to whether internal whistleblowing will be protected under this section? that is, where the employee files something with his or her employer. See 18 U.S.C. § 1514A(a)(2). While subsection (a)(1) of the statute specifies investigations to include federal regulatory and law enforcement agency investigations, Congressional investigations, and internal investigations, in Subsection (a)(2), the statute does not define the term “proceedings.” See 18 U.S.C. §

¹ Title VII reads: “It shall be an unlawful employment practice for an employer...to discriminate against any individual...because he has made a charge, testified, assisted, or participated in any manner in an investigation, proceeding, or hearing under this title.” See 42 U.S.C. § 2000e-3(a).
1514A(a)(2). Thus, it is likely that some courts will permit internal whistleblowing to fall within the parameters of the participation clause of the statute, while other courts will limit “proceeding” to mean a legal action taken by either a federal regulatory or law enforcement agency or Congress. See Morefield, supra. Nevertheless, until the statute is defined by the federal courts, employers should consider participation in internal whistleblowing as potentially protected activity under 18 U.S.C. § 1514A(a)(2).

To constitute protected activity under the Act, a whistleblower must have both a subjectively and objectively reasonable belief that the acts complained of were a violation of securities law or defrauded shareholders.

In Welch v. Cardinal Bankshares Corp., 2003-SOX-15 (ALJ Jan. 28, 2004), Welch, who was Cardinal’s CFO, sent letters and emails to Cardinal’s president and CEO stating that due to a number of accounting and financial concerns he would not certify the validity of the Company’s financial statements. Welch also complained that he was not given adequate access to external auditors and that too many unqualified people were allowed to make entries in the Company’s accounting journal. The ALJ found that Welch had an objectively reasonable belief that the acts he was complaining of constituted violations of securities law. In so holding, the ALJ relied on expert testimony corroborating Welch’s concerns, as well as evidence that the Company’s internal investigation proved those concerns to be well-founded. As a remedy, Welch received back pay, costs (including attorneys fees) and he was reinstated as Cardinal’s CFO.

Subsequent substantiation of a complainant’s concerns, while helpful to a complainant’s case, is not necessary to demonstrate protected activity. In Halloum v. Intel Corp., 2003-SOX-7 (ALJ Mar. 4, 2004), the ALJ held to be protected the Complainant’s report that he had been asked to delay invoices to subsequent quarters. The ALJ in that case explained that “[a] belief that an activity was illegal may be reasonable even when subsequent investigation proves a complainant was entirely wrong.” Despite finding that Halloum’s complaint constituted protected activity, Intel demonstrated by “clear and convincing evidence” (more than a preponderance of the evidence but less than “proof beyond a reasonable doubt”) that it had adequate reasons to fire the Complainant, unrelated to his protected disclosures.

Perhaps the best explanation to date of what a complainant must show to establish a “reasonable belief” that his or her employer violated securities law was recently provided in Lerbs v. Buca Di Beppo, (2004-SOX-8) (ALJ June 15, 2004), where the ALJ stated that the complainant’s belief “must be scrutinized under both subjective and objective standards, i.e., he must have actually believed that the employer was in violation of the relevant laws and regulations and that belief must be reasonable. The reasonableness of a complainant's belief regarding illegality of a respondent's conduct is to be determined on the basis of the knowledge available to a reasonable person in the circumstances with the employee's training and experience.”

In Lerbs, the Complainant was a cash manager reporting to the corporate controller of a public company. He alleged that he engaged in protected activity by reporting his concerns regarding three financial practices of the firm: (1) reclassifying outstanding cash balances to

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2 Internal quotations and citations omitted.
accounts payable; (2) hiring former employees of the Company’s outside auditor to work in financial accounting roles; and (3) increasing by $1,000 a day the charge for lunches received by the corporate offices, which were provided by one of the Company's restaurants.

Granting summary judgment for the Respondent, the ALJ disposed of each of Lerbs’s complaints, finding that he could not have had a reasonable belief regarding the illegality of his employer’s conduct as a matter of law.

With regard to the first area of reporting, the ALJ found that Lerbs merely made “general inquiries” about his employer’s accounting practices and never identified particular concerns about his employer’s conduct that he may have believed was illegal. With respect to the hiring of former employees of the company's outside auditors, Lerbs admitted in his affidavit that he knew that the practice was not illegal, and hence, the ALJ concluded that his complaint about this issue failed to satisfy the definition of protected activity under the Act. As to the final complaint raised, the ALJ concluded that Lerbs failed to establish that he reasonably believed the Company was engaged in any wrongdoing, because his assertion that the Company’s increased food charges could somehow mislead investors was "both speculative and unsubstantiated."

A good argument can be made that complaints, even if they are of a financial nature, should not be considered protected activity if they fall within an employee’s normal job duties. In *D’Agostino v. Workflow Management*, (Case No. 2-4173-03-032), a member of management and the Board of Directors alleged that he was terminated after he disagreed with and challenged certain financial projections being made to the Company’s lender as inaccurate and misleading. Dismissing his complaint, the DOL determination stated that suggesting changes to financial reports in the course of a senior manager or director’s normal job duties is not, for purposes of whistleblower protection, the same as reporting suspected securities fraud:

Complainant’s concerns appear to be a legitimate disagreement with [the corporation’s financial consultants] which [the consultants] took into consideration during that Board meeting and made adjustments to the recommendations and projections to accommodate Complainant’s concerns. Raising such concerns appears to be an appropriate function of a member of a Board of Directors, and in the end Complainant’s concerns may have been proved justifiable. However, expressing such concerns about "potential" errors is not a statement of knowledge of fraud or intentional wrongdoing. From the best evidence available, at no time did Complainant assert that [the consultant’s] recommendations or cost savings were fraudulent.”

*D’Agostino* is in accord with well-settled whistleblower law in the government context holding that reporting within normal job duties is not protected activity.

**Adverse Action Under Sarbanes-Oxley.**

With respect to the EEO laws, the federal circuits have developed four distinct standards regarding what constitutes an adverse action, based upon the rather limited statutory language.
In contrast, Sarbanes-Oxley is fairly precise as to what constitutes “adverse action” under the statute, to wit: discharging, demoting, suspending, threatening, harassing, or in any manner discriminating against an employee in the terms and conditions of employment. See 18 U.S.C. § 1514A(a). Although this definition appears narrower than that articulated under the EEO statutes, the only federal decision to date to address what constitutes an adverse action under Sarbanes-Oxley relied on an ADEA case in interpreting the term, holding that an allegation of a loss of job responsibilities was sufficient to state a claim under the Act. Willis v. VIE Financial Group, Inc., No. Civ.A. 04-435, 2004 WL 1774575, at *6 (E.D.Pa Aug. 6, 2004). The court reasoned that, under some circumstances, a loss of job responsibilities could be considered a “change in employment conditions.” Id. See also Dolan v. EMC Corp., 2004-SOX-1 (ALJ Mar. 24, 2004) (relying on interpretations of the term “adverse action” under Title VII and other retaliation provisions to hold that negative performance evaluations, absent tangible consequences, do not constitute an adverse employment action).

**Arbitration Of Sarbanes-Oxley Claims.**

In a case handled by Orrick attorneys in New York, the U.S. District Court for the Southern District of New York found in favor of the employer and compelled an ex-employee to submit his Sarbanes-Oxley claim to binding arbitration. The court ruled that “[t]here is nothing in the text...or legislative history of the Sarbanes-Oxley act evincing intent to preempt arbitration claims under the act.” Boss v. Salomon Smith Barney Inc., 263 F. Supp. 2d 684 (S.D.N.Y. 2003). Other jurisdictions that are notoriously antagonistic to mandatory binding arbitration of employment disputes, like the Ninth Circuit, may come to a different conclusion.

The Solicitor of Labor has also issued an advice memorandum which identifies whistleblower cases as among the types of cases where, under certain circumstances, enforcement agencies like OSHA can consider staying enforcement in deference to private arbitration agreements. (Solicitor’s “Memorandum Consideration of Employment Arbitration Agreements” (August 9, 2000, posted on Solicitor of Labor website). The Memorandum recognizes, however, that deferral may not be appropriate in cases where immediate reinstatement may be unavailable in arbitration.

**Prima Facie Cases And Burdens Of Proof.**

To establish a *prima facie* case a complainant must show (1) he or she engaged in a protected activity; (2) the employer was aware of the protected activity; (3) he or she suffered an adverse employment action; and (4) circumstances are sufficient to raise an inference that the protected activity was likely a contributing factor in the unfavorable action. See, e.g., Platone, 2003-SOX-27 at 20; Welch, 2003-SOX-15 at 35. At the investigative level, a complainant must merely raise an inference of unlawful retaliation, whereas at the ALJ level, a complainant must prove that the protected activity was a contributing factor in an unfavorable employment action by a preponderance of the evidence. See, e.g., Halloum, 2003-SOX-7 at 10; Welch, 2003-SOX-15 at 35-36.

If the complainant meets this burden of proof, the respondent may avoid liability by presenting evidence sufficient to “clearly and convincingly” demonstrate a legitimate purpose or motive for the adverse personnel action. See, e.g., id. The Secretary and the courts recognize
that this evidentiary standard is higher than the preponderance of the evidence standard (i.e., complainant’s *prima facie* standard), but less than proof beyond a reasonable doubt. *See, e.g.*, *Platone*, 2003-SOX-27 at 21; *Welch*, 2003-SOX-15 at 35.

Once a respondent meets its burden, it is unclear whether the complainant may then offer evidence that the proffered reason is a pretext for unlawful retaliation. The regulations state: “Relief *may not* be ordered if the named person demonstrates by clear and convincing evidence that it would have taken the same unfavorable personnel action in the absence of any protected behavior,” suggesting that complainants are not afforded this opportunity. 29 CFR 1980.109 (emphasis supplied). Some ALJ decisions, however, have stated that by meeting its burden, the respondent has merely rebutted the presumption of retaliation, and that the complainant may still prevail by showing “that the rationale offered by the respondent was pretextual, i.e., not the actual motivation.” *Platone*, 2003-SOX-27 at 21; *Getman*, 2003-SOX-8 at 10.

**Criminal Penalties.**

By amending 18 U.S.C. § 1513, which is entitled “Retaliating against a witness victim or informant,” Sarbanes-Oxley also sets forth stiff new criminal penalties. In its previous form, that section was limited to retaliations causing death, bodily injury, or damage to tangible property. The addition of subsection (e) to Sarbanes-Oxley exponentially expands the meaning of retaliation under this section, which reads:

> Whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, *for providing a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense*, shall be fined under this title or imprisoned not more than 10 years, or both.

*See* 18 U.S.C. 1513(e). Although this section is limited to employees who provide information to federal law enforcement officers, and therefore will apply only to a select number of cases, employers must exercise extreme caution in this area. To date, there have been no reported criminal prosecutions for retaliation against whistleblowers under Sarbanes-Oxley.

**Sarbanes-Oxley Potential To Resurrect Civil RICO Claims In The Employment Context.**

Because of the prospect of treble damages and attorneys’ fees, a number of wrongful discharge cases were brought over the years under The Racketeering Influenced and Corrupt Organizations Act (“RICO”), 18 U.S.C. Sections 1961-1968.

In *Beck v. Prupis*, 529 U.S. 494 (2000), Beck, a former president, CEO, and director of an insurance company, alleged that when he discovered his company was engaging in certain acts of racketeering, he contacted regulators to disclose the improper conduct. Thereafter, he alleged that the defendants “orchestrated a scheme to remove” him as president, by claiming that he had failed to perform his material duties as president. Beck sued, alleging that his wrongful termination was done in furtherance of a RICO conspiracy, and hence, he had standing to sue
under RICO for damages (trebled) from the loss of his employment. The Supreme Court, agreeing with the courts below, dismissed, holding that Beck’s termination, allegedly in furtherance of a RICO conspiracy, was not independently wrongful under any substantive provision of RICO, and therefore did not give rise to a cause of action under RICO.

As noted above, Sarbanes-Oxley criminalizes certain behavior, including “interference with the lawful employment or livelihood of any person, for providing a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense...” See 18 U.S.C. § 1513(e) (emphasis added). Section 1513 is one of the statutes specifically cited in the definition of “racketeering activity” in Section 1961 of RICO. As a result, termination of employment in violation of Section 1513 will likely constitute a “predicate act” under RICO, and we can expect to see a new generation of RICO claims related to prohibited Sarbanes-Oxley conduct.

Special Provisions For Securities Analysts.

Sarbanes-Oxley also contains highly specific anti-retaliatory provisions which affect only a limited number of employees: securities analysts who work for brokers or dealers in the investment banking area. Specifically, brokers and dealers (and persons employed by them) who are involved with investment banking activities may not, directly or indirectly, retaliate against or threaten to retaliate against any securities analyst employed by the broker or dealer because a securities analyst presented a research report that contained adverse, negative, or otherwise unfavorable research that adversely affected a present or potential investment banking relationship. See 15 U.S.C. § 78o-6(a).

10. Other Public Policy Implications Of Sarbanes-Oxley.

The reach of the public policy implications of the Sarbanes-Oxley whistleblower provisions is already being felt in non-employment litigation. In JDS Uniphase Corporation Securities Litigation, 238 F. Supp.2d 1127 (N.D. Ca. 2002), the plaintiff in a class action securities litigation made a motion to limit the scope of confidentiality agreements signed by former employees of the defendant corporation. The former employees had indicated to plaintiff’s counsel that they were prepared to give relevant information about the claims in the securities class action, but they believed that confidentiality agreements they had entered into with their employer prevented them from disclosing that information. In partially invalidating the confidentiality agreements, the Court stated:

Congress has also indicated a public policy in favor or whistleblowers in securities cases. The recently enacted Sarbanes-Oxley Act of 2002 prohibits companies from discriminating against employees because of any unlawful act by the employee to assist in an investigation of securities fraud. 18 U.S.C. § 1514A(a)(1). At oral argument, defendants correctly pointed out that this section only applied to investigations conducted by the government, or by the company itself. Nonetheless, the statute demonstrates the public policy in favor of allowing even current employees to assist in securities fraud investigations. It certainly
does not establish a public policy in favor of allowing employers to muzzle their employees with overbroad confidentiality agreements.

_Id._ at 1136 (emphasis supplied).

It remains to be seen how this public policy argument will advance itself in other non-employment litigation.

11. **States React To Sarbanes-Oxley With New Whistleblower Legislation.**

Perhaps moved by the same public pressure that inspired an act of Congress, the State of California amended its own whistleblower statute to place additional obligations on employers. (See Cal. Labor Code § 1102.5 et seq.) In doing so, California essentially deputized all employees into becoming the eyes and ears of the government. In the legislative findings of the newly-revised act, California’s legislature stated:

unlawful activities of private corporations may result in damages not only to the corporation and its shareholders and investors, but also to employees of the corporation and the public at large. The damages caused by unlawful activities may be prevented by the early detection of corporate wrongdoing. The employees of a corporation are in a unique position to report corporate wrongdoing to an appropriate government or law enforcement agency... it is the public policy of the State of California to encourage employees to notify an appropriate government or law enforcement agency when they have reason to believe their employer is violating laws enacted for the protection of corporate shareholders, investors, employees, and the general public. Cal. S. 777, 2003-2004 Leg., Reg. Sess. (CA 2003).

Specifically, California’s newly-revised whistleblower act covers all employees who report a violation of a state or federal rule, who refuse to participate in an activity that would result in a violation of a state or federal statute, rule or regulation, or who exercised these rights in a former employment. California also makes certain violations a misdemeanor and provides for civil penalties. See Cal. Labor Code § 1102.5(f) and § 1103.

California also changed the burdens of proof applicable to a claim under Section 1102.5. Formerly, the plaintiff had to prove his/her case to the preponderance of the evidence. Now, under California’s revised law, once a plaintiff demonstrates by a preponderance of the evidence that an employee’s protected activity was merely a contributing factor in a retaliatory act, the employer has the burden of proof to demonstrate by clear and convincing evidence that the alleged action would have occurred for legitimate reasons even if the employee had not engaged in protected activity. Cal. Labor Code § 1102.6.
Conclusion

In light of the growing number of Sarbanes-Oxley complaints, there are some safe assumptions for employers: first, expect more retaliation and whistleblower claims. Second, with the increased media attention to Enron, Worldcom, Adelphia, Tyco and other corporate scandals, expect juries to frown on anything but an ethical, fair and well-documented employment decision. Third, expect states to follow California’s lead and enact newer and tougher anti-retaliation statutes. Fourth, expect employees to know their rights--take caution when dealing with a whistleblower.